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comment and opinion

CHIEF RESTRUCTURING OFFICERS – A LOOK TO THE FUTURE

How chief restructuring officers are helping to turnaround troubled companies.

The Australian restructuring, insolvency and turnaround sector is poised for significant change. Submissions to the recent Murray Inquiry into the Financial System called for revision to existing processes including the introduction of US bankruptcy-style protections. Further, the Australian Institute of Company Directors is advocating for the inclusion of an honest and reasonable director's defence which could, in certain circumstances, be relied on by directors who faced allegations that they had breached their legal responsibilities, including trading while insolvent.

These calls for change reflect a growing recognition that Australia's strict insolvency laws discourage attempts to rescue businesses which might otherwise be saved. In particular, even if an insolvency practitioner elects to trade a business pending a turnaround the challenges can be significant. Not the least of which include the difficulties presented by personal liability on trading debts and ipso facto clauses in key contracts which, if enforced by suppliers and customers, often can bring an already struggling enterprise to a grinding halt.

In addition to the changing legislative landscape, Australian stakeholders are increasingly relying on more lateral and creative solutions to rescue a troubled enterprise. Stakeholders in foreign jurisdictions have long seen merit in encouraging boards to supplement the skill of their management team with someone experienced in corporate turnarounds and restructures.

Independent directors and financiers are increasingly seeing merit in supplementing the incumbent management team with the appointment of a chief restructuring officer (CRO) in return for the provision of support during challenging times.

WHAT DOES A CRO DO?

A CRO is appointed to improve the performance and outlook of a troubled organisation. While there are no hard rules, they will usually report to either the CEO or the Board directly. They generally have direct lines of communications to financiers and act as an independent and trusted conduit between stakeholders. They are responsible for delivering meaningful change in the short-to-medium term and providing timely and credible information.

CROs should approach each assignment with an open mind. Experience shows that improvements usually come from a combination of organisational performance improvement and capital management initiatives.

A back to basics approach is adopted as CROs work with the management team to identify root causes and fixes. This analysis is often completed by the CRO with the help of a small team.

Many troubled organisations display weak internal controls. An initial focus often involves introducing management systems that improve cash flow management and forecasting, product costing and pricing, and the timely production of monthly management accounts.

Given the circumstances of their appointment, CROs often seek out sacred cows for special attention. Corporate performance can be adversely impacted by products, activities or customers, who for whatever reason, have been regarded as untouchable. A common example is the decision by a company to continue supplying unprofitable products to customers because they have been loyal supporters.

It's important not to lose sight of the fact that the goal of the appointment is to ensure the company trades through its current difficulties and emerges stronger. Accordingly, it is critical to provide the management team with the time and space necessary to discharge their day-to-day responsibilities.

The ability to quickly achieve consensus on the remediation path is an important skill that the CRO should possess. Often success is correlated to the speed with which the management team get on board and start working towards an agreed set of goals.

WHO SHOULD ACT AS A CRO?

CROs come from a variety of backgrounds. Some have deep industry experience whereas others have functional competence in finance, marketing, operations, IT or a combination of these. All are good communicators, have a bias for action and are comfortable making difficult decisions with less than perfect information. They work well in challenging situations and are adept at managing complex and competing stakeholders.

While it is useful to have a working knowledge of insolvency law and practice it does not follow that all insolvency practitioners make effective CROs. While some practitioners do make the transition their success is due to commercial acumen, judgement and experience, as opposed to a detailed knowledge of the insolvency process and reporting obligations.

TIPS AND TRAPS

Here are five tips and two traps from my experience as a CRO:

Tip 1: Speed is more important than perfection

Decisions need to be made and actioned in hours, days and weeks. It is important to start generating positive momentum with experienced practitioners targeting low-hanging fruit as the catalyst for more substantive change to follow.

Tip 2: Cash is king

Cash is always important however in a turnaround environment it is critical. Most CROs quickly move to develop a robust 13 week rolling cash flow. In the early stages managers often have to make daily decisions as to who gets paid and who can wait.

Any action that can quickly generate cash should be identified and implemented. The most obvious initiatives are the tightening of terms, sale of unwanted assets and older inventory, and the conversion of debtors into cash.

Tip 3: Focus on the issues with the highest impact

Distressed companies have limited financial, operational and strategic bandwidth with which to digest change. It is necessary to focus resources behind fewer but more impactful activities and initiatives. Inexperienced management teams waste precious time attempting to boil the ocean before regrouping and focusing on a smaller list of manageable activities.

Tip 4: Make the tough people calls

While the CRO should be regarded as supplementary to the incumbent management team the relationship can, understandably at times, be strained. Tension can stem from the fact that the some managers have contributed to the current situation and seek to defend rather than rectify previous decisions. In instances where people need to depart it is best that these changes are made quickly.

Tip 5: Unfreeze the organisation

Functional silos, internal politics and personal empires always undermine corporate performance. It is important not to underestimate the power of liberating an organisation. In times of crisis, decisions that previously took months can often be made in a period of hours.

Trap 1: Cutting muscle along with fat

In a distressed environment it is generally accepted that it is better to cut hard and early. It's however important not to confuse removing unnecessary costs with core operating expenditure. Cutting costs indiscriminately may result in higher short term cost savings but in the long run it may result in the organisation being unable to trade out of its current problems.

Trap 2: Focusing solely on survival

Survival alone should not be the end or ultimate goal. CROs need to keep one eye on the longer term or the organisation they are guiding may risk becoming a so called 'corporate zombie'. These companies live a hand to mouth existence and, while generating sufficient cash flow to carry on trading and paying their bills, have inadequate financial resources to invest in growth or repay debt.

We can expect CROs to play an increasingly important role in overseeing financial restructures and corporate turnarounds in the Australian market. While the role will continue to evolve, it's clear that forward thinking financiers, independent directors and other affected stakeholders have another arrow in their quivers when dealing with troubled companies.

CASE STUDY: CRO IN AN AUSTRALIAN ONLINE RETAILER

1. THE SITUATION

- A large, private equity backed, Australian-based online retailer found itself with rapidly deteriorating margins and an inability to fund capex.
- The CFO had recently resigned and management reports were not being prepared.
- After failing to make a quarterly interest payment the bank agreed that if the company retained a CRO they would be prepared to provide on-going financial support. This would enable the company to better understand the situation, improve short-term performance and complete a capital raising.
- A CRO and two analysts started in the business with a bank meeting scheduled for seven days.

2. INITIAL FINDINGS

After seven days the CRO and his team met with the board and bank and reported the following:

- The business exhibited many of the characteristics seen in companies established by creative, brand-focused entrepreneurs.
- While the core business was fundamentally sound, the purchasing, inventory management and logistical activities did not meet the needs of the business.
- There had been a breakdown in the finance function and the balance sheet had been fudged for several months. The working capital and cash-flow position was not properly understood or managed, and the accounts payable team was several months behind in processing the paperwork.
- Month-end financial reports had been manipulated using inter-company loan balances to avoid alarming the CEO and board.
- A serious reduction in the cost base and the injection of capital would be needed if the company was to be saved.

3. CRO'S FOCUS

At the completion of the initial review the Chief Restructuring Officer focused on the following priorities:

- Preparing a rolling 13 week cash flow forecast in order to understand future needs and pressure points,
- In conjunction with the auditors, preparing the YTD financial statements,
- Identifying the root causes for the deterioration in revenue,
- Revenue enhancement and cost-saving initiatives,
- Creating an enterprise-wide transformation plan that touched all activities of the business, and
- Developing a brief information memorandum to be used as the basis for raising rescue capital.

4. THE RESULTS

The CRO and his team were involved with the business for three months during which time:

- The cost base was materially reduced and unprofitable products were eliminated from the range.
- Warehouses were consolidated and a number of regional facilities were closed.
- Internal controls, systems and processes were improved and embedded into all divisions.
- Detailed 12 month transformation plans and programs were developed and implementation was commenced.
- Several inexperienced and underperforming managers were exited and replaced.
- Covenants were renegotiated with the incumbent financier.
- Additional equity in excess of $20 million was sourced to reduce debt and fund growth.