Managing a Financially Stressed Company (Back to **Table of Contents**)

How do you turn around an under-performing company, particularly when under-performing to the extent of financial distress? There are degrees of difficulty, however, when a company has under-preformed for a year or more with a decrease in profitability and equity and an increase in borrowing to the extent that ratios are threatening credit worthiness, then degrees of difficulty no longer matter because the company is in jeopardy of failure.

Most companies in financial distress did not see it coming, however, they only needed to look at the **Manifestations of Distress** in the above article: **A Fiscal Check-up For Construction Companies** to have known in advance. Any three of the manifestations in one company is an indicator that the company is stressed. It may not be financial, but any distress typically becomes a financial problem: (See above)

Risk Analysis Based on Assets. Our credit-granting system is heavily based on assets and to a lesser extent on performance. Consider a good performing, low-asset company where the income and revenues compare favorably to assets. Such a company lacks staying power because of limited reserves of cash or credit. It does not have large assists to borrow against or sell. Therefore, it is at higher risk than a similar firm with more assets.

Survival Mode

You need to differentiate between slipping a little and being in jeopardy of failure. If you are slipping a little, you can take some action. But if you are in jeopardy, you need to take drastic action which means going into survival mode.

Bankruptcy

Bankruptcy is a huge step. The up-side to filling for bankruptcy is an opportunity to cleanse past mistakes. It may work for huge corporations, but is a difficult vehicle for closely-held construction enterprises. A Yale Law School journal said that 80 percent of the companies that enter Chapter 11 fail. A University of Wisconsin law professor stated that fewer than 20 percent of smaller companies who enter bankruptcy even survive.

Contractors have an emotional attachment to their companies and a propensity to delay the admission of financial distress and unlike most public corporations do not have serious assets to borrow against or sell. They also have a tough time persuading lenders or investors to put up more capital. Bankruptcy drags on for years, can be an incredibly expensive process and too many small companies don't survive the effort depleting what they might have had in liquidation. My experience is that it has not been a viable option for small and mid-size construction enterprises.

Banks

It can be tough to get money out of banks, although they are work-out conscious. Getting new money after financial distress is a problem. There seems to be a big-borrower syndrome that if you owe a bank $1 million, you have a problem. If you owe a bank $100 million, the bank has a problem. And, in most cases contractors are not big enough and don't owe enough to threaten a bank. If we do, and the big-borrower syndrome sets in, then there are some reasonable work-outs. However, all do not survive that bank work-outs which usually depend on showing favorable results in the first year and turning around an under-preforming construction company is somewhat like turning and ocean liner—it takes some time from initial action to noticeable results.

Bonding Companies

It is fair to say that sureties provide bond credit to successful construction enterprises and few would take on a new account that was under-preforming. If an underperforming contractor has a long-term relationship with their surety workout is possible, but not guaranteed. It can only be learned by talking with the surety about the financial distress, but there is no guarantee what the reaction will be. Obviously turnaround requires continuing bond credit so advising surety early rather than when disaster strikes is the best route to staying in their good graces. It is critical to have a viable, detailed plan on what actions will be taken to accomplish the turnaround at the initial meeting with surety including where any required funding will come from. Relying on surety for finding is not a viable because in most cases if surety funds a contractor to complete bonded work new bonds should not be expected. The odds of being bonded by another surety after your surety has incurred a loss are close to zero. So what do we do?

Curing Company Madness

Individual imprudence is rare, but for groups, nations, or companies in survival, it is the rule. In survival it is critical to keep control of emotions and come to grips with the difficult decisions required to turnaround a financially distressed organization. This includes partners and top managers. Actions necessary for turnaround will appear exactly opposite to what you consider normal business practice, which is why it is so difficult for normal business people to digest. For this and other reasons it is probably best to rely on outside advice. Board members or business associates may have some experience with turnaround, but if not consultant advice will be needed.

Re-engineering

An understanding of the dynamics of the construction business is a prerequisite to taking corrective action to unsatisfactory trends. There are three functional areas to consider:
1. Marketing and sales - getting the work. In survival, we put this on the back burner.
2. Operations or production - doing the work. In survival this is all that matters.
3. Administration and accounting - measurement of performance. In survival, do not worry about this function because there is no need to invest in the measurement of non-performance. In survival, because time is critical, we work on the middle area, operations. Survival time for a company that is in jeopardy of failure is eleven months or less. It is the period between today, the day we make the decision, and the close of the fiscal year. It is a seven-month plan, a four-month plan, an eight-month plan, because banks and bonding companies are merciless when it comes to under-performing companies. During survival time it is critical to:

Serve the financial statement. When business is going well we do not run our company to serve the financial statement. In survival, we reverse that and work for it. If the company is under-performing, the liabilities are already out of balance to assets. We are not going to be able to correct that in a short-term plan for the next fiscal year, so we are going to work the first fiscal year to show a profit or break-even. To do that, we operate the work in a suicidal manner. We drive profit, not long-term value. That is, we consume equipment: we use the wrong equipment for the job because we own it as opposed to renting it. We fall short of cheating on materials, but ratchet quality down to the least acceptable level.

Reduce Volume. We plan for the year after the close of the fiscal year to operate at a volume of 25 to 50 percent of normal volume. Drastically cutting volume improves our balance sheet because as we complete the backlog we will not be replacing receivables the same rate we have in the past because of the reduction of work put in place. We will also be spending less on the reduced amount of new work.

Reduce Overhead. While reducing volume we immediately cut overhead ending up with the best people and the best equipment. We reduce equipment payments and slow them until or unless it is ready for repossession. Put a moratorium for an additional 30 days payables except the phone company, and even there we can squeeze another 45 or 60 days.

By enacting a 30-day moratorium, we are immediately borrowing one-twelfth of our payables. In effect, we have a ten percent loan to improve working capital.

Build Cash. Survival activities put bank credit in jeopardy, so cash needs to be protected. One step may be to reduce deposits with banks owed to and place new funds with an institution where there is no debt. This is a short term crisis plan that will not please the bank if/when they become aware. Additional bond credit may not be available, but will not be needed for a while as backlog gets completed without immediate replacement.

Reduce staff. However, do not lay off the field people because the backlog has to be completed. So who does get laid off? There will be no new work until we reduce to the new size so overhead staff is cut immediately. With work to finish and reduction is size fewer marketing people are needed so they will have to hammer, weld, or leave. Morale will be an issue and needs to be shored up. It is critical that the principle(s) be present in the field as well as the office to explain how the recovery plan will work so that those who remain feel secure.

Assets. There may be the inclination to sell off the old equipment, however, it generates less because of its lower value. Because the newer equipment carries the major secured debt, it may be wise to sell the newest pieces or those with the highest debt on them. If liabilities are trimmed, asset-to-liability balance improves and, to the extent that some high-debt pieces are required to complete backlog, it will produce some cash flow through delayed payments. Replacing sold equipment with leased or rental equipment improves the balance sheet and cash flow. These are desperation moves, but selling assets generates cash, reduces debt or both.

Union Issues

If the company is union consider visiting the business agents, advise them of the problem and attempt to negotiate improved work rules during the recovery. This is not always done and may depend on relationships and how strong the unions' area are in the area worked in.

Conclusion

The attempt is to get to the close of the first fiscal year and show positive results on the annual financial statements. It is difficult to improve asset-to-liabilities a lot, but hopefully debt to equity is improved. Showing the predicted even modest performance is important to demonstrate that the recovery plan shown to the surety was accomplished which makes that early plan critical. If the turnaround process can be verified there is a possibility that the reduced amount of bond credit will be available.

No one ever goes through survival twice. They do it once and, if it works, they never again get caught in under-performance. If it does not work after performing all of the above activities the company would not likely have survived anyway, because every one of the above actions produces either cash or profit or reduced liabilities the outflow of cash. None of these can hurt a healthy organization, however the methods of attaining them are painful.