



QUARTERLY Review



Business Health: Beyond the Balance Sheet

by Guy Morgan, Managing Director, Excerpted from *Financier Worldwide*

Poor financial health, plainly visible from balance sheets and income statements, is an obvious business indicator and often the primary focus of turnaround initiatives. But there are other hidden and not-so-hidden problems that can impact the viability of existing or new business ventures. In manufacturing companies, for example, operational waste and inefficiency produce significant cost overruns and are often the real reason behind insolvency.

Unfortunately, there is a common misconception that waste elimination is no more than a euphemism for lay-offs. This makes for interesting press, but the truth of the matter is that industries around the globe have succeeded in saving tremendous resources through waste elimination without reducing the workforce. In fact, when turnarounds are limited to fixing the balance sheet, results are rarely sustained. The simple reason is that such a limited approach neglects the value of the human asset, without which no enterprise can succeed.

Value stream analysis: path to enlightenment

Waste elimination addresses the efficiency of the 'work envelope' – the manner in which workers perform the activities associated with a particular task in their environment. This includes the exchange of information through communication systems and the flow of material through the operation. Identifying waste begins with an analysis of the 'value stream', the map that defines a product's path from raw material through the various work envelopes to finished goods shipment. Value

stream analysis travels backwards on this map, following the product from the finished goods storage area to the purchase of raw material. In a plastics plant, for example, value stream analysis begins with finished consoles and travels back to the purchase of plastic resin. As this discipline reveals waste and scrap generators, poor communication systems and inefficient operating systems, the opportunities for cost savings begin to manifest themselves very quickly.

Once value stream analysis reveals areas of the process where productivity is low, it allows turnaround experts to address each area with action plans, called 'kaizen bursts' in manufacturing lingo. Kaizen is a lean manufacturing term for continuous improvement. Kaizen bursts are action plans applied to unproductive areas to eliminate waste and drive out cost. Value stream analysis follows continuous improvement wisdom which says, "Let the process speak to you and ask why five times" to get to the bottom of inefficiency. Therein lies potential enlightenment.

Generating capital without bricks and mortar

Value stream analysis leads to the recognition of operational inefficiencies. It also indicates opportunities for cost-reduction with minimal capital expenditures and, in some cases, none at all. It's a way to generate capital without bricks and mortar. In most struggling manufacturing concerns, this analysis reveals inefficiencies in two areas: standard work and workplace organization and visual controls.

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ANNOUNCEMENTS

BBK is proud to announce the following team additions:

Alice Abrams, Analyst
Southfield

Joshua Hunter, Analyst
Southfield

Jeanette Ji, Analyst
Shanghai

Andrew Kirk, Director
Southfield

Edward Macek, Director
Southfield

Kenneth Munn, Managing Director
Southfield

Martin Paul, Controller
Frankfurt

Dennis Strach, Director
Southfield

William Van Horn, Associate
Southfield

Liang Xiaoxiao, Administrative Assistant
Shanghai

Andrew Zeleney, Associate
Southfield

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INDUSTRY VIEWPOINT

Automotive Debt and High Yield Heroin

By Chris Schindler, Managing Director

Globalizing automotive markets in the 1990's created a unique set of challenges for the industry's supply base. The need for growth and integration put many players

in the passing lane as they tried to get ahead of the industry consolidation curve by acquiring regional presence and system supplier status. Equity and debt capital were readily available to support the speed rush. What was often missing, though, was a solid strategy for integrating the acquired entities.

Going into the new millennium, corporate investing had created highly leveraged balance sheets— which is okay if you are on the sunny side of growing and consolidating markets. Tragically though, the game had changed. Instead of expanding platforms, economies of scale and integration, aggressive suppliers were suddenly faced with Big 3 volume implosion, cost-downs, rising commodity prices and fierce Asian competition. Those who saw the clouds gathering restructured hard and fast. A larger group, though, couldn't take the curve fast enough. They lacked the discipline and commitment to tackle the challenges of leverage and over-complexity early.

Without an option, they might have been forced to right-size themselves while they could. But as fate would have it, many suppliers succumbed to the temptations of cheap and available credit. Heroin for free.

Indeed, in recent years underperforming, highly leveraged automotive suppliers have not had great difficulty in tapping very liquid markets for subordinated and high yield debt. Bullish conditions in leveraged and asset-based loan markets, for instance, have raised interest in yield stretching investments, providing additional capital for traditional instruments as well as creating new segments.

Junior secured debt, for instance, almost non-existent in 2003, has accelerated to a current volume of roughly \$20 billion. Much of this so-called 2nd lien financing has gone towards recaps and refinancings, giving debtors some breathing room but also taking away some of the pain needed for making tough decisions.

In Europe, most recent high-visibility distressed supplier cases in the automotive sector exhibit this common history. Some crisis situations may have been induced by Chapter 11 filings in the US, but all have in common re-financings with second lien and subordinated, high yield instruments at times where focused commitment to a restructuring plan would have been necessary. Added room to maneuver meant, in reality, postponing the inevitable overdose.

As we now experience the shakeout in the automotive supply base, even aggressive hedge funds are getting increasingly frustrated with the results of their "loan to own" debt acquisition strategies. They are finding that there is not much company value left to carve out or flip. Perhaps the heroin killed not only the pain but also the patient. ■

ENGAGEMENT SPOTLIGHT

Aerospace Design

Interviewee and Managing Director Tim Hassenger is a seasoned professional with more than 20 years of experience in corporate restructuring. Tim assists the owners of underperforming companies either in an advisory capacity or in an executive/ interim management role. He has extensive hands-on experience operating companies in a wide variety of industries, including (but not limited to): aerospace; business services; manufacturing and health care.

Q: Tim, what kind of engagements have you been working on since joining BBK?

A: *One has been an aerospace design company. A big gap in its strategic planning process has left the company woefully short from an operating perspective - the challenge right now is that the company is committed to building specific airplanes and is unable to deliver on the timeline. This carries a huge economic impact. What's interesting is that while they're utilizing us in a reactive respect, they are also beginning to understand what can be done proactively to prevent future issues.*

Q: What could they have done, proactively?

A: *Lack of a true strategic plan positioned them to respond too late to operational problems. Strategic planning means looking at your own processes and capabilities and knowing what you can do. We're bringing the management team through the strategic process right now and analyzing them in respect to what's in the market place. This provides a very relevant, valuable context for decision-making – if you want to do this kind of work, here's what you need.*

Q: What are your predictions for this company's success, based on their current track?

A: *Favorable. Understanding the root cause of what went wrong is a critical step. They're taking a deep dive into their current strategy and rebuilding. It's hard, and time consuming, but they're doing it the right way - the only way if you want solid results. Quick fixes only yield short-term success. That doesn't usually spell commanding market position. ■*

FINANCIAL

Unlocking Value of Commercial Real Estate During Economic Uncertainty

By Dan Wollschlager, Managing Director

Overview

Corporate real estate has traditionally been viewed as a solid asset on the balance sheet by CFOs. With the complexity of managing the various assets of the corporate financial statement, most CFOs didn't have to place as much emphasis on managing corporate real estate. After all, it was the asset that was strategically necessary for a number of different reasons. Depending on your business situation, one might consider competitive reasons, appreciation, cash flow for investors, location to an adequate work force at competitive wages, close to customers, logistical issues or other strategic reasons identified by management or investors. However, the global and competitive landscape is changing this focus. In a recent survey, corporate CFOs have indicated an increasing focus on managing corporate real estate, and investors are managing their commercial real estate with a new direction.

Hedge funds/REITS

To support the new commercial real estate market that is emerging, it will be important to review the growth of hedge funds/REITS and understand the potential role that they can play in this market. In 2006, industry assets rose to \$1.43 trillion, up 29% from 2005. As a result of this growth, they represent a critical player that can provide liquidity in the event you are interested in a "sale leaseback" transaction or just a strategic purchaser in the event you want to sell or balance your investment in certain types of property. The financial strength and specialization of property types by hedge funds/REITS provide the support to make their role an important focus in any commercial real estate strategy.

Economic Trends

2006 statistics, as reported by the National Council of Real Estate Investment Fiduciaries and Torto Wheaton Research, indicate that the

one-year returns for various types of real estate were 18.76% for retail properties and in the 20.23% to 20.9% for office, apartment and industrial properties, but those returns fell into the low teens and even single digits at the five-year holding period, and again after 10 years. This trend becomes significant if you believe that the "buy and hold" theory of purchasing and owning commercial

TOP FOUR GLOBAL TRENDS

- Real estate financial markets will continue to be more structured and productive.
- New capital will continue to flow into real estate, but at a much slower pace.
- Buyers will continue to expand outside the local markets and around the globe.
- More REITS worldwide and less REITS in the United States.

Other trends like the drop in disposable personal income and nominal job growth need to be considered when forecasting the management of your commercial real estate.

real estate provides the best long-term returns. When you combine these returns with the increasing cost of capital, it will force the strategic CFO or investors to review the other options of managing commercial real estate. Some interesting statistics to support the new trends that need to be addressed in the future are:

- Industrial capacity utilization at 81.2%.
- Manufacturing capacity utilization at 80.4%.
- Business sales rising by 8.5% year over year.

- Inventories to sales ratio extremely low at 1.24 times.
- Corporate profits are rising at 21.3% year over year.
- Commercial & Industrial lending up 12.3% year over year.
- Exports are rising at a 13.5% annual rate.

Sale and Leaseback

As CFOs are continually challenged to achieve maximum return for the stakeholders, a continuous review of corporate real estate will have increased importance in the future. No longer can this asset be viewed as the "sacred cow," but the option of supporting the cost and return on investment will, in some situations, warrant the consideration of a 'sale and leaseback.'

Many successful turnaround strategies have relied upon a sale and leaseback of corporate assets as a fresh source of capital. This financial vehicle is also used as a means to restructure the debt and capital side of the balance sheet. With the increasing cost of capital and the different liquidity markets that face any business manager, from capital for a turnaround to expansion capital to managing the assets of a strategic acquisition, many CFOs are finding the sale and leaseback strategy a good tool. However, each situation requires an analysis of the economic and strategic direction of the business.

The Strategy

Being proactive and looking at all the options for your commercial real estate will pay big dividends in the uncertain times we face. Addressing all the complex issues of different property types in different markets and economic conditions, requires superb execution, which may require strategies that are often overlooked, including remediation, remodeling and/or rezoning. Having diverse, tenured expertise on your team is the answer to success in the face of economic uncertainty. ■

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Business Health

Standard work

The absence of standardized work manifests itself in waste, scrap, poor communication, ineffective information systems, excess inventory and missed customer shipments. Standard work, the performance of tasks in an effective and repetitious manner, is a prerequisite for continuous improvement because it produces insights into how a process can be made more efficient. When workers perform tasks repeatedly, they become highly adept. The more they perform the task, the more efficient they become as they decrease waste in walking motion, hand and head motion. Their physical dexterity increases, and ergonomic stressors decrease. In addition, they recognize opportunities for streamlining processes to eliminate redundancies and increase efficiency.

Creating a work envelope is only the first step. Sometimes other factors can generate inefficiencies, and that's where value stream analysis comes in to reveal additional opportunities.

“The primary reason, however, for the recent progress in manufacturing is that companies finally recognized the value of the human asset.”

Say, hypothetically, material arrives at a worker's station, protectively enclosed in high-density bubble-wrap. Having to remove the wrapping slows down the operator considerably. A kaizen burst addresses this inefficiency by utilizing a different type of protective material that is easier to remove. Another alternative might be to implement a refined packaging system that allows the worker to remove the bubble-wrap more quickly.

Workplace organization and visual controls

A second deficiency common in manufacturing is the failure to eliminate or reduce processes that don't add value to operations. When quality or overtime issues, in addition to waste and scrap, impinge on the bottom line, it's usually a sign that processes don't make sense. Work-in-process inventory is too high, and there is a clear lack of organization around workflow.

'Workplace organization and visual controls' is a system to create a leaner manufacturing operation. It simply means producing clear visibility across the operation. Everyone involved understands how the cogs and wheels interact, which machines are running and which are down, how many pieces are being produced and how many are being rejected. The entire environment is designed to communicate and show how performance is being attained to point the way to opportunities for improvement.

Five steps to turnaround

Companies don't become insolvent overnight. Unfortunately, turnarounds are expected to occur over night. A leader who is brought in to turn a company around needs great intestinal fortitude to stay the course.

- Perform a careful assessment.
- Openly communicate with employees about the company's difficulties without casting blame.
- Listen. Truly listen. Develop a clear understanding of the company's core competencies.
- Plan a path to success.
- Execute, execute, execute.

In a turnaround situation, the impact of good leadership is magnified exponentially. The leader's actions not only affect employees, customers and shareholders, but often the entire community, particularly in cases where the insolvent company is the largest factory in town. The far-reaching potential impact of a successful turnaround demands a leader who is both courageous and excited about the task.

Human and capital assets in the global economy

In the last 10 years, manufacturing has become an exciting realm in the global economy. Companies have made significant strides by optimizing the flow of material in operations to enhance available capital and the bottom line. They have learned that the more quickly and efficiently materials flow through a factory, the more productive the use of capital and the less necessary it becomes to rely on offshore outsourcing.

The primary reason, however, for the recent progress in manufacturing is that companies have finally recognized the value of the human asset. Operators no longer leave their hats and heads at the door. The Toyota Production System and others modeled on it value what goes on between the workers' ears. When employees are given a voice and expected to make key decisions, they work smarter and more responsibly for their employer's success in the global economy. ■



PRIVATE EQUITY

Managing Due Diligence

By Jim Connor, Managing Director

In February, BBK moderated a panel at Institutional Investors' Turnaround Management and Distressed Investing Forum in New York. This panel included Michael H. Kalb, Managing Director, Sun Capital Partners, Inc; Michael Psaros, Managing Principal, KPS Capital Partners, LP; and Raymond A. Whiteman, Managing Director, The Carlyle Group. Our topic was Private Equity and Turnaround Management: Critical Skills and Competencies for Succeeding in a Flooded Market, and we covered the financial due diligence required on a deal and the practical side of managing the process.

So why did this topic create such interest you ask? Why did we run over our time and cut off floor questions? After all isn't the whole due diligence process kind of a "cook book" thing? You spend more money than you want on a group of know-it-all MBA's, they give you a canned report with statistics that enable you to make up your mind, right? EBITDA multiples of over five are probably bad - right? Leverage stats and capital structure all have parameters that make a deal good or bad, right? Add it up. Check a box. Bada boom - bada bing. Right?

Au contraire! The importance of proper due diligence couldn't have been a hotter topic on these panelists' minds. All of us agreed that the success of an investment or lack thereof is usually determined before the deal is closed. The process is not canned but one where a specific work plan needs to be generated for each transaction. Objectives regarding risk analysis, suspected hard and soft spots in the financial projections, as well as management's ability to implement a plan all need to be addressed up front. It generally requires a full day, including interactive discussions with the PE firm, to plan even the smallest transactions regarding the scope of due diligence.

Industry expertise was also deemed important for at least three reasons. First, to reduce costs as PE firms should not pay to educate consultants. Second, to get



an informed assessment on the target company. Third, to utilize a network of contacts for intelligence found only on the street. Without a blink, all of our panelists agreed that industry expertise was paramount.

We then focused on the cost issue. How can funds manage this process to keep control of costs? Particularly before knowing whether a deal is a go or not. Pouring money into a due diligence exercise, then walking away from a deal (while prudent) doesn't make your limited partners very happy. Walking away

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ANNOUNCEMENTS

B.N. Bahadur, BBK's Founder & Chairman, received an Honorary Doctor of Law degree from the University of Mysore, India. Mr. Bahadur was one of four individuals who received honorary degrees at the University's 87th Convocation.

INDUSTRY EVENTS

BBK spoke at the following industry events:

January 23, 2007 Michigan Association for Certified Professional Accountants, Alicia Masse, Managing Director & North American Automotive Advisory Group Co-Lead, presented "Financial Benchmarking"; and Guy Morgan, Managing Director, presented "Lean Metrics."

February 7, 2007 Institutional Investors' Turnaround Management and Distressed Investing Forum, Jim Connor, Managing Director, moderated a panel, "Private Equity and Turnaround Management."

February 22, 2007 Michigan Association for Certified Professional Accountants, Phil Goy, C.P.A., Senior Director, presented, "Financial Forecasting Best Practices".

BBK is scheduled to speak at the following upcoming events:

April 2007, at SAE's World Congress, Mark Ripple, Manager, will present "Scrap Reduction: A Case Study".

May 2007, at The Automotive News Manufacturing Conference, Bill Diehl, President, CEO and Global Automotive Advisory Group Lead, is scheduled to present on supply chain management.

June 2007, at the annual conference for the Association of Insolvency and Restructuring Advisors, Guy Morgan will join a panel to present, "Manufacturing in the New Millennium".

CASE STUDY

International Computer Manufacturer

Interim Chief Financial Officer

BBK Corporate Advisory Group

In 2006, BBK was engaged by a publicly listed international computer manufacturer. The Company produces build-to-order desktop and notebook personal computers, servers and storage devices. Declining sales, overcapacity, and intense overseas competition led to significant operating losses over the past three years. These losses and the Company's inability to refinance its expiring credit facility, along with pressure from unpaid vendors and the announced resignation of its Chief Financial Officer, left the Company contemplating a Chapter 11 bankruptcy filing.

The Company engaged BBK to provide services as its interim CFO. In addition, BBK provided certain financial advisory services involving a comprehensive client status assessment as well as the development of many restructuring initiatives. BBK developed new financial projections and entered into successful negotiations with the Company's existing lender to extend the \$25 million asset-based credit facility for an interim four and one-half month period. Additionally, the Company closed two separate private placement equity raises of approximately \$5 million each, providing the Company with additional temporary liquidity. Concurrently, BBK helped manage negotiations with vendors to continue shipment



of raw material to maintain production during the critical seasonal selling period.

With additional liquidity in place, BBK directed the Company towards a new strategic plan, reflecting the realities of a market that increasingly perceives their product as a commodity. The Company became well positioned to consider multiple alternatives and may, in fact, seek a partner that can help them take advantages of global markets and economies of scale. ■

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Managing Due Diligence

is hard after you've put not only your money but sometimes your emotions into the deal. One of our panelists commented, "There's no shortage of bad investments out there, but you have to walk away sometimes." In short, controlling the

"All of us agreed that the success of an investment or lack thereof is usually determined before the deal is closed."

cost requires several things. Most importantly, trust that the advisory firm you choose will do the right thing for you. These are or should be firms that have the PE fund's interest at heart (not their own fees). The up-front work plan is also critical. You need specific reportable milestones that help you monitor progress.

So where did our panelists disagree? The mix of internal and external advisors was an issue, although as we talked it through, the size of the fund really determined the staff a firm could afford to keep busy. Even the large funds noted that opportunities were abundant and the internal advisory staff always had work. The challenge was to keep them productive, looking at the good deals and not waste time on the throw-aways. In most cases, once identified as a potential, the PE firm retained an outside advisor to work either independently or along side any internal advisors.

The bottom line from our panel? Engage an advisor you can trust, make sure they have industry expertise, demand a tailored work plan up front, and put together milestones to monitor progress and cost.

I was at Cape Canaveral last month and saw the launch of an unmanned rocket. Amazing! That's rocket science! Performing due diligence for a PE fund isn't, you just have to have the right team. ■