Addressing Early Signs of Financial Distress

The situation

Operational challenges have delayed again a Voltco from reaching their stated production targets of the new Model X. As a result, revenue is less than market analysts expected and the company is still cash flow negative. The stock price declines 8% upon announcement of the earnings.

The earnings call

Despite these conditions, the earnings call was going smoothly for, the CEO of Voltco until the second question was asked by one of the equity research analysts. Bill Jones, a noted market cynic who was *only* neutral on Voltco's stock and seemed to be moving towards issuing a sell recommendation asked the CEO mildly, "Frank, with these market conditions and the operational delays, do you anticipate the need to raise any additional capital this year?" There's an awkward pause. Silence.

Then, Frank breathed in and slightly puffed his chest in preparation for a bold, decisive action intended to appease the bulls on the call. Those bulls needed inspiration and a leader, especially since Voltco's stock was already down 8% this morning since the earnings were released on the newswire last night.

Must. Keep. Stock. Price. Up. Even though there was risk. And Voltco maybe needed to raise capital. But not "down here" at this price. No way, thought the CEO. No way.

"No. I'm not raising capital right now. We believe we can manage thru the storm. No new capital is required."
The analyst responds with a statement posed as question, "So you are holding your own?""
"Yes," he states confidently, "We are holding our own".

The research analysts report

The research analyst had already drafted the headline and was adding in a few quick notes to finish off the sell recommendation on Voltco. The headline of the recommendation read, "Voltco declares 'We are holding our own'[1] : Sell now before it sinks like the Edmund Fitzgerald". Thirty minutes after the report was out trading was halted after the report as the stock was not able to open again that day due to selling pressure.

[1] Those words were the last transmission before sinking of the SS Edmund Fitzgerald, the freighter that sank in Lake Superior in 1975 with 29 crew aboard.

Actions to avert a crisis

Analysts questions can put management teams in an awkward position forcing real time decisions on towing the line versus going into elaborate detail on everything that could go wrong. While investors relations, lawyers and other professionals can help craft a message to accompany tough news, management and boards can take their own action behind the scenes to avert a crisis.

Here are some actions that can increase optionality and help to prevent financial stress or distress from leading to a necessary restructuring and are applicable especially in circumstances when there is uncertainty about liquidity and the viability or attractiveness of future financing plans.

1. **Be open to hear the market's perspective and to recognizing the signs of financial stress.** Being tone deaf to markets simply is not a strategy, especially if a company may need to access the markets for additional capital. Listening and being perceptive to changes in the investor base, their questions and concerns as well as prices are all fundamental concepts. Being able to address investor concerns head on is preferable to stonewalling or simply avoiding the conversation.

2. **Bolster the team: Recruit to the board an independent director experienced in stressed, distressed or balance sheet restructuring situations.** Independent directors bring perspective from a process point of view—when should turnaround or restructuring advisors be considered. Which firms? What scope of work? These are specialized areas where independent directors can help the board with an experienced perspective.

3. **Begin to educate the board and senior leadership team on a range of restructuring strategies, processes and issues.** Interview professionals, ask trusted advisors, research competitors and other situations for relevant professionals, strategies and methods. Look outside, not just in, for answers.

4. **Develop and maintain a detailed 13-week cash flow model and understand the risks to maintaining adequate liquidity.** A 13-week cash flow is the compass of any company in distress and serves as a guide to how much runway exists before there is a payment default and also identifies payments or cash flows that may vary or be ripe for deferral. Also consider monthly cash planning over longer periods.

5. **Develop contingency plans including alternatives for accessing additional capital. Consider that market conditions and investor perceptions of risk can change quickly**. Markets can change overnight and investor sentiment can too. Contingency plans may

range from knowing what firms are good at alternative capital (not necessarily the same ones that did your last, higher-rated bond deal), having an idea of the private equity interest in the sector and the financial position and resources of competitors.

6. **Be prepared to provide transparency and detailed responses to third-party financing sources or relevant stakeholders subject to appropriate confidentiality or standstill agreements.** Scrutiny by investors providing liquidity ranges from practically nil in some underwritings to extreme in more troubled circumstances. Once the questions begin, companies may be placed under increased scrutiny by new investors to prove the investment thesis or turnaround story. "Trust me we got this" is not an investment thesis. Written turnaround plans with cash flow implications are a best practice in these situations and likely to be a demand of many new money sources.

7. **Be realistic, keep things in perspective and consider getting help from experienced professionals.** Is this an industry wide phenomenon that is impacting investors at competitors? Or is the distress related more unique to the company? If other similar companies have experienced distress there may be already a set of market expectations for how to proceed. Understanding and diagnosing the type of distress, the best sources of capital and the financial, operational and legal strategies that are available can be complex and time consuming. There are many qualified firms with experience at developing and analyzing the strategic alternatives your company may be facing. Beginning a confidential dialogue with the right professionals can help bring reality, direction and perspective to the uncertainty.

These are some of the strategies that can enable greater likelihood of success in stressed and distressed situations and potentially keep them from becoming restructurings.