With the worldwide recession posing a danger to SMEs, the ones with sound restructuring strategies stand the best chance of surviving these economic doldrums

staying ALIVE

By John Lorinc

It was one of those roller-coaster rides that have become all too common in Canada's corporate landscape. In March 2008, Kim Yost, then president and CEO of The Brick Group Income Fund, announced on a fourth-quarter conference call that "2007 was the strongest year ever for the Brick Group since its inception more than 36 years ago."

What a difference 12 months made for the furniture chain. In mid-March, 2009, Brick executives were forced to scramble when an analyst report by TD Newcrest informed investors that the company, struggling with same-store sales growth that had plunged nearly 20% since the first quarter of 2008, had churned through all but $10 million of its main operating line.

The company hinted it was looking to renegotiate those credit lines in order to get itself back on solid ground. And less than two months later, Brick officials revealed their wholesale financial restructuring. They paid off senior lenders — HSBC, the Royal Bank and CIBC — to the tune of $140 million. By way of replacement, the company raised $110 million in new financing from the sale of $1,000 debt units with

illustration by JIM FRAZIER

Fairfax Financial Holdings Ltd. and Brick founder William Comrie buying up the bulk of the units. The company lined up another $65 million through a new asset-based credit facility. As Yost put it, "The recapitalization transaction provides the necessary financial flexibility and capital resources to manage the business in the current economic climate."

The Brick was lucky to survive. BDO Dunwoody financial recovery services partner Susan Taves, based in Kitchener, Ont., has spent the past year watching many small and medium enterprises (SMEs) endure their variations of The Brick's story, or worse, as is the case in southern Ontario's auto-parts sector, where venerable companies are so hobbled that even a stem-to-stern restructuring won't help. "The most dramatic issue is the reduction in sales volume," says Taves, a CA who is also a chartered insolvency and restructuring practitioner (CIRP). "Within a year, if a company was doing $12 million, now we're talking half, maybe. With such a dramatic decrease, it's just so significant."

The problems, of course, aren't limited to Ontario's manufacturing and retail sectors. Bruce Alger, president of Alberta-based Alger & Associates Inc., a corporate and personal financial restructuring company, says he's seeing clients in the oil and gas sector, small-scale retail, and tourist-driven businesses in the mountains.

On the bright side, there is some emerging evidence to suggest that small businesses are more likely to survive because they had started the process of containing costs before the mass layoffs began in earnest last year.

Still, the existential question facing business owners is whether there are restructuring strategies — either an informal or formal insolvency process — that can bring their recession-hobbled companies through the hurricane. Much depends on the sector in question, cautions RSM Richter senior partner and CA-CIRP Peter Farkas. "If there's no viability, you're going to wind it up in the most efficient way. If there is viability," he adds, "at a minimum you're looking at a balance-sheet fix."

In this climate, surgery may also be needed. Some may be able to pull it off on an outpatient basis while others are looking at a major operation. Whatever is required, restructuring experts say it is critical not to wait until things go crazy before seeking advice. "Time is of the essence," says bankruptcy trustee Stéphane Lachance, a CA-CIRP and partner at Demers Beaulne in Montreal. "They need to act promptly."

When chartered accountants with CIRP designations are retained by companies with mounting financial strains, they quickly check the corporate vitals for signs of distress. Loss of top-line income may be the most obvious symptom, but in this climate, there are many other warning signals: difficulty meeting short-term payables; stringing along suppliers; eroding liquidity ratios; exhausted bank lines; and a general decline in working capital. "They've gotten to the point where there isn't any more credit available to them," says CA-CIRP Ira Smith, a Toronto-based trustee in bankruptcy. "They're hitting the wall."

In the past half-year, however, many firms have been felled by an economic domino effect as the global credit crunch decimated consumer spending and the effects were felt all the way down the commercial food chain. The final straw may be the loss of shelf space at Wal-Mart or some other big-box store. "Sometimes the signs are very rapid," says Lachance. "You may lose your biggest customer because [it] may have filed for creditor protection under the [Companies' Creditors Arrangement Act]."

Jervis Rodrigues, a Vancouver-based CA-CIRP and partner in charge of Deloitte's financial advisory practice, also notes that many companies have also found themselves in a vice, with reduced orders from customers and higher input costs due to rising prices for some commodities, such as steel. "They're getting squeezed from both ends," he says. "There's less and less margin available for them to make a viable business going forward."

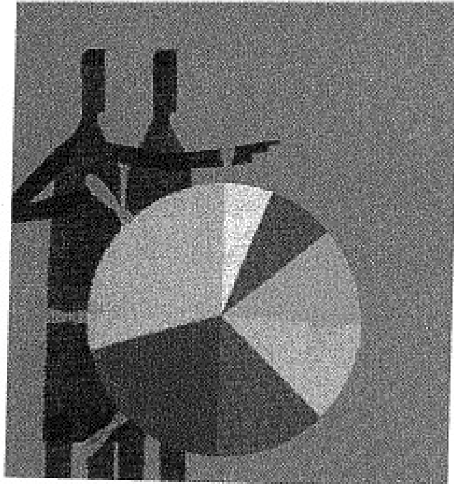
Companies facing such pressures need to take a couple key steps. The first is to be proactive and frank about sharing the bad news with their bankers. "The universal rule is, never surprise your banker," says Rebecca Reuber, professor of strategic management at the University of Toronto's Rotman School of Management. Tell them about relationships with key customers and suppliers, and provide accurate financial information. "Be in touch with your banker every month."

The other important step, says Taves, is to quickly snuff out signs of crisis by clearly communicating with employees and suppliers. She cites the common example of the accounts payable staff fielding frantic calls from angry suppliers who haven't been paid for months. Instead, senior management should hustle to fax out a general letter to all suppliers acknowledging the cash-flow problem and assuring them it's being addressed. "Everyone is getting the same message," says Taves. "Now your accounts payable staff isn't on the phone the whole day talking to screaming people."

Similar steps should be taken with employees and management as a way of tamping down the rumour mill and preserving productivity. "It relieves pressure on CEOs so they can get their team to focus on what they need to do," Taves says. And thus the search for cash begins.

Restructuring tips

- Don't wait until you run out of cash and credit to see a restructuring specialist.
- Identify key employees the company can't survive without; they may include controllers, shop foremen and key sales people.
- Talk frankly to your key customers and find ways to make sure they don't leave you.
- Resist the temptation to use your tax remittances as short-term emergency cash. CRA has more rights than other creditors.
- Ensure your lenders have timely and credible financial information.
- If you are heading for a proposal, calculate your anticipated burn rate and then build a war chest with enough cash to cover two months of operating costs.
- Once you have filed, don't dither. The courts will grant extensions, but not indefinitely. — JL



The moral of Smith's story is that a formal restructuring process, when managed with strategic savvy, may yield surprising results, not the least of which is that the distressed company lives to see another day. The insolvency practitioner's task is not merely palliative

Restructuring experts tell owner-operators to go through the balance sheet with a fine-tooth comb, looking for opportunities to monetize assets or reduce costs. "Every business — small, medium or large — should be looking at its entire [selling, general and administrative] costs," says Rodrigues. The obvious steps include laying off surplus employees, paring back benefits, freezing salaries, and doing away with frills — for example, first-class airfare and hotels for business travel, and client entertaining.

While the need to cut is great and immediate, businesses need to ensure they don't sustain self-inflicted wounds. Before cutting staff, senior management must identify key employees who should be retained. And they should cut marketing expenses judiciously. If a firm suddenly stops attending important trade shows, competitors, suppliers and customers may read that absence as evidence of critical illness.

PricewaterhouseCoopers advisory services partner Greg Prince recommends that his clients look for other sources of ready cash — uncollected receivables, stale inventory that can be liquidated in nontraditional retail or wholesale channels, and unredeemed scientific research and experimental development tax credits. Make sure tax filings are up to date to avoid late charges, and ensure that any foreign currency accounts are hedged. Other options include renegotiating prepaid orders and asking vendors to extend payment periods. Lastly, many companies have real estate holdings that can be sold and leased back, even if at a loss. "The key message," says Prince, "is that you can walk down the left side of the balance sheet and see what you've got." Adds Rodrigues: "In a recession, cash is king."

Given the economic climate, however, such steps may not be sufficient to address short- and medium-term cash needs. And many owner-operators will find themselves thinking about how to squeeze additional credit from lenders whose antennae are up. At this point, though, it's no longer just about maintaining an open relationship with the bankers. "They will ask entrepreneurs to put up assets that haven't been pledged to prove they believe in their own recovery plan," says Smith. "Those are gut-wrenching decisions." He urges entrepreneurs, who tend to be emotionally invested in their companies, to be as clinical as possible: "If the business won't survive, don't pledge personal assets. Rather, use those as the starting point for the rest of your life."

Last year, Toronto fashion designer Linda Lundström hired Smith to deal with what looked to be an escalating crisis. Lundström, who operated a manufacturing facility and a small chain of retail boutiques, had hit a wall and Smith recommended she file a proposal for creditor protection under the Bankruptcy and Insolvency Act (BIA). After analyzing the situation, Smith's firm partnered with a liquidator who was prepared to finance enough additional production to hold a bankruptcy sale at Lundström's retail outlets. Having moved to bring in some cash from the business, he put together a plan for the secured creditors that involved a small shortfall the principals would agree to cover. "The bank," says Smith, "bought into the plan."

Lundström then moved quickly to file the formal restructuring proposal and commence the liquidation, all while keeping the company's retail outlets open to the public. With the stores operating as a separate legal entity, Smith bankrupted the retail division in order to run the liquidation sale. But due to the publicity generated by the advertising for the sale, a pair of investors approached Lundström about acquiring the manufacturing operation. "The return," he says, "was even more than they'd expected." Lundström today is making and selling her brand across Canada and the US in partnership with Eleventh Floor Apparel Ltd., the Canadian investor who stepped up to buy the insolvent firm.

The moral of Smith's story is that a formal restructuring process, when managed with some strategic savvy, may yield surprising results, not the least of which is that the distressed company lives to see another day. It's a point Taves stresses with her clients in order to counter the perception that the insolvency practitioner's task is essentially palliative. "We are not just the undertakers of the business world," she says. "Coming to see an insolvency and restructuring professional is not the end of the world."

Formal insolvency is not a cheap process; costs for an SME can run from $25,000 into the hundreds of thousands

Trustees also point out that the current climate has created a very different dynamic between distressed firms and their creditors. There's a greater appetite for prepackaged bankruptcies and informal proposals to creditors made outside the legal process.

What's more, trustees say they're seeing some unprecedented attitudinal changes on the part of banks, whose loan officials recognize that aggressively petitioning troubled companies into receivership may make sense on paper but can serve to aggravate the social woes of the economy. "I think there are increasingly large amounts of patience," says Alger, a CA who is also on the national board of the Canadian Association of Insolvency and Restructuring Professionals. Banks, he says, can see for themselves that a growing number of troubled firms aren't badly managed but rather victims of large-scale economic decline.

"I've never before seen banks considering the social benefits of allowing a company to survive," adds Joe Albert, senior vice-president at msi Spergel inc., an Ontario company specializing in commercial and consumer insolvency and restructuring. "Banks are very reluctant to enforce their security unless it involves a game plan that the company's shareholders consent to."

What's also true is that secured creditors know they are not going to recoup much from selling off a company's assets in the current climate. "Lenders realize that asset values on the liquidation market are very, very low," says Prince. "There is a desire to see if they can ride it out. But they don't want to be worse off."

Despite such expressions of forbearance, and the implications for pulling off a restructuring plan, formal insolvency is not a cheap process — costs for an SME can run from $25,000 into the hundreds of thousands, depending on the complexity of the organization, so companies considering this step need to find that kind of cash at a time when their reserves are severely depleted.

What's more, the mere act of filing a notice of intent to apply for creditor protection can be ammunition for a firm's competitors, who will spread the word among your customers that the firm's gone bust. "You'll lose some of your clients," says Lachance.

To mitigate the problem of costs and loss of confidence, Alger says he has been doing a lot of informal restructurings lately. In such scenarios, the trustee and the company approach suppliers and secured creditors with a plan — for example, proposing payment at 70¢ or 80¢ on the dollar. "They are trading on their goodwill and long-term relationships," he says. "If you have a long-term track record, you can frequently do things that may not seem possible."

Farkas adds that it is also possible to approach creditors such as landlords and propose rejigging payment terms, with an eye to temporarily reducing the current burn rate but holding to the overall lease commitments by offering to back-end payments: "I'm not saying I'll never pay you, just not now."

The prepackaged or "orderly" bankruptcy is a variation on the theme, with the parties and prospective stakeholders having negotiated the deal before going to court. Avoiding a free-fall bankruptcy is especially important for service firms with sensitive reputations, such as courier companies or private schools, observes Farkas. "It's doubly imperative to do a prepack in a service business, otherwise the goodwill disappears instantly."

Yet the reality is that some restructurings require insolvent firms to legally extricate themselves from long-term supplier contracts and real estate or equipment leases. But with vendors and landlords also feeling the economic heat, they may be unwilling to renegotiate.

Albert observes that expected changes in the BIA will facilitate this process. Under the existing law, companies can terminate property leases, with the landlord becoming a creditor. "With the new act, you'll be able to get out of any contract that impairs the company's viability," he says, noting one qualifier. "For political reasons, the government stopped short of allowing companies to terminate a collective agreement." As a compromise, the amendments will allow bankruptcy courts to order the parties to re-open bargaining.

Last, but not least, it is crucial for firms that are in the midst of a formal restructuring to reconsider the ownership structure. Farkas says he often encounters a troubled SME with several shareholders, only one of whom — probably the founder — still believes in the business. Using net worth that is not tied up in the company, "the founder can become part of the new company that emerges from the restructuring." That transition may also entail this shareholder buying out his or her partners. "You put it through the washing machine so that this owner ends up with 100% of the equity. That can be a pretty effective restructuring regime."

Though he's in the business of tallying up numbers, Albert says the owner-operator's attitude may be the pivot upon which a restructuring turns. "In my opinion, one of the biggest keys to success is having a passion for the business. It's such a strong indicator of success."

Picking up on that point, Reuber points out that hard times provide determined SMEs with a mandate to focus intensively on their customers and to make sure they don't bolt or vanish in times of stress. "Now," she says, "is the time to surprise them favourably." It's also an opportunity for companies to take a hard look at their HR practices and get rid of ineffective employees. And, given the tight job markets, firms that are hiring have the pick of the crop — in short, the downturn opens up a window for firms to equip themselves with the best employees they can recruit. "In terms of business processes, I do firmly believe that the businesses that survive this recession will emerge so much stronger and focused, internally consistent and innovative."

John Lorinc is a Toronto-based writer