Dr. Michael Bormann
bdp-Gründungspartner
bdp Venturis Management Consultants GmbH, Berlin/Hamburg

Success Factors for Complex Restructuring

Experts fear that there will be at least 43,000 company insolvencies in 2009, more than in 2004 and 2005, the years of big crisis. The global economic crisis affects a huge number of companies in very different sectors of the economy. Those companies are most at risk whose revenues suffer an above-average decline and that were not able to achieve ample returns and sufficient equity before the crisis.

Apart from a collapse of their sales, medium-sized companies have to tackle the challenge of massive financing problems. In spite of public loan programmes and support granted to the banks amounting to billions of euros, those funds are being transferred to the affected companies only in a very dilatory way. The banks look after their own balance sheets first. Many companies are undertaking strict and thorough restructuring processes that offer a chance for a turnaround despite considerable cuts. In this respect, professional advice may give support to avoid mistakes. This support is not just on paper, but "hands on" in the daily business of the companies. The first step focuses on an open analysis of weak points and quick action that is required in such a situation. Different measures may contribute to stabilize and rehabilitate the company.

Continuance prognosis and redevelopment expertise according to IdW (Institute of Public Auditors)

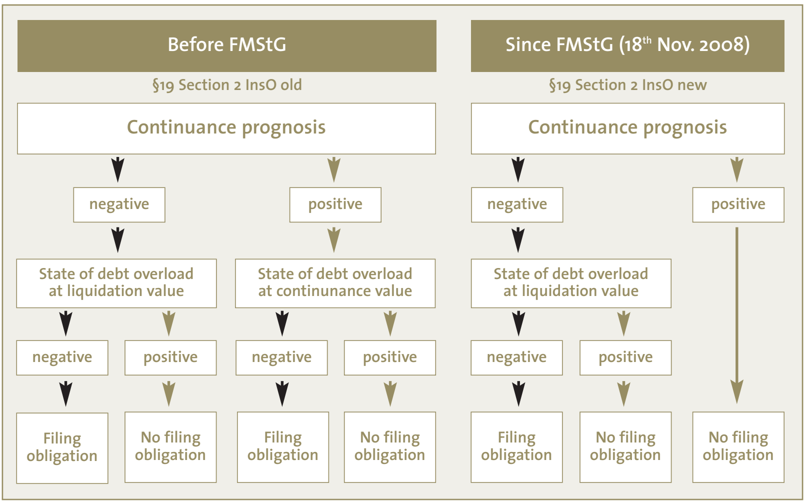
Since November 2008 a new law has been in force: the Financial Market Stabilisation Act *(Finanzmarkstabilsierungsgesetz, FMStG)* as amended on 18 September 2009 has suspended the reason for applying for insolvency of "excessive debts" temporarily until 31 December 2013, if a positive continuance prognosis can be presented. By this, the requirements in terms of a positive continuance

Matthias Kramm
Senior Consultant und Prokurist
bdp Venturis Management Consultants GmbH, Berlin

prognosis have been considerably tightened: As regards the areas of liquidity, competitiveness and sustainable profitability, positive prospects have to be ascertained and certified for the next three years. This requires a lot of experience if the company has to be analysed within a short period of time and if the prognosis for the future shall be assessed with the entrepreneur. In August 2008 the Institute of Public Auditors prepared a new guideline called ES 6 that has to be taken into account from now on.

These criteria play a decisively bigger role because the effects of the positive continuance prognosis have been considerably strengthened: The positive continuance prognosis may "overrule" excessive debts leading to the fact that the obligation to apply for insolvency is avoided.

The new legal situation due to the Financial Market Stabilisation Act Fig. 1



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Christian Polensky
Senior Consultant und Prokurist
bdp Venturis Management Consultants GmbH, Hamburg

Banks and managing directors must be sure that the presented positive continuance prognosis does really correspond to these strict new criteria. If not, one would have relied on an analysis that only conceals the reason for insolvency instead of eliminating it. The consequences would be serious: The managing director would have committed delay in filing a petition in insolvency and the accompanying banks would have possibly aided and abetted. Another essential new aspect: The planning calculation to be used by the consultant must include a period of three years and must be made within an integrated, closed system. This means, there must be a link between the planning of yield, liquidity and annual account items transferring each change in one of the partial plans automatically to the other partial plans. Any separate change in only one of these partial plans is therefore precluded.

Risk Analysis

At present, several factors involve risks for medium-sized companies. Both the problems of some big holdings as main contractors as well as the slackening of the export boom do considerably affect many medium-sized companies, be they automotive suppliers, engine building companies, logistic companies, haulage companies or port handling factories. Even good risk management procedures do not make a company resistant to the present accumulation of problems, such as high competitive pressure, low profit margins, negative yield components or decrease in sales due to declining demand.

Main attention is therefore often paid to the profit and loss account and the liability and equity side at first. Low profit margins, a low equity capital base and a high level of indebtness are signs of considerable problems. If, in addition, credit lines expire or debt has to be repaid, then the question arises of how to get follow-up financing. All banks look at risks more intensively than they used to one year ago, risks that have, in fact, increased at numerous companies. Many companies do not succeed in finding capital providers in the present situation.

The credit crunch is real for medium-sized companies. Anybody who is not able to play on the claviature of very different financial products and of integrating public programmes, such as the new KfW-special programme or the application for state guarantees, will have problems. In past months, bdp was able to realise numerous successful company financings, e.g. at Kinella, the number two German producer of baby juice *(see bdp aktuell edition 50)*, where the Bürgschaftsbank Sachsen was involved, or the alu-druckguss GmbH & Co. Brandenburg KG, Brieselang, where a state guarantee was integrated.

Restructuring as a change – but it costs a pretty penny

Distinction must be made between restrictive and expansive restructuring. Whereas restrictive restructuring responds to the downturn in demand only with short-time work, reduction of capacities, dismissals and some other austerity measures, expansive restructuring possibly strengthens business segments, which do not show such a big decline in demand, by extending engineering and marketing capacities. There is no “right” or “wrong” when selecting these two totally different restructuring approaches; it is important to analyse precisely the company’s situation. If there is a realistic approach for a new orientation, then much speaks in favour of expansive restructuring. However, both methods incur costs at first: Both severance payments in case of staff reduction, as well as the establishment of extended marketing capacities have to be financed. In the short run, however, the costs, cannot be reduced as fast as the downturn in demand becomes evident on the revenue side of some companies. Liquidity is often affected by such a big downturn in demand.

Analysing the real causes

Open analysis – that’s how restructuring starts. But today there is frequently far less time than some years ago. Quite often the banks expect to get a clear statement within 14 days. In order to comply, you have to be professionally placed and be able to master the tools of market research and of professional analyses in the company.

Numerous *in-house trouble spots*, which are hidden by entrepreneurs or blamed on the world recession, are also possible reasons for the crisis of a company: wrong product policy, weak marketing, excessive costs, negligence of important investments, excessive dependence on individual customers or suppliers, overly expensive acquisitions in subsidiaries or participations.

In medium-sized companies, the *risk management system*, or even more tangible, the *controlling system*, are not sufficiently well developed in order to detect these internal causes as early as necessary. Even the basic tool of profit and liquidity planning is sometimes non-existent in medium-sized companies.

It is also indispensable to disclose such deficiencies because otherwise the proposed restructuring measures would miss the point. In addition, it is necessary, for example, as regards the application for the new, public *KfW special programme* to precisely analyse and confirm the actual start of the crisis: Only those companies that have suffered from the financial crisis after 30 June 2008 may benefit from the Kfw special programme.

The phases of the crisis

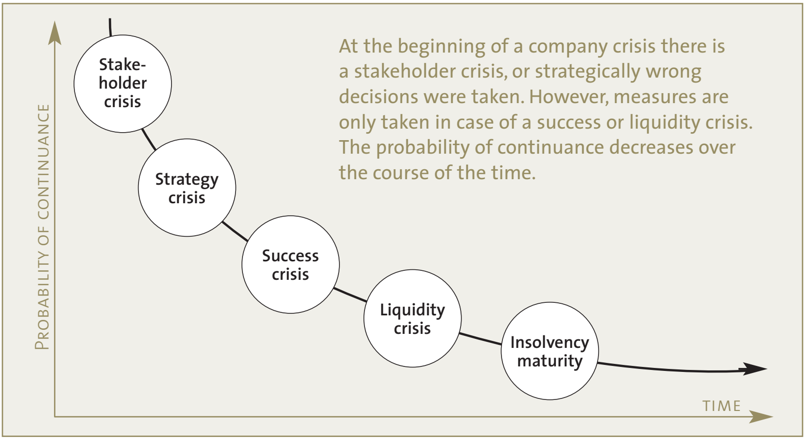
Classically, any crisis is always marked by several phases. According to the new IdW-standard ES 6, it is now necessary to find out which individual phases exist in the affected company at present.

If the crisis has been caused by *stakeholders*, then this issue has to be tackled very individually. This might include shareholder groups, problems of employees, but also a worsening of the relationship with financial backers.

The *strategy crisis* is marked by the fact that demand is anticipated wrongly and that the product range no longer corresponds to the customers' market expectations. This phase is followed by the *profit and liquidity phases of the crisis*. At first, profits are shrinking; some creative entrepreneurs still try to compensate this decrease by a so-called "balancing policy".

Course of a company crisis

Fig. 2



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Then the most dangerous crisis will take effect, the *liquidity crisis*. In this respect, the scope of action is limited; ass early as 2005, the BGH *(Federal Court of Justice – Bundesgerichtshof)* decided: Anybody not being able to pay debts due is considered to be insolvent. In such an event, the affected company has either to restore solvency within three weeks or to file for insolvency. Insolvency has to be proven by the *cash and debt position*.

The short deadlines already show how dangerous the situation is: it is getting more difficult for companies to settle loan claims, suppliers ask for advance payments, loan insurers cut the limits, the lessor threatens with termination, leasing contracts are in danger, etc. In such a situation, professional consultants may already contact individual contractual partners in parallel to the actual preparation of an appraisal report: Only somebody who is able to signal trust in a convincing manner may calm the situation so that there will be at least a chance of completing the analysis and implementing the required measures. In such a situation, practitioners are needed who exactly know, based on many cases of restructuring, how to address the problem and which issues have to be taken into account.

The *restructuring measures* have to *involve the entire company*, starting from drastic reductions of production time and arrangements with the staff (or according to the legal framework with the works council, in case of collective bargaining agreements with the trade union, etc.). Experience has shown that nearly everything is negotiable in critical situations, if there is a trustworthy relationship and if the restructuring person demonstrates confidence and trust in overcoming the crisis.

Suppliers have to be involved as well, because parts of the *supplier liabilities* are tied up in inventories, which the customers of the company may not call for at present. Experience gained from different cases shows that directness towards the suppliers may be of huge benefit. For example, it will be possible to show which inventories are tied up in which customer projects and that it will also be possible to pay the suppliers pro rata.

Existing *purchasing contracts* must also be taken into account in such a situation. Of course, it is true that contracts among merchants must be honoured ("pacta sunt servanda"). However, before any purchasing agreements initially made in a totally different situation will be allowed to die, it is better to renegotiate. Consultants may sometimes be of considerable help during such highly demanding negotiations.

There is another element that the financing partners are demanding in a restructuring concept: namely, that the customers are involved in this process as well. This is something entrepreneurs do not like to do, or if so, only in a hesitating manner, as they fear the customers could abandon them totally. Experience has shown, however, that customers are basically willing to make allowances., They buy considerably fewer goods than before, but they still need a particular basic provision. If one supplier "disappears" suddenly, then the basic provision will be at risk. Such talks with the customers require the *ability to tactfully and skilfully handle the unique situation to the satisfaction of all parties*. By using concepts prepared in detail and showing clearly the increased unit costs of a reduced volume, you will be able to successfully obtain price increases, shortening of payment periods, advance payments or guarantees to be accepted by many customers.

Core document of a successful restructuring process

If the causes are evident, the restructuring success will depend on taking the correct measures quickly and without any hesitation. In this respect, bdp prepared a particular list many years ago: OAC = objective, actions, control; that is a plan of measures required by IdW in ES 6 for the "comprehensive restructuring concept".

Liquidity procurement

Liquidity procurement often decides on success or failure of the restructuring process. This ranges from asset sales, the introduction of factoring, deferral or suspension of redemption payments as regards loans up to a renewal of terms with suppliers (consideration of commercial credit insurers), new partners' loans or increase of equity capital.

Nevertheless, new outside capital is still required. In this respect, the current *special programmes* may be used, or guarantees may be applied for at the local guarantee banks up to a certain credit limit (mostly up to a maximum of € 1 million); in case of credits exceeding this limit *state guarantees* have to be applied for. The latter will also become necessary if the company no longer has the status of a small and medium-sized firm because it is bigger now.

Interim management and restructuring trust

The interim manager, i.e. the expert on site during the crisis, knows how to negotiate in such a special situation and how to implement measures. The crisis is not an exception for the interim manager, but it is the rule. He possesses a lot of experience in how to behave in special situations.

However, an extreme situation may sometimes occur in which considerable additional financial means have to be provided to the company that cannot be provided by the current shareholders. In such a situation, pure owners of non-equity capital could become equity capital owners, or individual groups of shareholders may extend their share just to justify the additional investment.

In this case, a restructuring trust would be appropriate: corporate shares are assigned to a trustee who possesses the necessary tools under company law during the crisis and who may possibly already be asked at the transfer of the funds to prepare the sale of the shares in the medium term. However, this will only be possible if all parties involved in the assignment of shares agree to this procedure.

Summary

As many successful restructuring cases and financing projects of recent weeks show, professional support can often help to avoid the worst case scenario. And even this, namely insolvency, will probably not mean the end. Successful examples show that insolvency may definitely help in a (partial) sale of a company while a core business can be retained. But the following rule also applies in such a case: Only good preparation improves the chances of success.

Michael.Bormann@bdp-team.de | Matthias.Kramm@bdp-team.de
Christian.Polensky@bdp-team.de