

Funding a Business Turnaround – 5 steps to success

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A business turnaround is usually precipitated by a [cash flow crisis](#) and so funding a turnaround therefore usually involves firstly managing the business's [real cash flow](#) so as to deal with the initial cash flow forecast problems and survive to stabilise the business; and then refinancing to fund the regrowth and future trading of the business.

At both points in a turnaround, lenders' confidence in both the business's management and its ability to meet repayments of borrowings out of future forecasts of cash flows are likely to be low given the business's current situation or recent history.

Funding for turnarounds therefore tends to rely on:

- whatever funds you can generate from within the business;
- together with asset based lending from sources whose principal concern is the value of the security available, at its most extreme on pawn broking basis.

The focus of this article is therefore on surviving an immediate cash crisis. The type of funding you will need to raise to finance the business's future development will depend very much on the nature of the business and your plans for it.

Wealth Warning

You must not simply use the techniques outlined in this section to obtain more cash, particularly by increasing borrowings or taking further credit simply in order to stave off an inevitable collapse. You should seek to raise money to support a business in difficulties only if you have a real plan for turning it around which will involve making major changes in how it is operating.

If you simply put more money into a business without making such changes, or insufficient money to see the changes through, all you will be doing is simply sending good money after bad as the business will burn through the new cash introduced. But in doing so you may have actually worsened your position in that you may have:

- converted your own assets, such as money held in a pension scheme into cash to invest into the business which is then lost;
- had to give personal guarantees for new borrowings; and/or
- become personally liable for the business's debts as a result of wrongful trading which is essentially where you took credit from suppliers and carried on trading after the point when you knew or ought to have known that there was no reasonable prospect of avoiding failure.

The purpose of this article is to help you to weather a cash crisis in order to put a turnaround plan, with some reasonable chance of success, into place. If you are in a cash crisis and you have (or it would be reasonable to have) any concerns about whether there is a reasonable prospect of the business surviving, you must take professional advice to protect your personal position.

Three Key Questions in a Cash Flow Crisis

The key questions in a cash flow crisis are:

1 Is the company insolvent? Because if it is, whilst you do not necessarily have to cease trading, there are potential implications and risks of personal liability for the directors (which includes defacto and shadow directors) that can arise out of your legal duties on which you need to obtain advice.

2 Does the company have sufficient cash for the immediate/foreseeable future? If not, you have just answered the first question.

3 Will the lenders continue to support you? This may well determine the answer to the second question.

Step 2 The Three Key Questions

The first question to ask in a cash crisis then is whether the business meets an [insolvency definition](#) as if it does, it will need [insolvency help](#).

Is The Company Insolvent?

In principle, insolvency simply means that the company is unable to pay its debts as they fall due. Where a winding up is sought on these grounds, the Insolvency Act (1986) sets out four tests, failure of any of which is taken to prove insolvency:

- failure to deal with a statutory demand;
- failure to pay a judgement debt;
- the court is satisfied that the company is failing to pay its debts where due (the cash flow test);
- the court is satisfied that the company's liabilities (including contingent and prospective ones) are greater than its assets (the balance sheet test).

Insolvency is important because if the company fails, a liquidator can potentially:

- act to set aside some transactions made when the company was insolvent; and
- hold you personally liable for the company's losses.

Additionally, your responsibility for the insolvency will be taken into account when considering company director disqualification proceedings.

If you are not trading through a company but are acting as a sole trader however, you have unlimited liability for all your own debts (business and personal). If you are trading in a partnership, all the partners are liable together and individually for the partnership's business liabilities (jointly and severally).

The moral is, when in doubt, if you are concerned about solvency, you should seek professional advice concerning your balance sheet position and your short and medium term cash flows. This advice may then enable you to legitimately continue to trade your way through while meeting your legal responsibilities.

Do You Have Sufficient Cash For The Immediate Foreseeable Future?

To answer this you need a cash flow forecast. At this stage you usually need to concentrate on the short-term and prepare a forecast on a weekly basis for the next 13 weeks, but in extreme cases you may need to prepare one on a daily basis, covering only the next few weeks.

The cash flow forecast will be a vital document, for:

- actively managing the cash to ensure survival;
- obtaining proper advice as to whether to continue to trade (to protect your personal position); and
- obtaining and maintaining bank support.

Cash flow forecasting is essentially straightforward as you are dealing with real cash movements into and out of your business, not more abstract accounting transactions, such as accruals, prepayments or depreciation.

For a weekly forecast, all you are looking to calculate is:

- the cash you are going to get in that week
- less the cash you are going to pay out that week
- to give a net movement (flow) of cash into or out of the company.

Adding the net inflow (or deducting the net outflow) of cash to the balance held at the start of the week gives the balance at the end of the week to be carried forward to the next.

When preparing a cash flow forecast:

- Be realistic in your estimates of timings and amounts of cash and when in doubt, be prudent. Be pessimistic about when and how much people are going to pay you and when you are going to have to pay others.
- Make your assumptions explicit. If your forecast assumes sales are going to increase by 20% next month because a new contract comes on stream then you should say so, otherwise lenders who may be looking at the figures may just think that you are relying on the new sales fairy to wave a wand and make this happen.
- Experiment with sensitivities by flexing some of your key assumptions (what if sales go up by 5% instead of 10%, what if customers take 60 days to pay instead of 45?) to see how sensitive the forecast is to these fluctuations.
- Think widely. Check that you have allowed for all possible payments that may need to be made. Have you allowed for any unusual or one off payments such as corporation tax, redundancy payments, pension top ups, capital expenditure or repairs if any of these are likely to fall due in the period? Turnarounds tend to require professional assistance. Have you allowed sufficient to cover the accountants', lawyers' and bankers' fees?
- Finally, remember that you do not have a 100% reliable crystal ball. Build in a margin as a round sum contingency to allow for the things that will inevitably come crawling out of the woodwork. The more

uncertain you're starting point, the larger this needs to be, up to say, 10% or 20% of payments in some cases. Part of the reason for cash flow forecasting is to build your lender's confidence that you are in control of your finances. Having a contingency in place is not only prudent, but if it helps to ensure that you beat your forecast cash performance, it will also help to ensure that your lender's confidence in your management skills will increase.

Will Your Lenders Continue to Support You?

The good news is that lenders will tend to support customers in difficulties where:

- the lender trusts your integrity;
- you talk to them in time (and seem likely to continue to talk to them);
- you seem to be in control of your business (and its numbers);
- you have a plan;
- the plan sets out clearly what support you need (how much, how long, how it is to be paid back);
- you are prepared to get in help where you need it;
- the lender is confident your plan can work;
- the lender is confident you can make it happen; and
- your plan does not materially increase the lender's risk.

This last point is concerned with the current level of the lender's security which will be covered in the next step.

Step 3: Understanding Lender Security Calculations

Where a lender has concerns about a business and their security position they will often instruct an [independent business review](#) from an insolvency practitioner, or very occasionally, one of the [turnaround firms](#).

Bank security in this scenario is concerned with the simple questions:

- can the lender currently get out or not? and
- how does your plan affect this ability going forwards?

Essentially a lender's security will be the assets over which they have taken a fixed or floating charge with which to secure their loans to the business, together with any supporting security held such as a personal guarantee from a director or shareholder. Normally a bank will hold a debenture from a company for its borrowings giving:

- a fixed charge over property, and sometimes over major items of plant and machinery, under which the company is unable to sell the specified items without the lender's consent and under which the lender receives payment first from the proceeds of sale if they are ever realised; and
- a floating charge over everything else in the business, including its receivables, which will then crystallise to catch the value of everything that the company owns at the moment of any insolvency, under which the lender will get paid out after certain other claims are met.

A full estimate of a lender's security position will be a complex matter, requiring specialist assistance in the valuation of assets and assessing reservation of title clauses.

For the purposes of most businesses however, simply looking at the position comparing the realistic realisable value of the property, and the likely realistic recovery that might be expected from debtors in an insolvency, should

provide a reasonable broad brush view of the lender's position. If your business has a significant value of fixed plant and machinery over which the bank has security, you will need to add lines in for this as well.

This can then allow you to understand how confident or exposed the lender will feel about your business. By rolling this calculation forward based on your forecast balance sheet you can also see how the lender's security position is likely to be affected by further trading. By discovering whether you are asking them to become more exposed or if your action will help them to improve their position, you can help to ensure their support.

This assumes however that all finance is through a single lender, such as a bank and of course these days you may not have a simple single bank funding position. For many companies the debtors may be funded separately, by a factor or invoice discounter, while another lender may be providing a mortgage on the property and a third finances the plant and machinery. In these cases each funder will have to look at their own particular position.

In any event, whatever your security position, obtaining increases in funding from your bankers to deal with a cash crisis may be difficult so in the next article we will start to look at the steps you take to manage a real cash crisis.

Step 4 How to Survive a Cash Crisis

In a cash crisis, the first task facing you or your [turnaround business consultant](#) in the [business rescue](#) is ensuring the business's short-term survival. This will depend on taking emergency measures to conserve and generate cash to buy time for longer-term issues to be addressed.

Unfortunately you may need to take action before making a full assessment of your business's problems or deciding on your recovery strategy. There is therefore always a risk that the short-term actions you take will be detrimental to your business's long-term interests.

While surviving the short term must take priority at this stage in order to have a long-term future to worry about, where possible you should try to consider the long-term consequences and adopt an approach that balances:

- Short-term survival; and
- Long-term regeneration.

But when in doubt, short-term survival must come first.

A cash crisis can arise for a number of reasons ranging from operating losses or excessive levels of debt draining the cash away; to excessive capital expenditure or inefficient trading operations absorbing too much cash into illiquid assets; through even to a rate of growth that is too fast for your supply of cash to keep up.

The key areas to focus on to survive a cash crisis are to:

- 1 Control the cash the business has: centralise and tighten cash management throughout the business;
- 2 Do more with less: squeeze the working capital cycle;
- 3 What you don't spend, you get to keep: stop the leaks and reduce outflows;
- 4 Get more cash in: Free up cash elsewhere, improve profit generation, raise new funding.

Prioritisation

This gives a wide range of possible actions so prioritise these based on which will have the largest and fastest relative effects so that you can focus on the ones that will make a real difference.

The good news is that if you can demonstrate that you can identify, face up to, and deal with, a severe cash crisis by taking the actions necessary to survive, you will be increasing your credibility with your lenders and therefore their willingness to support you through the process.

Step 1: Control the Cash You Have

It is surprising how many businesses in a cash crisis fail to take the basic steps to control this scarcest of resources and to ensure it is used as efficiently as possible. As has already been discussed, you will need to prepare a cash flow forecast. From this exercise it will logically follow that to efficiently manage the business's cash you need to:

- Centralise control of cash receipts, payments and forecasting (and forecast daily on a cleared funds at bank basis). You can then prioritise and schedule payments so the available cash is best used for the benefit of the whole business, rather than being used say, by individual managers, sites or branches as they see fit.
- Roll forward the cash flow forecast on a regular basis, reviewing performance against forecast each time you do so to pick up any variances that need to be investigated or which can be used to improve the next forecast's accuracy.
- Increase the level of authority required for ordering goods or making payments. Company credit or charge cards should usually be cancelled or restricted so that cash is not wasted or committed outside the central forecasting regime.

In using your cash flow forecast you may be able to identify where the cash is leaking out. Is it particular branches, sites or parts of the business? If so, you can target these areas for specific reviews and remedial action.

Step 2 Do More with Less, Reduce the Amount of Cash You Need to Trade

Your working capital cycle should be a virtuous circle with stock turning into sales and debtors and then into cash to provide funds with which to pay your suppliers and contribute to covering your overheads and generating a profit:

Whether this cycle requires funding is determined by your actual terms of trade with suppliers and the degree to which you are holding cash tied up in firstly stock and then debtors.

If on average you have say six weeks' worth of stock in various forms, raw materials, work in progress and finished goods, and on average your debtors are taking say 60 days to pay the from the moment you buy some product to the moment you see the cash in from its eventual sale is some 102 days. So if you need to pay your supplier say 45 days after they deliver then you have a 57 day funding hole that needs to be covered between paying for the goods and seeing the benefit of the relevant receipt.

And obviously the higher the volume of trading you are undertaking, the larger the value of this gap which is why high growth businesses can fail through running out of cash, a problem known as overtrading.

So, if you can reduce the average periods of stock holdings or the day's debtors are outstanding (or increase time taken to pay creditors); then you will either free up cash for use within the business, or reduce the cash needed with which to support the level of trading. Whichever way you want to look at it, they both amount to good news.

There are many techniques derived from lean manufacturing techniques which a business can use to develop a 'Lean Cash flow' in respect of stockholdings such as:

- using theory of constraints planning, kanbans and cellular manufacturing systems to substantially reduce the supply cycle time and hence stockholdings;
- only buying in goods when it has a firm order and can ship it straight out; or
- taking in all its goods on a consignment stock basis, where while it physically holds the items on site, it only buys them from the supplier when they are used.

You are likely to have a lot of money tied up in debtors. As trading and sales becomes more difficult, many businesses feel less confident in demanding payment from customers for fear of losing future business, or are distracted from the day-to-day necessity of chasing in debts and by default allow debtors to enjoy longer or more extensive credit terms than normal. This ties up vital working capital and is often one of the first places to look for funds.

You should review your debtor's ledger and take action to:

- reduce credit terms to customers; and
- target and get in overdue debts.

If as a result you find that your credit control procedure or practices are poor, mark this as an area for specific action as part of your turnaround plan. In the meantime, introduce tougher credit terms for customers.

The next step will cover reducing outflows and sourcing other inflows.

Step 5 Managing a Cash Crisis Continued

Managing a [cash crisis](#) so as to achieve a [business rescue](#) involves tackling four areas, the last two of which are reducing the amount of cash going out and getting more cash coming in by way of everything from asset sales, to new investment and in the longer term to achieving sustained increased profitability which to me is the real turnaround definition.

Step 3 Reduce the Amount of Cash Going Out

Just as with everything else in life, what you don't spend, you get to keep, so look at:

- Cancelling voluntary outflows back to shareholders such as dividend payments.
- Cutting back or cancelling:
- Advertising and marketing (but only after assessing how immediate the link is between this and sales and do not cut advertising that is vital for short-term turnover).
- Training; but keep any required to meet statutory requirements.
- Research and development; but assess the risk that you may run of losing any key projects or staff that are vital to the long-term recovery plan.
- Capital expenditure; but assess how vital any such planned expenditure is to improving profitability in the short-term or the long-term turnaround plan.
- Increasing creditor payment periods by agreement with suppliers.

- Negotiating scheduled payments with key creditors or HM Revenue & Customs (an informal arrangement). If agreeing scheduled payments with suppliers, be clear as to what proportion of the payments made is going to be used by the supplier to reduce the total amount you owe and what proportion will be used to allow further supplies on credit.
- Consider using an insolvency act procedure such as a Company Voluntary Arrangement (CVA) or administration to obtain protection or agree a formal binding deal with creditors.
- Consider whether any key creditors might be willing to convert their debt to shares in the business (a debt for equity swap) if this is acceptable to the existing shareholders.

Step 4 Get More Cash Coming In (Or Credit From Elsewhere)

Other than trading, possible other sources of cash are from:

- Selling assets;
- Improving profit generation; or
- Raising new borrowings or obtaining investment.

Selling assets: Review the assets on your balance sheet to identify:

- Surplus fixed assets (land and buildings, plant and machinery, motor vehicles) that can be sold.
- Assets that could potentially be made surplus (and then sold), for example by subcontracting out your manufacturing processes.
- Essential fixed assets that you need to continue to use, but which can be sold and leased back to provide cash.
- Underutilized plant and machinery capacity that can be hired out, or spare factory or office space that could be sub-let.
- Separable and saleable investments, subsidiaries or any parts of the business (such as a specific branch) that could be disposed of for cash
- Is there any equipment lying around that is not even on the balance sheet that can be sold?

Improving profitability: Fundamentally, to improve profits requires achieving some combination of the following, depending on which area is most responsible for the problem:

- Increasing turnover; by increasing some or all customer numbers, value of spend per customer or frequency of spend
- Increasing margins; by reducing costs of sales; and/or
- Reducing overheads; which includes dealing with any non-performing parts of the business that are dragging the rest down.

In the situation of a cash crisis, the steps that have the highest short-term return tend to be focused on cost reduction (although often simply raising prices is a surprisingly easy early win). In the longer term the focus shifts to re-positioning the business so that it moves into the most profitable areas open to it.

Raising new borrowings or obtaining investment: There are a number of sources of funding that can be looked at but please do bear in mind the 'Wealth Warning' given in the first of these articles:

- Use your cash flow forecast to seek an extension of your existing bank facilities or other borrowings to cover the forecast requirement. If appropriate, seek to agree deferment of loan repayments or to roll up

interest for later payment. Do you have any unpledged assets that can provide security for new loans, such as brands, trademarks, and other intellectual property rights?

- Asset based lenders who specialise in lending against a specific type of security (such as factors who lend against your debtor book) will often advance a higher loan to value against these assets or security than may be available from normal banking arrangements. Can you use such sources to obtain more borrowings against your assets than you currently have available from your bank?
- Consider your trading partners, agree new stocking arrangements with supportive creditors such as sale or return; pay when paid; or agreed longer payment terms; ask customers to supply free issue stock for you to work on so that you do not have to buy in materials.
- Seek injections of capital from existing shareholders or directors (your bank may well put pressure on for this to happen in any event as a sign of commitment to the turnaround, as well as a way of managing or reducing its exposure).
- Seek investment from specialist turnaround equity investors.

Obviously we could drill down into each of the areas of action covered in this series of articles, such as for example profit improvement of which the comments above barely scratch the surface, to generate a greater depth of possible suggestions for actions, but hopefully this series will have given you some pointers as to how to begin to manage surviving a cash crisis and funding a turnaround.

Mark Blayney of Gold TMA sponsors Galen Partners is an accredited business rescue expert and founder of one of the UK's leading [business turnaround firms](#).

For a free copy of his 13 Key Steps Guide to managing a turnaround, contact him at: <http://www.gpsuk.biz>

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