Groves & Partners

BUSINESS TURNAROUND

AN INTRODUCTION

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INTRODUCTION

In this document I provide an overview of business turnarounds. In doing so, I have endeavoured to answer a number of common questions that I am asked, specifically:

1. What is a business turnaround?
2. What is the difference between a turnaround and a restructure?
3. What are the stages of a turnaround?
4. What factors are important to the success of a turnaround?
5. What are some of the common symptoms of a business in distress?

I trust that this document will assist with providing answers to some of these common questions.

WHAT IS A BUSINESS TURNAROUND?

Turnaround is the management-led financial recovery of a business in significant decline. Turnarounds are a program of business improvements designed to return a distressed business to stability. Once the business is stabilised, it then has a platform for future growth and long-term viability.

Turnaround exists as a preventative measure to avoid insolvency. When a business is experiencing distress, early action by the directors is required to preserve value in the business. Other jurisdictions (particularly in North America), have vastly different insolvency regimes which allow the directors to maintain control over the distressed business (i.e. Chapter 11).

In recent years, Australian business owners and their advisors have increasingly sought the help of turnaround experts to implement informal measures designed to rescue their business. A liquidation will invariably leave the directors and business owners with nothing to show for their investment and years of hard work.

Business turnaround is usually assisted by a **turnaround expert**. The process undertaken by a turnaround expert usually involves a top-down review of the entire business to diagnose the problems the business is facing, and working with the directors, management and other stakeholders to rectify the issues.

At a high-level, a turnaround expert will assist the directors and management in directing resources to the areas of the business that can secure the survival of the business, and away from the areas of the business that are draining profits and cash flow.

TURNAROUND VS RESTRUCTURE

"Restructuring" and "Turnaround" are terms that are often used interchangeably. Generally, **restructuring** is a range of formal insolvency processes aimed at helping a business which is in financial distress. Businesses which are experiencing severe financial distress have historically used the Voluntary Administration regime to restructure their business and avoid a Liquidation. However, there is a growing number of businesses which are seeking to informally restructure their business.

Legislators and industry have already contemplated this change in market sentiment with recent changes to the Corporations Act 2001, including new provisions for directors to seek "safe harbour" (*Corporations Act 2001 section 588GA*). In addition, the Federal Government has also recently introduced new measures for small businesses with debts under $1 million to enter into a voluntary restructuring plan. Both of these measures are similar to "debtor-in-possession" models seen in other jurisdictions. "Debtor-in-possession" has the effect of allowing directors to continue trading an insolvent company, provided the courses of action and restructuring plan are reasonably likely to lead to a better outcome for company's creditors.

There are a number of potential reasons why a business and its directors may not want to initiate formal restructuring proceedings:

1. The directors wish to maintain control over the outcome of a business exit;

2. Ipso Facto clauses, which provide counterparties with a right to terminate contracts and agreements in the event of insolvency (only applicable to certain insolvency appointments);

3. Director's personal guarantees to suppliers or financiers which may crystallise in the event of an insolvency;

4. Director's personal liabilities to the Australian Taxation Office and other statutory debts which may crystallise in the event of an insolvency; and/or

5. The directors wish to avoid the negative implications of an insolvency event, which may adversely impact customers, suppliers and employees.

Formal insolvency proceedings such as Voluntary Administrations or Deeds of Company Arrangement can be effective tools in alleviating the financial pressure on a business and reorganising its affairs while the business continues to trade. However, they do not ordinarily contemplate fixing the business problems which have led to insolvency. The Voluntary Administrator has no statutory or fiduciary obligation to solve the problems in the business or implement a turnaround. In addition, the Voluntary Administration period is limited to a 4-6 week period under legislation, unless an extension is granted by the Federal Court. This may not provide adequate time to implement a business turnaround.

Turnaround experts look further than numbers and corporate structures. They take a holistic approach to the business, and work with the directors and management to develop a program of strategic, operational and financial initiatives to turn the business around and ensure it returns to profitability. Turnarounds are generally more operational than a restructure, with a hands-on approach required from the turnaround expert and management. A turnaround expert will invariably have restructuring skills, but it is only one tool in their turnaround toolkit.

WHAT ARE THE STAGES OF A TURNAROUND?

Turnarounds vary in length depending on the size and complexity of the business. They will usually last from anywhere between 90 days to 24 months. Given the business is in distress, Turnarounds need to be performed expeditiously and with the help of an expert. Engaging a turnaround expert will greatly assist the directors in making timeley and informed decisions.

A turnaround expert will provide strategic, operational and financial advice and assist the directors and management with implementation. Generally, there are three distinct phases of every turnaround:

1. **Diagnostic review of the business** – the turnaround expert will be engaged to perform a top-down review of the business to assess the level of distress and diagnose the critical business problems. This will often include analysis of the financial health of the business, identifying where there is leakage of cash and other resources, and an initial assessment of action areas for the directors and management.

2. **Action plan** – the turnaround expert will work with the directors and management to develop an actionable turnaround plan. The diagnostic review phase may determine a number of initiatives, however, some may not be achievable depending on the level of business distress. The turnaround expert will assist the directors in prioritising the initiatives which are actionable, profitable and time sensitive.

3. **Implementation** – the turnaround expert will assist the directors and management with executing the turnaround plan and tracking progress. Sometimes the turnaround expert will sit in the business to ensure the action plan is implemented, or otherwise provide the directors with ongoing high-level support. All of this depends on the size and complexity of the turnaround, and the ability of current management to execute the turnaround.

WHAT FACTORS ARE IMPORTANT TO THE SUCCESS OF A TURNAROUND?

Turnarounds are vastly different depending on their size and complexity. The turnaround initiatives which work for one business, may not work for the next business regardless of whether they are in the same industry. However, there are some factors that are critical to success, which are likely to be applicable to every turnaround journey.

In my experience facilitating turnarounds, and based on research within the market, these six factors are key to the success of a turnaround:

1. **Engage an expert** – having an experienced turnaround advisor in your business is essential to any turnaround. Not only will they provide expert advice, but they act as a sounding board and help coach management through the transformation. Sometimes the biggest impact an expert turnaround advisor can have is in alleviating some of the pressure on the directors, helping them make decisions and prioritising resources.

2. **Act fast, move fast** – when a business is in distress, the directors must act fast to avoid an insolvency event. They need to put their hand up and get the help needed to continue with their business. The earlier that help arrives, the more likely the turnaround is achievable. The same goes for decision-making, with initiatives and options needing to be analysed and executed swiftly to successfully change the trajectory of the business.

3. **Plan for success** – planning is a critical part of the success of any business. Adequate strategic planning of your business turnaround will allow you to have greater visibility over the financial outcomes of your turnaround initiatives. Furthermore, it will allow you to share these plans with management to obtain their buy in.

4. **Cash is king** – you've probably heard this phrase mentioned in a lot of business scenarios, however, it is much more critical in a turnaround. I like to compare cash in a business to oxygen in the human body – without it, you will not survive. Turnaround initiatives will need to be funded by some form of cash flow, so it is important to wring out as much cash as possible from payables, receivables, inventory and fixed assets.

5. **Focus on your core business** – business coaches and business growth advisors will often advise clients to diversify their business and enter into new markets or products. In a turnaround, the opposite is key – refocus on the core business, what you do well and what makes you money. This is often as simple as a change in strategic mindset, but can also be as drastic as divesting a business unit or discontinuing product offerings.

6. **Management needs to buy in** – a successful turnaround cannot be achieved without the agreement and acceptance of the turnaround action plan by directors and management. Management have the ultimate responsibility to execute turnaround initiatives at a

granular level under the guidance of the directors and the turnaround expert. If these stakeholders are disillusioned or unmotivated, it will adversely affect the success of the turnaround.

WHAT ARE THE COMMON SYMPTOMS OF A BUSINESS IN DISTRESS?

There can be any number of syptoms of a business in distress. However, it is important to distinguish between business problems and symptoms of business problems. Symptoms are indications that there is a larger problem which needs to be addressed. In the context of a business turnaround, there are a number of common symptoms which assist existing advisors and directors in diagnosing the need for a business turnaround (all or one may be applicable):

1. The business is making significant or sustained losses;
2. Overdue tax debt or ATO payment plans;
3. Inability to pay suppliers in a timely manner;
4. Operating costs are too high and eroding profits;
5. The directors have no short, medium or long term solutions to cash shortages;
6. The business is in default with its financiers, or otherwise expected to miss repayments;
7. The business owners lack strategic or financial direction; and
8. The directors are working harder, but improvements are not being realised.

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