STRATEGIES FOR ADDRESSING FINANCIAL CHALLENGES

By Steven Strom

Many strategies are available to avoid a serious restructuring for companies concerned about the challenges of higher interest rates, high leverage, refinancing risk, or financial underperformance. However, not every strategy works in every situation.

A key consideration in overcoming challenges is pairing the strategy with the problem. For example, if the problem is that operating margins have eroded, an operational turnaround is likely appropriate. If that turnaround takes time, bringing in additional capital may also be necessary to fund the turnaround process.

A second consideration is to assess the company's resources; large companies often have vast resources (or can afford to bring them in). In contrast, middle-market companies may have less to work with. While each company's threats, opportunities, and resources are unique, several core strategies are commonly used to avoid financial distress, as described below.

EXPENSE CUTS

Many companies' initial reaction to financial stress or underperformance is to reduce expenses (often via headcount reduction, hiring freezes, travel restrictions, and similar measures) and other spending, including dividends, new projects, and capital expenditures.

These strategies are often successful in navigating temporary or single-cause challenges. Existing management often executes this strategy organically (i.e., without advisors). It targets the left side of the balance sheet, often with significant implications for human talent and workforce culture.

AMEND AND EXTEND CREDIT AGREEMENTS

- This is a common strategy to directly address issues on the right side of the balance sheet, especially for bank debt or leveraged loans that either offer inadequate capital or include covenants that may present an obstacle to a borrower. Companies typically use outside counsel for these transactions and depending on the complexity and magnitude of the changes, they may also bring in outside financial advisors.

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- Sometimes, lenders will agree to extend maturities while extracting only fees or increasing the interest rate. In other circumstances, lenders may demand a partial paydown to extend maturities and amend other terms.
- In some circumstances, after multiple amendments and limited progress in reducing leverage, lenders may initiate a restructuring or ask a borrower to try to find outside capital to pay down all or part of their loan.

BUY TIME WITH ALTERNATIVE LENDERS

For companies trying to bridge to an event (such as a turnaround, new customer contract, or other milestone), time and funding are necessary to get to a better place. In these situations, private credit firms can move quickly to price risk and offer creative and flexible lending structures that may enable additional borrowing. Often, firms use outside advisors to approach multiple private credit firms to raise additional debt using a competitive, rapidly executed process. Because these loans typically bring additional risk to the lenders, diligence can be extensive, so plan accordingly.

LIABILITY MANAGEMENT TRANSACTIONS (LMTS)

- LMTs enable companies to raise additional debt by taking advantage of loan documents that allow asset transfers and using this collateral to raise additional debt. The structure of the transactions is often highly complex.
- LMTs are most used by companies that have leveraged loans with debt above $500 million. Outside financial and legal advisors are almost always utilized.
- A critical decision in many LMTs is who to invite to participate. The least controversial structure is to have all existing secured lenders participate pro rata. Only specific lenders or outsiders participate in the new loans in more controversial structures. Controversy arises as the transfer of assets may result in lower recoveries in specific scenarios to creditors that do not also participate in the new financing.

AT-THE-MARKET (ATM) OFFERINGS

For publicly traded companies, ATM transactions can raise incremental capital by issuing new stock through an underwriting firm that will continuously sell the maximum volume (~20% of daily volume). ATMs are sometimes viewed as highly dilutive and require an active shelf registration statement.

CAPITAL RATIONALIZATION

Excess or non-core assets can be converted into cash for some companies with the proceeds used to reduce debt or fund operations. In other circumstances, working capital needs can be better managed to reduce cash operating needs. These strategies may be done organically or with outside specialty advisors. Some examples of this strategy and potential implications are below:

- Sale of excess inventory − may impact the borrowing base
- Sale of unprofitable operations − may require an asset impairment charge
- Stretch accounts payable − practical limits to maintain access to goods/services
- Demand faster payment terms (on the other side of c above)
- Customers purchase the raw materials for their suppliers

PERFORMANCE IMPROVEMENT

This strategy involves improving the company's cash flow (often measured by EBITDA). Depending on the complexity, outside advisors may be brought in to help implement the necessary changes. Selected strategies are summarized below:

- Revenue improvement can be accomplished by increased unit volume or unit pricing. For businesses that are part of complex supply chains (e.g., automotive or aerospace), unit price adjustment to contracts is often a highly specialized process, with the purchasers having a standardized playbook first to see if the company has exercised self-help. Another strategy for companies with a less structured sales process may be to simplify the business by "firing" unprofitable customers, which may also enable adjustments in the fixed costs.
- Cost reductions can focus on fixed or variable costs. As a companion strategy, companies may seek to digitize or transform their business processes to improve operational efficiency. When these strategies are implemented organically (i.e., by existing management), adjusting performance metrics in compensation programs may be appropriate.

Matching the strategy to the company's specific needs is essential to achieving a successful outcome. Having an engaged board with experience in turnarounds and workouts can help ensure this alignment and identify reportable KPIs and other monitoring mechanisms to ensure that further slippage doesn't occur. Starting too late is the most common mistake that most companies make — not acknowledging a problem limits the ability to address the problem. While conversations about dealing with financial challenges can be uncomfortable, not addressing the issues early can make later conversations much more uncomfortable.

Here are ten things to consider when boards implement these and other strategies in reaction to financial challenges:

1. Correctly diagnosing the problem is critical to selecting the right strategy.
2. Having a high-quality 13-week cash flow forecast is a basic tool to understand the timing of threats as well as how the business operates from a cash point of view.
3. Understanding the company's credit documents is fundamental – use outside counsel to understand likely market resolutions and creditor expectations best.
4. Implementation can often take longer than expected so starting early is essential.
5. Clear communication at the board level on strategy and expectations is essential.
6. When involving outside stakeholders, direct board involvement may be advisable.
7. Monitoring progress is essential, as is being open-minded to subsequent strategy pivots.
8. Consider adjusting the compensation structure and incentives to align with the circumstances and resources necessary for recovery.
9. Consider the views of stakeholders and outside advisors and consider the resources the company has available to develop and implement strategies.
10. Consider supplementing your board's skillset by adding an individual with relevant experience in these situations.

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