Bain Corporate Renewal Group



Challenges and Opportunities in Today's Economy

December 3, 2008

To recap: the economic environment is deteriorating rapidly and companies need to take action

- U.S. speculative grade **defaults expected to spike** from a low of 21 in 2007 to ~95 in ‘08; 160-190 in ’09; and 120-140 in ’10
- Acceptable **leverage ratios should drop** to historical averages of ~4.5X, from a peak of 6.2X in 2007
- High yield market will see over **50% CAGR in maturing issuances** over the next 4 years, rising from $28B to $100B in 2011
- Negative **trends are most pronounced now in consumer sensitive sectors:** CPG, autos, housing, retail/restaurants, and media & entertainment
- Declining leverage and poor economic conditions place a premium on preemptively **managing all businesses as if they are facing a liquidity crisis** to build cash balances
- For companies already in distress, **a singular focus on cash, communication, and control are critical** for stabilization

Economic situations can deteriorate quickly from any number of triggers; without cash, time is the enemy

Management teams slow to adjust to a crisis environment …

- Management believes they can manage out of the crisis despite repeatedly missing forecasts
- Underestimation or denial of the severity of the situation
  - Reluctance to take aggressive, early actions
  - Protection of 'sacred cows'
- Relationship between management, lenders and Board is strained

…the slow reaction furthers the downward spiral…

- Financial and operational issues are interrelated and can adversely impact one another
- Bad news leads vendors and customers to take actions that worsen the situation
- Options shrink as time runs short and/or lenders take control
- Sector distress means the first to monetize assets will get best – maybe only – value

… and there is no 'silver bullet'

- It's very difficult to grow out of a liquidity crisis in a weak economic environment
- Likewise, cost cuts alone can't stop spiraling EBITDA declines
- Balance sheet changes are almost always a part of the solution – in, or out of court

Specifically, options for recovery narrow dramatically as time progresses if nothing is done

EXACT TIME PERIODS WILL VARY

6 + months

- Strategy changes are possible
- Able to raise new debt or equity
- Asset sales can be done for reasonable values
- Can pursue cost reductions that require Capex or expense (e.g., severance)

2-6 months

- Harder to achieve benefit from anything but 'quick hit' changes to operations
- Expense cuts and working capital tightening are primary levers
- Asset sales can still make a difference

< 2 months

- Desperation adds price premium to new money
- Market awareness can lead to trade credit tightening and customer losses
- Lenders may limit borrowing availability

Sensitivity to crisis triggers

Moderate **High** **Crisis**

Practically, early issue identification offers an ability to succeed at strategically prospering from the downturn

A few early warning indicators…

- Revenues increase without associated profit increases
- Profits without cash or availability
- Inventory up with flat or declining sales
- Growing AR with flat or declining sales
- Shrinking backlog or slowdown in orders
- Declining unit selling price
- Reduced sales per employee
- Cost accounting that is unreliable and inaccurate
- Standard cost variances greater than normal that cannot be explained

When issues are recognized and acted on early, challenges and opportunities exist…

- **We are in a downturn which is unlikely to improve before the second half of 2009**
  - **This downturn will be longer and steeper** due to tight credit markets and all-time low consumer confidence
  - This downturn has impacted and will **impact some industries more than others**

- **Downturns present 'once-in-a-decade' inflection points for risk <u>and</u> opportunity**
  - Companies make **more dramatic gains and losses during recessions** than in good times
  - Sector performance does not fully explain performance – ***company strategy and execution matter***

- **Companies that survive/thrive** in a downturn will:
  - **Create flexibility** to weather the next 6-12 months **while continuing to invest** against longer-term opportunities
  - **Fine-tune their action plan** based on the sensitivity of their industry to this downturn <u>and</u> their current strategic and financial position

Early stage distress: best practices

1. **Rapidly build picture of future cash flows and covenant risks**
   Cash and availability is business oxygen
2. **Take early, aggressive and comprehensive action to build cash**
   Costs of over-reacting outweighed by impact of default
3. **Establish a structured process for distress management**
   Focused team, senior leadership, high frequency of interaction
4. **Prepare to revisit recent major business decisions**
   Strategy and/or operational 'U' turns may be needed
5. **Modify approach and team as liquidity crisis is resolved or evolves**
   Early stage intervention can be kept small, 'below the radar' and prevent a crisis; latter stages become very public and involve many constituents

An approach for capitalizing on inflection point opportunities in a downturn are provided in the later section on renewal

Sadly, the norm of late issue identification narrows options to near term survival tactics and sustainability

Obvious, late indicators…

- Depressed markets
- Declining sales / "surprise" losses
- Shrinking margins, particularly if on higher
- Operating losses
- Cash availability diminished
- Covenant coverage in danger of or not being met
- AR growing/aging
- AP growing/aging
- Ineligibles climbing

When recognized late, options constrict…

As distress deepens, the focus needs to tighten from:

A. proactive management (sustainable, opportunistic growth i.e. physical therapy)

to

B. crisis management (survivable, stabilization i.e. ER triage)

Research has shown that survival depends on correct focus

Late stage distress: cash, communication, control become the mantra for survival and sustainability

B

1 **Cash**

Without short-term cash, there is no survival; profit/long term come second

"…where the knowledge of what the right thing to do exists, we still to frequently fail to do it…"

Gawande, Atul. Complications: A Surgeon's Notes on an Imperfect Science. 2002. 236, 238.

2 **Communication**

Overcommunicate to and enroll all key constituencies who impact cash

"Transparency builds credibility, the only currency available for negotiating through this crisis."

Anonymous workout officer in admonishing a delinquent credit regarding repeatedly poor reporting

3 **Control**

Consistent and relentless focus on and reward for a few, meaningful KPIs

"That which is measured if focused on, that which is rewarded is done." (paraphrased)

Kerr, Stephen. 1975,1995. "On the Folly of Rewarding A While Hoping for B." Academy of Management Journal

Under severe stress, our ability to process complex information diminishes, perceptions distort, and focus narrows to "the one thing [we] consider most important, and it may be the wrong thing."

Gonzales, Laurence. Deep Survival: Who Lives, Who Dies, and Why. 2003. 39.

Liquidity crisis management typically includes seven primary initiatives run simultaneously and iteratively

Reports to:
- PMO (blue)
- CFO/CEO (yellow)

Steering Committee

Program management office (PMO)

IR / Communi-cations

A — Cash Flow Modeling and Management
- Build model
- Maintain and improve model
- Build DIP model, if needed
- Interface with creditor consultants
- Manage daily A/P

B — Expense management and cash generation
- Eliminate all discretionary expenses
- Reduce non-essential personnel
- Identify improvements to W/C
- Identify quick hit cash benefits from operations

C — Asset Monetization
- Identify non core assets and begin process to sell
- If needed, prioritize core assets for possible sale
- Manage sale process

D — Business Plan development
- Build or update future budget and link to cash model
- Build or update future business plan
- New plan is likely to involve closures and/or consolidation

E — Legal / bankruptcy contingency planning
- Up to date view on covenants, terms and conditions of loans
- Expand legal team to include restructuring lawyers, if necessary
- Potentially initiate BK document prep

F — New financing
- Expand team to include restructuring Investment bank, if necessary
- Solicit new financing
- Interface with lenders

A Cash flow management: the rolling 13-week cash flow model and weekly variance report are a…

- Key tool to diagnose ***short term severity of a liquidity crisis***
  - Also useful as a managerial tool to control and manage cash
- ***Living document*** to be used for planning and tracked frequently
  - Model is the 'bible" for expenditure decisions and performance metrics
  - Model should be tracked weekly and variance to budget reported
  - A "13-week" time horizon is industry standard but horizon can vary
- Model based on ***receipts and disbursements***, different from
  - Revenues and expenses (as accrued on income statement)
  - Indirect cash flow (as seen on Statement of Cash Flow)
- ***Critical*** tool to understand:
  - Need for additional financing
  - Sources and uses of cash
  - Structure of the company's operations
  - Core vs. non-core divisions
  - Cash intensive areas of the business
  - Primary assets of a company
  - Split of fixed vs. variable costs
  - Areas for potential cost reduction

Cash generation and conservation: improving cash position is possible reducing costs or monetizing assets

Reduce costs	Monetize assets
• Ongoing benefit to the business' performance	• One time cash generation actions
• May be sufficient to stabilize a less severe situation	• Required to retrench in more serious cases of financial distress
• Depending on severity of liquidity crunch, may be limited to immediate payback decisions • Expense cuts, cost avoidance, and operational improvements	• Typical balance sheet plays include reducing receivables, accelerating inventory turns, as well as selling non core assets

B

Reducing costs requires modification/elimination of any non-core, non-essential service, benefit, business line*

Some examples include (in no particular order):

- Sales and marketing programs (cuts/deferrals)
- Permanent or temporary comp reductions (bonuses, management, other?)
- OT monitoring and optimization
- P-card clamp down
- T&E expense freeze
- Corporate jet sale / grounding
- Accelerating vendor rebate payments
- SGA personnel cuts
- Temporary insurance deductible increases
- Elimination of all dues and subscriptions
- Elimination or cut in ‘cosmetic’ services (lawncare, cleaning)
- Reduction in all Capex other than what is required to stay safe and legal
- Closing money losing operations

Reduction of costs must be done legally and responsibly!

* Payroll related, employee expenses/benefits, safety and regulatory compliance, and maintained

C

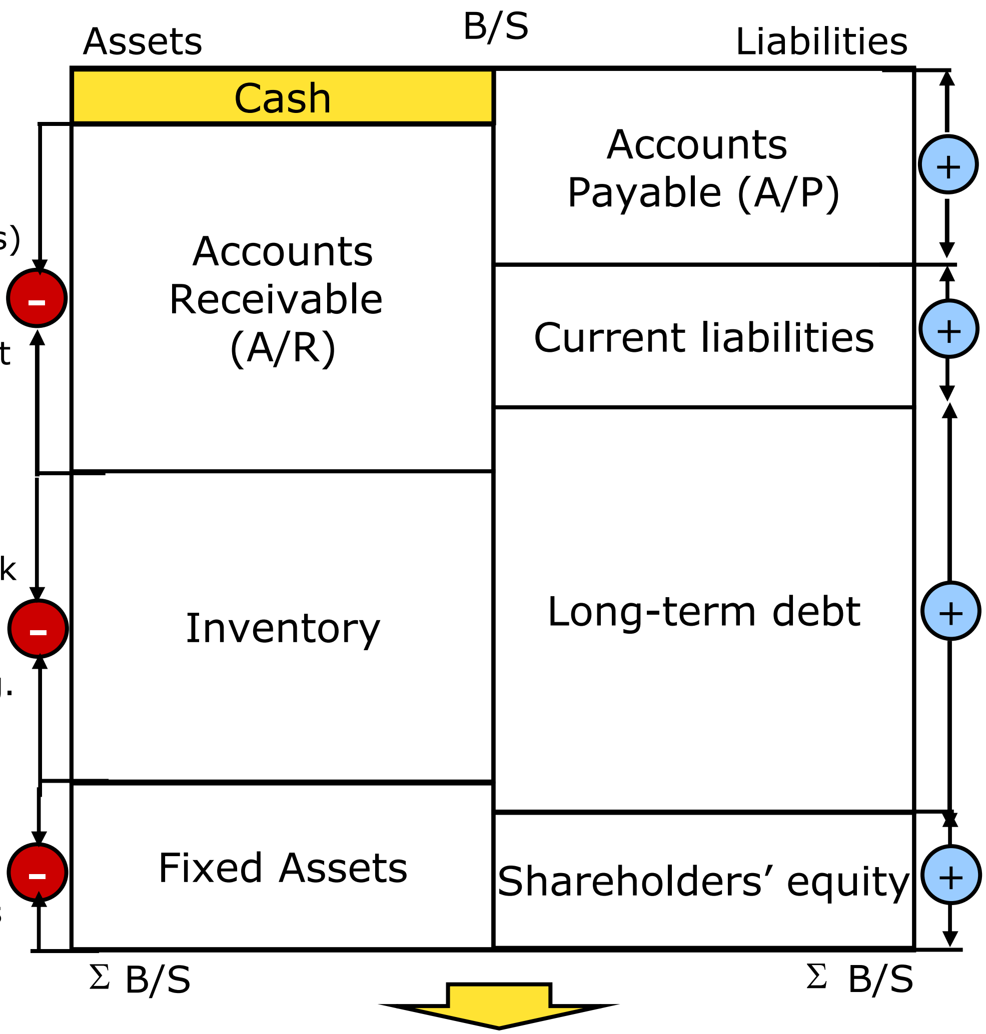
Monetizing assets can take a number of forms

ILLUSTRATIVE

- Proactively collect overdue and becoming due debtors (via key account managers)
- Use factoring of debtors
- Achieve pre-payments
- Shorten customer payment terms

- Minimize raw material inventory
- Increase consignment stock
- Reduce cycle times & WIP inventory
- Reduce finished goods (e.g. immediate invoicing)
- Move ineligible inventory

- Sale & lease back of fixed assets
- Stop/postpone investments



- Negotiate for longer creditor payment terms
- Prioritize suppliers and only pay most vital suppliers
- Use installments

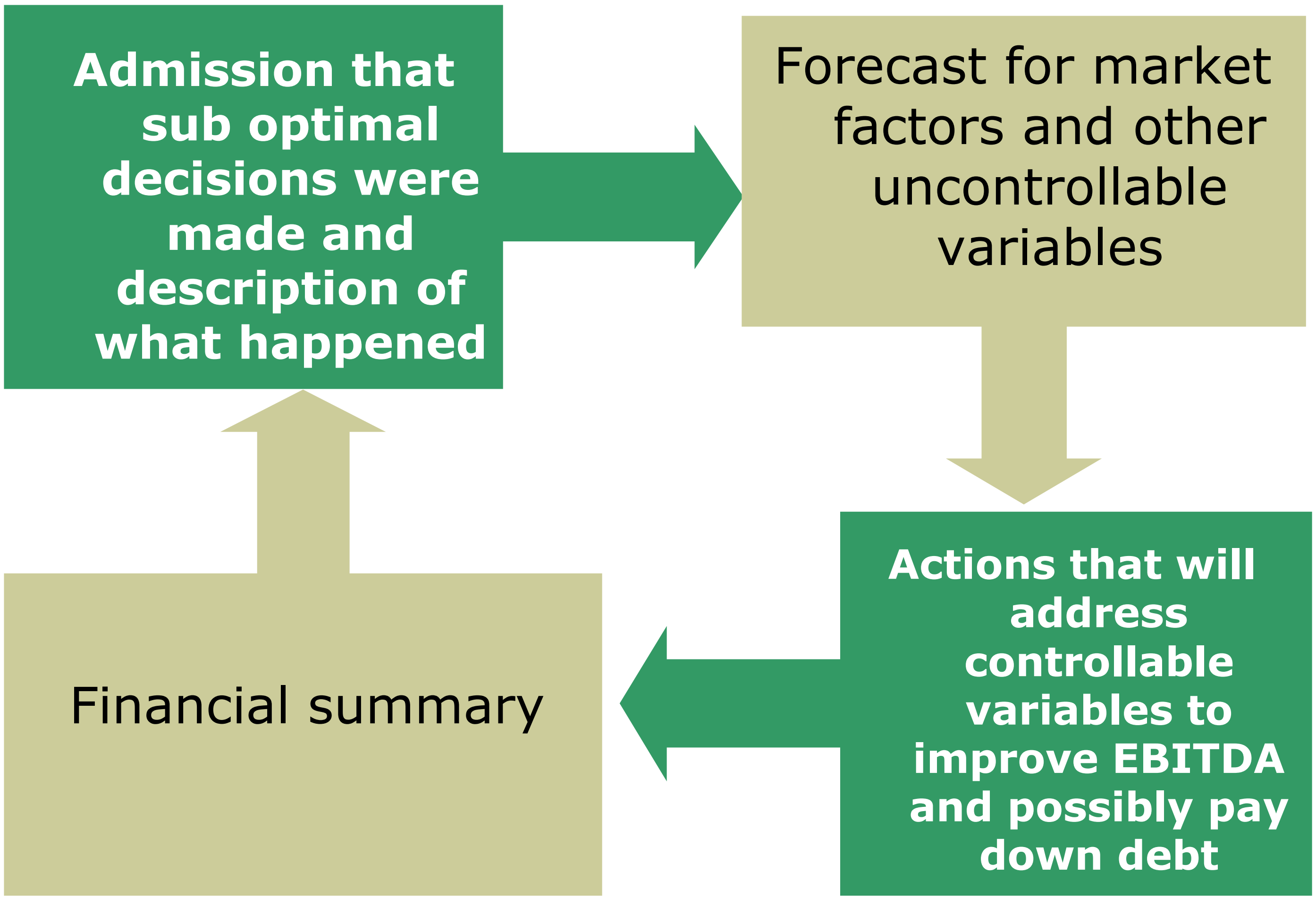
- Raise additional short-term credit lines and debt

- Raise additional mid/long-term debt

- Raise debt/equity from shareholders

Implementing requires (a) understanding if proceeds from asset sales must be used to retire debt and (b) zone of insolvency obligations

A pro active business plan is a key element of success



Key Benefits

- Serves to re-establish credibility of management
- Admission of change
- Demonstrates the run to daylight
- Protects management's ability to control outcome
- Failure to provide a comprehensive plan will mitigate trust and could result in the request for a CRO

A business plan and financial model is required by lenders and by new money

E

The legal team usually requires expansion in a crisis

- Company General Counsel and/or Outside Counsel
- Specialty Bankruptcy Counsel
- 3rd party for Chapter 11 document preparation

- Integrated legal solution for an in or out of court restructuring

E

New funds are critical but difficult to come by for any company today but near impossible for distressed firms

E

New funds are critical but difficult to come by for any company today but particularly for distressed firms

Estimated timing of credit tightness until economic turnaround

This downturn is likely to be **longer and deeper** though there is no consensus

2009 | **2010**

Q2 | **Q3** | **Q4** | **Q1**

Business Week (20-Oct)

Standard & Poor (25-Oct)

Wachovia (10-Oct)

IHS Global Insights (24-Oct)

*"It is **impossible to accurately assess the severity** of effects on the real economy from the financial crisis."*

JP Morgan, October 2008

*"What may not be so mild about this recession is its length […] that would mean the slump would have to run **through April 2009**—or **16 months**—to tie the severe 1973-1975 and 1981-82 recessions for the longest in postwar history."*

Business Week, 20 October 2008

*"The US economy appears to be plunging into what many experts believe will be the **worst recession since 1982**."*

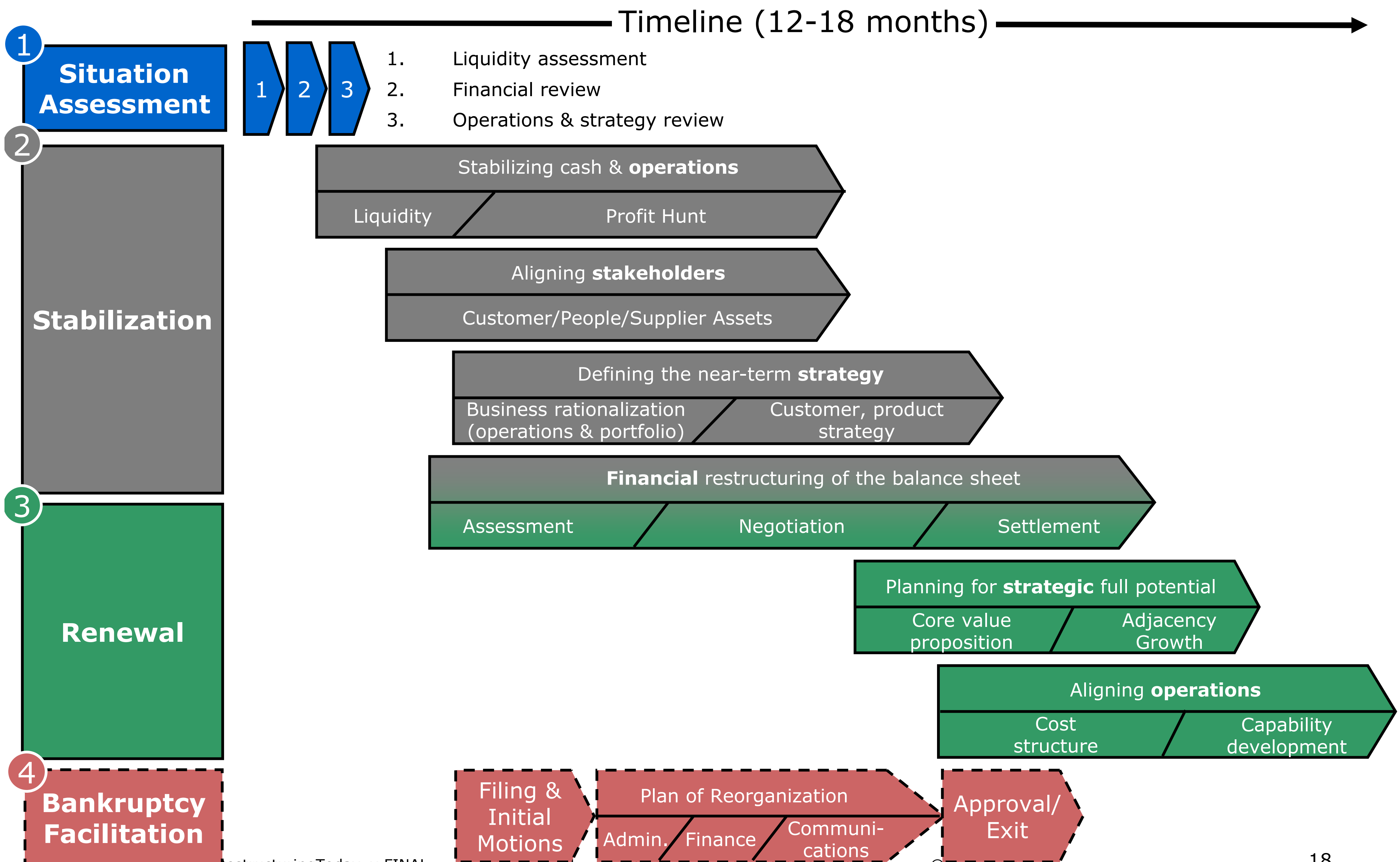
Financial Times, 20 October 2008

*"**No one thinks we are anywhere near the bottom** of this, and we're already rivaling these other recessions."*

Economist at the Economic Policy Institute, Wall Street Journal, 27 October 2008

NOTE: Projected market and financial information should not be construed as definitive forecasts or guarantees of future performance
Source: Lit Search; Analyst Reports; data as of Nov. 10, 2008

Restructuring timeline driven by liquidity requirements



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