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Analysis

The Slippery Slope from Triumphant Profitability to Financial Disaster

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Biography

Nick Hood is the Senior Business Adviser at the Opus Business Advisory Group (https://www.opusllp.com), the largest independent advisory, restructuring and insolvency firm in the UK.

Nick was a licensed Insolvency Practitioner, working in the business rescue market for 25 years. He is a committed internationalist, having created the largest global network of independent business rescue firms and having also worked overseas in Canada, Milan and Bahrain.

In his earlier career and after qualifying as a Chartered Accountant in 1970, Nick held senior executive positions in major companies in the construction, engineering and media sectors, as well as working for a boutique investment bank.

Nick's thought leadership and opinion blogs for Opus can be found at https://opusllp.com/resources/.

Keywords Turnaround, Restructuring, Budget, Decline, Distress, Crisis, Losses, Options, Outcomes, Stabilization, Recovery, Stakeholders, Expert help

Paper type Opinion

Abstract

Seeing a business descend from the calm of profitability to the chaos of collapse and liquidation is watching a tragedy that destroys jobs, devastates communities, and imposes losses on stakeholders such as creditors, landlords and lenders. In almost every case it can be avoided with prompt and decisive action as warning signs flash up on management's dashboard. In this article, the author looks in detail at the negative indicators and the potential solutions.

Introduction

Start to read any learned article or book by a restructuring guru and one very simple message will become obvious almost immediately: the sooner warning signs of decline are spotted, and the quicker decisive action can be taken, the better the options and the more positive the outcomes. Prevarication and delay breed disappointment, which can soon turn into financial devastation.

Let's start at the beginning, when all seems well and the sunny uplands of performance are bathed in the glory of significant profitability and a company's stakeholders are all happy.

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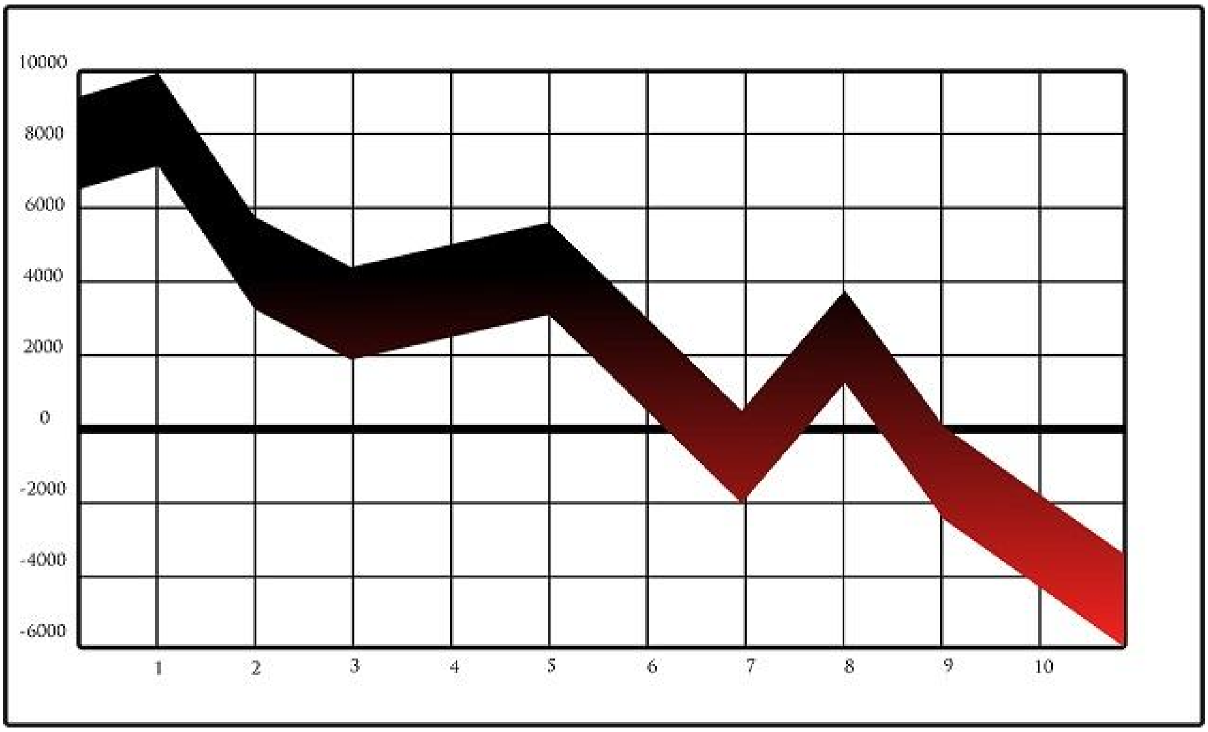

Sitting at the peak of the business decline curve

Even before any problems emerge, management should constantly challenge the status quo. Just a few of the questions to ask include:

- Are profits sustainable?
- Is achieving safe growth realistic?
- What needs doing to maintain the existing profit and performance levels?
- Is there sufficient funding in place to support growth, or to finance existing activity levels?
- What are competitors doing differently and is it working?
- What's changing in the marketplace and what is the best response?
- How robust and loyal are senior management and middle management?
- Is the workforce sufficiently motivated?
- How reliable is the supply chain?
- Has the business's reputation changed – for better or worse?
- Are there strong relationships with all key stakeholders?
- What do technology developments mean for the business?

Undershooting the budget – working out why?

The reality of business life is that budgets are always wrong, the only issues are by how much and in which direction. What is important is working out why and how significant a shortfall in any key area is going to be and then taking the appropriate

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remedial action, as well as learning from the variation from expectation. Missing a forecast in the wrong direction is always a warning sign, which should never be just routinely reported and then dismissed as either inevitable or just one of those things that happen. Questions need to be asked and answered honestly:

- Was the forecast over-ambitious?
- How widespread was the miss: just at the sales line, say, or all over the profit and loss account?
- Were external factors beyond management's control to blame?
- Are competitors having similar issues?
- Assuming the issues are more than a one off, what should be done to put things right?
- Have management got the bandwidth and the skills to tackle the issues?

Under performance and losses – moving into turnaround mode

At this stage, all options are still on the table. If the shortfall against budget is significant and especially if it has pushed the business into persistent losses, a comprehensive business review, including the adequacy of financial resources should be commissioned. This should lead to the preparation and the implementation of a turnaround plan bought into by management and staff at all levels. It must include clearly assigned actions and responsibilities, as well as a progress monitoring process.

The response might involve shrinking the business by turning away less profitable sales, abandoning overly competitive markets, or closing down product or service lines. It could even prompt a decision to sell the business, to merge with a competitor or to bring in new investors. None of this will be comfortable for entrepreneurs and it represents a powerful argument for bringing in experienced outside turnaround specialists to work alongside management.

Balance sheet distress and other mounting pressures

At this point, profit underperformance has been allowed to become embedded and is now causing problems in the balance sheet as well:

- The ratio of creditors to sales is escalating and creditor payment days are increasing.
- Creditor relationships are becoming sour and credit terms are being tightened.
- The use of finance facilities has hardened, rather than moving between peaks and troughs, so that the use of overdraft and invoice discounting facilities are constantly up against their limits.
- Capex has fallen away so that fixed asset values are falling not through disposals but because depreciation and amortization outweighs new spending.
- Shareholders' funds are dropping, and net worth looks likely to turn negative.
- Debt gearing is heading off the chart, either in net or gross terms, or both.
- Interest costs are rising not just because of increased borrowings, but because lenders have re-priced their facilities because of the obvious balance sheet strain.
- Key ratios right across the balance sheet are deteriorating.

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It still isn't too late to re-visit the turnaround option, or to instigate one if none has been instigated already. But now the shape of the balance sheet also needs some serious restructuring. Debt and gearing need to be returned to normal parameters, either by raising new equity to pay it down or through surplus asset sales to generate cash. Lenders need to be reassured and facilities renegotiated to reduce servicing costs, extend repayment terms or increase limits where necessary. Merger and sale options need to be looked at again but are unlikely to be on as acceptable terms as been previously hoped.

Just as with turnaround projects, restructuring is a task requiring experience, in depth knowledge of what is achievable and independent judgement. Few management teams have the necessary capacity, skills, or detachment to take the really tough decisions that are involved without help and support from dispassionate advisers.

Crisis – is there a way forward?

By now, cash and creditor management has taken over the lives of management, who are constantly having to take sub-optimal decisions just to keep the ship afloat. Turnaround may have been tried and failed; restructuring may have only delayed matters. Paying staff is a struggle each month, rent is in arrears, HMRC liabilities are mounting and some of the more proactive creditors are threatening enforcement action. Lenders are taking an uncomfortably keen interest in the business's day-to-day affairs and may be threatening to instruct investigating accountants to report on the company's solvency. Trade insurers are pulling cover and suppliers are cutting credit terms, some even asking for cash on delivery. Customers and key staff are defecting. Marketplace rumours abound.

Even now, there are options, but they are shrinking fast and the potential outcomes for stakeholders are diminishing. It may still be possible to find a White Knight trade rescuer. Administration could be the answer, protecting the business and assets from creditor enforcement action while a solution is found or as a damage limitation exercise. If the problems really are solvable and there is a viable business underneath the mounting chaos, then a Company Voluntary Arrangement (CVA) may be the answer.

Here too, considering and choosing between these remaining options requires expert assistance, this time from insolvency practitioners.

Insolvent liquidation – the end of the line

Occasionally a situation is simply beyond rescuing, no matter how soon the rescue attempts start. More often, it will be a case of management delaying decisive action until so late that there is nothing left to rescue, and liquidation becomes inevitable, either forced on the company by a creditor through the Court as a Compulsory Winding Up or instigated by the shareholders and the directors as Creditors Voluntary Liquidation (CVL).

An alternative scenario – taking the off ramp to recovery via stabilization

At every stage of this descent down the decline curve, there are positive options whether it is a turnaround plan, a more fundamental restructuring or taking

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advantage of one of the business rescue-focused insolvency procedures, such as Administration or a CVA.

- **Stabilization –** Every scenario is different, but, at its core, an effective turnaround needs a comprehensive and credible plan based on the particular circumstances. It will likely involve temporary rescue funding, an honest and open dialogue with creditors, the belief and commitment of management and staff, but, most of all, clear and achievable objectives. Creditor pressure must be eased, and key stakeholders brought on board with the proposed way forward.

- **Recovery** – The business that emerges will be different to the struggling entity from the distress and crisis phases. It may well be smaller, but hopefully more effectively and securely structured and with a revitalized business model that will provide a positive long term future for its stakeholders.

The moral of this cautionary tale – get expert help and get it early!

It's never too soon for management to think about how their business is performing. Not doing so is complacency. It shouldn't take a budget miss to push them into action. Some major companies operate in a constant state of turnaround; a few have specialist teams dedicated to it as an ongoing function. What is certain is that once a decline has started, the slippery slope just gets steadily steeper. The remedial action needed becomes ever more apocalyptic and the outcomes are soon unpalatable.