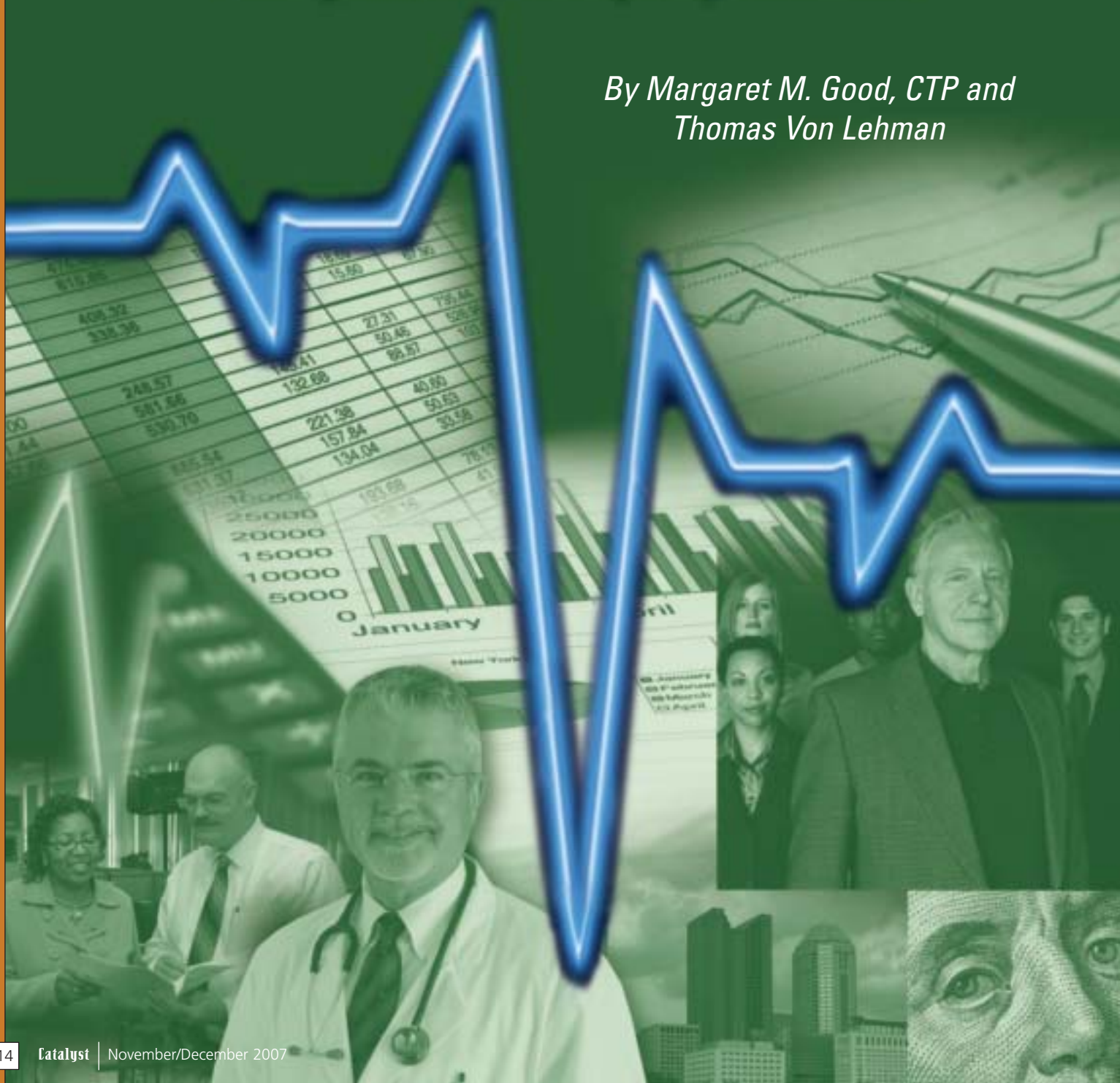


Curing a company's ills

*Calling turnaround expert early
can prevent company demise*

*By Margaret M. Good, CTP and
Thomas Von Lehman*



A successful turnaround is rare.

The Executive Office for the United States Trustees has reported that the success rate of Chapter 11 bankruptcy cases, as measured by the percentage of cases confirmed each year, is only 27%. Of course, just because a bankruptcy filing is confirmed does not mean it will result in a successful financial outcome, making the actual financial successes less than 27%. The success rate for turnarounds outside of bankruptcy is also low because companies don't seek professional help early enough.

The chart below describes the various stages of decline. Realize the probability of a successful business turnaround diminishes at each stage.

Unfortunately, far too many companies don't seek help until they reach the cash crisis stage. Even at this stage, the lender is often forcing the company to seek professional assistance. As turnaround consultants, we have been brought in on a Tuesday when the company realizes it cannot make payroll on the next Friday.

Stage	Indicators	Time until cash crisis
Declining profits	<ul style="list-style-type: none"> Operating margins are squeezed Trend of declining profits Reduced operating cash flow 	24 – 48 months
Operating losses	<ul style="list-style-type: none"> Company reports operating loss Cash flow coming mainly from depreciation Drawing down lines of credit 	12 – 36 months
Balance sheet erosion	<ul style="list-style-type: none"> Inventory on the rise Accounts payable aging increasing sharply Covenant defaults on loans 	9 – 18 months
Cash crisis	<ul style="list-style-type: none"> Lines of credit at max or overdrawn Company on COD terms with vendors Questionable whether payroll can be met 	NOW

An award-winning turnaround case study is R.G. Barry Corporation, which won the Turnaround Management Association's 2006 Turnaround of the Year Award for Mid-sized Companies. Fortunately, in this case, help was brought in somewhere between the balance sheet erosion and cash crisis stages, when there was at least some time to develop a reorganization plan and obtain new long-term financing for the company. This case study demonstrates the power of the turnaround process and how it can turn a failing organization into a healthy, profitable company with a bright future.

PATIENT PROFILE

Name: R.G. Barry Corporation, Columbus, Ohio

Known for: Comfort footwear

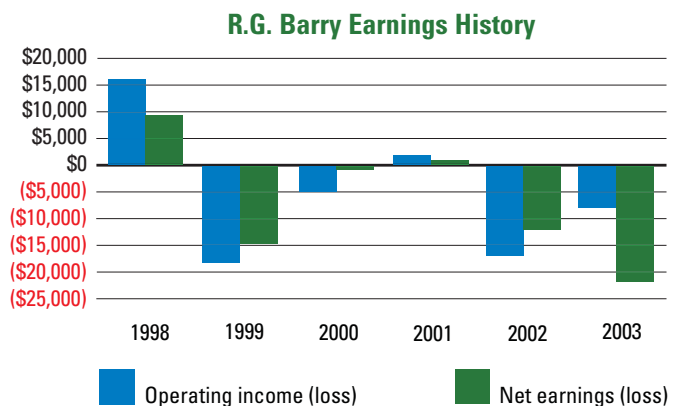
Description: A publicly traded company, its principal business is designing, manufacturing and marketing "around-the-home" comfort footwear, principally slippers. R.G. Barry sells through most traditional retail channels under a variety of brands and retail private labels. Its primary brand is Dearfoams slippers.

Birth date and family history: The company was founded in 1947 and used newly discovered foam rubber to create comfortable, washable slippers and footwear. The son of two of the company founders served as chair and CEO, and had been running R.G. Barry for 40 years. Under the chair's management, annual revenues peaked in the mid 1990s at \$150 million. R.G. Barry's stock price peaked at \$25 in November 1994.

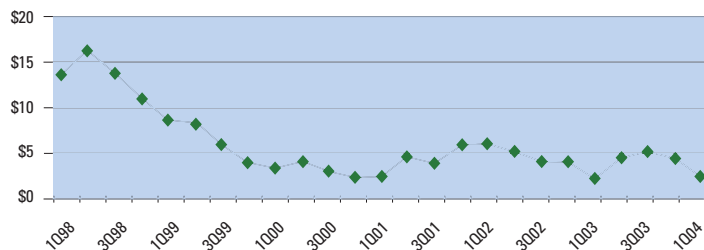
Past illnesses: After experiencing the highest losses in its history in 1999, and facing a probable loss in 2000, R.G. Barry developed a three-year strategic plan (2001 – 2003) to regain profitability. The company moved its manufacturing operations outside the United States to Mexico to take advantage of lower labor costs. It also began importing product from China. Executives knew manufacturing costs in Mexico were higher than in China, but convinced themselves that "speed to market" justified the higher cost. The strategic plan focused on increasing sales to support the company's high overhead. This required R.G. Barry to broaden its product mix by pursuing new customers and new channels, resulting in a significant increase in the number of styles and products.

The diagnosis

The strategic plan failed miserably. While implementing it, the company's revenues actually declined by \$8 million to \$123 million in 2003. Operating losses totaled \$23 million for the three years. Shareholder equity declined from \$80 million at the end of 1998 to a little more than \$25 million at the end of 2003. The company's stock price fell to \$2.08 per share. See R.G. Barry Earnings History and Quarterly Closing Share Price charts.



Quarterly Closing Share Price 1Q1998 to 1Q2004



R.G. Barry's net loss of more than \$21 million in 2003 resulted in it defaulting under the covenants of its revolving loan with its bank. The bank encouraged the company to hire a turnaround firm to develop a restructuring plan and to find another lender(s) to participate in the credit. In January 2004, the company hired The Meridian Group as its turnaround consultant. After touring the manufacturing facilities and seeing excess inventory at every turn, the bank's concerns increased considerably. As a result, before the end of January, the bank changed its position from finding a lender(s) to share in the credit to announcing that it would call its loan in five weeks. At the time, R.G. Barry's short-term borrowing exceeded \$4 million and its additional borrowing needs were growing on the order of \$1 million per week to meet its cash flow requirements through the first quarter.

The prescription

The turnaround process can be expressed in six stages. Each stage will be addressed in more detail using the R.G. Barry case as an example.

The turnaround process

- Stage 1: Initiate damage control procedures*
- Stage 2: Evaluate current conditions and causes*
- Stage 3: Stay alive through short-term life support*
- Stage 4: Communicate problems to all creditor groups*
- Stage 5: Develop a long-term solution*
- Stage 6: Develop and implement reorganization plan*

Stage 1: Stem the bleeding with damage control procedures

Controlling cash flow is the single most important element in achieving a successful turnaround. This process involves isolating the control of cash outflows to a few key individuals and aggressively looking at ways to turn assets into cash as quickly as possible, such as collection of receivables and sale of unneeded assets.

It is also critically important to know the company's cash flow position and what its cash needs are projected to be over the near term. An invaluable tool in turnarounds is the 13-week cash flow forecast, which projects weekly cash outflows and inflows.

Most finance departments never look at cash flow in weekly buckets, instead performing a monthly "sources and uses of cash" analysis and then dividing by four or five to generate a weekly forecast. This method is too inaccurate when a company is in a financial crisis. The 13-week cash flow is a weekly forecast of what bills need to be paid and what deposits should be collected. That information can then be used to prioritize payments and communicate requirements with stakeholders.

In the case of R.G. Barry, at the initiation of Meridian's engagement, there did not appear to be a short-term cash shortfall issue because the bank was working with the company and the borrowing base had plenty of availability. However, this changed dramatically after the senior vice president of operations told the bank that he was running his plants full-out, despite inventory being excessively high, because "inventory was not his responsibility." As a result, the bank lost confidence in the company's stewardship of its collateral, changing its position from finding a co-lender within six months to calling in the loan in five weeks.

In addition to the normal tightening of controls, Meridian searched hard to find additional cash sources to minimize borrowings and to convince the lender to stay in the loan until an alternative lender could be found. Some additional cash was generated by aggressively

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selling off excess inventory, but the big ticket item that bought time with the bank was the collection of \$2.2 million from the cash surrender value of an insurance policy on the life of the chair of the company. This money was turned over to the bank to reduce the outstanding balance on the revolver and demonstrated enough good faith to the bank for it to give the company another month to find an alternative lender.

Stage 2: Check vital signs – evaluate current conditions and causes

The purpose is not to determine exactly what got the company into trouble, but more to define exactly how much trouble the company is in.

- What is the aging of accounts receivable and accounts payable?
- How much inventory is there and what is its condition?
- What loan agreements are in place and what is their current status?
- What is the short term sales forecast and projection of current costs and expenses?

These items help define the depth of the financial hole the company is in and what degree of freedom it has to get out of its current distressed state.

On this front, R.G. Barry had some positives and negatives. The positives were that its payables were in relatively good condition and its vendors were generally supportive of the company.

Inventory was a mixed bag. R.G. Barry had almost six months of finished goods inventory on hand, most of which was stale and had to be sold through discount channels. But at least it comprised an asset that could be converted to cash relatively quickly. On the negative side, many of the accounts receivable from the prior holiday season were being held by the customers because they had return privileges and refused to pay until the returns were "trued-up," a process that in many cases took four to six months. This was a long term problem that needed to be addressed in the reorganization of the company's business model.

The company also needed a continued inflow of cash from a lender through the end of the next selling season, which was 11 months away. The amount needed was on the order of \$35 million, and there was no way of generating that much cash flow internally.

Stage 3: Stay alive with short-term life support

Most reorganizations require at least 12 months to take hold and generate positive financial outcomes. How does a company survive the transition?

For R.G. Barry, getting a new lender was necessary, but not the sole answer. Because much of the company's inventory and assets were in Mexico, the borrowing power of the remaining assets would not generate the cash necessary to fund the working capital needs for the next season. Fortunately, Meridian secured lending on the value of the brand equity of the company and added a seasonal over-advance to cover the worst cash flow months.

Stage 4: Talk about your symptoms – communicate problems to all creditor groups

It might seem that the worst thing to do is tell lenders and vendors how much trouble the company is in. However, by the time a company is in a true turnaround, its lenders, vendors and probably its customers already suspect the worse.

The key to communications is to be upfront early and earn the stakeholders' trust. Most importantly, the company needs to communicate its plan to fix the situation. It is amazing how cooperative and flexible stakeholders are in a crisis situation, as long as they feel they are being kept informed and the requests of them are reasonable.

In the R.G. Barry situation, it was impossible to keep the financial status of the company quiet since it is a public company. It had to issue 8K announcements when the bank decided to call the loan in five weeks. The fact that R.G. Barry's audit firm issued a "going concern" modification was immediately public knowledge.

To offset this bad news, the company made a special effort to reach out to its customers and vendors to let them know it was in the turnaround mode and had a plan to reorganize and become profitable again. These communications were critical in keeping its Chinese vendors on 30-day terms. If they would have demanded letters of credit or cash up front, the cash outflow could have sunk the company. Fortunately, part of the restructuring plan was to purchase more from the Chinese vendors, so they saw the reorganization as an opportunity to get more business. Customers were also concerned because R.G. Barry announced its difficulties when they had to make their holiday season commitments to the various suppliers. R.G. Barry was able to convince all of their critical customers that the company would be successful in meeting the retailers' requirements for the coming season.

Stage 5: Find the cure—develop a long-term solution

To develop a long-term solution to a company's financial problems, it is important to ask some very basic questions:

- Is the company's basic value proposition still valid?
- If there is a valid value proposition, what is preventing the company from providing that value profitably?
- Does the company have what it takes to survive the transformation to a more efficient model?

We have encountered cases where the value proposition was not there. One case was an engineering services company whose major customers were steel companies. The bankruptcies that occurred in the late '90s and the general downturn in the industry after Sept. 11 left the company with large uncollectible receivables and insufficient business to sustain its operating costs. The only answer for the company was to sell to a larger more diversified engineering company.

In another case, a startup using new technology to produce large, reinforced plastic parts for the transportation industry ran out of money after operating at losses for its first five years. The company had priced its products to attract its initial customers but could never get its costs low enough to make money at those price points. There were no breakthroughs in development that could change the basic economics of the technology, so there was no choice but to phase out of business in a manner that allowed the customers to source product from alternative suppliers.

R.G. Barry was a different story. There was nothing wrong with its basic value proposition. Its core business of supplying slippers to major retailers was steady and predictable. It had the number one brand in the business and had been the market leader for many years. The issue was that the company had evolved into a very inefficient business model to supply the market.

Inefficiency drivers for R. G. Barry

1. The company sourced product from its own manufacturing plants in Mexico and from China, requiring excessive overhead to manage both.
2. The majority of the product came from its own plants, which were significantly more costly than product outsourced from China.
3. Distribution costs were excessive because the supply chain was focused on serving manufacturing, not transporting product to the customer at the lowest cost possible.
4. In trying to grow sales, the company went after too many customers with too many products. Over 75% of the company's revenue and more than 100% of its profit came from just 14 of over 800 customers.
5. The selling philosophy was to load up the retailers with as much product as they would place and take returns of unsold product. A returned product costs as much to reprocess as its original cost, inflates inventory levels and results in slow payments by the customers.
6. Overhead was excessive throughout the company, exemplified by the fact that there were 23 vice presidents, each making more than \$100,000 per year.

The long-term solution involved a plan that would overcome these inefficiencies and establish a business model and culture focused on efficiency and profitability, not revenue growth. The ability to undertake a successful transformation required a financing package that provided the necessary cash to fund the transition. This financing was obtained from CIT two days before the bank's target date for recalling its loan.

Stage 6: Develop and implement a treatment plan

The final stage of a turnaround is to develop and implement the reorganization plan. In the case of R.G. Barry, the Board felt new leadership was necessary to implement such a dramatically different

Turnaround plan elements and accomplishments

(M=millions)

Plan element	Results
Close manufacturing and transfer sourcing to Asia without supply or quality disruption.	Accomplished by end of May 2004, one month ahead of schedule – no supply/quality issues.
Achieve at least 3 percentage points of profit margin improvement by outsourcing manufacturing.	Profit margin increased from 35% in 2003 to 42% in 2005.
Outsource bulk of distribution and reduce associated costs by \$5M.	Distribution facilities associated with manufacturing closed by October 2004. Distribution costs reduced from \$13.7M (2003) to \$7.7M (2005).
Reduce overhead (SGA) by closing operations office, reducing layers of management and implementing better expense control.	In addition to \$6M of distribution savings, other SGA expenses were reduced by \$8.1M (2005 vs. 2003) for a total reduction of \$14.1M (29% reduction).
Reduce inventory through lower returns, less product complexity and more aggressive close-out sales.	<ul style="list-style-type: none"> Inventory reduced from \$32.8M (2003) to \$20.2 M (2004) then to \$19.1M (2005). Returns reduced from \$9.3M to \$4.0M (2003 vs. 2004). Close-out sales doubled from 2003 to 2004. SKUs reduced from 10,000 to 3,000.
Keep peak borrowing under \$35M and within borrowing base availability	Borrowing peaked at \$29 M in 2004 and at less than \$23M in 2005.
Move to committed loan facility in 2005, remove “going-concern” modification for 2004 and get on an exchange.	All accomplished, trading started as DFZ on AMEX in December 2005.
Become a market-focused company.	Market research and marketing were reinstated for the first time in five years in late 2004 and guided a totally revamped product line and packaging/point of sale for fall 2005.
Lose none of the core 14 customers.	No core customer was lost. Revenues declined in 2004 due to elimination of non-profitable lines and customers.
Return to profitability in 2005.	Net income in 2005 was \$8M versus a loss of \$21.7M in 2003 and cumulative net losses of \$68 M from 1999-2004.

business model and asked one of the authors (Von Lehman) to become interim CEO. The elements of the two-year reorganization plan and the results obtained are listed above.

Conclusion

Although there were some bumps in the road, overall the turnaround generated remarkable results.

- The company returned to profitability in 2005, with EBITDA of \$9.6 million, versus a negative EBITDA of \$8.4 million in 2003, an improvement of \$18 million.
- Earnings before interest, taxes, depreciation, amortization and restructuring (EBITDAR) improved from negative \$5.9 million in 2003 to positive \$227 thousand in 2004, and then to positive \$11.3 million in 2005.
- Peak loan requirements were reduced from \$36 million to under \$23 million.
- A new, market-focused business model was solidly entrenched.
- As a result, shareholders were rewarded with an increase in the company's market value from a low of \$14 million in early 2004 to \$66 million by the end of 2005.

Von Lehman was replaced in mid-2006 by an experienced footwear executive, Greg Tunney. In 2006, the company changed the beginning of its fiscal year to July 1 from January 1. R.G. Barry just announced its results for fiscal 2007 (ending June 30) with pre-tax operating income of \$12.1 million and net income of \$25.1 million (\$13.6 million tax benefit from the reversal of the deferred tax asset valuation allowance). The stock price has continued to climb through 2006 and 2007, reaching its 52-week high of \$13 per share in the second quarter of 2007, before falling back with the general market decline (Exhibit E).

Quarterly Closing Share Price
1Q2004 to 1Q2007

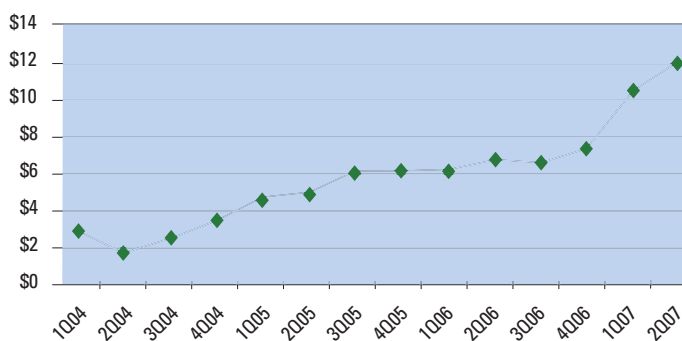


Exhibit D

The key to long-term business health is quickly recognizing the signs of a downturn and taking necessary steps to reverse the trend. Bringing in outside help is not a sign of failure, but often the best way to provide an objective look at how to restore company health and profitability. 📌

Margaret M. Good is the founder and president of The Meridian Group, a boutique investment banking and financial consulting firm focused on middle-market companies and specializing in turnarounds and restructurings. Good founded the firm in 1987 and has led many successful reorganizations of financially distressed clients as well as provided advisory services for financing and M&A activity. Good is a Certified Turnaround Professional and on the Board of the Turnaround Management Association.

Thomas Von Lehman is a managing director at The Meridian Group. He joined Meridian in 2001 after a successful 21-year career at PPG Industries, Inc., finishing his career as vice president, Specialty Chemicals, a \$700 million division of PPG. Von Lehman served as the president and CEO of R.G. Barry Corporation during its turnaround from March 2004 until June 2006.