Does Your Company Need a Workout?

Here's how to implement informal plans of reorganization and avoid Chapter 11 or liquidation.

BY GLAYDON IVERSON, CPA

Four years ago, a $23 million manufacturer of electronic circuit boards was seriously considering selling the company at a discounted price after its expansion plan failed. Losses for several years had created $4 million in negative equity, and 90% of its trade creditors had placed the company on cash on delivery (C.O.D.). One year later, that same company posted a $1.1 million profit, had positive equity on its balance sheet of more than $1 million and EBITDA of $3.25 million, and the creditors were on normal terms.

What turned this company around is a concept that many CFOs, CEOs, and owners may not have fully considered: the informal financial restructuring or informal plan of reorganization known also as a "workout." This is an alternative to filing Chapter 11 or liquidating assets. It isn't for every organization that finds itself swamped with debt, but—with changes to operations and with time and patience—it can achieve a positive turnaround.

Like many other businesses in the 1990s, this manufacturer had anticipated substantial growth so had built up an extensive sales and accounting infrastructure, primarily staff, to accommodate the forecast. But when revenues were missed, the cost structure became more than was needed to

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support actual sales. Net result: The business was running out of cash, which led to stretching payables over time.

A GOOD WORKOUT CANDIDATE

With consecutive years of losses and stretching out payments to its suppliers, available cash for increasing C.O.D. demands became a serious problem. What's more, the company was unable to borrow additional funds from its asset-based lender due to violations of loan covenants already in effect. The decision to sell resulted in one letter of intent that would have covered the company's debt only—with nothing left for the owner who previously had invested $2 million of his own money.

Rather than filing for bankruptcy, the company hired a turnaround management firm to improve operations and resolve the credit problem with the unsecured creditors who were pushing hard for payment. The manufacturer was a good candidate for the informal workout for two key reasons: credibility and leverage.

Credibility. This company had not gone through a restructuring plan in the past. It is highly improbable for any business to go back to its creditors for a second time—Chapter 11 or workout—to resolve major credit issues. And the company had been in business for years and had long-term relationships with many suppliers. This all helped to establish credibility.

Leverage. A liquidation analysis, as part of the up-front due diligence, indicated that converting assets to cash wouldn't cover the payment to all unsecured creditors. This assessment became instrumental in convincing unsecured creditors that it made more sense to rework the debt because there was a better chance for them to be paid. In other words, a significant "negative liquidation value" meant that unsecured creditors were less likely to get paid.

THE WORKOUT PROCESS

Companies falling on tough times or those having trouble gaining payment from their customers can benefit from a better understanding of the workout process.

Step 1: Operational restructuring and new forecast. The first step is to develop a workout plan that fixes problems in the operations area of the business and improves profitability. If a company needs help in identifying areas of business improvement or making major changes, then the owner or board of directors can bring in a new CEO, subject-matter experts in operations or marketing, or interim management to get the job done as quickly and efficiently as possible.

The workout plan must convince creditors that the business can generate enough cash going forward to operate in a profitable mode as well as start paying off the debt.

An up-front due diligence by an outside adviser to examine the current situation can take up to three weeks or more. This is an extensive review process that assesses, for example, a company's sales/marketing, operations, finances, strategy, management, and leadership. But time is of the essence when creditors are knocking at the door. If they aren't satisfied quickly, they may file suit and gain a judgment that can garnish a company's bank account and force a Chapter 11 filing.

The workout plan must convince creditors that the business can generate enough cash going forward to operate in a profitable mode as well as start paying off the debt. In calculating what the company can afford to pay creditors, it is best to stay on the conservative side. For example, if the forecast is $1 million in cash next year, then earmarking no more than 30% or 40% for debt reduction allows a cushion for operational support and necessary capital expenditures. Key to the forecast is a company's cash burn position in the short term—how long cash will last given the circumstances, such as the need to pay C.O.D. to all vendors once they become more aware of the current situation.

If a short-term conversion with full payment isn't possible to pay off all of the debt, based on the forecast, then a portion of the plan may be handled through stock. When determining how much debt to convert to equity, an important goal is to flip the balance sheet from a negative deficit position to positive equity. The result: more borrowing power with banks and other potential lenders and more possibilities with equity investors. In this manufacturer's case, negotiations to restructure the loan agreement with the asset-based lender began as stability was created with the creditors during the workout proceedings.

Step 2: Proposal to creditors. Creditors want information—what happened, what positive changes are being made, and how they are going to get paid. That's why the debt restructuring proposal comes in the form of a highly detailed, professional letter to all unsecured creditors. Some secured creditors also may receive the workout letter if, for example, the company has no further use for leased equipment because of reorganized business operations.

The introductory section of the workout letter states the current situation: amount of debt, kinds of losses, revenues, number of creditors, and reasons behind the debt. The next section communicates the significant improvements that are in process that demonstrate the company's ability to pay back the debt. This is followed by the proposal to unsecured creditors with the terms and a one-page ballot requesting their vote of participation.

In this manufacturer's case, unsecured creditors would receive a 5% lump-sum payment of the balance due in four months. The remaining amount would be paid in two ways: 35% of the debt converted to a three-year promissory note based on quarterly payments with interest and 60% converted to preferred stock in the company with a quarterly coupon or dividend payment.

In preparing the workout letter, the owner or management must be willing to not make any exceptions to the plan in order for it to succeed. In other words, it's imperative that everybody is asked to participate in the same plan, even long-time business associates, friends, or relatives. If creditors find out that others aren't being asked to participate, they may not want to accept the plan.

Step 3: Communication and education. Once the letter has been mailed, it's time to follow up with face-to-face meetings and phone calls to help creditors understand the plan and how they are going to be paid. Establishing good rapport and believability is important from the start, which can be enhanced by having a third-party facilitator involved in these meetings rather than an insider. Being accessible is essential because creditors want information they can relay to their own management in a timely fashion. Fielding phone calls from creditors and handling C.O.D. problems can be time-consuming for internal management, who should be more focused on fixing the problems and day-to-day business operations. Yet there will be times that the owner or a top manager should meet with individual suppliers to provide more details on how things are progressing.

Education is important when stock is part of the payment because it's more difficult to persuade creditors about the need to accept stock when all they want is their money. It takes much more effort to convince creditors that the workout plan—not liquidation or bankruptcy—will improve their chances to recover their money. What's more, many creditors are currently making money from the troubled company by providing a product or service on C.O.D., which wouldn't be the case if another route were taken.

This step can take 60 to 90 days after the letter goes out in order to allow time for concerns, answers, and decisions to take place.

Step 4: Administration. Once the unsecured creditors have voted to participate, a promissory note for the debt portion of the plan is prepared and accompanies the first note payment to the creditors. Then the trade-debt cancellation/stock-subscription agreement is prepared and issued in compliance with Securities & Exchange Commission rules. When this agreement is signed by the creditors, stock certificates are prepared and mailed to each one.

The number of creditors and nature of the proposal (especially when equity is involved) will determine the length of time for managing an informal workout. In the case of this manufacturer—with more than 200 unsecured creditors—the process took about nine months. Key milestones: The workout letter was dated March 31, the first quarterly note payment was dated September 30, and the stock certificates were issued in the latter part of December.

IN THE FINAL ANALYSIS

Informal workouts have a couple of key advantages. They are less costly than going into Chapter 11 with its associated U.S. Bankruptcy court and attorney fees. They are also less risky because, unlike a Chapter 11, there's no public knowledge that a company is in trouble. The informal workout eliminates the need to notify customers and risk losing their business, which impacts revenues and profitability.

In the final analysis, some creditors may file suit and get a judgment that might force the company to pay them off. Yet in this manufacturer's case, as in many others, the combination of operational improvements and successful participation among its creditors in the workout led to some impressive results. Increasing profitability, positive equity on its balance sheet, and a normalized creditor environment provided ample opportunity to explore options with confidence at a company that at one time had seriously considered selling at a discounted price. ■

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