The Big Turnaround

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Business turnaround is a growing concern in the UK. The emergence of organisations like the Society of Turnaround Professionals and the Turnaround Finance Group marks a growth in both awareness and pertinence of turnaround in today's business climate.

The STP and TFG are just two examples of established communities of experienced practitioners from business leadership, general management, tax, accountancy, insolvency and legal backgrounds, operating with a specific focus on business rescue and recovery.

Background

Although it has only become a much used business buzz word relatively recently, there is a significant history of business turnaround within the UK in the last 20 years. Corporate UK spoke to Grant Jones, co-founder of the Turnaround Finance Group, about the background for business rescue. As Mr Jones explained, the movement in the 1980s of the major banks away from the previous model of branch-based personal customer service towards a centralised business centre model paved the way for new modes of finance for distressed companies. Where before lending for a company in distress had been handed out at the branch manager's discretion, with a heavy emphasis placed on his knowledge of the individual in question, the lending policies of major banks moved towards a more impersonal pro forma approach. Lending was decided from centralised locations rather than branches, subject to statistical scoring procedures and the viability of lending propositions.

For firms that did not fit the pro forma of the banks, a funding gap developed. Mr Jones explained: "They were often companies that were in difficulties, or companies that were being bought out of insolvency, and given that they had no track record, they didn't fit the business centre pro forma. Before their local bank manager would have loaned to individuals on the basis of personal discretion and his relationship with the customer. Into that breach came the receivable financiers, who were really at the forefront of what we now call turnaround finance."

The options for turnaround finance are not straight-forward by any means. Financiers of distressed companies take a potentially bigger risk than creditors lending to profitable businesses. Neil Chesterton is a qualified insolvency practitioner with The MacDonald Partnership. He is also a director of the Turnaround Management Association, a body of financiers, accountancy and legal practitioners.

Mr Chesterton said: "There is a different risk profile for turnaround finance. There is also the issue of knowledge on the part of the financier of what the insolvency implications are. Clearly the financier is always looking for a situation in which they are as secure as possible. The main factor in turnaround finance of course is the potential high return that debt lending can produce for financiers. There is a history of asset finance and stock finance. And more recently equity has become an option. Equity players are typically highly conscious of insolvency, so they tend to lay their exposure towards the secure end. So in a situation in which the financier could put in a loan, they would put as much asset based lending in as possible."

The Three Legged Stool

Finance is only one element of a successful turnaround however. Doug MacDonald – founder of The MacDonald Partnership, a multi-disciplined firm specialising in business turnarounds of financially distressed businesses, and co-founder of the TFG – devised an oft-quoted analogy to illustrate the three key components of any successful business turnaround. The first leg of the three-legged stool concerns the management of the business in distress. And the biggest issue that a turnaround specialist faces when dealing with an existing management team is denial.

Culturally and historically the UK business world has not been very forgiving of failure. Further to this the management team of any company do not want to know that their company is in danger because of the obvious implication that their jobs are at threat. As a result management teams of distressed companies are often loathe to admit that their company has a problem. While it is essential for a turnaround professional to be permitted to assist a company as high up the decline curve as possible if the company has a chance of being saved, many management teams will simply not accept that they need help until the last moment. This of course jeopardizes the success of any turnaround that might have been affected.

Managing chaos

Chris Wallis is a strategic planning and operational management specialist and a partner with DB Consultants. His experience of denial in management teams is telling: “People often don’t realise that they are heading for a brick wall, and in some cases the brick wall is very close. The two crucial things that we see are people in denial and people not looking after the books properly. In any difficult situation I will ask to see the business’ cash flow forecasts, and usually there will be a pregnant pause before I am told that there aren’t any cash flow forecasts, that they haven’t prepared any.”

A successful business turnaround therefore hinges on strong management, and the ability of the turnaround specialist to lead the management team is crucial. Nick Ferguson of the Society of Turnaround Professionals said: “Diplomacy and leadership are of leadership coming into play. I suppose that, because it is a rather old-fashioned concept, people overlook the importance of strong leadership, but the ability to lead effectively is absolutely vital. The great thing about turning the existing management team around is that they feel part ownership of the turnaround and they therefore buy into it. That of course means that, when the turnaround professional has to make his or her exit, the team is in good health and they are in a good performance state to take the business forward.”

Restructuring

An element of company restructuring is normally necessary in any successful turnaround. The distinction made in Doug MacDonald’s analogy is between a formal and informal restructuring of the company’s balance sheet. An informal restructuring refers to one that is not by way of a formal insolvency procedure as defined under the Insolvency Act, whereas a formal restructuring takes this route as a necessity. In the first example a compromise may be reached with the company’s creditors so that insolvency is not necessary. As Neil Chesterton explained, this route can be a more complicated process than insolvency. “If you strike a deal with a number of creditors, it only takes one of those creditors to decide that in fact they are unhappy with the arrangement and that they want to take their own action against the company for there to be an insolvency anyway, despite your attempts to avoid it. But properly done and with early warning, informal workouts can be very successful.”

While avoidance of insolvency is definitely a priority for a turnaround adviser, there have been instances in which insolvency has been a successful turnaround tool in itself. As Doug MacDonald points out in his writings on turnaround, the most famous example of this recent years is undoubtedly Canary Wharf, which went into administration and went on to become a hugely successful enterprise.

Viability

Although there are three defined strands for a successful turnaround specified by Mr MacDonald – finance, restructuring and changes to management – these elements are not enough to save a business that does not have long-term viability after the turnaround. Mr Chesterton commented: “The support for the whole process needs to be a viable business. Typically a good example of viability is something which has been profitable in the past, which has had some large problem, like a bank debt for example. But the emphasis is on that company recovering and moving forward after having drawn a line under the problem.”

Langbar

A big story in the business world of recent months has been the investigation by the Serious Fraud Office into Langbar International Ltd after an investigation by Kroll that uncovered a deficit of cash balances of £365 million stated in the AIM listed company's balance sheet. While a criminal investigation is underway to determine the whereabouts of the missing funds, DB Consultants were appointed to assist in the possible rescue of the company for the shareholders. David Buchler was appointed as Executive Chairman of Langbar. Chris Wallis also joined the Langbar board as finance director. Commenting on the appointment, Mr Wallis said: “People might ask why we would take on an appointment like Langbar, to which the logical answer is because it looks like it involves a fraud. We have to make an assessment on that quite quickly. Of course if it is a criminal issue then there are individuals at fault rather than a company. We are really doing what is best for the company, and by extension what is best for the shareholders. That is true of any situation that we work in. We specialise in operational management, rather than just the financial reconstruction of a business, which is what the big accountancy to now, because they can do that in an advisory capacity as opposed to using an executive appointment.”

Culture shock?

Mr Jones expanded on some of the cultural changes that might be affected to circumvent this element of denial that is so common to ailing businesses. “I’m not quite sure how you address that problem without killing the goose that lays the golden egg. One of the ways of addressing the denial issue is to make life difficult if the business fails, as a greater incentive to save it. In continental Europe, Germany especially, denial isn’t that much of an issue because people are much more conscious of the ramifications of failure. But that consciousness breeds excessive caution and can lead to a non-vibrant economy. Contrary to that is the situation in the USA where it isn’t so much denial which is at issue but failure. And failure within business is not regarded as failure to the extent that it is in the UK. If your business fails you have learnt a lesson. So I think that there is less of a stigma attached to failure than in the UK.”

This disparity between the cultures of the UK and USA is an important consideration. The American legal system seems to have an innate preparedness for dealing with insolvency. Under Chapter 11 insolvency in the USA, a Chief Restructuring Officer can be appointed to the firm on a statutory basis. Because the appointment of the CRO is a statutory appointment, the person who fills that role has the same legal protections as an insolvency practitioner. So there is a provision in place under American law for a turnaround professional to enter the company as a board member and provide a business recovery service under legal protection. So while historically the culture in the UK dictates that insolvency essentially marks the end of the operations of that business, the American model allows for recovery, even after insolvency.

So while historically the culture in the UK dictates that insolvency essentially marks the end of the operations of that business, the American model allows for recovery, even after insolvency. Grant Jones suggested that a shift might be taking place in regards to this within the UK: “The UK banking culture doesn’t understand the USA culture of shareholder value being designed to be maintained. In the UK the attitude is much more that if a company is going into insolvency then that is the end of shareholder value. We now have large wedges of money that look at equity solutions rather than just the receivable finance end of the market. So we are now seeing major restructurings that look at writing down loan in order to take an equity position.”

In Mr Jones’ opinion the trends that surround the development of turnaround in the UK have been seen before with the development of venture capital: “The model is similar if you think that venture capital as a trend was something that really migrated to the UK from America. The UK was then a springboard for venture capital to launch itself into Europe. The same is true for turnaround. We are ahead of Europe at the moment in terms of turnaround practice, but TFG has started to set up branches abroad, the Holland branch being one of them.”

The problem, as Mr Jones pointed out, with the expansion of turnaround in Europe is another cultural difference between the UK and the Continent. The opinion of turnaround organisations held by some in the business communities around the EU is not as complimentary as it is in the UK. The term ‘vulture capitalists’ has been coined to describe providers of turnaround finance, who invest in distressed companies and reap large benefits later on. There is a growing concern surrounding the large returns generated by turnaround financiers, which is accompanied by a perception that they are merely rapacious opportunists. German ex-chancellor Schroeder famously denounced American turnaround funds as ‘parasites’.

Getting in there early

Langbar is of course an extreme rarity. Most businesses will not have to concern themselves with the implications of £365 million cash assets going astray. But all businesses can struggle, and for a whole host of different reasons. One aspect of business turnaround that all our commentators emphasised was the importance of an early intervention. Nick Ferguson said: “The culture is very much to try and save the business, and the earlier a business can receive the benefits of the skill sets of a turnaround professional, the less risk there is of that business going down the tubes.” Chris Wallis agreed: “One of the things that we are actively promoting at the moment is a non-executive director service. So we would talk to the banks and the shareholders, and if they have any concerns they can put us on the board for three months or six months or however long they want, so that we can affect a turnaround from the inside. The big problem from our perspective is that a management team in denial is really only prolonging the inevitable. Seeking advice early is the most important thing. Boards and management teams have to be more willing to approach their professional advisors whether they are accountants or lawyers. If a management team went to their lawyer, even if he or she doesn't have the answers, the chances are that they will know someone who does. There is still such a stigma in the UK attached to asking for help.

The future of turnaround

The inevitable consequences of an economic downturn are that more and more companies will become distressed and go into decline. Whether or not those companies also go into insolvency depends very much on the input where applicable, and where solicited, of professional turnaround specialists. The seemingly inevitable consumer slowdown might augur difficulties for several retail groups. MVC, Kookai and Unwins are three retail chains that have recently gone into administration. There seems to be a likelihood that more will follow.

Grant Jones predicts that the changes to the Pensions Act will cause difficulties for larger corporate entities. "There will be a lot of corporate failures because operationally sound companies are going to have big problems meeting the new pensions criteria. The original pensions act would have been very anti-turnaround culture, but changes were made to it after pressure from various elements within the government and the civil service. So that will be another change. We are going to see government pressure to assist in turnarounds, so it's going to be politically correct to approach turnaround. We will see more pressure from government and civil servants to advance the turnaround culture."

Neil Chesterton sees a continuation of the growth in the turnaround market. He warned however that this is not necessarily totally positive. "At the moment, turnaround is a buzzword that is used often during insolvency. And a lot of people only really pay lip service to the fundamental concepts of turnaround practice. There are, unfortunately, a number of people operating at present with the claim that they are turnaround specialists, who are really just entering into terminal situations for the fees that are generated."

The need for regulating the profession of turnaround was recognised towards the end of the 1990's, resulting in the establishment of the Society of Turnaround Professionals in 2000. STP is the sole accrediting body for turnaround professionals in UK and the rigorous entry criteria are reflected in the fact that it only has 162 members countrywide. Increasingly, business and public entities requiring the intervention of a turnaround practitioner call for professionals with STP accreditation.

With regulation in place, a fair availability of finance, and a number of qualified practitioners operating, the future for turnaround in the UK looks bright.