





How restructuring can return a company to competitive strength and financial health

> Restructuring – the rule of three

Once a manufacturer veers into crisis and gets caught in the liquidity trap, it can be difficult to escape even in a lucrative market. **Uwe Johnen**, Partner at Roland Berger Strategy Consultants, shows how companies can return to health and vitality – and examines the pivotal issues involved in this process.

A glance at the personnel figures shows just how rigorously many companies have been restructured in recent years. Yet some of them are still struggling to get their performance back up to par. In many cases, past crises have left a legacy of liability burdens, while obstacles to growth still seem insurmountable. Heavy debt servicing charges and banks' more restrictive lending practices in the wake of Basel II are weighing heavily on operating business. So finding the necessary funds is becoming increasingly difficult – and is putting an ever tighter squeeze on growth.

Comprehensive restructuring includes finance too

Often, strategic and operational actions alone miss the mark. A company's finances too need to be realigned. The traditional practice of restructuring operations and strategies must go hand in hand with thorough financial restructuring. Only this comprehensive approach to the problem can really free firms from the liquidity trap and give them the breathing space they need to take action and get moving again.

Restructuring – the rule of three

When a company slips into crisis, it needs to act fast. Immediate steps must be taken. Operations must be restructured to steer the company back out of the acute danger zone. At the same time, it is important not to lose sight of the longer-term picture. Strategic realignment is essential to chart a course to sustainable profitability. Where a company has sufficient cash, this traditional approach is usually enough to help it weather the crisis. When money is running short, however, even the best laid plans come to nothing as positive effects are swallowed by declining output. These are precisely the situations where financial restructuring must complement the proven plan of action. This three-pronged attack, combining operational and strategic restructuring actions, will not have to be applied wholesale in every case. But the options and the leeway it provides should always be borne in mind.

A typical example: the reorganization of Wind, Inc.

No two corporate restructurings are based on the same parameters or follow the same course. Having said that, even the most exceptional cases still reveal certain typical patterns and unwritten rules. Our example describes what happened to an industrial systems company that we shall call Wind, Inc., a fictitious name. This case study illustrates our comprehensive approach to reorganization, highlights the difficulties that can arise and shows how they can impact the company.

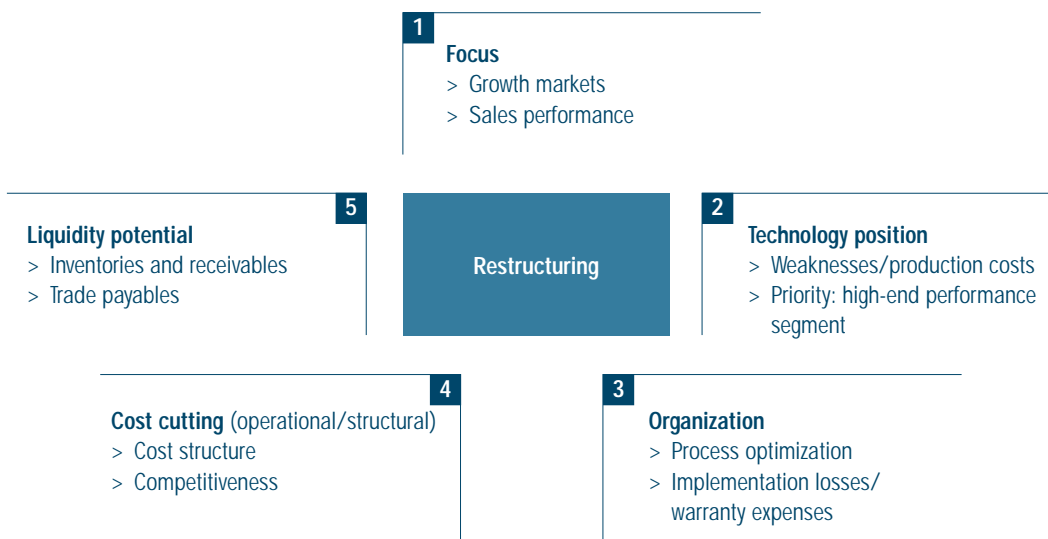
Wind, Inc. is a leading provider of wind energy plants. Its core business is to manufacture and sell these plants. In addition, the company provides after-sales service and also sells project development and project management services.

Wind, Inc.'s efforts to become the industry's technology leader had led to an ill-coordinated program of immature products. The resultant technological risks in turn translated into massive warranty expenditure to remedy damage to industrial systems. Personnel growth and uncontrolled international expansion simultaneously caused major process problems and drove up structural costs. When Germany, the company's key sales market, then slumped, operating losses began to pile up. In fiscal 2003, operational losses and provisions produced a deficit equivalent to two thirds of revenue. Equity was virtually exhausted.

Reorientation corrects past errors

The plan of action that the company then drew up in collaboration with Roland Berger was built around five key aspects. In future, Wind, Inc. would focus on attractive core markets, regain its position as technology leader in the high-end performance segment, eliminate organizational weaknesses, slash costs through a radical program of operational and structural actions, and tap fresh liquidity potential in working capital.

Five key aspects of restructuring at Wind, Inc.



Source: Roland Berger Strategy Consultants

Under the lead of a new top management team, the plan was implemented and refined in 18 months. During this time, initial plans to improve earnings by around 20 percent of total revenue had to be sharply ramped up as sales continued to collapse.

The operational and strategic reorganization measures outlined in this article are indispensable in crisis situations. They are a must if the company is to survive. In many cases, however, they are not enough – especially in the engineered products business, whose need for up-front financing and guarantees is particularly high. Even in a growing market, a company whose operations and strategies have been realigned can still fail if it cannot gain

(or regain) a share of the market's growth. Even modest performance targets are often missed as a result. In this context, banks' often rigorously restrictive lending policy becomes an impediment to growth and prevents companies from returning to profitable dimensions. Banks are often reluctant to lend more money to struggling companies. In some cases, they are not even willing to supply advance funding to cover extra orders. Having just emerged from a crisis, many firms nevertheless lack the cash resources to finance growth on their own. A coherent recapitalization roadmap is therefore the only way to break out of this vicious circle. And any such strategy must be designed in a way that demands contributions from each and every stakeholder.

Recapitalization creates breathing space

A recapitalization roadmap allows the company to tap both conventional and alternative sources of funding. This effectively puts the financial conditions for profitable growth in place. After operational and strategic actions, financial restructuring thus constitutes the third main building block as the company seeks to return to strong growth and sustainable competitiveness.

Even then, however, recapitalization will succeed only if the strategy takes account of various interrelated levers to improve the company's financial health. These levers include:

- > "Fresh money" or extended credit lines to finance growth
- > Improvements to the balance sheet structure and to relevant ratios
- > Less interest-bearing debt and thereby a reduction in debt servicing charges
- > Keeping the group of financial backers as small and stable as possible

In the case of Wind, Inc., accumulated losses on the liabilities side of the balance sheet were the reason for lenders' extreme reluctance to provide further liquidity and guarantees. This made it very difficult for the company to acquire new project business, causing both sales and earnings to plunge. To make matters worse, a shift toward more large international projects created the need for even more up-front finance and sizeable guarantees. Although Wind, Inc. stepped up its planned reorganization measures, it very quickly became clear that a boost in performance was the only way to turn the company around. It was imperative to improve the financial situation. To break out of the vicious circle, the company drafted a recapitalization roadmap and went looking for financial investors, assisted by an investment consultant and the Roland Berger network. At the same time, the company engaged in a broad spectrum of iterative negotiations with banks to explore the possibilities for future financial commitments and examine how the banks might help a new financial investor. For investors and banks, the overall package included a wide range of instruments, including capital writedowns/increases, larger credit lines, debt/equity swaps, and even factoring with a partial waiver clause.

The key tenets of the financial reorganization program for Wind, Inc. were staked out as follows:

- > New investors would acquire a qualified majority interest and would participate in the company's value growth in line with their yield requirements
- > Legacy shareholders would have to accept the dilution of their shares
- > Financial investors who withdrew would have to waive at least part of their claim on the company
- > Other financial institutions would be compensated in line with corporate performance and would increase their credit lines

This package gave Wind, Inc. greater financial room to maneuver and hence to seize market opportunities for growth.

Five key tenets of the recapitalization roadmap at Wind, Inc.



Source: Roland Berger Strategy Consultants

Persuade and reconcile

The success of such a venture hinges on the company's ability to persuade investors and banks that the company has a positive long-term outlook, and to reconcile the diverging interests of the various stakeholders. The overarching goal must naturally be to have a solidly financed company that can genuinely tap future growth. Yet it is equally important to consider the interests of new investors (minimum returns, a majority interest, exit prospects, etc.), legacy shareholders (avoidance of total losses and, where possible, the prospect of participating in upside potential) and the banks. The banks in particular often adopt widely varying stances. Banks that wish to withdraw, for example, must be given a short-

term exit perspective. On the other hand, banks that wish to stay the course must be persuaded that their receivables will retain their value in the long run, and that the company will in future be able to repay its debts. Months can elapse between the initial idea and the day when the extra money is actually made available. Accordingly, financial restructuring cannot be regarded as a short-term lever to heave a company out of its crisis. Even so, it is often a necessary step if the company is to stay on an even keel after weathering the storm.

Five success factors

The example of Wind, Inc. confirms what we have experienced in practice: that five key success factors help turn around a company that is operating in a generally upbeat market but is faced with fierce competition and restrictive financing terms.

Independent moderator: Extensive talks and negotiations with all stakeholders are necessary if consensus is to be reached on the nature of reorganization. Even then, the plan of action will continue to evolve over time. Given that different stakeholders have different interests, achieving consensus is no easy task. The obvious choice is to recruit an independent moderator to lead the negotiations. Only a moderator who has no vested interests can maintain a clear, objective overview of the various alternative courses of action. And only such an outside instance can, by generating ideas, designing strategies and sustaining momentum, deliver acceptable decision proposals and ensure that the plan of action is realized efficiently. Clearly, however, this moderator must possess a very thorough knowledge of both the company and the market, and must have sufficient expertise to define financing models.

Can-do management: In such a sensitive context, the process of restructuring and recapitalization will not succeed if management does not command the trust of all stakeholders. Ideally, top management should be largely unburdened by associations with the causes of crisis and the events of the past.

Comprehensive solution: It is not enough just to focus on cutting costs, increasing earnings and generating fresh liquidity. Especially in growth markets, solid financing is critical to the survival of the company.

Customized solution: There is no patent remedy. A great deal of in-depth conceptual work will be needed whatever the case. Finding exactly the right mix of actions for the company concerned will improve the chances that a workable stand-alone strategy can be formulated. Also, it will lay a firm foundation for strategic collaboration.

Balanced solution: In the long term, all stakeholders must benefit from financial reorganization. The company will get the leeway it needs to realize targeted growth. Ideally, the resultant profits and value growth will benefit the shareholders and investors. Accordingly, banks can safely look forward to having their loans repaid and avoiding losses in the long run.

Financial reorganization can create a win-win situation for all stakeholders



Source: Roland Berger Strategy Consultants

Avoiding the liquidity trap

In many cases, restructuring is a last-gasp attempt to salvage a distressed company. And traditional restructuring actions have proven highly successful in this context in the past. Not every restructuring project will necessarily involve reorganizing the company's finances. Nevertheless, the "rule of three" outlined in this article should be borne in mind in every restructuring exercise, so that – just in case – fast action can be taken to keep the company out of the liquidity trap.

