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Turnaround Management Association
www.turnaround.org

page 4

The Workout Lender and the Turnaround Consultant: The Good, the Bad and the Ugly

page 8

An Alternative Approach to Evaluating Inventory

page 12

Risk Exposure Assessment in Turnarounds: A First Step in Improving Cash Positions

Cover Story

The Workout Lender and the Turnaround Consultant: The Good, the Bad and the Ugly

Edited by Hugh C. Larratt-Smith, Principal, Trimingham Advisors (Americas) Inc.

The following article was transcribed from the panel discussion, "The Workout Lender and the Turnaround Consultant: The Good, the Bad and the Ugly," which highlighted the agenda of the TMA 2000 Spring Meeting in Phoenix. Panel Moderator Hugh C. Larratt-Smith of Trimingham Advisors (Americas) Inc., directed the dialogue for the following leaders in the workout industry: Stephen M. Cole, Foothill Capital Corporation; Randall B. Durant, Bank One, Texas; Vincent J. Harper, HSBC Bank USA and Jae L. Walker, Wells Fargo Bank.

Hugh Larratt-Smith: Gentlemen, it's been said that the workout credit officer eats in the roughest lunchroom in town. You workout portfolio managers are smack in the middle of this lunchroom. The audience would be interested to know what makes you and your workout department tick. Jae, I'd like to start with you—what are the trigger points that send a credit on to workout status at your institution?

Jae Walker: It can be one or more of the following things. It may become obvious to us that management lacks experience or competence in working through a deteriorating situation. The management team may be terrific at growing a company, and terrible at dealing with the pressures, stresses and demands of early decline. Or they may be ethically challenged—we may discover that management has done something that destroys our trust in them. Or there may be conflicts between the owners and management—more time and more money will not turn the company around. Sometimes, there is a dramatic change in the borrower's industry—changing distribution, such as the Internet; changing competition, such as Wal-Mart or changes in legislation, such as new environmental laws. These, along with high executive turnover in key positions are the types of situations where we typically refer consultants to our borrowers.

Vince Harper: If our bank sees a drastic shift in a company's environment, then a credit will get referred to us for either partial or complete management. Let's say a retailer tells us that they're going to lose money for the first time ever and there's no plan to deal with the competition on the Internet. Even if they haven't broken covenants, we'll get called in and we may bring in a consultant right away.

Hugh Larratt-Smith: Randy, how do you choose a turnaround consultant?

Randy Durant: By far the most important factor in our choice is whether we've had a good experience with the consulting firm before. If we're considering a consultant who's new to us, it's important that other lenders we trust can give us good references. If we can't get references from our usual sources, then the consultant's standing in the workout community is important—recognition as an outstanding turnaround firm by peers in the TMA, for example. Here's one good example of the value of TMA.

Hugh Larratt-Smith: Steve, some lenders use loan documentation that allows the lender to send in a turnaround consultant at any time. Is this becoming more commonplace?

Steve Cole: In general, Foothill's loan documents provide us with the flexibility to bring a turnaround consultant into a lending relationship if and when the need arises. Over the past few years, we have had a number of new business opportunities in which we recognized during the underwriting stage that there was significant execution risk in a borrower's business plan. In many of these cases, we required the retention of a consulting firm to work alongside management. In our experience, when dealing with a turnaround situation, we have found the learning curve too high for most incumbent management teams. As such, the use of a consultant is key to coaching management beyond the short term and intermediate hurdles they face. In many of these situations, the borrowers retain the turnaround professional on an ongoing basis, to ensure the company stays on course.

Hugh Larratt-Smith: Jae, can you share with us characteristics that you dislike about turnaround consultants?

Jae Walker: I don't like consultants who over-promise. This can happen when the consultant hasn't realistically assessed the real problems of the company. Or, the consultant gets in the back pocket of management or the owners. Then we feel we've doubled our problem; first, we were struggling with an over-promising owner in denial, and now the owner has reinforcements! I also don't like when consultants come back to the well too often. My institution doesn't like surprises, especially the type that happen when the consultant has to come back to the well time and time again requesting more concessions. We expect the consultant to give us a realistic appraisal of the situation, even if the news is bad.

Steve Cole: Some consultants don't spend enough time on the job. They work hard to land the assignment, then disappear for periods of time on other engagements. The owners are wondering who they hired and why, and start asking questions. I want to know my assignments have the highest priority for the consultant.

Hugh Larratt-Smith: Vince, do you typically hire the turnaround consultant for the bank, or prefer that the borrower engage the turnaround consultant?

Vince Harper: For companies that are in early decline, we prefer the company to engage the consultant. This way, the likelihood of buy-in from the owner/manager is greater. In early decline, there are usually more options open to the stakeholders. A good relationship between the consultant and the borrower may increase the likelihood that all options will be identified and analyzed, instead of management doing the same thing over and over while expecting a different outcome.

Conversely, if we've lost faith in the owner/manager and the numbers, then we might want to hire the consultant to work directly for the bank.

Hugh Larratt-Smith: Steve, do you get involved in discussions about the turnaround consultant's fees?

Steve Cole: We usually don't get involved in the negotiations about the consultant's fees. All of the turnaround consultants that we recommend have a proven track record of providing value. When we give the borrower a list of consultants to consider, we're saying to the borrower that the fees will be market appropriate — and that the fees should be nominal in comparison to the positive impact of the consulting work. If the turnaround consultant wants an equity kicker after the viability analysis is finished, we're fine with that as long as it's a reasonable percentage of the overall fee.

Hugh Larratt-Smith: Jae, if the borrower is hiring the turnaround consultant, do you want to see the scope of work that is under negotiation?

Jae Walker: Definitely. We want to make sure that everyone is on the same page. This is crucial because many of our borrowers have never used a consulting firm before. So it's a foreign process to them. Quite often, the borrower's counsel will be involved, trying to limit the scope of work. Or there's an area of the company's operation that the owner/manager doesn't want put under a magnifying glass. For example, the owner/manager may be in denial about falling revenues, and thinks it's a complete waste of time and money for the turnaround consultant to analyze the company's competitive positioning in the marketplace. We want to get the scope of work hammered out before the engagement starts.

Hugh Larratt-Smith: Randy, what about the issue of whether the turnaround consultant is permitted to communicate directly with the lender or not?

Randy Durant: In many of our situations, the turnaround consultant is permitted to talk directly with the bank. In some instances, the borrower wants to attend all meetings with the turnaround consultant;

continued on page 6

The Workout Lender

continued from page 5

in other cases, the turnaround consultant meets alone with us. The turnaround consultant can play a vital role by brokering the negotiations between the lender and the borrower. This can be very useful in situations in which the borrower has little experience dealing with the bank, and doesn't have realistic expectations about what the bank will and won't do. Straight talk is critical, because nobody wins when information is whitewashed and as we all know, time is the enemy. Direct, open communication is one of the critical success factors in a turnaround.

Hugh Larratt-Smith: Vince, once the engagement has started, do you like to have a kick off meeting with the borrower and the turnaround consultant?

Vince Harper: Absolutely. I want my staff to set the ground rules with the borrower, such as reporting timelines. Borrowers don't realize that most reports are read by more than one person in the bank, and that decisions are often made by a group within the bank. Let's say that we're expecting a viability analysis today, and the borrower calls to say that it's two weeks late. This is a negative signal to us—the borrower may be scrambling and the numbers may be rubbery, or management has been broad sided by a surprise. When a report is delayed, the anxiety level within the bank goes up. We may have to reschedule internal resources, like approval signing authorities—these are busy people, and missed deadlines can be a severe irritant to the bank.

In a kick off meeting, we make it crystal clear that we want a hard-hitting assessment of where things are at with the company and what will it take to fix the company, if it can be fixed. If the situation is hopeless, we want to know quickly and accurately. Early on in the process, we'd prefer to know exactly how bad things are instead of finding out later—possibly when the options are fewer. We don't want a candy-coated report that doesn't give us something to work with. We don't want the consultant simply putting makeup on the corpse.

Hugh Larratt-Smith: Jae, how about with you?

Jae Walker: We let them know that we expect regular and honest communications with the consultant, recognizing that he/she works for the borrower. It is a challenging position to be in.

> ***For companies that are in early decline, we prefer the company to engage the consultant. This way, the likelihood of buy-in from the owner/manager is greater.***

Hugh Larratt-Smith: Steve, do you try to guide an agenda for the workout?

Steve Cole: We are very clear about the information we need to support the turnaround plan of the company. We always stress that a turnaround is a game of inches—no long bombs, no Hail Mary's here—so we want reporting timelines in days and weeks, not months or quarters. We don't want three hundred page reports that look forward five years. We're asking the borrower and the turnaround consultant for a clear realistic roadmap for the immediate path ahead of us, so we can do our job. You sometimes hear people say that there were no tire tracks at the edge of the cliff—nobody saw the cliff coming.

Hugh Larratt-Smith: Randy, in these meetings, do you often find that the owner/manager is in denial? And a second question: Do you expect the turnaround consultant to shake the owner/manager out of denial?

Randy Durant: We see a lot of owner/managers in denial. One place where denial rears its ugly head is financial forecasts. We can't count the number of owner/managers who walk through our door with a recovery plan that forecasts an improvement in gross margin with no detailed justification. Gross margin improvements of 5 percent, 10 percent, even 15 percent in one year are often based on untested assumptions like price hikes and sharper purchasing.

We expect the turnaround consultant to validate and justify every number on the forecast with realistic arguments. Or, not to be in the room in the first place. The turnaround consultant is not there to make the owner/manager feel good.

Hugh Larratt-Smith: Jae, what if you suspect that the turnaround consultant has been co-opted by the owner manager?

Jae Walker: We expect the consultant to be fair and equitable to all parties at interest. If the consultant starts to make unreasonable demands, show favoritism and generally beat on only the bank, we will react negatively. As Randy mentioned earlier, we value consultants because they can be the valuable go-between and broker the interests of the two sides. If the consultant loses sight of this objective role, then the consultant no longer serves any interests well.

Hugh Larratt-Smith: Vince, if the turnaround plan is clearly unrealistic, would you ask the turnaround consultant to resign? Under what circumstances should a turnaround consultant resign?

Vince Harper: If the turnaround consultant gave us a recovery plan that was clearly unrealistic and unjustifiable, we would suggest to the borrower that another consultant be hired. If the consultant were battling with the borrower on a daily basis, we would also recommend that a different consultant be hired. I think any good turnaround consultant would resign if: 1) information was being withheld from the consultant or distorted by the borrower; 2) the borrower was using the consultant's work in external meetings where the consultant was not invited to join by the borrower and 3) it became clear that the owner/manager was ethically challenged and the turnaround consultant was unable to communicate directly and candidly with other stakeholders.

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