ADDRESSING THE EARLY SIGNS OF FINANCIAL DISTRESS

ODINBROOK
GLOBAL ADVISORS

THE SITUATION

A fictional company, Voltco, has raised money to build new electric vehicles. The vehicles feature an exciting design combined with an ESG-friendly business model. Voltco has been struggling to increase production and is experiencing supply chain and other delays.

Recently, more serious operational challenges have caused Voltco to miss its expected production targets for the new Model X. As a result, revenue is less than market analysts expected and Voltco continues to burn cash. Stock prices decline 8% upon announcement of the earnings.

THE EARNINGS CALL

The earnings call started smoothly for the CEO of Voltco, Frank. That was until Katie Jones, an equity analyst and noted market cynic, who was *only* neutral (not a buy!) on Voltco's stock and seemed to be moving toward issuing a *sell* recommendation, posed a question. Katie asked the CEO: "Frank, with these market conditions and the operational delays, do you anticipate the need to raise any additional capital this year?"

During an awkward pause, Frank thought to himself: Must. Keep. Stock. Price. Up! Even though there was a risk Voltco's cash would run low, and the company may need to raise capital. But not "down here," not at this price. No way, he thought.

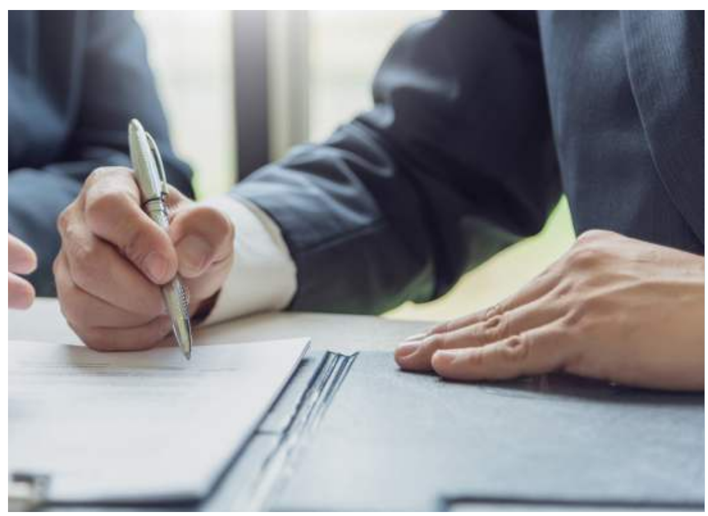
He breathed in and slightly puffed his chest in preparation for a bold, decisive action intended to appease the bulls on the call. Frank stated, "No. I'm not raising capital right now. We believe we can manage through the storm. No new capital is required."

The analyst responded with a statement posed as question: "So, you are holding your own?"
"Yes," he replied confidently. "We are holding our own."

THE RESEARCH ANALYST REPORT

The research analyst had already drafted the headline and was adding in a few quick notes to finish off the sell recommendation on Voltco. The headline of the report read, "Voltco doesn't see need for additional capital. Why they're wrong and why you should sell now."

Thirty minutes after the research report was released, trading was halted in Voltco stock due to selling pressure.



ACTIONS TO AVERT A CRISIS

Analysts' questions can put management teams in an awkward position of forcing real-time decisions on whether to toe the line or go into elaborate detail on everything that could go wrong. While investors relations, lawyers and other professionals can help craft a message to accompany tough news, management and boards must take their own action behind the scenes to avert a crisis.

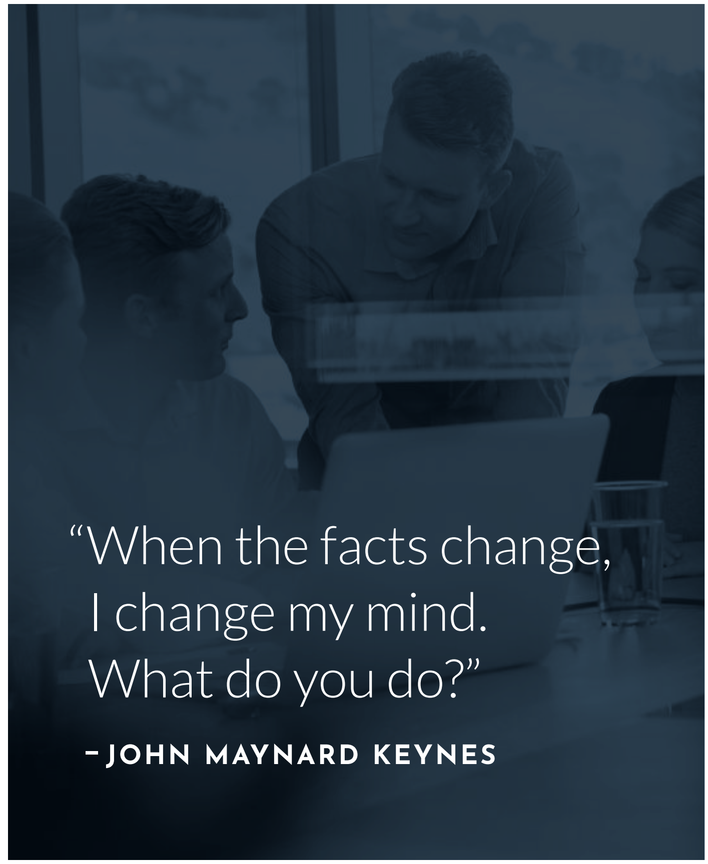
WHAT COULD THE CEO HAVE DONE DIFFERENTLY IN THE CASE OF VOLTCO?

First, it would have helped to better anticipate analyst questions and have a sense of investor concerns. Recognizing that investors are wondering about capital availability and liquidity, Frank could have responded in a manner that gave capital providers an open invitation to express their interest in funding the business, creating more options for Voltco.

For example, responding to the new money question by saying: “We have not decided on issuing more stock at this time, but we are interested and focused on raising additional capital. More on that as talks progress.” This could have alleviated equity investors’ concerns of near-term dilution. Meanwhile, the company should be examining alternative options to increase financing flexibility and raise alternative sources of liquidity – non-core asset sales, spinouts, vendor financing, alternative capital, secured IP-backed financing, sale-leasebacks, stretching payables, amending credit terms, etc.

Here are specific actions that can increase optionality and help to prevent financial stress or distress from leading to a restructuring. These are applicable especially in circumstances when there is uncertainty about liquidity and the viability or attractiveness of future financing plans.

1. **Be open to hearing the market’s perspective and recognize the signs of financial stress.** Being tone deaf to markets simply is not a strategy, especially if a company may need to access the markets for additional capital. Listening and being perceptive to changes in the investor base, their questions and concerns as well as prices are all fundamental concepts. Being able to address investor concerns head on is preferable to stonewalling or simply avoiding the conversation. Listening to market feedback can help to determine the best path forward for raising capital, i.e., getting real information on who is willing to finance and under what conditions.



2. **Bolster the team: Recruit to the board an independent director experienced in stressed, distressed or balance sheet restructuring situations.** Independent directors bring perspective from a process point of view. They can help boards recognize how serious and urgent a threat may be and address issues, such as when should turn around or restructuring advisors be considered? Which firms? What scope of work? These are specialized areas where independent directors can help the board with an experienced perspective.

3. **Begin to educate the board and senior leadership on a range of restructuring strategies, processes and issues.** Interview professionals, ask trusted advisors, research competitors and other situations for relevant professionals, strategies and methods. Look outside, not just in, for answers.

4. **Develop and maintain a detailed 13-week cash flow model and understand the risks to maintaining adequate liquidity.** A 13-week cash flow is the compass of any company in distress and serves as a guide to how much runway exists before there is a payment default. It also identifies payments or cash flows that may vary or be ripe for deferral. Also consider monthly cash planning over longer periods.

WHAT COULD THE CEO HAVE DONE DIFFERENTLY IN THE CASE OF VOLTCO? CONTINUED

5. **Develop contingency plans, including alternatives for accessing additional capital. Consider that market conditions and investor perceptions of risk can change quickly.** Markets and investor sentiment can change overnight. Contingency plans may range from knowing what firms are good at raising alternative capital (not necessarily the same ones that did your last, higher-rated bond deal), having an idea of the private-equity interest in the sector, and the financial position and resources of competitors.

6. **Be prepared to provide transparency and detailed responses to third-party financing sources or relevant stakeholders subject to appropriate confidentiality or standstill agreements.** Scrutiny by investors providing liquidity ranges from practically nil in some underwritings to extreme in more troubled circumstances. Once the questions begin, companies may be placed under increased scrutiny by new investors to prove the investment thesis or turnaround story. "Trust me, we got this" is not an investment thesis. Written turnaround plans with cash flow implications are a best practice in these situations and are likely to be a demand of many new money sources.

7. **Be realistic, keep things in perspective and consider getting help from experienced professionals.** Is this an industry-wide phenomenon that is impacting investors and competitors? Or is the distress related more uniquely to the company? If other similar companies have experienced distress, there may already be a set of market expectations for how to proceed. Understanding and diagnosing the type of distress, the best sources of capital and the financial, operational and legal strategies that are available can be complex and time consuming. There are many qualified firms with experience in developing and analyzing the strategic alternatives your company may be facing. Beginning a confidential dialogue with the right professionals can help bring reality, direction and perspective to the uncertainty.

CONCLUSION

While every situation is unique, these practices can help stressed and distressed companies avoid default and return to prosperity. If your company is showing signs of trouble, we'd be happy to discuss it further with you.

STEVEN STROM

Managing Director

Investment banker and restructuring advisor with more than 30 years of experience in advising companies, creditors and other stakeholders in distressed, bankruptcy and special situations. Advised clients in more than 150 transactions with total aggregate debt well in excess of $100 billion and testified as an expert witness in more than a dozen matters. Board member experience at three companies.

Direct: 203.918.4500 | Office: 844.634.6456 | Email: steven@odinbrook.com | www.odinbrook.com