



## Applying Yesterday's Lessons Today

by Rick Ferrell and John Hawkins, Senior Directors, excerpted from *Institutional Investor's Real Estate Restructuring & Reorganization Guide*

Those who have made real estate a career for a number of decades have been through a series of rough spots: the 1974–75 and 1981–82 inflation-killing credit crunches, the Savings & Loan crisis and 1986 Tax Reform Act upsets, 1987's Black Monday and the 1998 Long Term Capital Management financial crisis, as well as the bursting of the dot-com stock bubble in 2000. Now, we are beginning another rough patch, one that started in mid-2007 and continues today. All indications are that it might not be a minor speed bump.

There are common elements to all these events—lessons learned from past disruptions that can be effectively applied today and might be useful to commercial property owners, developers, lenders and investors facing financial hardship.

### The Situation

Some say the start of this mess was when two mortgage hedge funds sponsored by Bear Stearns failed to meet margin calls in June 2007. Ironically, now a year later, Bear Stearns is no more and the securitized mortgage market run by the investment banks, which took over the real estate finance industry after the demise of the savings and loans, has melted down. Simultaneously, but somewhat causally related, the ownership housing bubble burst.

So, the start of the current recession situation appears to have been caused by the collision of two related phenomenon: the collapse of a Main Street housing bubble and a Wall Street financial market meltdown. Right now, we are observing two immediate impacts in the real estate loan workout business.

First, there are fewer residential buyers in the ownership housing market. Land loans and construction loans are suffering from depleted interest reserves; there are maturity date defaults; and collateral valuations are falling. One substantive result will be that refinance proposals, going forward, will produce inadequate net proceeds.

Second, we are experiencing a mortgage industry with little appetite for risk and a constrained ability to aggregate new capital to fund the mortgage financing needs of the U.S. real estate industry. A new loan underwriting paradigm is sure to be imposed: lower loan-to-value and loan-to-cost ratios, higher debt service coverage ratios, and increased reserves and other holdbacks. The result will be new loans with lower net proceeds to the owner/developer/investor.

As in 1974–75 and 1981–82, cash has become king. Owners will need to access additional capital to close the gap between old loan payoffs and a new loan's lower proceeds.

### Time is Not Your Friend

There is a critical need to gather accurate information and make timely decisions in any business, including real estate. The single largest source of failure is the inability to correctly interpret the current conditions, and as a result, act appropriately and decisively.

Delays make things worse. In decades of experience, the only thing that might be accomplished by a delay is borrower asset protection, which many lenders' lawyers feel is really just well-planned fraud. A delay causes

## ANNOUNCEMENTS

*BBK is proud to announce the following team additions:*

Duane Bolinger, Managing Director  
*Shanghai*

Jason Bonin, Manager  
*Detroit*

Tina Chen, Executive Assistant  
*Shanghai*

Trina Hyder, Executive Assistant  
*Detroit*

Gregory Jaroch, Director  
*Detroit*

Mark Kozak, Manager  
*Detroit*

Michael Martin, Director  
*Detroit*

Bill Park, Manager  
*Detroit*

## IN THIS ISSUE

### PAGE 1

Announcements  
Applying Yesterday's Lessons Today

### PAGE 2

Case Study: Operational Improvement  
The Restaurant Industry

### PAGE 3

A Holistic Approach for Manufacturing  
Performance Improvement

### PAGE 4

Applying Lessons, continued  
Industry Events

### PAGE 5

Why is BBK in China?  
PE PowerTrak

### PAGE 6

The Restaurant Industry, continued

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## CASE STUDY

# Operational Improvement in Mexico

BBK was engaged to develop and implement an operational improvement plan for an aerospace manufacturer in Mexico.

### Engagement Challenges

- Company was resistant toward Lean initiatives
- The culture lacked systems and disciplines
- Manufacturing flow was negatively impacted by processing issues and on-time delivery of purchase material
- Client was concerned with poor shipment compliance
- Company's time was allocated towards crises, instead of focusing on supply chain and supply risk management

### BBK's Approach + Strategy

- Conducted a plant assessment to identify improvement opportunities
- Met with individual staff members to brainstorm action strategies
- Agreed upon key metrics and developed a consistent format for tracking of the improvement actions
- Developed a scorecard to measure and communicate performance
- Provided 20 page report and reviewed progress of improvement initiatives weekly
- Focused closely on quality issues
- Worked with supplier issues on behalf of Client



### Results

- Lead-time reduced by 75 percent
- Throughput increased by 325 percent
- First time yields improved by 50 percent
- The Company is in the process of implementing all improvement initiatives
- This engagement is still in progress to reach all goals documented in the plan

## CORPORATE ADVISORY GROUP

# The Restaurant Industry: Headed Towards a Historic Crisis

by Vince Lambiase, Managing Director

A confluence of uncontrollable economic circumstances has the restaurant industry reeling. Declining customer counts compounded by soaring (record high) operating costs have created the worse possible scenario for restaurant operators.

### Customer Counts

The erosion of U.S. consumer spending, influenced by higher energy costs and tighter credit, is taking a heavy toll on restaurant revenue and profits. As consumers reduce their restaurant occasions or seek value at less expensive restaurants, high-end and family restaurants are being hurt the most. Recent casualties include Buffets Holdings Inc. (Ryan's Steak House) and Vicorp Restaurants, Inc. (Bakers Square and Village Inn) who filed for bankruptcy court protection earlier this year. Brinker International, Inc. (Chili's, Macaroni Grill, South of the Border) reported a \$38 million loss in the first quarter of 2008. Even McDonald's, the largest restaurant

chain and a lower price provider, saw U.S. restaurant same store sales decline 0.8 percent in March—their first decline in monthly same-store sales in five years.

Dining occasions away from home have plateaued around 47 percent, according to the Economic Research Center USDA, after continuous year-over-year increases since 1950. Eating at home may be perceived as less expensive than eating out, and there are signs that grocery stores are taking market share from restaurants.

According to Nation's Restaurant News, industry experts believe this "soft" revenue trend will continue and that casual dining restaurants with average checks above \$10.00 (per guest per visit) will face the most significant traffic declines.

### Operations Costs

The major cost pressures of the restaurant industry include commodities, minimum wage, hiring and training, utilities, insurance

and new regulatory requirements. Collectively, these increases will be too great for many small and large operators to survive. Examples include:

- The cost of beef has risen to its highest levels in 10 years (36 percent since January 2002)
- March 2008 spring wheat traded at \$24 a bushel, more than double the price two months prior and the highest price ever, on the Minneapolis Grain Exchange
- The minimum wage rose to \$5.85 an hour in July 2007 and will increase to \$6.55 on 7/24/08 and \$7.25 on 7/24/09, a 41 percent increase
- Costs continue to rise on liability insurance, workers' compensation insurance and health insurance

While all restaurants will be hit by declining customer visits and increasing costs, quick service restaurants (QSR) like

## VIEW FROM EUROPE

# A Holistic Approach for Manufacturing Performance Improvement

by Frank Bunte, Manager

It's known that customers want reduced costs with higher levels of quality and value. This results in a race for survival and profitability as most companies attempt to meet the customers' needs. The winning businesses turn out to be those strong and conditioned firms that have experience in operations and exceptionally well-tuned processes. These qualities can be achieved through performance improvement methodologies—and the often overlooked is “TLS,” a combination of Theory of Constraints, Lean and Six Sigma.

If appropriately implemented, this combination approach can allow your company to reach reduced costs and higher levels of quality and value—at the same time.

### Theory of Constraints (TOC)

TOC focuses on a system improvement (the system being a group of interdependent links working together toward the overall goal). The constraint in this process is a weak link, and the performance of the entire system is limited by the strength of the weakest link. In manufacturing processes, TOC concentrates on the process that slows the speed of product through the entire system. By focusing on constraints, this methodology produces positive effects on the flow time of the product or service through the system. Reduction of waste in the constraint increases throughput and improves throughput time. When the constraint is improved, variation is reduced and quality is improved.

### Lean

Lean focuses on the removal of waste, which is defined as anything unnecessary to produce the product or service. A common measure is touch time, meaning the amount of time the product is actually being worked on, or touched by the worker. Frequently, Lean's focus is manifested with an emphasis on flow. While Lean focuses on removing waste and improving flow, it too has a

secondary effect—quality is improved. The product spends less time in process, reducing the chances of damage or obsolescence. Simplification of processes results in reduction of variation. As the company looks at all the activities in the value stream, the system constraint is removed and performance is improved.

### Six Sigma

Six Sigma focuses on the reduction of variation to solve process and business problems. By using a set of statistical tools, Six Sigma helps to further understand the elements influencing the process. Focusing on the primary area of variation reduction produces other secondary effects—quality is improved and investigation produces the re-evaluation of many elements. Some elements are modified while others are discontinued, and mistakes and opportunities for mistakes are reduced. Other elements discovered constrain the flow of products or services through the system. Improvement of a process that was restricting flow results in reduced variation, better quality and improvement in the volume of process output.

### Example

A European-based automotive Tier 1 supplier headquartered in Germany, with several plants globally and 5,700 employees, was facing an increase of demand from its major OEM customers for its safety-related components. Upper management was concerned that the best approach was not being deployed at each plant location, and the leadership team was anxious to find the best solution and implement quickly.

To help make the most beneficial decision, the company hired external support which came to a unique conclusion: combine the best components of TOC, Lean and Six Sigma to form TLS.

In its initial conditions the company had been using continuous performance improvement (Kaizen) to expose and



eliminate root causes of its problems, but the company realized that adding TLS could provide even higher yields.

TLS was deployed across all plant locations in various regions of Central and Eastern Europe. To track the success of TLS, the company measured and tracked a series of process indicators as its key measurements, which became drivers for new project selections. These measurements included indicators such as warranty costs, customer returns, on-time delivery, inventory reduction, cycle time reduction and scrap expense.

As a result, the use of the TLS performance improvement methodology delivered significantly higher cost savings by using its processes in a special sequence. Its application resulted in a contribution of nearly 80 percent of the total savings reported.

### Conclusion

The TLS approach is deployed as a standard approach for continuous performance improvements. The sequence of activities begins with the application of TOC, which enables users to investigate the problem and identify the existing or potential constraints by following a series of various steps. TOC is followed by steps to eliminate waste, and create order and discipline from the Lean process. Finally, Six Sigma is deployed to identify and isolate the sources of process deviation and systematically remove or minimize those variations.

Throughout the TLS process, key metrics are put in place to track results and ensure correct implementation. A process audit should also be designed to examine performance over time. If any deviations are observed during the audit process, they should be the triggers for corrective and preventive action plans.

As every company varies in processes used, TLS is a unique combination that—with the right leadership and strategy—can provide great results. ■

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## Applying Lessons

cash reserves to evaporate, company morale declines and employees leave, lenders become frustrated and lose faith in their borrowers, and good banking relationships go bad—and the participants get vindictive.

Often the lender is the one who creates the delay, waiting in a state of denial hoping for a market turnaround and putting off the filing of a Notice of Default (NOD). Our experience is that the serious discussions only occur after the NOD is filed. The NOD is what really gets the borrower's attention and, before that, talk is cheap.

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*“The single largest source of failure is the inability to correctly interpret the current conditions.”*

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### It's Not That You're Confused

You know you need to act, but why is it so tough to start? People in conflict get stuck. Anxiety, denial and procrastination are common when trouble is on the horizon—it is human nature to put off dealing with problems because problems are unpleasant and cause stress.

People directly involved in the problems have difficulty in assessing them accurately (gathering and interpreting information) for numerous reasons. They may have a sense of guilt because they or someone they know in the organization may have contributed to the problem. They just don't like the idea of failure and, as a result, the information gathered is often suspect and not useful in making real-world decisions.

The situation is often made worse by the inherent nature of real estate developers. As visionaries, optimists and risk-takers who must operate over extended time horizons, developers are often the last people to have a fair and balanced view of their circumstances. As such, developers and those who lend to them or invest with them must be wary of their own biases in

terms of the information that is captured and the conclusions reached.

### Analysis, Not Paralysis

Borrowers and lenders can essentially apply the same framework of analysis. For residential and land development projects, both parties need to capture realistic accounting and financial information on key decision variables. These include carrying costs, cost to complete, forward-looking market research on expected sales rates and pricing, possible additional marketing expenses, risk of expiration of entitlements and costs associated with property management/maintenance.

For income-producing properties, owners and lenders need detailed analyses of existing leases, including terms and conditions, and a realistic view of future operating costs. In addition, they will need a realistic estimate of leasing commissions and improvements required for vacant space and a realistic assessment of other concessions required to attract tenants.

Furthermore, borrowers and lenders should seek legal counsel that is, more likely than not, a different person than the lawyer who put the deal together. Both parties should seek the services of a bankruptcy restructuring attorney.

### Know When to Ask for Help

In the U.S. financing culture, it is often the developer's attorney who assumes the role of consigliere when the developer gets in financial trouble. The attorney/consigliere is ordinarily qualified to provide an evaluation of the legal implications, but we are finding more attorneys are bringing in real estate and finance professionals who offer additional skill sets to round out a team (such as broader experience, quantitative skills, fresh eyes and new ideas).

If the workout produces a bankruptcy, the developer will ultimately end up with a collection of consultants anyway. However, there is a huge benefit of bringing in consultants early, as they are able to provide advice to potentially avoid the bankruptcy in the first place. ■

*Authors Rick Ferrell and John Hawkins are real estate experts in BBK's Corporate Advisory Group.*

## INDUSTRY EVENTS

*BBK voiced its thought leadership at the following industry events:*

**March 27, 2008** Global Auto Industry Seminar, Richard Leal, Senior Director, presented “Risk Management in Mexico and China: Operations and Supply Chain Risk.”

**April 2, 2008** Industry Week's Best Plants Conference, Guy Morgan, Managing Director, presented “How to Identify and Execute Successful Kaizen Events.”

**April 24, 2008** Alabama Germany Partnership Annual Dinner, William G. Diehl, President and CEO, presented “Consolidation Trend in Manufacturing: Proactive Supply Risk.”

**May 8, 2008** BG&L's Global M&A Conference, Chris Schindler, Managing Director, was a panelist on “Opportunities in Foreclosed Real Estate.”

**May 14, 2008** iiBig Distressed & Turnaround Investment Forum - East, Jim Connor, Managing Director, participated on a panel “Turnaround Management Strategies.”

**May 28, 2008** Automotive Press Association Luncheon, William G. Diehl, President and CEO, presented the 2008 BBK Ratings Study “Measuring the Financial Health of the Automotive Supply Base.”

**June 6, 2008** AIRA's Bankruptcy and Restructuring Conference, Mark Schumacher, Senior Director, participated on a panel “Accommodation Agreements: Driving for the Checkered Flag.”

**June 10, 2008** Euroforum, Ulrich Koch, Director of BBK Ratings, and Michael Petrik, Senior Director, each presented on “Supplier Risk Management in the Automotive Industry.”

**June 13 & 14, 2008** ABI Central States Workshop, Ken Munn, Managing Director, participated on the panel “Executory Contracts: Execution at the Guillotine?”

*For information on upcoming events, contact [marketing@e-bbk.com](mailto:marketing@e-bbk.com).*



## LETTER FROM BBK

# Why is BBK in China?

If you are interested in, or just happen to be involved in manufacturing, and enjoy seeing the complexities, scale and scope of various plants and all of the associated supply chains—then you can't help but be awestruck of China.

Microwaves are a 55-60 million unit market worldwide and 50 million are made in China with three manufacturers comprising 85 percent. Nokia sold 71 million mobile phones in China last year and that is only 35 percent of the mobile phone market in China. Imagine seeing an assembly line in the southern city of Guangzhou that can produce 20 million LCD panels and PC monitors a year—and the list goes on. With manufacturing as BBK's core competency, BBK fits hand-in-glove with China's current manufacturing environment.

However, there are challenges. A recent survey showed that more than two-thirds of companies in the American Chamber of Commerce in Shanghai believe that China is losing its luster for low-cost production, as rising prices for energy, materials and labor, combined with the steady appreciation of the renminbi (RMB), have increased factory operating costs. Add price pressures from competition and major customers, real estate cost inflation, and new labor laws requiring stronger employment contracts (which are expected to raise costs even more)—and you can see how the pressure on manufacturers and supply chains can tighten efficiency and lower costs.

Does "Made in China" still make sense? It depends on what business you are in and how efficient your operation is. If your business relied on low cost labor and government tax rebates for profit, and if you are an export-oriented manufacturer, especially in the low-margin sectors such as toys, garments and shoes, then you might already be looking to India, Vietnam, Thailand, Malaysia or Indonesia.

For many companies, especially those that are focused on the potentially huge Chinese market, leaving China is a last resort. A new report called "China Manufacturing Competitiveness 2007-2008" surveyed 66 manufacturing companies, most of them foreign owned, and found that 83 percent of the respondents say they have no plans to move capacity from China. The biggest reason to remain in China is access to its vast domestic market, availability of supply base, the IT infrastructure, and the high quality of the Chinese labor.

Despite some challenges, there are still opportunities in China. A study on the state of manufacturing competitiveness in China found that the manufacturing philosophy employed in recent decades by foreign multinationals in China is in need of an overhaul. The study also found that three out of four companies today lack fundamental best practices in their China operations.

For years it seemed that virtually any plant built in China could be profitable because costs were low. Far too many companies built factories and distribution systems with low levels of technology and without widespread adoption of best practices, assuming that the low costs associated with operation in China would offset omissions. However, the changing cost and currency structure have shifted the equation—forcing adjustments on how these companies structure their Chinese operations and how they position China in their overall global strategy.

Why is BBK in China? BBK's manufacturing expertise, coupled with advisory activity surrounding performance improvement and supply risk management, are a perfect match for manufacturing companies in China. As I just started as Managing Director in Shanghai and have already hit-the-ground running on recent engagements, I can say that there are endless opportunities for companies with the right strategy—the boom in China is not over.

**Duane Bolinger**  
Managing Director

## BBK PE POWERTRAK

Top Five International Private Equity Firms in Automotive Related Deals:

CURRENT EQUITY INVESTOR	# OF AUTO INVESTMENTS
3I GROUP PLC	23
COFIDES, S.A.	16
CARLYLE GROUP	11
SUN CAPITAL PARTNERS	10
COURT SQUARE CAPITAL	9

Source: Capital IQ as of Second Quarter 2008

*BBK PE PowerTrak identifies monthly changes and activities relative to private equity firms with significant automotive related investments.*

## SPECIAL EVENT

BBK hosted a webinar in conjunction with Automotive News on "Managing Supply Chain Risk: Not Just the OEs Job Anymore" on June 12, 2008, featuring:

William G. Diehl  
*President & CEO, BBK*

Bryan Clay  
*Manager Supply Chain Risk Management, Honda of America*

Joachim Hofmann  
*Assistant Manager in Finance, Product Controlling, Mercedes-Benz U.S. International, Inc. (MBUSI)*

Gene Tabor  
*General Manager, Supplier Relations, Toyota Motor Engineering & Manufacturing North America, Inc. (TEMA)*

Neil De Koker  
*President & CEO, Original Equipment Suppliers Association (OESA)*

*If you would like to view the webinar recording, contact [marketing@e-bbk.com](mailto:marketing@e-bbk.com).*

## EXPANDING LEADERSHIP

Duane Bolinger leads BBK's presence in the Asia Pacific as Managing Director in Shanghai. He is a results-oriented executive with more than 30 years of experience. Duane's past senior roles include Plant Manager at Delco Remy, Managing Director - Asia Pacific and Global Purchasing Director at Delphi, and Director of Strategic Planning at General Motors Worldwide Purchasing and Production Control.

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## CORPORATE ADVISORY GROUP

The Restaurant Industry *(continued)*

McDonald's, Burger King and Wendy's are best positioned to weather the storm. The factors in favor for QSRs include the flight to value from family and higher-end dining, and many QSR customers are paid wages close to minimum wage and will consequently have more disposable income.

Franchisors are somewhat insulated from these cost pressures, since royalties are calculated as a percentage of sales. However, declining customer counts and revenue are still of great concern to this group.

There may be a bright spot for all—real estate costs. The over supply of commercial property that was developed over the last few years, coupled with failing retail and restaurants (creating vacancies) could be an opportunity to add locations

for the best capitalized operators who compete well for customer visits during the downturn. But, only the bravest of heart with unwavering confidence should act on this apparent opportunity.

**Looking Forward**

There will be a disproportionate (to past years) number of bankruptcies over the next 18 months. Private equity firms have been very active acquirers of restaurants in 2006 and 2007 (more than 10 notable deals in 2007). The high leverage deals will be a challenge due to the lack of liquidity in the debt capital markets.

In attempts to avoid bankruptcy and stay profitable, restaurant operators are taking dramatic steps to cut costs. As a result, new store openings are being reduced or eliminated, marginal stores are being closed, menu portions are being reduced

**DID YOU KNOW?**

BBK's restaurant industry experts are poised to help clients make necessary menu, supply chain and process improvements to weather this storm and come closer to operating normalcy. Focus areas include:

- Reformulating unit economics
- Menu modification
- Improving sourcing and distribution with proven supply chain techniques
- Restaurant operations efficiencies
- Unit rationalization
- Organizing, realigning and/or managing intervention

(to support current and/or lower menu prices), and "extras" that were given away freely in the past are being eliminated.

Restaurants are facing challenges, but there are changes that can be made and support available to ensure profitability during these turbulent times. ■



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