

# Avoiding Corporate Turnarounds, and the people who fix them

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The Association of  
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Financial Professionals  
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## Summary:

### Quick Summary

1. Types of Turnaround
2. When help is needed
3. How to identify the solutions and the expertise
4. Strategy & Tactics of a turnaround
5. Shared sacrifices and teamwork
6. Deep dive into Cash Conversion Cycle and the Debt Stack



# Types of Turnarounds:

## Income Statement Turnarounds

**An unprofitable business that is draining cash and retained earnings through ongoing operating losses.**

- The business must become cash-based profitable within weeks
- With cash stability, the business must be made proforma accrual based profitable within months.
- There are 2 primary levers to accomplish this:
  - Increased gross profit margin dollars
  - Decreased SG&A costs

## Balance Sheet Turnarounds

**Perhaps a profitable business but one that is being drained through suffocating levels of debt service.**

- Debt service must be reduced below the level of cash generation
- Debts can be Reprofiled (stretched out over longer amortization period) to protect cash flows
- Debts can Restructured (reduced principal, reduced interest, interest only, bifurcated into A & B notes with B suspended, longer amortization period, converted to equity, or PIK'd where interest is rolled into new debt, etc.)



# What Forces a Turnaround:

## Why hire a Turnaround Professional (CRO)?

- Reasons - Broken Balance Sheet or Broken Income Statement
- Triggering Event such as; DSCR, Can't make payroll, Frozen supply chain
- Don't be Cleopatra, the Queen of Denial

## Who Initiates the hiring of a CRO

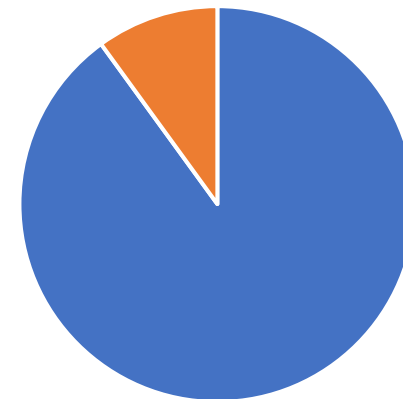
- Board / Management
- Court appointment
- Lender

## Who does a typical turnaround professional work for?

- Fiduciary duty to shareholders
- Obligation to stakeholders

When a lender imposes a workout/turnaround, the business is automatically on defense and no longer in control.

Who Decides a Turnaround is Needed



■ Bank ■ Proactive Board



# Debt Service Coverage Ratio:

The Debt Service Coverage Ratio usually pushes borrowers into a bank workout.  
This is a trailing-12-month calculation so distress can be well entrenched by the time it is noticed.

The DSCR is calculated by taking net operating income and dividing it by total debt service (principal and interest).

Month	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
Revenue	1,200	1,100	1,150	1,050	1,000	1,100	950	900	950	1,000	1,100	1,150	1,200	1,100	1,150	1,050	1,000	1,100
Gross Profit Margin	378	347	362	331	315	347	299	284	280	295	325	339	354	325	339	310	295	325
SG&A Costs	300	300	300	300	300	305	305	305	305	305	310	310	310	310	310	310	310	310
Net Income	78	47	62	31	15	42	-6	-22	-25	-10	15	29	44	15	29	0	-15	15
										TTM Net Income		256	222	190	157	126	96	69
Loan Interest	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5	5
Loan Principal	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3
Debt Service	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8
										TTM Net Income		96	96	96	96	96	96	96
										Net Income		256	222	190	157	126	96	69
										Debt Service		96	96	96	96	96	96	96
										<b>DCSR</b>		<b>2.66</b>	<b>2.31</b>	<b>1.98</b>	<b>1.63</b>	<b>1.31</b>	<b>1.00</b>	<b>0.72</b>
										Loan Covenant		1.25	1.25	1.25	1.25	1.25	1.25	1.25



# Who Can Help:

## **Company is headed towards trouble. What are the options?**

- DIY. (the person who got us into this mess will now get us out)
- CPA
- A consultant or CFO who says he did a turnaround once
- W2 CEO with multiple turnarounds
- CTP, Certified Turnaround Professional
  - CIRA (certified insolvency & Restructuring Advisor)
  - CFA (certified fraud advisor)

## **Role of the CRO - Guide not Hero**

- Luke and Yoda
- Frodo and Gandalf
- Daniel and Mr. Miyagi

## **What are the skillsets?**

- 50% Finance
  - 50% Operations
  - 50% Psychology
1. Financial analysis to work with lenders
  2. Legal understanding to untangle debts and lawsuits
  3. Leadership skills to rally the team
  4. Management skills to keep everyone on track
  5. Sales skills to get vendor support

## **Personality type best suited for turnaround work?**

- Solution oriented
- Impatient and relentless
- Creative and orderly under pressure
- Attracted to challenge



## Strategy of a Turnaround:

The following summary was presented to a recent client

### Problems:

I will gently describe your situation as dire. You have orders but can't buy materials, dangerous debts are coming due and you've been draining retirement savings to fund payroll, even though you can't afford the materials to keep your customers supplied. Opportunities for growth and profitability are being missed because of these cash flow issues. The feeling of being in a death spiral is accurate.

### Solutions:

We need to unwind that death spiral. We need to get some breathing room from the creditors which provides time for us to bring in more capital. With more capital we can order parts and materials. With parts and materials, we can better utilize our labor and make shipments and build accounts receivable (AR). With AR we can borrow more to buy more materials and parts and ship more orders. Then the customers will replenish their orders and we will enter a virtuous cycle of cashflow and profitability. From that foundation we can take on new business and opportunities to grow the business and secure our earnings.



## Program of Shared Sacrifices:

### Turnarounds are Team Sports, and they only work if everyone plays their part

- Lenders need to keep lending and offer relief on debt payments
- Customers need to keep consuming while paying more and faster for the products
- Workers need to keep working - harder and with more accountability
- Suppliers need to keep supplying, with better terms and lower prices

Our job is to get everyone to give more and work harder than they planned to, for the mutual benefit of all.

That's the only way it works





# Tactics of a Turnaround:

## Tactics:

- Attack the biggest flames first
- Find the holes in the bottom of the boat
- Working outward in concentric circles
- Get control of cash
- Get control of the accounting
- Control working capital
- Cut costs
- Raise Prices
- Boost Sales
- Drive efficiencies
- Look for fraud. Report and resolve any findings
- Find Sacrificial Lambs
- Stretch the limits of possibility



**Status List Provided to Bank in Actual Recent Turnaround**

#	Action	Status
1	Fire CEO, CFO, COO	Complete
2	Replace with global restructuring team	Complete
3	Cease all non-critical spending	Complete
4	Contact customers / seller note holders	Complete
5	Cease payments and begin negotiation of seller notes	Complete
6	Freeze all past due payables	Complete
7	Model proforma forecast 2019	Complete
8	Chairman, CEO or CRO to every facility	Complete
9	Cease IT projects and reduce IT spend	Complete
10	Replace overpriced attorneys	Complete
11	Replace overpriced IT consultants	Complete
12	Move HQ, sublease corporate clubhouse	Complete
13	Establish supply chain credit programs with vendors	In Process
14	Stop losses in factory #8 within 30 days	In Process
15	Stop losses in factory #7 within 30 days	In Process
16	Gain customer financial support for factory #6	in Process
17	Accelerate A/R collections to 10 days	In Process
18	Headcount reductions	In Process
19	Wage and benefit reductions	In Process
20	Eliminate 4/6 of senior management positions	In Process
21	Double size of the sales force	In Process



# Back to Basics, the Foundational ‘Physics’ of Commerce:

Before we get started, let’s step back and revisit the basics, the core foundational building blocks of commerce.

## Cash Conversion Cycle

**The time and duration that cash is moved off your balance sheet and on to the balance sheets of your customers and suppliers.**

- The #1 tool in all business, especially startups and turnarounds
- The single greatest lever in all business
- Also, one of the most under-taught business concepts

## Debt Stack

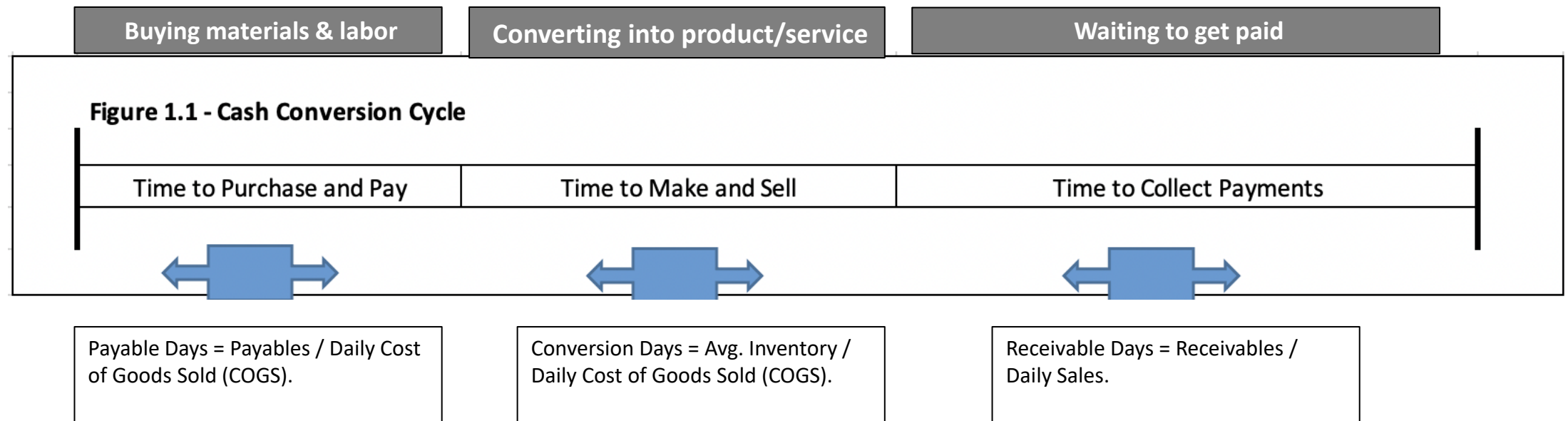
**Perhaps older than money itself, the Debt Stack determines who owes whom, what, in what order, with what claims.**

- The very foundation of corporate finance and free markets
- The basis of all corporate law
- Perhaps the only authority that can ‘out-rank’ the IRS in collections



# Cash Conversion Cycle - CCC:

The CCC is your cash-exposure window, the number of days that the working capital of your business is tied up funding the operations of that business. It's the time and money invested in turning iron ore into a new car rolling off the showroom floor. It is the time needed to sell your inventory plus the amount of time needed to collect receivables minus your vendor payment terms. Each of these factors are variable and as a CEO you can influence each to your advantage. If you can pay more slowly for expenses, it keeps cash on your balance sheet and off your suppliers. If you collect more quickly, it moves cash from your customer's balance sheet onto yours. When you need the cash more than them, you should "borrow" from them. The core of a turnaround is shifting your balance sheet to absorb the impacts of distress, then shifting back toward reinvestment and recovery, and managing the CCC is the quickest way to achieve that.





# CCC – Processing Faster & Cheaper:

**Figure 1.3 - Inventory Conversion - time to make & sell**

Days	10	20	30	40	50	60	70	80	90	100
Inventory										

Conversion Days = Avg. Inventory / Daily Cost of Goods Sold (COGS).

## Processing Faster from Order to Invoice

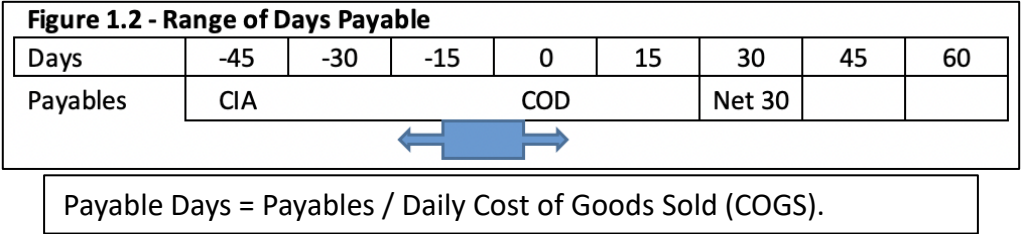
- Lean Processes
- Time Motion Studies
- Ounces to Grams
- Order Input
- Engineering
- Order Release
- Production and Delivery
- Shipping
- Invoicing
- Cost Cutting
- Workforce or Payroll Reductions

## By Industry

- Manufacturer
- Restaurant
- Plumbing Contractor
- Oil Distributor
- Distributor
- Retailer



# CCC - Paying Slower:

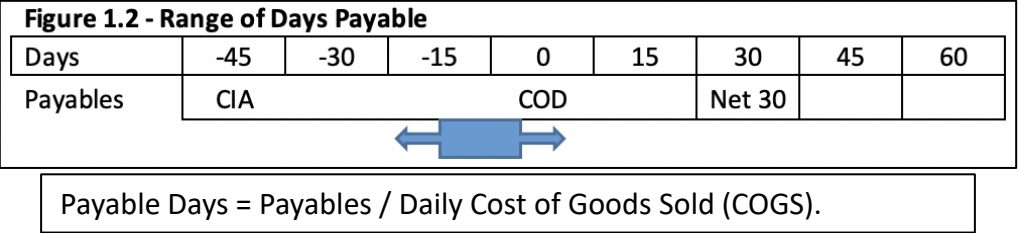


Civil Moves to Pay Slower

Non-Civil Moves to Pay Slower



# CCC - Paying Slower:



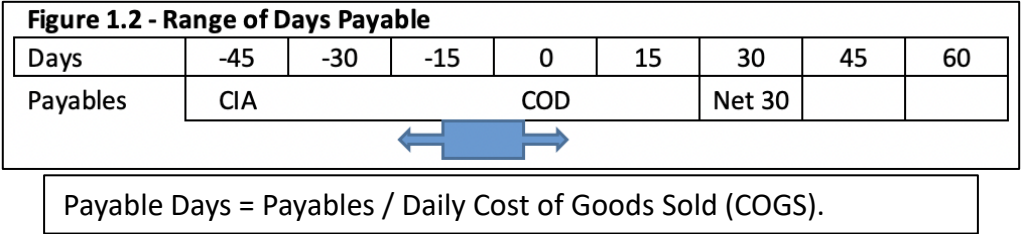
Civil Moves to Pay Slower

- Paying slower without asking
- Requesting extended payment terms
- Paying on credit card
- New tranche of debt like factoring, PO financing,
- Inventory on consignment and other exotic solutions
- Moving to a different vendor with longer payment terms
- Providing a note, guarantee, credit support or equity
- Inviting vendors into a debt reprofiling program to term out and stretch debt payments over a few years.

Non-Civil Moves to Pay Slower



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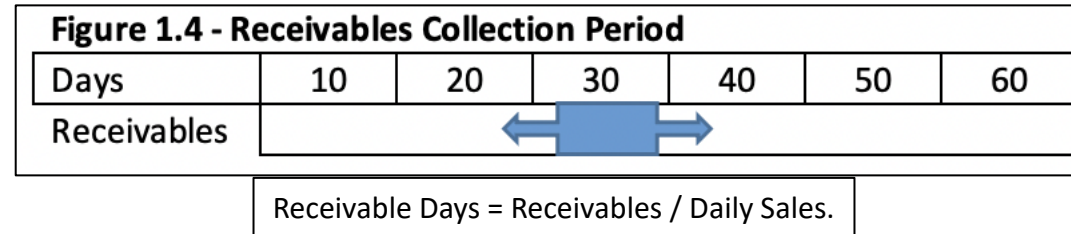
Non-Civil Moves to Pay Slower

- Declaring a workout to force vendors to term-out and stretch debt payments
- Inviting vendors into a debt restructuring program to haircut, term out and stretch debt payments over a few years.
- Lying, the check is in the mail
- So, sue me.
- Moving assets to become uncollectable. Borders on fraudulent conveyance.
- File bankruptcy
- International considerations





## CCC – Collecting More & Faster:

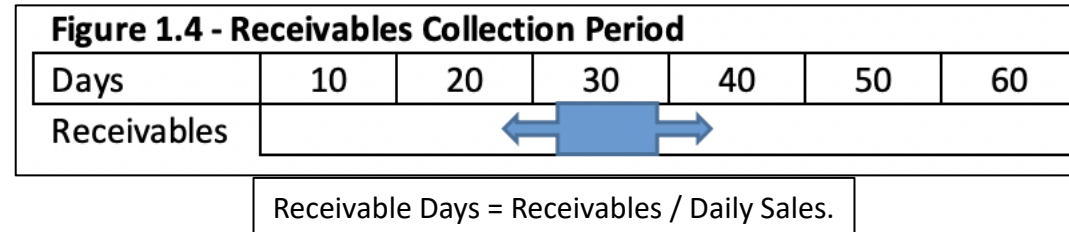


Civil Moves for Collecting More & Faster

Non-Civil Moves for Collecting More & Faster



# CCC – Collecting More & Faster:



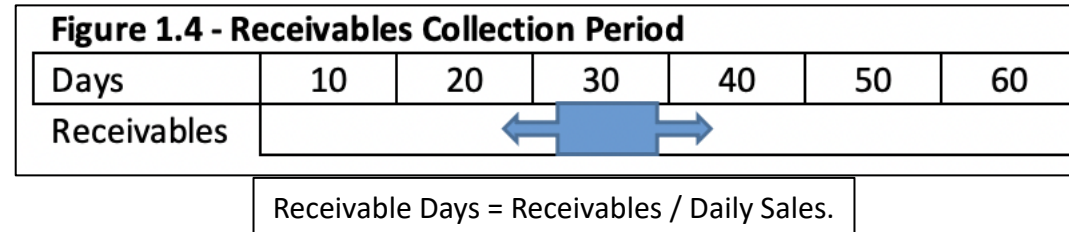
## Civil Moves for Collecting More & Faster

- Ask nicely
- Change credit terms
- Offer payment terms like 2% discount for payments within 10 days
- Accept credit card payments
- Improve collection practices
- Chase old A/R with collectors and an extra effort
- Increase prices
- Increase fees

## Non-Civil Moves for Collecting More & Faster



# CCC – Collecting More & Faster:



## Civil Moves for Collecting More & Faster

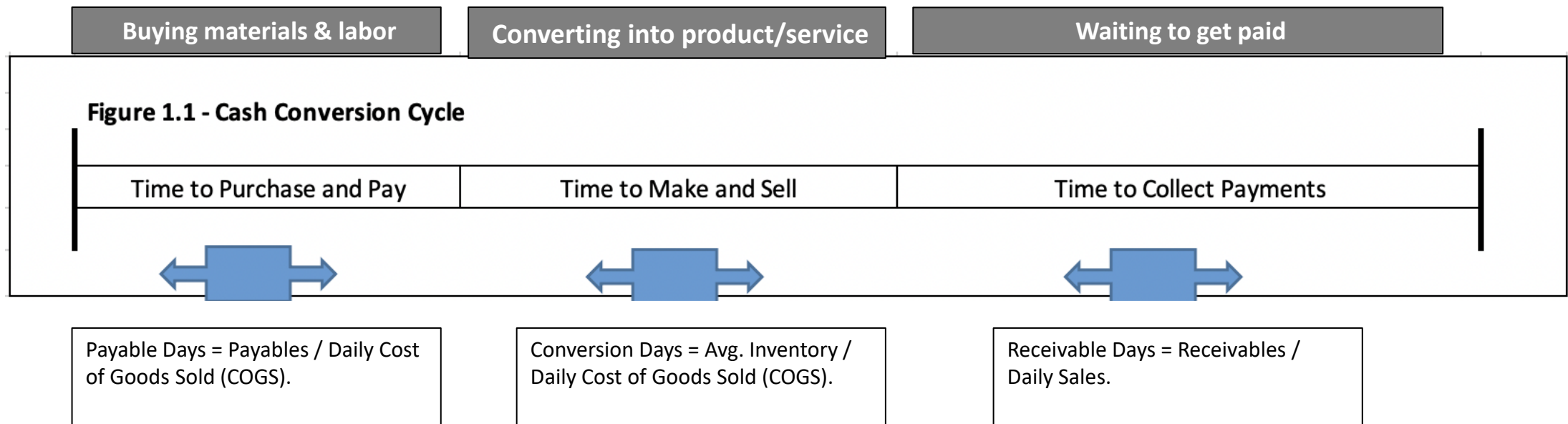
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- Increase prices
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## Non-Civil Moves for Collecting More & Faster

- Increase prices retroactively, with charm
- Increase prices retroactively through force
  - Risk, recent case
- Cease shipments and declare all payables due immediately
- Stealing, 97 candies in a bag of 100
- International considerations



## CCC Recap:

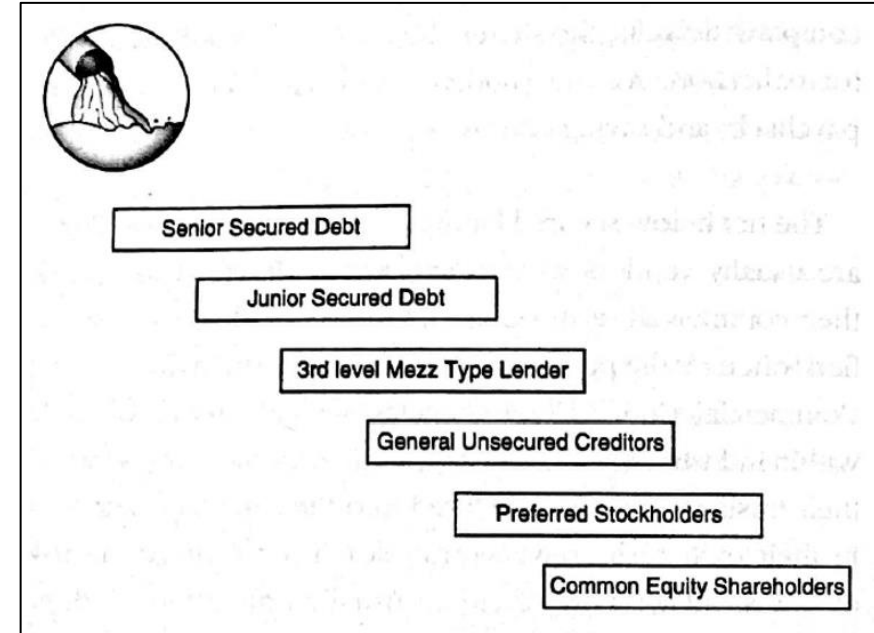




# Debt Stack:

## The Absolute Priority of Debt Rule

The underlying principle dictating the order of claims by which recoveries are distributed to creditors. The Bankruptcy Code mandates compliance to the strict hierarchy of claim payouts for the “fair and equitable” distribution of recovery proceeds.





# Debt Stack:

## Simple Example

Creditor
1st National Bank
Trade Payables

Very simple. Perhaps a rental property or just a well-run business.

## Normal Example

Creditor
1st National Bank - LOC
1st National Bank - Term Note
1st National Bank - Mortgage
Vehicle Lease
Trade Payables
Shareholder Loans

More typical of an industrial park type business with the assets/collateral to afford a revolving line credit, a term note or a mortgage.

## FUBAR Example

Creditor	Ineterest Rate	Balance	Monthly Debt Service
SBA Loan	3.75%	500,000	1,562
Equipment Lender 1	71.77%	2,440,000	200,000
Equipment Lender 2	20.23%	453,073	20,281
Equipment Lender 3	11.00%	368,383	10,160
Equipment Lender 4	16.24%	141,458	38,760
Equipment Lender 5	12.37%	109,151	4,508
Equipment Lender 6	14.30%	24,373	1,825
Equipment Lender 7	23.84%	23,874	843
Equipment Lender 8	24.03%	10,686	1,869
Secured Vendor		240,000	12,000
MCA 1	79.70%	809,322	89,568
MCA 2	119.29%	261,502	75,000
MCA 3	175.00%	183,692	72,240
MCA 4	101.13%	3,328	6,950
Credit Card 1	20.00%	141,049	28,210
Credit Card 2	20.00%	160,066	32,013
Accounts Payable		1,274,889	127,489
Friend & Family 1		425,000	
Friend & Family 2		302,713	
Friend & Family 3		139,000	
Friend & Family 4		100,000	
Friend & Family 5		20,712	
Friend & Family 6		11,000	
Friend & Family 7		11,000	
Friend & Family 8		2,584	
		<b>8,156,854</b>	<b>723,278</b>
		w/o AP	595,789

A dog's breakfast of a debt stack from a current client.

Debt service is 70% of revenues!



# Debt Stack:

All Assets in Bankruptcy - Liquidation Value and Waterfall			
Assets	Book Value	% Value, OLV	\$ OLV
AR	4,277,411	50%	2,138,706
M&E	4,737,035	20%	947,407
INV.	502,002	20%	100,400
			<u>3,186,513</u>
Percentage recovery of creditor claims			33.5%
Creditor by lien date	Claim	New Balance	
Balance through Liquidation		<u>3,186,513</u>	
Bankruptcy expense	500,000	2,686,513	
Equip - 1	24,373	2,662,140	
Equip - 2	153,552	2,508,588	
Equip - 2	37,950	2,470,638	
Secured vendor	240,000	2,230,638	
Equip - 2	21,833	2,208,805	
Equip - 3	10,686	2,198,119	
Equip - 4	54,692	2,143,427	
Equip - 5	35,704	2,107,723	
Equip - 6	23,874	2,083,849	
Equip - 2	155,049	1,928,800	
Equip - 5	105,753	1,823,047	
Equip - 4	183,336	<u>1,639,711</u>	
Sale Leaseback	2,440,000	(800,289)	
Equip - 5	109,151	(909,440)	
Equip - 4	215,045	(1,124,485)	
SBA	500,000	(1,624,485)	
MCA-1	496,393	(2,120,878)	
MCA-2	183,692	(2,304,570)	
MCA-3	3,328	(2,307,898)	
MCA-1	80,301	(2,388,199)	
MCA-1	232,628	(2,620,827)	
MCA-4	261,502	(2,882,329)	
Other ??	-	(2,882,329)	
Credit cards	332,730	(3,215,059)	
Accounts Payable	1,274,889	(4,489,949)	
Family and Friends	1,012,009	(5,501,958)	
Shareholder Loans	1,310,715	(6,812,672)	



## Debt Stack:

### Liability Threats

- Wages
- Senior secured
- Junior secured
- Vendor suit
- Customer suit
- Employee suit
- Class action suit
- Feds – IRS, EPA, DOJ
- Lease holder
- Broken hotel contract

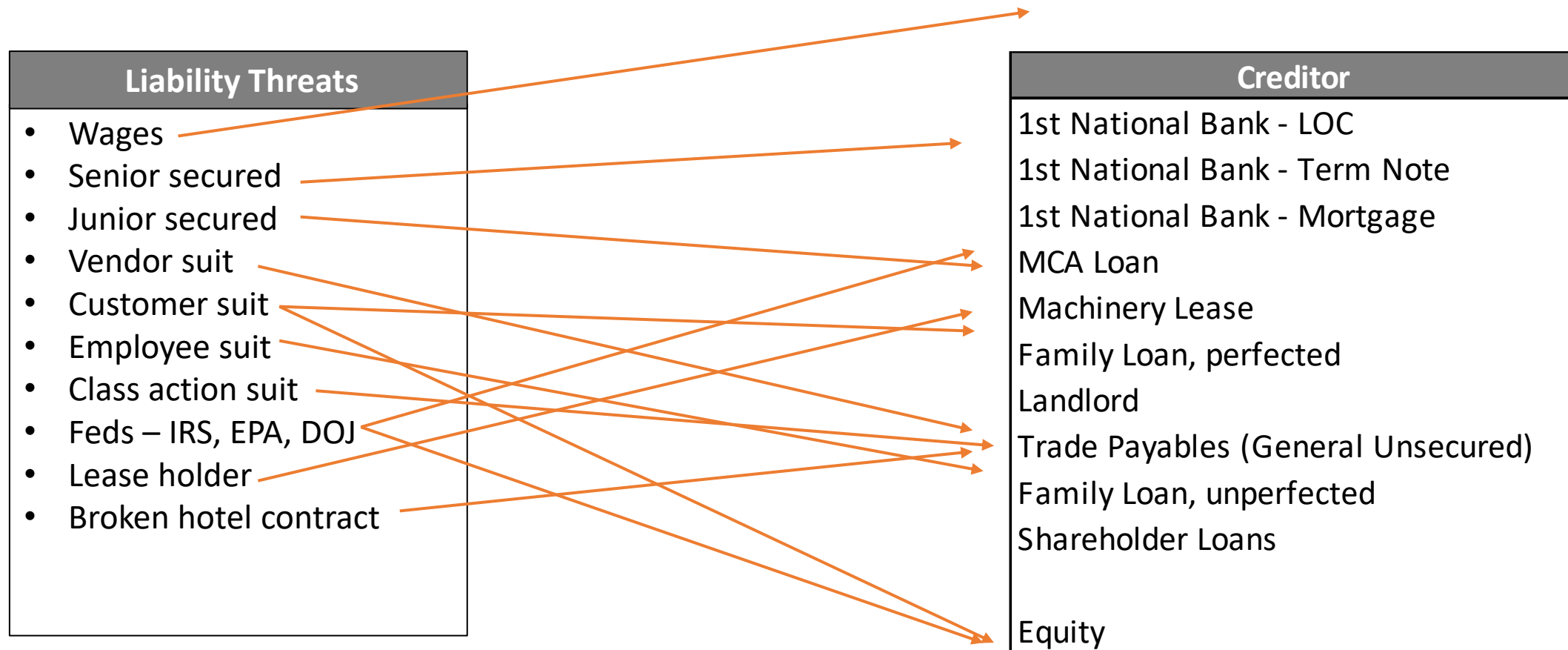
### Creditor

1st National Bank - LOC  
1st National Bank - Term Note  
1st National Bank - Mortgage  
MCA Loan  
Machinery Lease  
Family Loan, perfected  
Landlord  
Trade Payables (General Unsecured)  
Family Loan, unperfected  
Shareholder Loans  
  
Equity





## Debt Stack:





For further discussion please contact:

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