The Advisor – Summer 2008

The Restructuring Plan

In our last newsletter, we talked about the business plan from a lender or investor perspective. In this newsletter, we delve into the special situation of a restructuring plan and how to ensure it (a) turns the business around; and (b) attracts the financing or investment required to achieve the intended results.

Generating a restructuring plan implies that there is something wrong with the company's business model. Some of the most common issues currently facing companies in a turnaround situation include:

1. **Increased Competition from Lower Cost Countries.** Many manufacturers in North America are feeling the pinch due to competition from the Far East. Managers need to make a decision on whether to try and compete on price or get out of the commodity end of their market and focus on value added products and customer service where higher prices can be commanded.

2. **A Business Model Built Entirely on a Favourable Currency.** Many companies existed in Canada solely due to the favourable exchange rate between the US and Canadian dollar. Once the Canadian dollar appreciated in 2007, the entire competitive advantage disappeared and they were no longer able to compete with their US counterparts. This combined with even cheaper competitors from the Far East created a perfect storm for many Canadian companies. In this situation, companies require a complete overhaul of their cost structure in order to make their business model viable in an environment where it appears that the Canadian dollar will trade at close to par with the US dollar for the foreseeable future.

3. **Loss of Market Share or a Shrinking Market.** New products or new technology may have reduced a company's share in a mature market or worse still, shrunk its overall size. A perfect example of this is the CD or DVD market where downloads are becoming more prevalent. This is a difficult issue to overcome because it usually involves an investment in technology or emerging markets in order to mitigate shrinking conditions in the original market. It also requires the company to be one of the lowest cost producers to generate the cash flows needed to make investments in any new markets.

4. **Too Many Initiatives.** A company may do well in one market and decide to expand in other markets where they are not successful. Management may be spread too thin so that they cannot manage more than one business effectively. Or they simply may have made an error in judgment about the acceptance of their products in the new marketplace. The restructuring plan should detail the strategy to rectify the situation

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which would normally include an exit strategy out of the unsuccessful markets and a refocusing on the core business.

An effective turnaround plan will identify what the problems are facing the company and explain what will be done differently in the future to ensure the issues will be resolved and not repeated.

Once the strategy above has been established, most restructuring plans include a plan to reduce overhead costs significantly as part of the turnaround process. The area that usually provides the biggest cost saving is salaries. Unfortunately it is also the most sensitive since the livelihood of the employees involved is at stake. Line managers will always give reasons why certain employees should stay even though the company can't afford them. Senior management must take a clinical view in this regard in order to ensure the long-term viability of the company. It is also an opportunity to remove non-performing staff members and to promote strong employees into their roles. The benefits of the staff reductions from a cash flow perspective won't be felt until a few months after the terminations when all severances have been paid in full. But the severance amounts can be booked in the current period from a profit and loss perspective, allowing for subsequent periods to illustrate improved results due to the staffing reductions.

Rent is also an area where costs can usually be reduced. A strategy should be incorporated into the restructuring plan to sell any obsolete inventory at whatever price that can be obtained. Any loss on disposal of inventory can be incorporated into the restructuring costs which are usually shown as a separate line item on the profit and loss statement in the forecasts included in the plan. This (combined with the lower headcount) should allow the company to move into smaller space so that the current space can be sublet.

Plausibility

As with any restructuring plan, potential lenders will review it to determine if the assumptions are sound, if the steps taken to turn the company around are plausible and if the forecasts and cash flows are consistent with the assumptions. Next, they need to satisfy themselves that the current management team can execute the plan. Most lenders would rather "bet the jockey and not the horse." That is, if the President has a history of success and this is his first misstep, they may be willing to give him another chance. But if the President has a history of both successes and failures (or if he is the main reason that the business model is broken), it be may be prudent to replace him and/or bring in a restructuring specialist to lend credibility to the turnaround process.

Aries Advisory Group Ltd. has significant experience in the preparation of restructuring plans. We can provide objective input and will ensure the plan is sound and meets potential lenders' criteria for lending into turnaround situations. If you have a business or restructuring plan requirement, please contact us at info@ariesag.com or at (416) 467-7878 to see how we can help.