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The Right Questions Make Workouts Work

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Against a backdrop of uncertain economic conditions and excess financial leverage, the rise in underperforming companies comes as no surprise. For the credit manager, this forces decisions on complex and delicate issues.

Deciding how to proceed with an underperforming customer is first dictated by the creditor company's profit structure and needs. When dealing with a troubled customer, one should take into account past performance, current experience and future relationships.

Cooperating with a customer can bring distinct advantages. First, by working closely with the customer, the creditor increases the probability that loss will be minimized. Second, the goodwill that a vendor earns from its workout customer can salvage or even strengthen a profitable account.

A creditor needs to establish a reasonable profit structure with the customer and have some confidence in obtaining continued business. If the customer does not provide an attractive business opportunity over the longer term, throwing good money after bad is no solution.

When dealing with an underperforming customer, critical variables one must assess are management credibility and the ability of the business to perform "as promised". Often during a workout situation, existing management has lost credibility. Furthermore, management may not have prior experience dealing with a cash crunch or be prepared for the painful adjustments—such as downsizing of operations—that may accompany a workout situation. A positive sign in such a situation is the willingness to change.

To evaluate the viability of a revitalization plan, the vendor first needs to understand the root causes of the customer's problems, and then judge the feasibility of the steps being taken to rectify them. While a turnaround strategy is still in the planning stage, creditors must ask themselves if they agree with the plan and whether the customer can execute all key elements of it. A credible plan should have substantive changes and measurable milestones.

Typically, creditors want to know when they will get paid. But vendors should be asking more. Specifically, vendors should be concerned with how and when the customer proposes to restore the account to a current basis and the likelihood of recovery. It is necessary to understand at all times where the customer's business is going. That determines the source of payments and provides the foundation for any future relationship. When a creditor assesses an underperforming situation, a critical factor in the equation is an evaluation of the standings of other creditors. The presence of tax liens, or senior and hostile creditors, must be factored into any analysis.

While it is important to gain a thorough understanding of the customer's revitalization plan, a creditor must recognize that a customer may not share all of the proprietary details of its plans. Nonetheless, the critical questions to ask are, where has the customer's business been? Where is it now? Where is it going? What will be different? If it is moving in some other strategic direction that before, what factors and resources will make that happen?

If an evaluation of management and/or the business plan leads a creditor to question the viability, candor or credibility of the customer, avoid extending additional credit to the customer, and also take immediate steps to protect and minimize the exposure. It may be possible to improve one's pre-existing credit position, depending on the leverage of the creditor. If the vendor is a sole-source supplier or occupies some other strong position relative to the customer, it is possible for the vendor to get guarantees such as a letter of credit.

Despite the emotional component of dealing with an underperforming account, the future relationship should be founded on the importance and profit potential of the customer. In a workout situation, creditors need to assure themselves that the customer's future performance will be a distinct improvement over the past. ■

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