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TURNAROUND corner

Other People's Money:
What Turnarounds Teach Us About Working with Lenders when a Deal Goes South

BY BAYARD HOLLINGSWORTH

While lenders carefully scrutinize companies seeking to borrow money, borrowers rarely exercise the same due diligence to screen potential lenders. No one embarks on a business venture planning to fail, but it does happen. Bayard Hollingsworth advises borrowers to investigate the ways lenders handle a deal that goes wrong before accepting other people's money.

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When accessing capital markets, business owners rarely evaluate their options critically through a turnaround or crisis management lens. If the *stuff* subsequently hits the ventilation, this failure in *reverse due diligence* can ultimately be a very costly mistake. In the optimistic context of growth and expansion (combined with their zeal for achieving quick success), business owners tend to focus largely on the price of new capital, not on the continuing availability of that capital if things don't go as planned. Management usually does not consider the dark aspects of falling short of expectations for fear of projecting an image of uncertainty in its business plan.

As a turnaround consultant, I have advised numerous clients whose roles or investments were existentially challenged because insufficient attention was given to considering the nature of the capital provider at the beginning of the relationship. Fueled by eagerness to land the deal, often the borrower failed to perform adequate — or any — due diligence on the capital source.

A lender or equity investor normally performs extensive due diligence on companies before investing capital, to the extent of investigating the owners and senior management personally. Why shouldn't a borrower do the same for a capital provider — especially given the security interests and other rights a company confers upon a lender in return for use of the capital?

If You Don't Ask, You Won't Know

This lack of proactive due diligence is not necessarily the fault of owners or management. When a company raises capital, it is usually experiencing growth and success and has never faced a capital provider's reaction to unmet commitments and expectations. Operating trends have generally been "up and to the right," so the company hasn't considered the consequences of a deteriorating relationship with a capital provider.

Further, business owners often don't truly conceptualize the capital they are raising as *Other People's Money* (OPM). The funding is simply one more necessary resource to be gathered and utilized along the path to ultimate success. The business owner believes the provider should feel lucky and blessed to serve that resource to those presenting the opportunity at hand.

In short, it simply never occurs to them before taking out a loan that they should investigate how a lender behaves when things go awry. After more than 20 years of leading or advising operating businesses experiencing challenges, I have come to view performing substantive due diligence on how any capital provider behaves across a range of circumstances to be a core fiduciary duty of management and owners.

A New Relationship

When the successful business outcome fails to materialize, the fact that the funding came from another person — who cares deeply about that money — can become painfully clear. The provider is now disappointed and angry, probably embarrassed and possibly even suspicious. The lender wants her money returned — now.

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This beast is a very different animal than the one who provided the funds and enjoyed the happy opportunity and heady optimism of earlier times. The lender's economic livelihood and reputation may be threatened, and the business owner must deal with funding sources exhibiting their worst behavior in a context of professional embarrassment and fear. This is the reason a lender or equity investor typically moves account management to a seasoned professional who is highly trained and adept at managing the relationship aggressively, dispassionately and energetically to achieve one goal — getting the money back.

Framing a Thorough Due Diligence Inquiry

Capital providers behave very differently in tough situations. Users of OPM must balance the interests of various financial constituencies to gain an understanding of the way a capital provider perceives and manages the relationship over an extended period of time — especially in difficult times.

Just because the capital is cheapest or appears to be *covenant light* doesn't mean it's the best choice for a borrower over the long term. Initial diligence on the capital provider should be focused on making an accurate evaluation and documenting it carefully. Learning first hand from other business owners, CEOs and CFOs how a provider of capital behaves when targets and goals are not achieved *before* accepting the first dollar is a critical factor in choosing a lender or investor.

The questions a borrower should ask about a prospective lender include:

- What is the capital provider's stated philosophy and reputation regarding management of underperforming or problem investments?
- How willing was the lender to provide references consisting of owners, CEOs and CFOs of companies that experienced a problem requiring significant flexibility on the part of the lender?
- If projections aren't met, how patient was the capital provider in allowing the management team to get things back on track, as opposed to bringing in another management team?
- How willing was the new capital provider to forebear from exercising its remedies such as foreclosure or appointment of a receiver?
- Has the capital provider ever engaged in or sold its investments to a firm engaged in *loan to own* activities?
- Was the capital source willing to agree to parameters that govern the range and nature of buyers to whom they are allowed to sell their position and under what circumstances? How quickly can a business find itself at the mercy of an unknown investor or lender?

The answers to these questions can be critical in properly positioning the company to successfully manage an unforeseen situation where actual events do not develop as hoped and expected. However, the most attractive capital — adaptable, patient and the least invasive for the business owner — is usually not the cheapest.

Experience in managing turnarounds has clearly demonstrated time and again that how the people at the chosen capital provider operate when things don't go as planned is often *far* more important than the price of other people's money.

Jettison the Naïveté

In almost all of my consulting engagements, I often hear the same desperate questions, complaints and naive assertions:

- Why are they acting this way? We have a 15-year relationship!
- Don't they believe that we can fix this? We've had issues before!
- Why do I have to provide weekly (or daily!) reporting? It's such a pain!
- Why are they unwilling to fund us the way they used to?
- Why do I have to hire a consultant? We know what we're doing!
- It's just a matter of time before we are out of the woods!
- We have the best management team in the industry!
- If they would only give me a few million more then we'd be just fine!
- Wait 'til I call my [very high up] old pal on the board who brought us the deal!

The fact is, despite the best of intentions, businesses do not always perform as expected. When this happens, the relationship with the capital provider can deteriorate quickly. Inevitably, the good friends who originated the deal become less involved when things get off track. The capital provider's tolerance for correctable oversights and mishaps in interim financial reporting becomes narrower. The demands for decisive action, such as refinancing or a sale of the company, become more strident. The requirement for written and signed legal releases for liability for past practices becomes standard. The capital user is often left with less money, few options and little recourse.

The bottom line is, corporate growth occurs in a risky business environment that depends on continuing access to funding. In evaluating proposals to provide funding, a capital user must carefully and thoroughly evaluate not only the comparative costs and benefits of term sheets, but the personalities and track records of the people behind them. Experience in managing turnarounds has clearly demonstrated time and again that how the people at the chosen capital provider operate when things don't go as planned is often *far* more important than the price of other people's money. abfj

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