# CASE STUDY: TURNAROUND STRATEGY FOR FINANCIALLY DISTRESSED FIRM

**Background/Overview:** 40-year old manufacturer of premium quality, premium priced specialty products for consumer niche markets. Total market size is $ 1.3 billion and has very well defined niche segments. Largest segment by-far is dominated by "commodity" suppliers who compete on the basis of price with low-cost, imported product offerings from China. Large number of suppliers in this segment, with the largest player at $ 185 million in annual revenues. As Chinese imported sourcing opportunities have become readily available, barriers to entry in this segment have been reduced and the number of new competitors into this segment has increased dramatically over the past ten years.

Subject firm competes in the smallest, but by far the most profitable segment in the market. Entire product offering is made in the U.S.; precision engineered using very complex and expensive manufacturing processes. Reputation for superior design innovation, and very strong brand identification, brand loyalty. Generally considered the "Rolex" of the industry. Traditionally, demand has not been very price sensitive for their offering and the number of competitors who service this niche are much smaller and generally are European.

The firm has literally thousands of SKU's in its offering, and thousands more component and bill of material items that go into these items. Bills of material are quite complex, with numerous items and multiple levels within the bills. Process flow is also very complex as reflected by the routings. Firm has a very strong, external focus and has historically been driven by sales, product design and development, and consumer pull-through marketing.

Internally, the firm has suffered for years from a secondary focus and lack of emphasis on cost management, cycle times and cycle efficiencies, process simplification & integration, and product & customer profitability. Product costing systems are antiquated, planning & budgeting are very ineffective, and ERP and shop floor fundamentals & disciplines have not been a priority. Fiscal and operating control environment is quite weak.

Firm is still entrepreneurially dominated by the founder and majority owner. Minority ownership is held evenly amongst second generation siblings, two of whom are involved in the business; one leads Sales the other Manufacturing. Like many family generational hand-offs, sibling rivalries are very much a business issue-especially for non-family member senior executive peers and rank and file associates.

Success has been defined as maximizing revenues and growth, and that shareholder value can best be created by an aggressive growth strategy in multiple directions. The hope is that substantial operating leverage can be exerted over a very substantial, and recently expanded fixed capital investment-high fixed overhead cost structure. Customers are divided into large, multi-location national accounts and small, single location specialty retailers. Pricing policies across these very different customer structures are subject to the constraints created by inadequate product-customer cost and profitability information.

**Situation-Critical Issues:**

- Five years ago, firm embarked on a major expansionary program. Two additional facilities were added and completely refurbished. Total cost of the RE expansions was close to $ 8 million and financed by very complex, government subsidized long-term financing packages in exchange for contractually promised job expansion.
- $ 16 million in equipment capital expenditures were also made and financed through equipment term loans.
- Office improvements in the new HQ were lavish, and created a $ 3.5 million over advance on their primary revolving line of credit facility. Responding to a competitive threat to move the credit to a new lender, agent lender agreed to fund this over-advance by rolling it into a 3-year term-loan secured by a pledge of intellectual property of the business, in particular the trademarks which were "appraised" at $ 10 million.
- Headcount grew over this time-frame from around 300 to 400+ associates.
- 5 additional regional distribution centers were added across the U.S. over the past two years.
- Several new, and non-traditional marketing-business ventures were attempted at the same time to dramatically accelerate growth:
    - A brand new signature line of products in a JV with a major celebrity in the entertainment world.
    - A new line of low-end, commodity products imported from China to "broaden" the product line and expand distribution into previously under-served segments of the market. These products would be warehoused in the five DC's added over the past couple of years.
    - A premium-priced, premium positioned line was added to attract the luxury consumer.
    - An entirely new business unit was created and staffed to expand into a specialty enthusiast segment. Numerous new management, sales, and support positions were created and staffed to pursue this very expensive and risky new venture.

- Because of import tariffs to protect U.S. Steel and Aluminum interests, and because of the impact of accelerated world demand out of China, commodity raw materials costs have increased 25-35% per year over the past 4-5 years. These increases have largely been passed through to their customers through price increases.
- The company's two core, traditional business units continued to perform quite well with modest, but stable and predictable growth. Unlike the other BU's, these two have been consistently profitable with strong cash flow and very manageable SKU offering. Manufacturing and support processes are quite efficient for these two BU's and brand demand and served market share is outstanding. Combined annual revenues in these two segments is close to $ 20 million.
- The majority owner has battled serious health issues over the past 8-10 years, and has slipped badly over the past 5-6 months.

**Financial Overview**: Please refer to the attached Excel template.

In five years, the firm has gone from 3 to 10 secured lenders. Out of $ 24 million in senior debt on the balance sheet, $ 17 million is with the agent, $ 5 million is with one equipment lender, and the rest represent individual equipment loans with various community banks and specialty equipment commercial finance companies. The RE debt of $ 8 million is held individually by the owner through a complex structure with the local EDC. The business leases the property in form, but is a guarantor on the debt and makes the payments directly to the lender. There is $ 9.5 million in trade payables to over 400 unsecured trade creditors. Over 80% of the balance is concentrated with the top 25 creditors.

The owner has personally guaranteed all of the secured debt.

8 months after funding the $ 3.5 million over-advance, the agent discovers over $ 1.8 million in unprocessed customer credit memos. The lender advances .80 against all receivables less than 120-days old. They also advance .60 against <u>all</u> inventories. Furthermore, after forecasting over $ 70 million in revenues, the firm revises its 3rd quarter forecast down to $ 52 million.

At the bank's encouragement, the firm has brought in two separate turnaround-crisis management firms within five months. The owner has infused $ 1.5 million of personally borrowed funds. Trade creditors have placed the firm on COD.

**Your Role**:

5 months after discovering the unprocessed credit memos, and two turnaround firms later, your team is called in and you agree to assume a Chief Restructuring Officer role. On day one, the agent lender informs you of their desire to quickly exit the credit-no later than 120 days.

Mindful of your fiduciary duty, you are quite sensitive to the critical analysis of solvency and when the date of insolvency can be first established. Once the firm is technically insolvent, your fiduciary duty and that of the corporate officers shifts to maximization of recovery to the creditors. As always, you want to consider a bankruptcy filing very carefully, if not as a last resort. You need to carefully and consistently monitor the degree of fatigue with the lenders-not an easy task given you have close to a dozen to contend with. You also have 400 unsecureds to be concerned with, and the possibility of filing an involuntary chapter 11 bankruptcy petition against the firm. A disorderly liquidation or a free-fall chapter 11 filing is something you want to avoid. By your experience, you know that a chapter 7 or 11 filing means little or nothing for the trade creditors, and usually zero for the ownership.

To "assist" you in your decision process, you have an appraisal done on the equipment and discover that the net orderly liquidation value is $ 5 million vs. $ 7.5 million outstanding in debt against this. Typically a secured lender wants a 20% collateral equity "cushion" against term debt. This means the most we can expect to realize in refinancing the equipment is $ 4 million.

With default conditions with each credit agreement, and no trade payables financing available, your phone is ringing constantly and there is a steady parade of associates queuing up or filing into your office. The ownership distrusts you and considers you a threat or a "plant" by the bank, in spite of your long-term previous personal and business relationship with them.

You have at most 30 days to emerge with a plan to deal with the numerous moving pieces in this crisis. Your choices are:

1. Out of court, non-judicial work-out with the existing lenders and trades still in place.
2. Out of court liquidation of assets such as an assignment for the benefit of creditors.
3. Formal traditional Chapter 11 filing to effect a court-protected, restructuring and work-out of the business with the goal of a re-organized entity eventually emerging. In 11, you have the opportunities to obtain debtor-in-possession financing (DIP) which will enable you to have some short-term working capital financing. You receive an automatic stay against ALL pre-petition creditors, and the opportunity to assume, reject, or assign the various warehouse and facilities leases. However, you are at the mercy of a very uncertain court proceeding, it is quite risky and expensive, and your client stands

to lose the business and then some because of the personal guarantees and the collateral value deficiencies. Remember also that the agent has the trademarks as collateral as well.

4. An out of court, orderly auction sale of the entire business under Article Nine of the Uniform Commercial Code. The challenge here is how to work out alternatives given the shear volume of trade and secured creditors within the timeframe as mandated by the agent bank.
5. An orderly auction sale of all the assets of the business under Section 363 of the bankruptcy code. This is a pre-packaged sale of the business, free of ALL liens and encumbrances that uses 11 to shred trade debt, remove unsecured collateral deficiencies, and allows an auction process to be used to market-sell the operating entity to a strategic or financial buyer. The same advantages of an 11 filing exist, but the exit has much more certainty. Also, the time spent in 11with a 363 sale is 4-6 weeks-not 12-24 months as is common with a standard 11 filing.
6. A court-projected liquidation of the assets of the business under Chapter 7 of the code. This is a fire-sale kind of process, when little or no intangible or going concern value is present.

You refer to your outline on stage of insolvency, you analyze the template, and your mission is a 1-2 page outline of your preferred plan including a summary of your rationale and your reasoning.

## Stages of decline:

- **<u>Early stage decline ("Incubation" period):</u>**
    - Change in product demand
    - Continuing increase in overhead costs
    - Obsolete production methods
    - Increase in competition
    - Incompetent managers in key positions
    - Acquisition of unprofitable subsidiaries
    - Over-expansion without adequate working capital
    - Incompetent credit and collections department
    - Lack of adequate banking facilities
    - Poor communications, especially with operating people
    - Margin erosion
    - ROA, ROE erosion
    - Leverage creep
    - Assets, liabilities growing faster than sales
    - Sales growing faster than profits
    - Z-factor score erosion
- **<u>Mid-stage decline ("Cash shortage"):</u>**
    - Unable to meet current obligations
    - Asset illiquidity-capital tied up in accounts receivable & inventory
    - Dire need of cash
    - Current ratio might be ok, current asset turnover is eroding rapidly.
    - Quality of earnings problem-could be reporting profits on the income statement, but working capital management is lacking
    - Vendor relationships beginning to erode
    - Customer service levels-fill rates, turnaround times, shortages, cancellations, backorders beginning to slip
    - Wild fluctuations in reported results
    - Early stage lender concern
    - Covenant violations, default conditions begin to appear
    - Serious erosion in 4-variable Z-factor
    - Extensive problematic inventory
- **<u>Financial insolvency:</u>**
    - Unable to obtain funds to meet maturing and overdue obligations through customary channels
    - Extensive damaged relationships with trade creditors
    - Uncured default and serious lender fatigue
    - Little or no bank or trade credit availability
    - Severe erosion in profitability and cash flow
    - Dangerous levels of leverage
    - Liquidity crisis
    - At a minimum, out-of-court workout must be considered, possibly Chapter 11.
    - Lender wants out of the credit, but demand letter has not been received.
    - Management credibility with critical third-party creditors is severely impaired.
    - 90-day window of insolvency has been reached; well within 1-year window for insiders
    - 4-Variable Z-factor is clearly in the danger zone
- **<u>Total insolvency</u>**:
    - Unable to secure more/new funding
    - Market value of assets is less than face value of liabilities
    - Filing is most likely scenario-recent trends to liquidation within Chap. 11 and Chap 7.
    - Out-of-court workout not likely. Lender is ready to seek a judgment, or demand letter has been received.
    - No opportunity for additional trade financing
    - Little or no sales momentum. Customer concentration/dependency often a major issue
    - Successful reorganization is unlikely
    - Risk of disorderly liquidation

**Corporate renewal industry overview**

Until recently, turnaround specialists were a relatively unknown breed in the business world. However, as once-stable companies struggle to maintain profitability, the expertise of corporate renewal professionals is more in demand than ever. Rising competition, cyclical financial markets and economic volatility have created a climate where no business can take economic stability for granted.

Many companies have turned to downsizing to improve their economic health. However, downsizing has taken its toll on corporations by robbing them of management talents. The ranks of managers groomed to assume top positions have been thinned. In addition, the volatile business environment has turned once-successful CEOs into hesitant managers who are no longer able to provide strong leadership.

New lender liability laws have also increased the need for turnaround management. At one time, banks could take control of client companies in serious financial peril. Today the courts view this action as equity participation, forcing banks to avoid direct involvement with corporate management. A turnaround specialist, operating as either an interim manager or consultant, may replace a company's CEO and temporarily take over the decision-making process of a company to lead it back toward stability. Or, the turnaround professional may become an active advisor to the troubled company's board of directors.

**Advantages of a turnaround professional**

The turnaround specialist enters a company with a fresh eye and complete objectivity. This professional is able to spot problems and create new solutions that may not be visible to company insiders.

The turnaround manager has no political agenda or other obligation to bias the decision-making process, allowing him or her to take the sometimes unpopular, yet necessary steps for survival.

Experience within a particular industry is not as important as experience in crisis situations when a company is facing bankruptcy or the loss of millions in revenue. Like an emergency room doctor, the talent lies in making critical decisions quickly to staunch the bleeding to give the patient the best chance for recovery.

Operating in the eye of the storm, the turnaround specialist must deal equitably with angry creditors, frightened employees, wary customers and a nervous board of directors. With the highest stakes on the table, clearly this is no assignment for the faint-hearted.

**Signs of a troubled business**

Executives who run into corporate troubles often go through the same processes that dying people do: denial, anger, bargaining, depression and then finally acceptance. The last stage is when corporations hire turnaround professionals, unless forced to do so earlier by a lender, equity sponsor, or bankruptcy court.

Corporate managers who recognize and acknowledge the signs of trouble and get help in the earlier stages have a much better chance of a successful recovery for their corporation.

Most businesses in distress will display more than one of these common signs of trouble:

**Ineffective management style**

The president and founder of a company is unable to delegate authority. No decision, big or small, can be made without his or her blessing. As a result, the rest of the management staff is without solid experience or any feeling of ownership. Dishonesty or fraud may exist. The board of directors is nonparticipative and ineffective. If the president suddenly becomes incapacitated or dies, the entire company is in danger of collapse.

**Overdiversification**

The business has yielded to pressure to diversify to reduce risk. However, too much diversification causes it to spread too thin. As a result, the business becomes vulnerable to the competition.

**Weak financial function**

The company with its excessive debt and inadequate capital is operating with little or no margin for error. Its credit is overextended and fixed assets and inventories are excessive.

**Poor lender relationships**

Its weak financial position has led to the company developing an adversarial relationship with its lending institution. Fearing that its loan may be in jeopardy, the company tries to hide financial information from the bank. Phone calls are not returned. Reports stop being filed. Since money is the lifeblood of most any business, this kind of lender relationship only leads to more trouble.

**Lack of operating controls**

The company is operating without adequate reporting mechanisms. This is like flying an airplane without an instrument control panel. Management decisions based on old or inaccurate information can head the company in the wrong direction.

**Market lag**

Changes in the marketplace have bypassed the company, leaving it with sagging sales and lost market share. For some, the deficiency is technology; their equipment or products and services have become obsolete. For others, the problem lies in sales and marketing; the company hasn't kept pace with the needs of the marketplace.

**Explosive growth**

The business is growing rapidly. A business that is a success at $5 million in sales a year can become a dismal failure at $10 million. Companies achieving fast growth from concentrating on boosting sales overlook the effects of growth on the balance sheet. Growth often carries a very high price tag from significant investments in R&D. Leveraging a company to such a degree means that management must operate with little or no margin for error.

In addition, growth has led to overrunning the people capacity. Staff is not able to work successfully at the new level. For example, managing engineering operations for a company with 12 plants is much different than managing one with two plants. The same challenge applies to others in key positions in marketing, sales, operations and manufacturing. A company can grow beyond its ability to manage.

**Precarious customer base**

The business relies on a few big customers for most of its sales. If a manufacturer selling to large retail chains has two customers representing 60% of its business, the company is obviously vulnerable. The loss of just one customer could put hundreds out of work and send the business into bankruptcy.

**Family vs. business matters**

Family issues are causing decisions to be made based on emotions, rather than sound business judgment. Sibling rivalry has ruined many privately-held companies. Deciding which relative should run the business after the founder's retirement or death can be one of the most difficult challenges a business can face. Divorce can also shatter a business, leaving it in fragments. Nepotism can cause bright, skillful managers who aren't part of the family circle to take their talents elsewhere.

**Operating without a business plan**

The growing company is operating without a business plan. Armed with 15 or 20 years in the business, management often operates by the seat of its pants. Its plan may change overnight because the plan is based on management's own "feel" for the market. In some cases the business plan exists in everyone's head rather than in writing. The result is that plans are carried out according to individual interpretation.

**Stages of a turnaround**

**Stage One : Changing the management**

Most CEOs or company presidents don't relinquish power easily. Often their egos make it hard for them to admit such a downturn is really happening or that they are unable to pull the company out of its nosedive. So, usually the first step is to put into place the top management team who will lead the turnaround effort. In many instances, the board of directors selects and hires the turnaround specialist, although others such as bankers and corporate attorneys may also be involved. As an outsider rather than a corporate insider, the turnaround specialist enters the company carrying no political baggage.

During this stage or after Stage Two—situation analysis—steps are taken to weed out or replace any top managers, which may include the CEO, CFO or weak board members, who might impede the effort.

**Stage Two : Analyzing the situation**

Before a turnaround specialist makes any major changes, he or she must determine the chances of the business's survival, identify appropriate strategies and develop a preliminary action plan.

This means the first days are spent fact-finding and diagnosing the scope and severity of the company's ills. Is it in imminent danger of failure? Does it have substantial losses but its survival is not yet threatened? Or is it merely in a declining business position? The first three requirements for viability are analyzed: one or more viable core businesses, adequate bridge financing and adequate organizational resources. A more detailed assessment of strengths and weaknesses follows in the areas of competitive position, engineering and R&D, finances, marketing, operations, organizational structure and personnel.

In the meantime, the turnaround professional must deal with various groups. The first is angry creditors who may have been kept in the dark about the company's financial status. Employees are confused and frightened. Customers, vendors and suppliers are wary about the future of the firm. The turnaround specialist must be open and frank with all these audiences.

Once the major problems are spotted and identified, the turnaround professional develops a strategic plan with specific goals and detailed functional actions. He or she must then sell it to all key parties in the company, including the board of directors, management team and employees. Presenting the plan to key parties outside the company—bankers, major creditors and vendors—should regain their confidence.

**Stage Three : Implementing an emergency action plan**

When the condition of the company is critical, the plan is simple but drastic. Emergency surgery is performed to stop the bleeding and enable the organization to survive. At this time emotions run high; employees are laid off or entire departments eliminated. After sizing up the situation objectively, the skilled turnaround leader makes these cuts swiftly.

Cash is the lifeblood of the business. A positive operating cash flow must be established as quickly as possible and enough cash to implement the turnaround strategies must be raised. Often, unprofitable divisions or business units are unloaded. Frequently, the turnaround specialist will apply some quick, corrective surgery before placing them on the market. If the unit fails to attract a buyer in a given time frame, liquidation occurs.

The plan typically includes other financial, marketing and operations actions to restructure debts, improve working capital, reduce costs, improve budgeting practices, correct pricing, prune product lines and accelerate high potential products.

The status quo is challenged and those who change as a result of the plans are rewarded and those who don't are sanctioned. In a typical turnaround, the new company emerges from the operating table, a smaller organization but no longer losing cash.

**Stage Four : Restructuring the business**

Once the bleeding has stopped, the losing divisions sold off and the administrative costs cut, turnaround efforts are directed toward making current operations effective and efficient. The company must be restructured to increase profits and return on assets and equity.

In many ways, this stage is the most difficult of all. Eliminating losses is one thing, but achieving an acceptable return on the firm's investment is another.

The financial state of the core business of the company is particularly important. If the core business is irreparably damaged, then the outlook is bleak. If the remaining corporation is capable of long-term survival, it must now concentrate on sustained profitability and the smooth operation of existing facilities.

During the turnaround, the product mix may have changed, requiring the company to do some repositioning. Core products neglected over time require immediate attention to remain competitive. In the new, leaner company, some facilities might be closed; the company may even withdraw from certain markets or target its products toward a different niche.

The "people mix" becomes more important as the company is restructured for competitive effectiveness. Reward and compensation systems that reinforce the turnaround effort get people to think "profits" and "return on investment." Survival, not tradition, determines the new shape of the business.

**Stage Five : Returning to normal**

In the final step of the turnaround, the company slowly returns to profitability. While earlier steps concentrated on correcting problems, this one focuses on institutionalizing an emphasis on profitability, return on equity and enhancing economic value-added. For example, the company may initiate new marketing programs to broaden the business base and increase market penetration. The company increases revenue by carefully adding new products and improving customer service. Strategic alliances with other world-class organizations are explored. Financially, the emphasis shifts from cash flow concerns to maintaining a strong balance sheet, long-term financing, and strategic accounting and control systems.

This final step cannot be successful without a psychological shift as well. Rebuilding momentum and morale is almost as important as rebuilding the ROI. It means a rebirth of the corporate culture and transforming the negative attitudes to positive, confident ones as the company maps out its future.

**Judging the success or failure of a turnaround**

Of course, not all turnarounds succeed in the manner outlined here. A company may put a quick end to its disastrous losses but never quite attain an acceptable return position. When this occurs, management may decide to sell the business to a company better able to produce an acceptable return on the funds invested. In a sense, this is not failure at all. The company may very well thrive and reach new heights under different ownership. Here, the turnaround manager can play a key role in identifying prospective purchasers and then negotiating a successful sale.

Ironically, some companies never reach Stage Five because of significant success in the earlier steps. The turnaround becomes so successful that the company becomes a target of a takeover bid. Again, this must not be viewed as a failure. The company was saved and continues to perform well with stronger sales than ever before.

**Choosing a turnaround professional**

For a troubled company, no decision may be more crucial than hiring a turnaround manager. Yet, with all the pressures and distractions taking place within the company, this decision comes at the worst possible time.

Questions to consider

• What length of time is expected for the services of a turnaround specialist?

• Can the company pay the turnaround specialist's fees?

• Will other specialists be brought in by the turnaround manager?

• Will the rest of the existing management team be able to work with the specialist?

• What exactly is expected of the turnaround specialist?

• Are the goals in writing?

• What are the chances of success in turning around the company?

• Is the company willing to let an outsider liquidate or sell key units of the business if necessary?

**Key factors in making the right choice**

Background Experience is the most important credential. MBA degrees and CPA designations count for little if the turnaround manager does not have a proven track record. The candidate should be able to produce a portfolio of success stories and satisfied clients.

**Ethics and professionalism**

Membership in the Turnaround Management Association indicates the degree of professionalism and honesty of a candidate. TMA holds members to a strict Code of Ethics and all members listed in this Directory have signed a statement acknowledging the TMA Code of Ethics.

TMA also encourages certification by the Association of Certified Turnaround Professionals as a further demonstration of expertise and commitment to the corporate renewal industry. The Certified Turnaround Professional (CTP) designation indicates that a turnaround specialist has met specific standards of education, experience and professional conduct and has successfully completed a rigorous written examination.

**Reputation**

No turnaround manager can expect to succeed without quickly gaining the confidence of creditors as well as accessing new sources of credit. Check the candidate's reputation with leading bankers, attorneys, accountants, financial

advisors, factors and trade creditors.

**Managerial skills**

As the chief architect and implementer of new strategies, the turnaround specialist must be an organizational leader. Look for a person of action, with entrepreneurial instincts, "hands on" experience, and interviewing and negotiating skills.

**Fee structure**

Make sure the fee structure of the turnaround specialist is clear and fair. A company should make sure it can afford such a service or else it may be trading one set of problems for another. Find out if there is an incentive or performance arrangement in the contract.

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**Firm X Inc.**

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|---|---|---|---|---|---|---|---|---|---|---|
| **HISTORICAL/COMPARATIVE** | | | | | | | | | | **UNAUDITED** |
| **INCOME STATEMENT** | **FY** | **FY** | **FY** | **FY** | **FY** | **FY** | **FY** | **FY** | **FY** | **FY** |
| **YEAR** | **1996** | **1997** | **1998** | **1999** | **2000** | **2001** | **2002** | **2003** | **2004** | **2005** |
| REVENUES | $21,548 | $22,464 | $25,165 | $30,269 | $34,326 | $37,215 | $43,053 | $40,084 | $46,091 | $51,761 |
| COGS | $16,210 | $18,123 | $17,772 | $20,997 | $26,887 | $28,492 | $30,837 | $30,542 | $35,659 | $42,926 |
| Gross Profit | $5,338 | $4,341 | $7,393 | $9,272 | $7,439 | $8,723 | $12,216 | $9,542 | $10,432 | $8,835 |
| SGA | $5,110 | $4,842 | $5,019 | $5,978 | $6,320 | $5,980 | $7,674 | $8,435 | $11,537 | $13,643 |
| **INC FROM OPS** | **$228** | **($501)** | **$2,374** | **$3,294** | **$1,119** | **$2,743** | **$4,542** | **$1,107** | **($1,105)** | **($4,808)** |
| interest | $851 | $971 | $1,031 | $1,472 | $1,711 | $1,783 | $1,404 | $1,192 | $1,315 | $1,900 |
| misc(inc.) | $641 | $560 | $326 | $472 | ($77) | ($14) | | ($996) | ($37) | $477 |
| **EBT** | **($1,264)** | **($2,032)** | **$1,017** | **$1,350** | **($515)** | **$974** | **$3,138** | **$911** | **($2,383)** | **($7,185)** |
| INC TAX EXP | ($208) | ($419) | $310 | $681 | | ($253) | $1,020 | $346 | ($1,080) | ($126) |
| **NET INC/(LOSS)** | **($1,056)** | **($1,613)** | **$707** | **$669** | **($515)** | **$1,227** | **$2,118** | **$565** | **($1,303)** | **($7,059)** |
| EBT | ($1,264) | ($2,032) | $1,017 | $1,350 | ($515) | $974 | $3,138 | $911 | ($2,383) | ($7,185) |
| ADD: INT | $851 | $971 | $1,031 | $1,472 | $1,711 | $1,783 | $1,404 | $1,192 | $1,315 | $1,900 |
| EBIT | ($413) | ($1,061) | $2,048 | $2,822 | $1,196 | $2,757 | $4,542 | $2,103 | ($1,068) | ($5,285) |
| ADD: DEPR | $491 | $526 | $941 | $943 | $1,452 | $1,898 | $2,026 | $2,184 | $2,655 | $2,772 |
| **EBITDA** | **$78** | **($535)** | **$2,989** | **$3,765** | **$2,648** | **$4,655** | **$6,568** | **$4,287** | **$1,587** | **($2,513)** |
| **3-5 YEAR WEIGHTED AVERAGE EBITDA** | | | $1,331 | $2,304 | $2,424 | $3,355 | $4,653 | $4,727 | $3,785 | $1,636 |
| **MULTIPLE** | | | 5 | 6 | 6 | 6 | 7 | 5 | 5 | 4 |
| **EST ENTERPRISE VALUE** | | | **$6,656** | **$12,669** | **$13,333** | **$18,454** | **$30,242** | **$23,634** | **$17,034** | **$6,545** |
| **LESS: SENIOR DEBT** | | | $7,012 | $15,086 | $17,702 | $19,544 | $18,354 | $21,115 | $26,552 | $25,579 |
| **"EQUITY" VALUE** | | | **($356)** | **($2,417)** | **($4,369)** | **($1,090)** | **$11,888** | **$2,519** | **($9,518)** | **($19,034)** |
| **LESS: MEZZ PIECE** | | | **$2,150** | **$0** | **$0** | **$0** | **$0** | **$0** | **$0** | **$0** |
| **AVAIL. FOR "COMMON"** | | | **($2,506)** | **($2,417)** | **($4,369)** | **($1,090)** | **$11,888** | **$2,519** | **($9,518)** | **($19,034)** |

**Firm X Inc.**
**HISTORICAL/COMPARATIVE**
**CASH FLOW**

| | | | | | | | | | | **UNAUDITED** |
|---|---|---|---|---|---|---|---|---|---|---|
| | **FY** | **FY** | **FY** | **FY** | **FY** | **FY** | **FY** | **FY** | **FY** | **FY** |
| | **1996** | **1997** | **1998** | **1999** | **2000** | **2001** | **2002** | **2003** | **2004** | **2005** |
| NET INCOME | ($1,056) | ($1,613) | $707 | $669 | ($515) | $1,227 | $2,118 | $565 | ($1,303) | ($7,059) |
| ADD : NON-CASH CHARGES | | | | | | | | | | |
| DEPR & AMORT | $491 | $526 | $941 | $943 | $1,452 | $1,898 | $2,026 | $2,184 | $2,655 | $2,772 |
| INTEREST EXPENSE | $851 | $971 | $1,031 | $1,472 | $1,711 | $1,783 | $1,404 | $1,192 | $1,315 | $1,900 |
| GAIN ON DISPOSALS OF FIXED ASSETS | | ($18) | | | $2 | $2 | $2 | | | |
| CHANGE IN DEF TAXES | $131 | $0 | $0 | $0 | $95 | ($95) | $0 | $768 | $256 | ($1,024) |
| BALANCE SHEET CHANGES: | | | | | | | | | | |
| RECEIVABLES | ($467) | ($249) | ($1,346) | ($2,827) | $607 | ($40) | ($2,226) | $247 | $1,661 | ($50) |
| INVENTORY | ($66) | $2,168 | ($1,219) | ($2,596) | ($1,278) | ($1,815) | ($1,563) | $498 | ($6,629) | $2,284 |
| OTHER CURRENT ASSETS | $764 | ($334) | $152 | ($12) | $26 | ($646) | $503 | ($1,188) | ($961) | $1,677 |
| ACCTS PAYABLE | $855 | ($601) | $60 | $1,487 | $1,838 | ($1,315) | $2,252 | $392 | $2,878 | $2,213 |
| OTHER CURRENT LIAB | ($482) | ($58) | $254 | ($38) | $103 | $101 | $701 | ($491) | $186 | ($95) |
| TOTAL FROM OPERATIONS | $1,021 | $792 | $580 | ($902) | $4,041 | $1,100 | $5,217 | $4,167 | $58 | $2,618 |
| | | | | | | | | | | |
| INVESTING ACTIVITIES | | | | | | | | | | |
| CAP EX (NET OF RETIRE./REPL) | ($418) | ($229) | ($2,035) | ($3,491) | ($5,142) | ($1,416) | ($2,614) | ($5,995) | ($3,480) | ($1,525) |
| OTHER LT ASSETS | | $9 | ($43) | ($57) | $197 | ($59) | $1 | ($42) | ($6) | ($51) |
| TOTAL FROM INVESTING ACTIVITIES | ($418) | ($220) | ($2,078) | ($3,548) | ($4,945) | ($1,475) | ($2,613) | ($6,037) | ($3,486) | ($1,576) |
| | | | | | | | | | | |
| FREE CASH FLOW | $603 | $572 | ($1,498) | ($4,450) | ($904) | ($375) | $2,604 | ($1,870) | ($3,428) | $1,042 |
| | | | | | | | | | | |
| FINANCING ACTIVITIES: | | | | | | | | | | |
| REVOLVER-NEW | | | | | | | | | | |
| NOTES PAYABLE: | | | | | | | | | | |
| SHORT-TERM | | ($2,528) | $1,822 | ($4,106) | $372 | $461 | ($420) | ($418) | $799 | $12,566 |
| LONG-TERM | $247 | $721 | $721 | $12,180 | $2,244 | $1,381 | ($770) | $3,179 | $4,638 | ($13,539) |
| SUB DEBT | | $1,400 | ($175) | ($1,225) | | | | | | |
| WARRANTS | | $800 | $125 | ($925) | | | | | | |
| RELATED PARTY NOTES-SUBORDINATED | | | | | | | | | | |
| INTEREST EXPENSE | ($851) | ($971) | ($1,031) | ($1,472) | ($1,711) | ($1,783) | ($1,404) | ($1,192) | ($1,315) | ($1,900) |
| CHANGE IN DERIVATIVE CONTRACTS | | $0 | $0 | $0 | $0 | $1,205 | ($416) | ($583) | ($156) | ($50) |
| ***EQUITY INFUSION*** | | $0 | $0 | $0 | $0 | $0 | $0 | $0 | $0 | $0 |
| ***DISTRIBUTIONS*** | | | | | | | | | | |
| TOTAL FROM FINANCING ACTIVITIES | ($604) | ($578) | $1,462 | $4,452 | $905 | $1,264 | ($3,010) | $986 | $3,966 | ($2,923) |
| | | | | | | | | | | |
| **NET CASH FLOW** | **($1)** | **($6)** | **($36)** | **$2** | **$1** | **$889** | **($406)** | **($884)** | **$538** | **($1,881)** |

Firm X Inc.

HISTORICAL/COMPARATIVE

| RATIO ANALYSIS: | FY 1996 | FY 1997 | FY 1998 | FY 1999 | FY 2000 | FY 2001 | FY 2002 | FY 2003 | FY 2004 | UNAUDITED FY 2005 |
|---|---|---|---|---|---|---|---|---|---|---|
| GROSS PROFIT % SALES | 24.8% | 19.3% | 29.4% | 30.6% | 21.7% | 23.4% | 28.4% | 23.8% | 22.6% | 17.1% |
| SGA COSTS % SALES | 23.7% | 21.6% | 19.9% | 19.7% | 18.4% | 16.1% | 17.8% | 21.0% | 25.0% | 26.4% |
| EBITDA % SALES | 0.4% | -2.4% | 11.9% | 12.4% | 7.7% | 12.5% | 15.3% | 10.7% | 3.4% | -4.9% |
| INT EXP % SALES | 3.9% | 4.3% | 4.1% | 4.9% | 5.0% | 4.8% | 3.3% | 3.0% | 2.9% | 3.7% |
| DSO ACCTS REC | 36 | 38 | 53 | 77 | 62 | 57 | 68 | 71 | 49 | 44 |
| ITO | 2.5 | 4.1 | 3.1 | 2.5 | 2.8 | 2.5 | 2.4 | 2.5 | 1.9 | 2.6 |
| DAYS COGS IN INVENTORY | 149 | 89 | 116 | 144 | 129 | 145 | 153 | 148 | 195 | 142 |
| DAYS COGS IN ACCTS PAY | 83 | 62 | 65 | 81 | 88 | 66 | 88 | 93 | 109 | 110 |
| CURR RATIO | 0.9 | 1.1 | 1.1 | 2.3 | 1.8 | 2.0 | 1.9 | 2.1 | 2.0 | 0.8 |
| QUICK RATIO | 0.3 | 0.5 | 0.5 | 1.1 | 0.7 | 0.8 | 0.8 | 1.0 | 0.7 | 0.3 |
| LEVERAGE RATIO | 15.7 | -10.6 | -52.9 | 47.8 | -274.0 | 106.3 | 10.1 | 7.3 | 15.9 | -9.1 |
| FIX ASSETS | 13.23 | 16.64 | 10.3 | 6.06 | 3.95 | 4.54 | 4.9 | 3.18 | 3.44 | 4.25 |
| TOT ASSETS | 1.95 | 2.45 | 1.99 | 1.46 | 1.38 | 1.38 | 1.4 | 1.14 | 1.1 | 1.41 |
| ROA | -9.6% | -17.6% | 5.6% | 3.2% | -2.1% | 4.6% | 6.9% | 1.6% | -3.1% | -19.2% |
| ROE | -159.5% | 169.6% | -289.8% | 157.8% | 565.9% | 488.8% | 76.4% | 13.4% | -52.4% | 155.4% |
| INT COVERAGE RATIO | -0.49 | -1.09 | 1.99 | 1.92 | 0.7 | 1.55 | 3.24 | 1.76 | -0.81 | -2.78 |
| 4-VARIABLE Z-FACTOR | -1.294983 | -1.734889 | 0.7220636 | 3.2526189 | 1.6767914 | 2.4738717 | 3.2461289 | 2.8984451 | 2.0709774 | -2.658797426 |
| SAFE LEVEL | 2.6 | 2.6 | 2.6 | 2.6 | 2.6 | 2.6 | 2.6 | 2.6 | 2.6 | 2.6 |
| MEAN NON-BANKRUPT | 7.7 | 7.7 | 7.7 | 7.7 | 7.7 | 7.7 | 7.7 | 7.7 | 7.7 | 7.7 |
| BANRUPTCY THRESHOLD | 1.1 | 1.1 | 1.1 | 1.1 | 1.1 | 1.1 | 1.1 | 1.1 | 1.1 | 1.1 |
| MEAN BANKRUPT | -4.1 | -4.1 | -4.1 | -4.1 | -4.1 | -4.1 | -4.1 | -4.1 | -4.1 | -4.1 |