Disaster Can Be Avoided, But Only By Careful Management

"It is the Best of Times and It is the Worst of Times"

Dear Clients, Friends and Colleagues,

As you are more than aware the U.S. economy appears to be in reasonable shape with modest growth and falling unemployment; however, the global economy is precariously balanced between continued recovery and a third leg of the global financial crisis, according to leading economists attending the 2016 World Economic Forum in Davos.

Even in relatively good markets, and especially those in maturing economic cycles, corporate distressed situations do occur.

The attached white paper summarizes how warning signs of distressed situations can be used as a catalyst for positive changes to create shareholder value in companies if identified quickly, managed properly and before formal restructuring negotiations are started. The potential key benefits of addressing warning signs early and how we might help includes:

Potential Benefits Of Reacting Swiftly	How We Can Help
▪ Focus on the competitive advantages of the company with early identification of (fixed) cost and expense management issues which helps reverse margin erosion and de-risks the operating model.	▪ Implementation of new strategic and budgetary plans, operating and organization models and key performance monitors. ▪ Identification and improvement of costs and expenses via complexity reduction.
▪ Increased rigor and control in forecasting helps manage cash flow during times of critical need in evaluating compliance with or negotiating amendments to financial covenants.	▪ Development of analytic tools to maintain and monitor newly implemented processes and budgets/forecasts. ▪ Design and development of customized cash flow models.
▪ Fast and sustainable improvements in cash flow and working capital levels, reducing interest costs and improving liquidity and thus improving shareholder value.	▪ Identification of where current business processes could be improved and the potential savings.
▪ Facilitate a change in corporate culture and approach, enhancing effectiveness in the control and management of working capital.	▪ Implementation of new or revised business processes, that can help convert working capital into cash flow.
▪ Developing and putting into place a timely and appropriate debt structure.	▪ Review and analysis of the current debt structure, potential future cash flows and financing requirements.

We very much look forward to speaking with you, learning more about your businesses and clients and explaining more about our advisory solutions and how we can help you protect and enhance shareholder value.

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Best regards

David

David Farrell

Farrell Advisory Inc.

1621 35th Street, N.W.
Washington, D.C. 20007 U.S.A.

+1 (202) 525-2055 **direct**
+1 (202) 436-2629 **cell**
David@FarrellAdvisory.com
www.farrelladvisory.com

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Executive Summary

The global economy is precariously balanced between continued recovery and a third leg of the global financial crisis, according to leading economists attending the 2016 World Economic Forum in Davos ("It is the Best of Times and It is the Worst of Times").

While the U.S. economy appears in reasonable shape with modest growth and falling unemployment, the credit markets are tightening as if there is a recession and/or for systemic stress, partly because of weakening balance sheets from loans to energy and commodity companies. Confidence was also not helped by Q4 2015 U.S. corporate profits dipping 11.5% compared to the same October through December period in the previous year. In addition, more than twice the number of U.S. listed multi-national companies (136, of which a fifth related to technology companies) alerted investors to the risk of higher taxes in their 2015 accounts than a year earlier due to a global crackdown on tax avoidance.

China's still-healthy growth is slowing down, dragged down by weak heavy industry, falling international trade and the ailing state-owned sector, and has a significant debt problem with debt to Gross Domestic Product ratio running as high as 230%. In addition, it is not certain whether quantitative easing is working quickly enough in Europe. Oil revenue-dependent Middle-East, Russia, Brazil, and Venezuela have taken the strain of lower prices.

Big banks like Citigroup and Morgan Stanley and the International Monetary Fund have voiced concern about the global economy partly because of the slowdown in the U.S economy in Q4 of 2015, as confirmed by the Federal Reserve last Wednesday. Morgan Stanley even hiked the probability of a global recession hitting the economy within the next year to 30% from 20% and forecasts U.S. growth will slow to 1.7% (2017F: 1.6%) in 2016F compared to 2.4% in 2015.

Whether triggered internally or by the U.S. or global marketplace dynamics, corporate distressed situations can be managed. Boards and senior management are responsible for the early detection and remediation of structural issues, be they operational or financial in nature. Key decisions have to be made early and actioned to successful closure, even if a crisis is not present. Do we have the right leadership in key areas? Are we effectively capitalized? Do we understand our cost structure and change levers? Do we have a crisis plan? Do we have a laser attention on the cash conversion cycle? Have we and our management team been trained in crisis communication with outside entities (e.g., press, stakeholders, vendors etc.)?

The following findings summarize how distressed situations can be used as a catalyst for positive changes to create shareholder value in companies if identified quickly and managed properly and before formal restructuring negotiations are started.

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Boards Are Responsible

When the credit cycle turns, you have a combination of higher volatility and tighter credit conditions. So what should the board of directors ("Board"), together with management, proactively do to protect shareholder value and reduce risks in their operations?

A major responsibility of the Board is to ensure the viability and sustainability of the business. Boards must not be complacent and ensure they continually receive relevant, accurate and timely information so that they can apply their "judgement" to taking proactive and decisive actions. In stressed conditions, the Board's risks increase due to the possibility of their company entering the "zone of insolvency" which basically means the company cannot meet its ordinary debt obligations as they become due. At this stage, the Boards primary fiduciary duties shifts from shareholders to creditors and the legal protections afforded to directors under the business "judgement" rule become less clear.

So What Should the Board Be Asking and Doing?

Business trouble can arise quickly and for a variety of reasons. Companies may suffer from missed market expectations with non-optimal products/services portfolios, uncompetitive cost base, reduced operating profit or severe cash flow problems. Whether triggered internally or by marketplace dynamics, **distressed situations can be managed and more easily the earlier the situation is identified.** The Board should be asking and doing the following:

- **Do we have the right management team for the task at hand?**

  Boards should avoid snap decisions as preserving continuity in leadership is generally always helpful; however, not all CEOs and management have the ability to decisively change track in distressed situations and aggressively act to remediate (e.g., to maintaining liquidity, monitoring cash flows and reduce the (fixed) overhead cost base).

- **Do we have the right strategic plan?**

  Recapitalizing the company's balance sheet does little to ensure demand for the company's products and services and long-term cash flows. Equal attention must be placed on deeper strategic and structural problems in the core business with a focus on the competitive advantages of the company so that the long-term sustainability of the company can be preserved.

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Implementing change is not easy but the goal is to create a compelling reason for change before conditions worsen and expensive crisis measures are required.

- **How do we preserve the Company's access to capital?**

  Boards must understand the company's long-term liquidity situation and requirements and the potential availability and cost of additional capital sources especially as relationships with present lenders become strained or fatigued during these difficult times. While valuation of the company and/or individual assets and the future cash flows of the business are key determinants of the ability to obtain capital, without confidence, transparency and trust in management, there is less ability to obtain refinancing. Management may also have to consider debt equity swaps but this may dilute current shareholders value.

- **Should we hire outside advisors?**

  Before the Board makes the decision to employ or not employ advisors, it should evaluate whether (i) it is receiving relevant, accurate and timely information and advice from management; and (ii) management has the ability and/or the appropriate resources to develop the new strategy and implement the change decisively? If either answer is no, then we suggest hiring an outsider advisor which would be beneficial to not only the Board but to management as well. Professional advisors can bring a wealth of experience, technical expertise and independence to rapidly push through focused and profitable change.

So What Should Management Be Asking and Doing?

Before any new strategies are implemented, we recommend that senior management performs an assessment of the company, organization, infrastructure and service/product offerings to see where the strengths and core (profitable) activities of the company are. Management should also evaluate the cost benefits of reorganization. This self-assessment will require management to look 'out of the box' and be more proactive in finding new efficiencies and opportunities to preserve profitability and cash. Examples of opportunities to increase profitability and cash include:

1. **Reporting, Planning and Forecast Controls**

   As liquidity becomes increasingly difficult to manage in distressed situations, management needs reliable and detailed reporting and planning tools that provide an understanding of business prospects. If a distressed company has weak coordination between Business Development (Pipeline Reporting), financial and operational reporting, FP&A (Budget/Forecasting), Operations and Treasury (Cash Management), management can be caught off guard given potential disconnects between functional and operating elements. These reporting tools need to be interactive so that management can assess how the potential changes in strategy will impact its business (e.g., infrastructure, work force structure, profitability).

2. **Operational Process Optimization**

Process improvements will not only provide enhanced transparency to operating results but will provide management with the necessary accountability model to manage and optimize, in real time, the future business activity without unduly impacting organizational effectiveness.

Management should look at their procurement and operations processes for opportunities to gain increased efficiencies in reducing material and overhead expenses and inventory holdings so that demand and supply are "in cycle".

Management needs to have in place effective controls to monitor all phases of the ordering and billing process to ensure a tight cash collection cycle.

Finally, management also needs effective and integrated tools in order to manage working capital and effectively promote the business to the capital markets especially as lending institutions will now be taking a more active monitoring role.

3. **Identify and Shift Mix of Services/Products to Core Profitable Areas**

Management will need to evaluate their business development pipeline to ensure that they are pursuing profitable opportunities in the core operations of the company rather than pursuing all new business regardless of competition, profitability and probability of winning.

Increasing Expectations of the Chief Financial Officer ("CFO")

CFOs will also have to step up. CFOs will not only be expected to deliver a finance organization that gets the numbers right ("Reactive Participant") but to partner with CEOs, Boards and Shareholders in shaping the company's infrastructure and strategy and provide the right tools to monitor and forecast (e.g., 13-week cash flow statement) the operations of the company ("Proactive Leader"). CFO will need to become more efficient in identifying and reacting to trends that unfavorably impact future levels of revenue, profitability and cash flows. In addition to considering cost reductions, CFOs should consider extracting efficiency savings from their business systems, eliminating unnecessary procedures, bolstering internal controls, focusing on the core profitable business and developing billing and cash collection procedures to maximize and improve cash flow.

Call to Action

Stressed situations can be used as a catalyst for positive change if identified quickly and managed properly. To achieve this scenario, the Board and management must be highly focused on cash management and preservation, developing a new strategic plan and operating model to achieve the right level of efficiencies and drive to a new cash culture.

It is also important for senior management to seek approval for its new strategy from not just the Board but also from other stakeholders like management, key shareholders and financers in advance, while still maintaining confidentiality. Without the buy in of all key stakeholders, their new strategy is unlikely to address all blind spots, or be implemented efficiently. A well-thought out strategy, with very specific criteria, needs to be clearly set so that management is focused on the right sectors, geographies, products/services and other skills and resources that the business needs, not necessarily wants, to bring to the table to implement decisive and profitable change.

Co-authored by:

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David Farrell
President
Farrell Advisory Inc.
(w) 202.436.2629
David@FarrellAdvisory.com

Vic Datta
Advisory Board Member
Farrell Advisory, Inc.
(w) 703.282.3108

www.farrelladvisory.com

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Farrell Advisory Inc. provides highly customized corporate finance advisory services to mainly private equity firms, corporations and banks with regards to (i) Restructuring and Business Reengineering; (ii) Chief Financial Officer Function; and (iii) Mergers and Acquisitions.

David Farrell has over twenty years of experience in Reengineering/Restructuring and Corporate Finance (buy-side and sell-side due diligence, carve-outs) either as a consultant (Partner and Managing Director) at Big 4 (KPMG), international consulting practices (FTI Consulting) and national accounting firms (Cherry Bekaert, a Baker Tilly network firm) or as principal (CFO or Strategic roles) at European listed businesses, covering both the strategic as well as the transactional side of the business, with deep knowledge of the U.S., European and emerging markets. Mr. Farrell earned a B.Sc. in Economics and Accountancy from Loughborough University in the United Kingdom. He is a Chartered Accountant ("ACA") in England and Wales, and has obtained the Corporate Finance ("CF") qualification from the Institute of Chartered Accountants in England and Wales ("ICAEW"). Mr. Farrell is also a board member of Higher Achievement, National Capital Poison Center and Capital for Children.

Vic Datta has over 20 years of operational restructuring experience. Mr. Datta has held CFO and CIO roles in Fortune 1000 Global Firms and has also been a partner for Big Four consulting firm KPMG and FTI Consulting, Inc. Mr. Datta has been called into complex over-leveraged situations to restore operational and financial stability in various industries. He has worked extensively with company leadership providing strategic advice, organizational design, cost optimization, working capital improvements, performance dashboards, budgets/forecasts for executive management and board members. Highly accomplished in linking technology to financial operations, Mr. Datta has deployed technology enabled, performance and financial management solutions in organizations leading to rapid return on investment. Mr. Datta received his B.Sc. and MS in Finance and Accounting at Purdue University, and has completed a comprehensive series of financial turnaround and restructuring courses at Harvard Business School ("HBS"). He is a Certified Public Accountant ("CPA"), Certified Financial Forensics ("CFF") and is Business Transformation Certified.