THE BANKRUPTCY STRATEGIST

NOVEMBER 2017

# Recognizing the Signs of Financial Distress

By Steven Strom

Financial distress is when a company is vulnerable in its ability to maintain its financial commitments related to operating expenses (*i.e.*, timely vendor payments, leases and payroll), debt holders (*i.e.*, lenders, noteholders), and capital expenditures.

Payment disruptions in the regular course of business can negatively affect both sides of the balance sheet. Operating statement disruptions manifest with challenges in customer retention, decrease in revenues, loss of key employees and eventually a long-term decline in financial performance. Balance Sheet impacts can be seen and felt as there's a shift from a cash flow valuation to hard asset and collateral valuation. This can be hard for a company to digest when your lender is underwriting your collateral based on liquidation analyses. These balance sheet changes will also impact your ability to attract fresh capital, and if it continues to deteriorate, could result in a default in credit agreement(s).

If left alone, the longer-term impact may be insolvency or a bankruptcy filing. Diagnosing financial distress, and the ability to address the relevant issues, is a necessary role of board members and senior executives.

**A Theoretical**

Before we look at the types of distress, how to measure it versus how the capital markets measure it, and some of the tools and solutions a company has to address the issues, we describe a theoretical progression of how things can unfold using the common strategy of denial.

As the first-quarter EBITDA target is missed due to "temporary market softness," bonds trade down from 99 to 91, and now have a yield to maturity of 10%. One of the large anchor buyers sells half of its position at that level. The stock also declines from $12 per share to $8. There are a lot of long faces as stock options and vesting shares to management are cut in half in a day. "Hang in there guys, stay tough!" one of the directors emails the team after the call. The leverage of the company jumps only a little, but only because the last 12 months has three good quarters of EBITDA and just the one "miss." Stress appears.

A lower-tier investment bank calls the CFO to ask if the company would be interested in doing an ATM. "No way," responds the vigilant CFO, "this is temporary and issuing stock now is crazy." The management team decides to accelerate spending on a new research project to show the market their bullish outlook.

A second quarter of "down EBITDA" is reported, and the bonds trade at 84, providing a yield to maturity of 13%, more than 1,000 basis points above comparable treasury securities. Distress is manifest. Another original holder sells its entire position. The company stops providing guidance to the street, since "they seem to be taking a very negative tone" and keeps asking how the company will fund capital expenditures next year; someone even asked about a bond issue that doesn't mature until 2019. Management "battens down the hatches" and stops talking altogether.

There is no more guidance and no conferences for the coming quarter. The CFO tells bondholders in private calls, “everything is fine, really — I really think the market has over-reacted.” Denial strategy is now in full swing. A restructuring lawyer from New York has the nerve to call the general counsel and ask if she can help, and a few pesky restructuring boutiques are calling and emailing.

Now, just before the end of the third quarter, the bank lender gets involved. The relationship officer is accompanied by a new person from “Special Assets” in an in-person visit. The new person asks about the projections, and if the company is concerned about a “going-concern opinion” for the next audit, since it’s likely, if this trend continues, that there will be a covenant breach in two quarters based on the lower EBITDA. Management dismisses the audit concern; “We’ve got projections showing everything is good.”

The CFO also throws an arm around the relationship banker’s shoulders, and asks to postpone the next measurement date. He also requests a covenant holiday for two years “until this market sorts itself out.” Meanwhile, the company also holds a party for clients as it moves into a new building owned by the CEO, who made $8MM last year.

“Way to go, Johnny!” shouts the director before the board meeting. “The new digs are great. Can’t wait for the market to turn and we can buy the property next door as well, so we can build a research center.”

The head of operations announces his resignation just before the board meeting, and the CFO is sorry to report a third “underperforming quarter.” “But we are in transition,” the CFO notes with optimism, even though the market appears to be weak and it’s not clear now when there will be a recovery. But the management team is “on it” and will begin considering some cost-cutting measures to address the problem.

The market looks at the new quarter and sees that numbers are so bad that the EBITDA run rate is now less than the cash interest. Now, the market begins analyzing how long the existing cash will last. Unfortunately, the market also begins to consider that the company will now require drawing on the revolver to pay the bondholder’s semiannual coupon payment in three months. “Good thing we’ve got a good relationship with the banks,” the CEO tells the board. The CFO remains confident about his relationship with the lenders.

The board meeting agenda goes on as planned — new research facility, still trying to fill some key management slots, competition appears to be facing headwinds in the market. There’s not much focus on the numbers and how the balance sheet and income statement relate to one another. But when someone asks about the declining cash balance, there is some uncomfortable discussion about having to use the revolver to pay bondholder interest. “Hey, let’s check on that equity raise idea from a couple of months ago!” cries one of the directors. The share price is now $2.00 and the stock exchange just sent a de-listing notice. “How about telling the bonds they need to PIK the next coupon so we can get thru this period,” geniuses another director.

The next day, Moody’s announces a new rating for the bonds: CCC- with a negative outlook. And the last remaining original bondholder calls to say it’s sold out of its position completely; a New York distressed loan-to-own player probably bought the bonds. Bonds are now trading now in the low 50s.

The banks send the company a notice citing covenant violation, and freeze the revolver. “Well that’s not good — what the heck? How did this happen so fast?” asks the CEO. Now it will be a restructuring.

As a company progresses from a temporary disruption into stress and then swiftly into distress, you can see how its options quickly diminish.

Now, let's look at the types of distress, how to measure it versus how the capital markets measure it, and some of the tools and solutions a company has to address the issues during times of stress.

**Three Types of Financial Distress**

***1. Event-Driven Distress***

An extraordinary event impacting operations or the capital structure, such as losing a large customer or contract, threatened litigation, merger integration failure, or new product launch failure. These can be the most challenging to acknowledge since management may think the issues are temporary.

***2. Cyclical Distress***

A type of distress that impacts an entire industry sector due to a common factor. The energy industry experienced this with low oil prices, shipping companies experienced this with excess supply, retailers experienced this with less foot traffic, and the airline industry when fuel prices were high. Cyclical distress is easier to observe because you see headlines ("Oil prices decline again"), but the challenge remains for the board and management to take action to address the potentially negative impacts on both sides of the balance sheet.

***3. Systemic Distress***

Speculation here runs wider. An example would be during the 2009 financial crisis, where access to bank credit was limited on a broad basis. Multiple industries, entire regions and even countries were affected. Depending on the degree of severity, acknowledging the financial distress may also be challenging: "Our bank has always been there and we expect they always will be." Ignorance may not create bliss.

These three types of distress may happen on an isolated basis, or may happen simultaneously.

**Typical Causes of Distress**

Financial distress manifests itself as the synchronicity between the left and right side of the balance sheet no longer match from a valuation and cash flow perspective. Typically, financial distress occurs with the simultaneous presence of two factors, both directly related to one or more of the three types of financial distress discussed herein: event driven, cyclically driven or systemic.

Poor performance is a subjective measure of how well a firm uses assets from its primary mode of business to generate revenues. Poor performance itself may have several causal factors that impact a company's key performance indictors (KPI), a measurement of a company's health and performance. A decrease in top-line revenue may be the result of the loss of a large customer, or the contraction of an industry that directly impacts your ability to utilize assets — whether people, inventory, equipment or real estate. A decrease in revenue eventually results in a deterioration in operating margins, loss of key employees, customer relations issues and eroding market share, ultimately resulting in a negative impact on free cash flow and liquidity.

Once the left and right side of the balance sheet become imbalanced, a company has a reduced ability to access required funding to operate the business. As a company's cash flow deteriorates, its ability to access debt moves from a cash flow-based analysis to a hard asset-based valuation. It may be disconcerting when your lender is underwriting your ability to access debt via a liquidation analysis of your collateral. Your availability of funds will max out based on this asset valuation and you will have no additional collateral to pledge and attract new sources of funding. Too much debt also limits a company's ability to attract new equity capital, whether public or private.

Poor performance and reduced availability of funds negatively impacts your access to the capital markets from an underwriting and risk-reward perspective. If action is not taken early, equity value disappears and your focus switches from growth to maintaining the value of your collateral. This happens quicker than you think.

**Measuring the Level of Financial Stress or Distress**

The severity of financial distress is usually characterized subjectively by the likelihood, quantum and timing of non-payment. In the case of stressed companies, balance sheets that may someday experience a payment interruption or a small debt issue with near term maturities, the condition may be referred to as stressed. In a distressed scenario, as the quantum of debt at risk increases and the prospects for non-payment increase (usually associated with financial performance at less-than-budgeted levels) companies are more appropriately categorized as distressed.

Shareholders of publicly traded companies, and bond investors watch several factors to determine the presence or level of financial distress. Typical metrics include analysis of top-line revenue, EBITDA and free cash flow, as well as disclosures about off-balance sheet liabilities or potential changes in funding sources (such as redetermination of revolvers in natural resource borrowers) that may impact liquidity and the ability to make future payments to necessary stakeholders. When there is uncertainty about a company's financial prospects, securities prices go down.

Companies experiencing poor performance, or with poor prospects, typically require higher returns. As a result, bonds often trade at discounts, and stock prices decline. For credit markets, the market generally measures financial distress as debt trading. In today's markets, if a bond is trading with a yield above 15% it's more likely to reflect a value to work-out than a yield-to-maturity. For private companies not reporting their financial performance, markets look to S&P and Moody's ratings.

The downgrade to any C-handle rating, or withdrawal of ratings, is a sign of distress. Depending on the balance sheet (*e.g.*, financial services) a decline to less than investment grade can create major uncertainty. Having to repeatedly reset covenant levels or "amend and extend" can indicate serious financial distress. Senior management is easier to lure away as stock prices decline and the shovel needed to dig out of the current hole gets bigger.

Many of these signs are relatively easy to spot, but often dismissed by directors and others for a variety of reasons. In some circumstances, directors and officers of highly leveraged companies don't want to hear about restructuring ("it's too early." "we're not there yet," "we have liquidity," "the market is turning") or they have a strategy to "brave through" the difficult period. "Damn the torpedoes," "Nuts" and a series of similar denial-related war cries are often heard. And that is how companies begin to slip from stress to distress, and ultimately into restructuring mode — not always with a bang (that insiders, management and directors can hear), but with a whimper. A little bit at a time, week by week, the ability to change things fades away.

If the signs of distress can be recognized, then corrective actions can be taken. Companies slipping from stress to distressed have alternatives. These may not seem attractive at the time unless they are compared with future scenarios that consider “lower longer” market conditions.

**Solutions**

The sooner the cause of financial distress is diagnosed, the more effectively it can be addressed. Typical ways of addressing a mismatch between the left and right sides of the balance sheet include:

- Expense reductions;
- Laying off employees;
- Revising the operating strategy;
- Asset sales/closing unprofitable locations;
- Proactively approaching lend- ers about revising credit terms;
- Exchanging debt at a discount or for longer-term maturities;
- M&A/sale of the company;
- Alternative funding for working capital;
- Raising equity (even at a “low” price); and
- Bringing on a new strategic capital partner or financial sponsor to provide additional equity.

Here is a short list of things that should trigger further consideration of talking with a restructuring professional:

- The Company suddenly fully drawing down on its revolver;
- The Company receiving calls from new debt holders requiring discounts or higher rates of return;
- The Company receiving calls from restructuring professionals requesting an introductory meeting;
- Bond debt trading at a spread of more than 1,000 basis points versus comparable maturing treasuries;
- Bond debt that is trading “flat” without automatic accrual of the interim coupon payment;
- An active and widening market for credit default swaps or no access to credit insurance for suppliers;
- Bank debt that begins trading, especially during solicitation of an amendment;
- Stock trading down significantly or being delisted from an exchange;
- Multiple sell recommendations for debt and equity by research coverage (but the absence of sell recommendations does NOT that guarantee all is well);
- Research coverage initiated by special situations, distressed analysts and distressed trading boutiques;
- Coverage of the company by Debtwire; and
- A developing or an active market at a discount to par for trade claims of the company

***** **Steven Strom** is CEO at Blackhill Partners, an investment bank. The author gratefully acknowledges the assistance of his colleague, **Lynne Long**, for her valuable insight and perspective in the preparation of this article.