Forward

There is no single leading metric or formulation of measures that determine whether an organization has gone beyond the manageable bounds of performance. In most cases there are combinations of signs that, taken in comparative context, indicate trouble ahead. This article will highlight some areas that can signal deteriorating performance and increasing risk.

In the event that you operate an organization, or provide services to a company, where some of the indicators raise warning signs, if you have not dealt with a similar situation before, you are well advised to seek the services of a company that has the experience to provide the analysis, options and direction necessary to navigate the pending difficulties. Familiarity with the situation is often accompanied by paradigms that inhibit insiders in defining and selecting appropriate solution alternatives. There is a single imperative in dealing with distressed situations; - time! As time passes, and scarce resources are depleted; actionable solution options rapidly disappear.

Professional leadership, in a distressed situation, focuses on cash, control and communication. Symptomatic acceleration of “urgent” and “important” operational issues often prevent line management from focusing on cash, control and communication, which are so critical in managing an organization in crisis.

Sources of distress

The one constant in an organization's progress is change. Inevitably, the rate and magnitude of change that an organization undergoes is a determining factor in its ability to manage operations and generate expected returns. These changes can be over short or long time horizons. Utilizing the appropriate measures, leadership can recognize deficiencies in performance.

Given a sufficient amount of change, the following areas can generate unmanageable stress for an organization:

- Business system controls
- Core business focus
Signs of an organization in distress
by: Chris Carr

- Cost of primary inputs
- Environment
- Leadership
- Market/customer characteristics
- Ownership

You might ask some of the following pertinent questions about changes within these areas, and decide if they may be indicating problems for the organization under consideration.

**Business systems**

- Are they adequate to provide accurate, pertinent and timely information?
- Do shared goals and objectives exist in the form of a “living” business plan?
- Is there clear accountability for defined operating measures?
- Are there plans to transition planning and control systems to new ERP, MRP?
- Have employees stopped offering suggestions and criticism of the business systems? Has the expectation become that nothing will get better?
- What direct and indirect costs are driven by the type of control systems?
- Does the organization have key metrics that define good, mediocre or poor performance?

**Core business focus**

- Has the business identified its core competence (product or process) and focus?
- What is the plan to adjust to changing market/customer requirements?
- What actions address competitor’s attack on core business?
- How are changes in channels affecting core business prospects?
- Is there a comprehensive 1 to 3 year business plan with specific, measurable, attainable, and timely goals?
- Are the obstacles to achieving the goals documented and are there projects in place to eliminate or mitigate the obstacles?
Cost of primary inputs

- Labor – new agreement that pushes the organizations ability to remain cost competitive? Accelerating health care costs? Historic pension agreement that is increasingly difficult to fund? Work rules, configured in the past, that are no longer competitive?
- Material – how have unit prices changed? Is your competition subject to the same changes? Are substitute materials being designed into competitive offerings?
- Benefits - Accelerating health care costs? Historic pension agreement that is increasingly difficult to fund? Paid time off that has historically increased?
- Energy - recent changes in energy inputs have a primary impact on direct usage and a secondary impact on raw material and the transportation of those items
- Overhead growth – administrative costs (people, facilities, support programs driven by administrative staff, cumbersome communication driven by stratification, etc.) grew over time. Is the organization still able to support this legacy?

The organization’s environment

- Market consolidation – have changing competitive structures or technological advances enabled market/competitive consolidations?
- Sales growth – does the organization have the resources to manage recent growth?
- Legislation – what changes are being driven by legislation? For example, how will the organization be impacted by pending pension plan legislation?
- New product/service developments – what is competitive? How close is the organization to the customers existing and developing requirements?
- Channels – for the company’s product and services are changing. Does the organization see change and what is the plan to remain competitive?
- Foreign competition/markets – shifting supply sources significantly affect cost and features. Is the company attuned to these changes and how is it leveraging potential benefits for its customers?
Organizational leadership

- Capable – has the management demonstrated the ability to formulate living business plans that are effectively communicated to the organization? What is the history of meeting or exceeding the objectives within the business plans? Has the human capital been upgraded to enable the company to compete at a continually higher expectation?
- Succession plan – has the leadership installed succession plans? Has tomorrows leaders been identified? What actions are preparing future leaders for demanding positions?
- Healthy turnover – how are the staff and employees evaluated? How often? What are the anticipated outcomes for under performers and innovators?
- Balanced outlook – has leadership demonstrated a balanced outlook in allocating resources to the development of both company assets and human capital? Does the organization understand how future investment decisions are driven?

Market/customers

- Consolidating market - in terms of control? Have changes in relative bargaining power reduced the company’s ability to control price? Are margins being eroded, and as a consequence does the cost structure need downward changes?
- Are new products available and/or preferred by customers of the company’s core business?
- Product development activities – is the company a leader or follower in product innovation?
- Are substitute products gaining share?
- Demographics – is the organization measuring change?
- Sales tools – is the sales force utilizing the latest industry-standard sales tools and practices?

Ownership

- Is the organization’s ownership structure stable? Have changes meant changing goals for the company and how well has the company been able to adjust operating characteristics? What motivates ownership, on a long term and short term basis?
- Participating or distant – is the ownership participating in the management or removed from the daily operations?
Equity/Leverage – to what degree does ownership determine direction as opposed to external financial resources?

Financial signs of distress

Having highlighted some areas that do change and may result in unmanageable pressures for an organization, where do we look for signs of problems? Traditionally, the financial metrics of an organization document performance. Timing and visibility sometimes cloud the message. Financial reports, available by the middle of the following month, will not change what happened last month. After the distribution of allocated costs and matching cost and revenue do you really have a pulse on primary drivers of performance?

Even in view of any short comings, financial indicators that, in combination and context, do signal pending problems include:

- Variations in ability to meet plan/forecast results and/or the systematic downward revisions of planned performance levels
- Year over year unit and/or dollar sales/profitability decline
- Increased use of sales discounts/markdowns to fortify declining sales
- Increases in sales returns and allowances to placate dissatisfied customers
- Increases in warranty costs, scrap & rework
- Losses
- High amounts of inventory or “bad debt” write offs
- Deteriorating quality of A/R and A/P as measured by days of sales outstanding
- Increase reliance on short term credit lines
- Deteriorating working capital and cash flow
- Current and total leverage ratios
- Inability to accurately forecast near-team cash requirements
- Deferred, late or non payment of statutory requirements –pension, worker’s compensation, with holding taxes
- Late financial statements
- Loan formula problems
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- Financial covenant defaults
- Payment defaults on debt
- Appearance of notes payable to suppliers
- Abnormal sale of fixed assets
- Early payment of “insider” debt
- Unusual number of liens being filed
- “Distressed” type financing is sought
- Change in auditors/advisors
- Increased requests by suppliers or customers checking references

Operational signs of distress

From an operational perspective, early warning signals appear as:

- Decline in backlog and rate of bookings
- Dramatic changes in booking horizons
- Deteriorating on time shipments, short shipments and increasing premium freight
- Difficulties making daily scheduled production and throughput
- Material shortages and premium inbound freight charges
- Loss of several key customers
- Reduction in product penetration to major customers
- Large raw, in process, finished goods or surplus/obsolete inventory levels
- Excessive internal scrap and dedicated internal rework areas
- Unscheduled process equipment downtime
- High overtime requirement
- Excessive employee turnover and high absenteeism rates
- Low/no spare parts inventory levels
- Safety issues, lost time injuries and poor plant housekeeping
- If unionized, high grievance load
- Negative articles in media
- Multiple senior level new manager hires
- “Abrupt” resignation or termination of CEO, COO, CFO and/or General Manager
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• “Early” resignation of a Board member
• High turning inventory supporting dead product as identified by a turns stratification analysis at the part number level
• Inability to quantify process (production or business system) error rates
• Absence of key performance metrics
• Excessive inventory variances discovered at physical inventory

External signs of distress
In addition to these financial and operational indicators, there are indicators external to the organization:

• Changes in the communication pattern of the company. If information that was forthcoming, is now guarded or non-existent, why?
• Customer feedback indicating quality/delivery performance changes
• Competitor opinions – taken in context, can indicate changes in the operating characteristics of the organization
• Supplier opinions can often confirm lagging payables, unexplained material returns, competitors position
• Increasing product liability claims or suits may evidence quality or design shortcomings
• Comparisons with industry or competitor statistics will highlight performance exceptions
• The status of a related business to the company can indicate pressures on the object organization

Next Steps
If a combination of the indicators above signal problems ahead, remember my opening comment, that the single imperative is time! Doing nothing will radically alter career paths and exhaust the number of options available to the distressed company.

In the case of an external financial lender, a prudent course of action would entail:
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- Communicating and documenting, with the company, the actions to remedy any information gap, performance deficits or planned direction
- Monitoring monthly or bi-weekly to confirm corrective action
- Anticipating a timeline and occurrences leading to default
- Utilizing your own organization’s resources, expertise and experience
- Defining and planning your options
  - business as usual
  - transition the obligation/risk to a third party
  - payment demand
  - forbearance
- Confirm with lending institutions internal stakeholders and legal resources.
- Maintaining a consistent message to your client in order that there are no surprises
- Recommend/require the use of a third party to evaluate and provide recommended options complete with expected outcome, timeline and budget to implement
- Determining and implementing planned corrective action with agreed milestones
- Defining and monitoring key performance indicators
- Utilizing periodic third party project reviews for an unbiased, objective reality check

If you happen to be an incumbent within the distress organization, you have options that enable you to deal with the problems, to the company’s and lenders satisfaction. Should you elect to address the issues with internal resources, you need to be able to answer the following:

- Why didn’t we see it happening?
- Are we certain we have the expertise to identify and prioritize all the issues?
- Do we have the experience that will allow us to deliver the solution with the highest probability of success in the shortest possible time? (Knowing that as time progresses, resources diminish and options disappear).
- Do we have the support of all the stakeholders?

Hillyer Group has a solid record of providing timely support to owners, management and financial lenders in dealing with distressed situations. Partnering with the stakeholders, Hillyer Group has:
• Provided a reality check to client management through the prompt and prioritized evaluation of the business condition in the assessment phase of an engagement.
• Prepared Options Analysis for management and stakeholders, taking into account:
  • Environment - market, competitors, and stressors to the business
  • Organizational strengths and weaknesses
  • Management abilities
  • External drivers - creditors, litigation
• Delivered measurable action plans that defined:
  • Operational remedies
  • Financial alternatives
  • Commercial options
• Executed agreed plans, meeting both budget and time constraints, while delivering projected outcomes
• Performed periodic performance reviews to assure continued performance improvement

In conclusion, change is certain; an organizations ability to deal with the stresses generated is not. This article has been written to give the readers some “heads up” information. In the event that some of the signs signal an imminent crisis, Hillyer Group is prepared to resolve challenges that are unique to distressed organizations.
About Chris Carr

Chris brings twenty-five years of hands-on executive leadership to his assignments. Chris has executed operational and financial turnarounds by identifying pragmatic strategic solutions, then provided focused leadership and the tactical insight necessary to implement sustainable change. Chris has successfully completed CEO interim leadership assignments as well as managed discrete process improvement projects with Hillyer Group’s clients. Notably in his last engagement, over a 30 month period Chris directed the turnaround of a national metals fabricator, improving EBITDA from - $ 6.5 million to + $ 9.2 million, on a base of $ 65 million revenue.

Prior to joining HG, as President and CEO, Chris led the operational and financial turnaround of a $35 million, privately held, metals business. He served as President of a Canadian manufacturer of automotive accessories. He functioned as both CEO and President of a $150 Million heavy equipment manufacturer with worldwide operations.

About Hillyer Group

Hillyer Group LLC is a professional services firm providing an array of Financial and Operational advisory services for challenging situations since 1987. Engagements are local, national and international. More information is available at www.hillyergroup.com or call (216) 672-6023.