WHAT CAN YOU DO FOR A “PROFITABLE" COMPANY THAT CAN’T PAY ITS BILLS?

By Michael Levitt

In January, our firm received a call from the accounting firm for a troubled company — Delicious Foods, Inc.* (DF), a $50 million foods manufacturer in the Midwest. A family business in operation for 40 years, DF had, until recently, honored its obligations. Now the company was unable to make payments on $18 million in loans secured by its machinery. And it was not a straightforward situation; there were 12 secured lenders involved, each a commercial bank.

When turnaround specialists are called in to assist a financially troubled company, they must examine every aspect of their client's finances, operations, management, and personnel. Delicious Foods, for example, did not get into this impasse overnight, or because of just one corporate ailment. A symptom such as the inability to pay creditors is usually the result of several problems — perhaps in multiple and disparate locations — that go unchecked for months, even years.

Financial records

Financial records are supposedly the shorthand account of a company's activities, so we started by reviewing DF's books. This usually gives a handle on where the problem might be originating. In this case, we found that its accounting system was antiquated: the company was still using ledger books with handwritten entries. And the accounting department had no senior people, only long service bookkeepers, all of whom reported directly to the president.

After examining the ledgers, we realized that the obsolete billing and accounts receivable system was one of the unplugged holes through which money could pour out unchecked. We also uncovered discrepancies apparent to a certified fraud examiner. Eventually, we were able to connect two circumstances. For four or five years, a long-time, trusted employee was taking five-figure advances at the beginning of each month. Before each month-end, he would pay back the advances. How was he able to do this? That's where the antiquated bookkeeping came in. The employee would intercept shipping documents. Then he would type out invoices to the company's clients without entering them as receivables and he'd intercept checks for their payment. Finally, when he had received these monies, he would pay back his advances by depositing checks made out to Delicious Foods, Inc. It amounted to a significant sum of money, which in itself wasn't enough to cripple the company, but nonetheless made a significant dent in its operating capital. Without senior accounting staff and a computerized ledger into which every transaction was entered, it was possible to perpetrate this kind of fraud.

Once we uncovered this initial problem, and because DF was still in a crisis situation, the company decided to expand the scope of our assignment. I was placed as acting CFO in order to bring the organization under control. We had three months to straighten things out, and we needed to develop a convincing plan for survival and restructure.

Approaching the financial institutions

The first and most pressing phase of the work was dealing with the banks, and, if possible, staving off bankruptcy procedures. A company in bankruptcy has much more to overcome in regaining fiscal health than a merely troubled company, in terms of lost time and reputation. Part of my job would be selling our restructuring plan to the banks. At this point, the substance of the plan was yet to be drawn up, and DF had pretty much run out of time even before contacting us. There was not a second to waste.

Although we, as financial specialists with a grasp of DF's situation, were convinced of our client's ability to stay solvent, it took a certain kind of salesmanship to convince the banks that it was in their best interests to hold back in anticipation of a plan yet to be articulated in all its specifics. However, the twofold fact that I was now acting CFO, and that DF had taken the step to hire turnaround specialists lent credibility to the process. We were able to buy time once I explained that DF had always been a profitable company; that it had been in business for 40 years; and that although it had recently hit this snag, it could be straightened out. Keeping relations with the financial institutions as specific and friendly as possible involved a separate negotiation with each lender. Once they decided to work with us, the 12 banks hired counsel to represent them as one.

At this point, we were to undertake a two-pronged approach to settling the company's debt problem. On the one hand, as mentioned, I became the liaison reporting to the 12 financial institutions which held the loans. On the other hand, we would closely analyze finances and operations within Delicious Foods. To recap, our long-range goal was to establish a realistic repayment schedule to amortize and pay back the $18 million debt. We established a financial/operations reorganization schedule that would enable us to "find" money not previously available, and apply it to these payments. Within two and a half months, we had worked out a multiphase blueprint to restructure company finances and operations, and delineated this to our client and the banks.

The plan for finances and operations

Our business plan included provisions for cost reduction, cash flow improvements, and adjustments in the pricing of the product. We looked at ways to moderate both operations and finances to optimize DF's profitability. For example, overhead could be reduced considerably by closing DF's nearby city sales office and consolidating sales and management. In the plant, a minimum-order size policy for rush orders was implemented, which eliminated full service (and the overhead it carries) for most small-dollar customers.

In analyzing the financial data of the operation, we looked at what gets produced and when; analysis of runs; profits on the product; kinds of customers; and compensation of employees. We estimated what could be saved with an automated billing system. While cutting back on headcount, such a system would also ensure that customers would be billed within 24 hours of receipt of all full or partial orders. Voluntary salary reductions were obtained from senior executives, saving Delicious Foods $100,000 annually.

In reducing the workforce, turnaround specialists need to decide whether the company can produce the same results with fewer personnel. In this case, we concluded that DF was paying 100 people to do a shift that could be done by 80 people with no loss of productivity. Of course, this kind of cutback is easier to do on paper than in actual practice; management and people skills are vital to the success of such a plan. It was important to communicate to the workforce that the company would simply not survive in its present overstaffed mode.

Other reorganizational acts included terminating the senior management person who had perpetrated the accounts receivable fraud; reducing employee perks and company car expenses; and improving cash flow by accelerating receivables payments. In addition to the improvements and adjustments already discussed, we also worked closely with the trucking and shipping areas of the company to effect more efficient scheduling. Controls were instituted to assure quality of incoming raw materials, immediately charging back to suppliers for any off-grade material. We negotiated reductions with outside cleanup and repair contractors, resulting in further savings to the company.

Future provisions

In our plans for the future, we made provisions to hire an experienced chief operating officer who would continue to evaluate departmental functions and personnel performance, production planning, quality assurance and shipping functions. Similarly, it would be necessary to hire my replacement, a chief financial officer to streamline company financials. The CFO put in place would maintain internal and accountability controls and accumulate and distribute timely and accurate interim financial and operational data for evaluating conformance to budgets. With these key personnel in place, all internal and external operations would be properly overseen and accountable.

Presenting the plan to the banks

We presented the plan to the banks, and renegotiated the terms of the loan. It was agreed that instead of paying back the $18 million in two years at 12-14 percent, DF would stretch out payments over four years, at 8.75 percent. In May, the company made its first good faith payment, even before final documentation was in place. During the next two months, we worked out a formal agreement between the banks and the company. Hammering out the agreement involved meeting with their counsel and the steering committee, which consisted of the three main lenders.

Win-win for everyone

When turnaround specialists are called upon to restructure a company, they should seek to effect multilevel adjustments that work synergistically. A common sense approach is necessary whereby no element vital to the company's immediate survival is eliminated. Which areas need to be fine-tuned? Look at every aspect of management, finances and operations, to see how it can be done better. Each adjustment will incrementally improve efficiency. Any of the actions earlier specified, enacted in isolation, would not have saved DF or noticeably improved its finances. But when dozens of adjustments were carried out concurrently, the company not only avoided bankruptcy, but significantly improved its bottom line.

Although the banks wound up earning a slightly less favorable interest rate, the bottom line is that everyone won by seeing the restructure through. DF became a far more efficient entity with a brand new infrastructure poised and capable of much growth over the next decade; the lending banks will get back all of their principal, along with favorable interest payments, instead of ending up with slim post-bankruptcy pickings in the form of machinery they would have to sell at distressed prices. Perhaps most importantly, jobs were saved both on the banking and manufacturing sides, which benefits not only the immediate community, but in a kind of ripple effect, those indirectly involved with Delicious Foods and the lending banks.

*Name has been changed to protect company's identity