

Mind & Money... *Sharing the Turnaround Stage*

By Edward Hostmann

Turnaround situations involve a complex interplay of heart, mind, and pocketbook. Lenders need to be continually aware that all three factors are forever present and interlocked within their loan portfolios.

Given the right combination of brains and timely information, lending institutions often develop a keen sense of potential holes in their loan portfolios. Much of this ability rests on proper numeric analysis of income statements and balance sheets, but there is also the qualitative side to identifying potential stress points, a side governed by a complex matrix of money, politics and psychology. In such cases, lenders quickly discover that while the money speaks for itself, the politics and psychology do not. When it comes to managing loans on the precipice, intellect and data must be coupled with intuition and sound judgment.

After several decades of guiding companies through periods of financial convulsion, often at the behest of lenders, I have observed numerous psycho-political themes that play out repeatedly in times of crisis. Once these themes are recognized, they can become a useful guide in managing various aspects of the turnaround process. The best way to illustrate these themes is to associate them with the classic symptoms of financial trouble, and show how mind and money intertwine in the twisted choreography of financial crisis.

The most fundamental symptom of a company in trouble is a persistent negative cash

flow. No matter what the financial statements say, if cash out continually exceeds cash in, something is fundamentally wrong — no matter how eloquent the arguments to the contrary. As a result, management often feels a strong sense of guilt, and attempts to avoid the resultant pain by failing to focus on the immediate cash flow situation. The key to resolving this issue is two-fold. First, cash management must be reduced to a daily exercise, so there is nowhere to run and hide in a fanciful future. Second, the cash management policy must be strictly and explicitly dictated by the party responsible for the turnaround process. This frees the company's management from the guilt associated with dealing with angry creditors: they are simply carrying out decisions made by someone else.

In many instances, this transfer of authority creates some very interesting and challenging scenarios for the turnaround consultant, who becomes the court of last resort in dealing with angry creditors. In one particular case, we received an anxious phone call from a controller regarding a creditor who simply would not accept the payment terms we had dictated. It seems this gentleman had shown up and requested a brief meeting, during which he opened a briefcase and exposed an automatic pistol while getting down to business. Needless to say, we recommended the creditor be paid. In another instance, we were in the process of liquidating a supply logistics company that was beyond fiscal redemption, which triggered the layoff of the company's work force. This included the IT specialist, who demanded a generous severance package. When he didn't get it, he threatened to introduce a "worm" which would destroy the company's financial systems. Since this was a clear case of extortion, we called a meeting with the individual, purportedly to give him his check, and had the police waiting when he arrived.

Another classic symptom of financial trouble involves top management's retreat from strategic thinking, which may involve some very tough decisions, to tactical matters, where they can still exert a certain amount of control over the outcomes. From an emotional standpoint, this type of behavior provides two types of temporary relief for people at the top. First, it isolates them from the true magnitude of the crisis at hand — and their personal responsibility for the company's present situation. Second, it allows them to focus on items where they can still effect a positive outcome, and bolster their self-esteem in the process. Second- or third-generation owners often exhibit this symptom, which stems from a sense of entitlement that insulates them from the true exigency facing their organizations.

A good case in point involves a major retail chain that found itself in the throes of a major financial upheaval. When we were called in, I interviewed the CEO, who told me the "real problem" was that the firm did not have a uniform leasing policy across its stores. This gentleman was prepared to devote all his energies in this direction at a time when the company was in dire financial condition, and rapidly losing money. During this same period, one of the company's store managers correctly assessed the firm's real situation and wrote a detailed letter outlining a number of possible solutions. The letter met with enthusiastic acceptance as it worked its way through multiple layers of

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management to the CEO. However, rather than respond in a material way to the suggestions, he simply corrected the grammar in the letter and sent it back down the chain of command. Thus, the leader of the company chose to descend into financial oblivion, secure in the knowledge that he possessed impeccable grammar skills.

In cases such as these, it's often better to go with the flow than attempt to bring top management to its senses. If you can channel their energies into pet projects which meet their basic need for positive reinforcement, you are then free to deal with the real issues at hand.

Yet another indication of impending financial doom is the rapid exodus of talented and capable employees at all levels of management. Often, the rank and file become the ones taking the daily hits for the company's leaders, who have retreated into the corporate bunkers. And being talented and capable, they correctly assess that their long-term employment prospects are something less than stellar, and head for the door. Once a trickle of defections turns into a stampede, a firm can rapidly pass the point of no return in terms of ultimate survival. More than once, I have waded through this kind of human wasteland in the course of liquidating the remains of a once-thriving business. Often, the company is so gutted that no reliable help remains even to assist in the liquidation.

I recall one particular retail operation where the sales force was so decimated it was incapable of running a sale to liquidate the remaining merchandise. We had no choice but to bring in an external sales force capable of moving the remaining inventory so as to maximize the return. The psychological moral here is simple: No matter how wonderful a company's culture is in its heyday, people will ultimately be forced to act in their own self interest during tough times — even if they feel bad about it. Any turnaround effort — either a liquidation or resuscitation — must take this fact into account.

Of course, employee flight is very often linked to another basic symptom of severe organizational distress: sagging employee moral. When a company becomes locked in a downward spiral, employees suddenly become a lot less tolerant of management perks and idiosyncrasies. This includes excessive opulence in the realm of top management, which in private companies is a lot more visible and irritating than excessive financial compensation. I recall a situation we encountered where a company was run by an individual with a long and lavish history of personal benefits, such as 24-7 personal assistants and

an enormous office. As long as the company generated a profit and generous paychecks, the employees had been willing to overlook this fact. But then trouble set in and we were called in to intervene on behalf of the secured lender. By this time, paychecks were bouncing and discretion was obviously called for on the part of the owner in terms of flaunting his lifestyle. Instead, he showed up at work driving his latest acquisition — a rare, imported limousine — in plain sight of the entire company. To cap this offensive behavior, he expressed genuine puzzlement as to why his workforce was upset.

Another top management practice that can contribute to plummeting employee morale is a failure to adapt and cope with declining financial fortunes in a positive or sensible manner. In one case, we dealt with an appliance dealer who ran a spectacularly successful operation centered largely on his personal energy and charisma. Based on this success, he decided to expand by acquiring a retail operation specializing in high-end consumer electronics — and quickly found himself in desperate financial straits. When we intervened, it quickly became apparent that the employees at the electronics store resented the new owner's sales techniques, which they viewed as being far too crass for their sophisticated merchandise. His failure to adapt to his new line of business quickly became a disaster and forced him into liquidation.

During the liquidation planning, an amusing and instructive incident occurred that pointed to the heart of the problem. The owner, who had high local visibility through extensive broadcast and print advertising, was scheduled to give a speech that evening. Part of his speaking routine was to open his suit coat and reveal row after row of wristwatches stitched into the lining. When he showed me the watches, I tactfully pointed out that they were part of the liquidation assets and needed to be returned. He replied that the watches were all broken, but they still made a great promotional prop. Even with his business in ruins, he stuck to his carnival barker approach.

Often, by the time we are called upon to take action, a company's payables are stretched very close to the breaking point. One quickly learns that the mindset of creditors in this situation is as important as that of employees. Once they see a potential loss due to someone else's mistake, they often feel justified in taking measures outside the boundaries of normal business relations. At one point, we were working with a trucking brokerage firm that acted as an intermediary between haulers and shippers. It became readily apparent that the company's anemic cash flow

would not support the payment of previously incurred bills from truckers. The only practical solution was to freeze the current payables and inform the haulers that all future bills would be paid cash on delivery. One particular trucker, who had a backlog of unpaid bills with the company, gave us a call soon afterwards. He had a \$75,000 dollar shipment of wine in transit at the time we froze the payables. We were informed that unless we paid the past obligations, the shipment could very well disappear somewhere out there on the road. (We paid). The lesson here is that cash flow control policies can never assume that creditors will behave in an entirely civilized manner when their backs are up against the wall.

A slightly more subtle, but very real sign of a company's deterioration is a continuous decline in product quality. Cash normally spent on product quality is being rerouted to compensate for trouble in other areas of operation. In a psychological sense, management is failing to confront the emotional pain of current failure, and borrowing on its future in a vain attempt to assure financial survival. Eventually, though, the bill becomes due — both figuratively and literally. And in an age of global competition, this day of reckoning can produce sad results. Recently, we worked with a U.S.-based company that manufactures a very high-volume product that demands stringent quality control to remain competitive. They had recently installed a very high-speed, on-line inspection system to ensure top quality, but off-shore competition was gnawing away at their market share and their financial health. To pay down a loan from a lender, they were forced to sell the inspection system. The company's parent, an off-shore firm, sold the system to a foreign producer of the same product, a company also owned by the parent. In this case, management was willing to forsake their future in the U.S. by effectively transferring a valuable asset to a country with lower operating costs.

All of the situations described in this article involve a complex interplay of heart, mind, and pocketbook. Lenders need to be continually aware that all three factors are forever present and interlocked within their loan portfolios. **abfj**

Edward Hostmann founded Edward Hostmann, Inc. in 1991 to provide consulting services to companies in financial distress. Hostmann has represented debtors and creditors in and out of bankruptcy, and, since 1996, has focused his practice on representing financial institutions that face the prospect of losses on loans. In his consulting practice, Hostmann has held positions as president, vice president, chief financial officer and general manager for companies in a variety of industries. In addition, Hostmann has been a Chapter 7 panel trustee. He is a member of the Turnaround Management Association.