



**C**learly, the trend of large company insolvencies that started in 1999 has come and gone. Most of us in the turnaround industry expect the next few years to have much slimmer “pickins.”

Industry insiders recognize that 1) big company bankruptcies, which drive the turnaround industry, are way down; 2) nonperforming assets (NPAs) of most lenders are again within fully reserved levels; 3) bank workout staffing is down 25-75 percent; 4) capital funding returned to the market in late 2003 in all segments—equity sponsors, high-yield bonds, M&A activity, even cash-flow lending; 5) the U.S. economy is expanding in almost all sectors, and; 6) the boom-to-bust cycles of “hot” industries (Internet, Telecom, energy) driven by technology or regulatory changes have mostly run their course.

by Daniel F. Dooley

So what’s a turnaround consulting firm to do when near-term business is likely to drop by 50 percent or so? The obvious solutions are being worked by many of us: skill redeployment to front-end M&A work, diversification into services such as M&A and litigation support, and geographic expansion, mostly to Western Europe where local laws are evolving toward debtor-friendly rehabilitation.

That said, there are numerous structural changes in the U.S. economy making turnarounds a growth industry for decades to come. Consider the following phenomena.

*Interest rates:* Many people believe that prime interest rates are about 200 basis points (or more) too low, based upon history. Fed Chairman Greenspan’s dilemma is

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to move rates up gradually without stalling the economic recovery.

*High-yield bonds:* The amount of capital in the market due to high-yield bonds is staggering and continues to grow. This is driven by major pension, insurance and mutual fund investors looking to improve fund IRR through higher-risk investing in asset pools, where up to 10 percent of all investments are assumed to default and lose most of their value every three to five years. Since the high-yield flood gates re-opened in 2003, one might predict the next wave of distress around 2006, given a likely three-year time lag.

*Equity sponsors:* After deal sponsors secure commitments for funds, they face a limited window (typically two to three years) in which to invest and deploy or return the money. With the equity markets and M&A activity nothing short of dismal in 2001 and 2002, activity levels started heating up in late 2003 and gained steam in 2004. Many equity sponsors possess significant “use it or lose it” money, so there is a great deal of “use it” buying going on right now which, of course, translates into increasing prices and pressure on lenders to increase allowable leverage.

Additionally, equity sponsors are loosely regulated when it comes to investment accounting. As such, sponsors are generally not eager to sustain investment losses, and frequently provide financial support to out-of-the-money investments to avoid write-offs.

Of note, too, many equity sponsors hold troubled companies within their portfolios that they continued to support during the recession. Some of these companies will not make it. The public accountants who audit these portfolios do the investors a disservice by allowing some of these investments to be carried at cost when clear losses exist. This is the type of self-serving accounting logic that contributed to the S&L crisis in the late '80s and still

overshadows how the Office of the Controller of the Currency (OCC) forces banks to rate and classify NPAs.

*Continuing bank consolidations:* With every bank acquisition comes the opportunity to play “purchase-price accounting.” Simply put, this allows the new owners to write-off/down, sell-off or workout loans they acquired, and book the losses in excess of current reserves to a “purchase-price reserve.” With every bank consolidation comes the rare opportunity to clean the loan slate without P&L penalty. There have been two mega-acquisitions in 2004, and numerous regional acquisitions that continue to create this workout activity bubble. Bank consolidations will continue for the foreseeable future.

*Increasing market strength of commercial finance:* There are now huge commercial finance shops, with nonbank roots, growing quickly both internally and by acquisition. Examples include GE Capital, Merrill Lynch and GMAC, to name a few. By their very nature, these are less regulated, higher risk/reward shops that tend to be more opportunistic and less structured in approach than traditional banks. Commercial finance shops plan for loan-workout problems and maintain processes to routinely support this activity.

*Financial instruments are increasingly more sophisticated:* In recent years, we have witnessed an increase in options, such as mezzanine, sub-debt, Tranche B lending, P.O. finance, export/import finance, stretch financing and others. Each of these instruments has one thing in common: helping companies increase financial leverage. However, when companies use these more sophisticated, higher-risk sources of capital, they have less flexibility to right the ship and work out their problems on their own.

*The pace of technology change:* As we saw with Telecom, the Internet and energy distribution, multibillion dollar industries can spring up in as little as five years. With the increased pace of technology, lightning-quick access to information across the world, and the ability of capital to be quickly deployed in quantity to exploit economic opportunities, the U.S. economic cycle arguably has been permanently shortened from a seven-to-ten year cycle to less than five years. We will witness more gold rush industries where what goes up, must come down.

*Public company pressure:* The U.S. public markets work on a quarterly scorecard, whether we like it or not. We as investors simply don't have the patience to reward long-term performance. This “instant-gratification” factor also supports the likelihood that U.S. economic cycles will be shorter in the future.

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Complicating matters is the generally accepted notion that a completely different management skill set is needed to effectively manage a turnaround, as opposed to leading a growth company. The two management skills are perhaps even mutually exclusive.

We regularly see this in workout situations: the management

*New liquidity from debt traders:* Investors with huge resources have moved from primarily large public companies into the middle-market. Their primary concern is investment arbitrage; they thrive on insolvency because banks aren't permitted by the OCC, as a practical matter, to maximize financial returns on troubled companies. They are forced to sell off nonperforming loans to the benefit of debt traders who often exercise their leverage or push for bankruptcy to maximize their gain at the expense of others.

*China:* Last year, we worried about low-labor rates in China destroying the U.S. industrial economy. This year, we're witnessing what happens to world commodity prices (steel, oil, etc.) as China's state-supported industry grows at an incredible 10 percent per year, heavily driven by internal consumption. The world's economic power is shifting from the U.S. to China and nothing is likely to stop it. In short, the China factor will foster often-unpredictable market upheaval for years to come.

*Resistance to train U.S. managers to play defense:* The U.S. management development process in both schools and organizations is designed around sales growth and developing critical mass, with management financial incentives designed to match. It's just like high school — only the quarterbacks, running backs and receivers were idolized because they put points on the scoreboard. The guys in the pits, especially the offensive line, were just players without much opportunity for glory.

team that was recruited to grow a business cannot adjust “psychologically” to what they perceive is the “bait and switch” of shifting to workout and downsizing actions. Compounding this issue is that owners and lenders are resistant to creating financial incentives for the management team now playing defense in a workout situation. In essence, the attitude of owners and lenders is that management should help us out of the mess without any incentives. This attitude is a mistake because owners and lenders should want to align the financial interests of senior management, owners and lenders. This is basic Motivation Theory 101. Until we develop managers within organizations who are good at managing troubled companies — and are rewarded financially and professionally for their success — turnaround consultants will continue to tap an unending flow of work.

Given all of the above factors, my prognosis is that business will be slow for turnaround professionals through the end of 2005. This will create a much needed shakeout of many newcomers to the industry... just in time for 2006's pickup. ▲



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