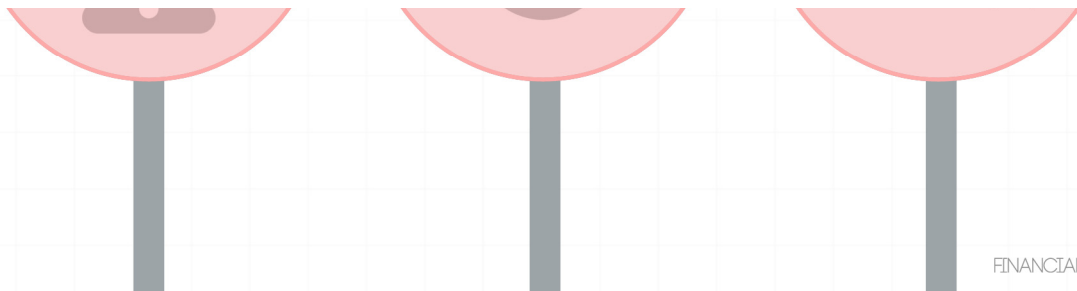




Signs of Financial Distress



Identifying Warning Signs



Identifying **early warning signs** of distress is therefore key to:

FINANCIALEDGE⁷

Identifying **early warning signs** of distress is therefore key to:



Identify Potential Restructuring Candidates



Who might become **clients of the restructuring firm** in the future

FINANCIALEDGE⁷

Identifying **early warning signs** of distress is therefore key to:



Assess The Situation in Detail Ahead of Time



Avoiding the time pressure when **a company is running out of liquidity**

FINANCIALEDGE⁷

Identifying **early warning signs** of distress is therefore key to:



Think About Potential Solutions Early



Improve profitability
and/or conserve cash

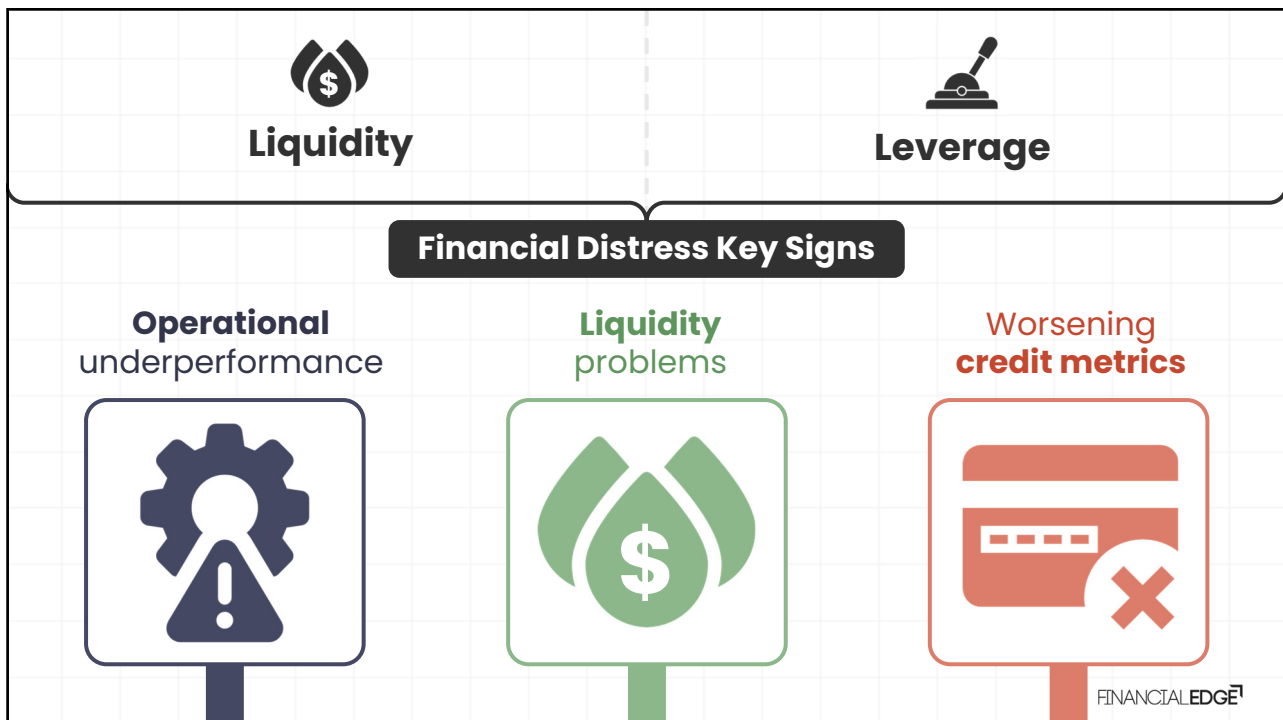
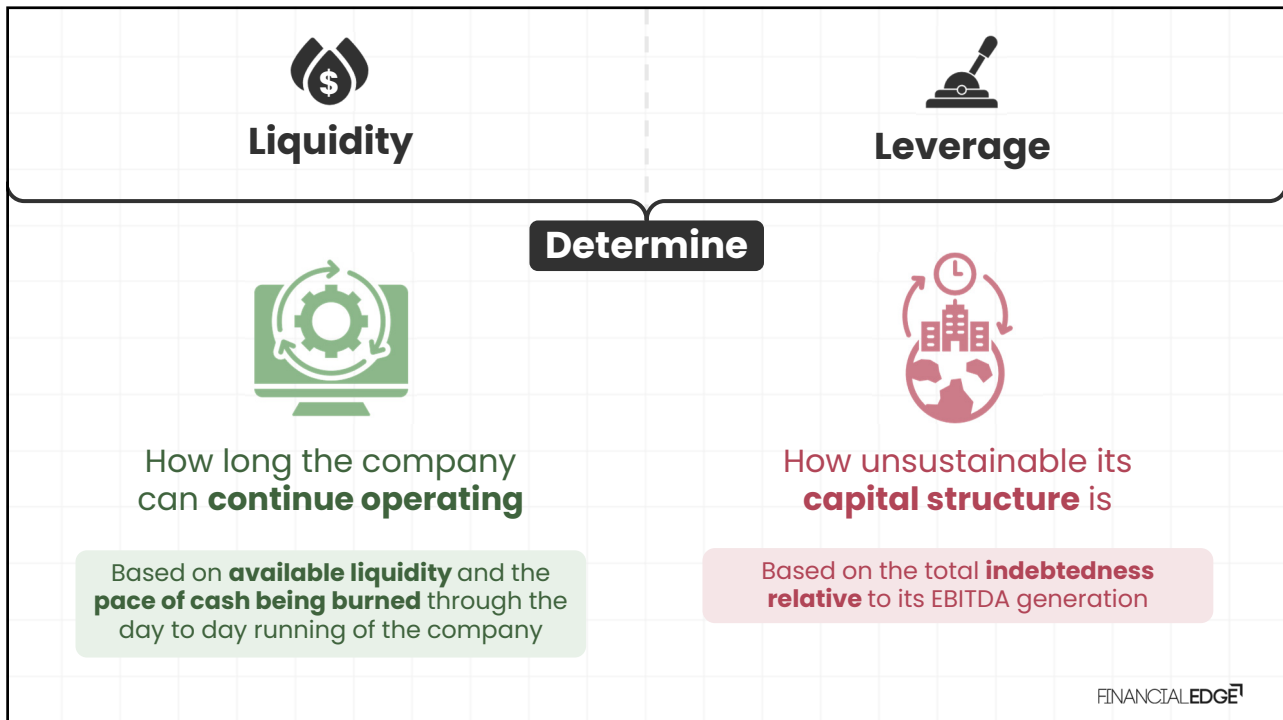


The **liquidation** of
company's assets



Asset disposals to raise
additional liquidity

FINANCIALEDGE⁷



Operational Underperformance

FINANCIALEDGE⁷

Material Operational (or Financial) Underperformance



1



Long-term
declines in **sales**
and **profitability**

2



Loss of key
customers or
contracts


3




Significant **costs**
or capex overruns
and or delays

FINANCIALEDGE⁷

1



Long-term declines in **sales and profitability**

 Frequent **Profit Warnings**

Q1

How well the **company is being run?**

Q2


Can it **compete against peers?**

Q3


Deserve to **remain operating?**


FINANCIALEDGE⁷


2



Loss of key customers or contracts

 Lower levels of **sales**

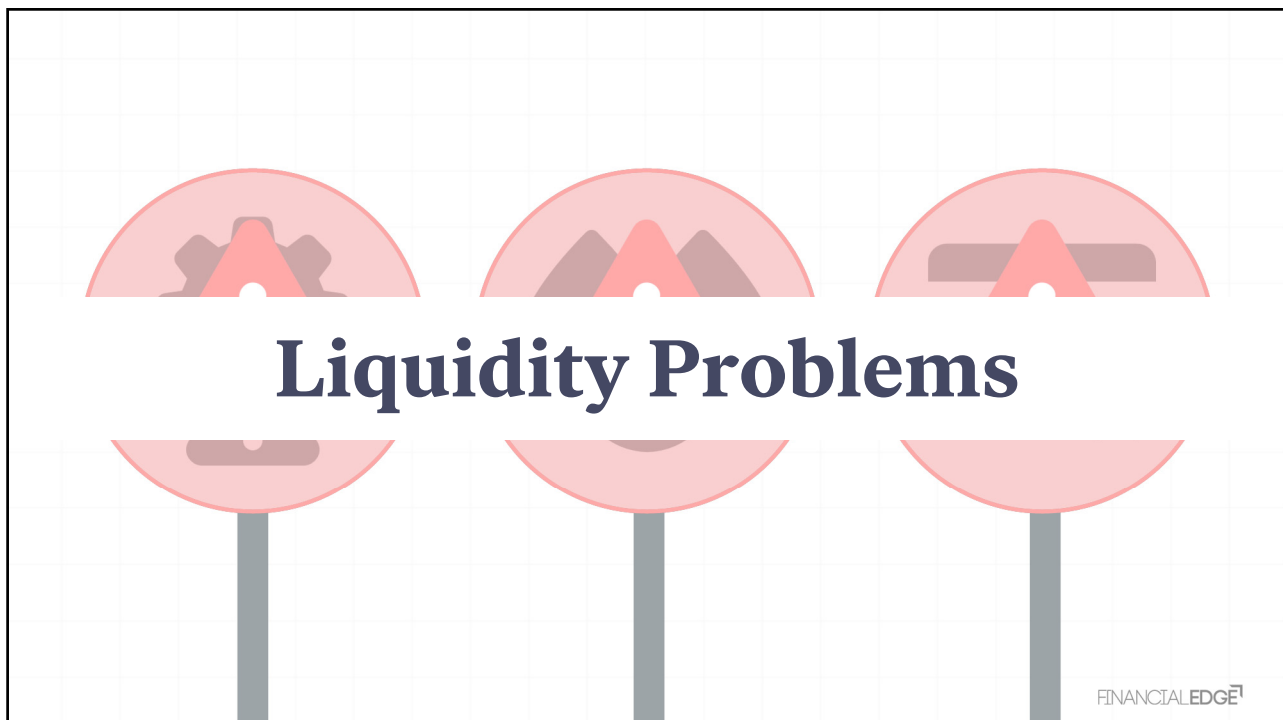
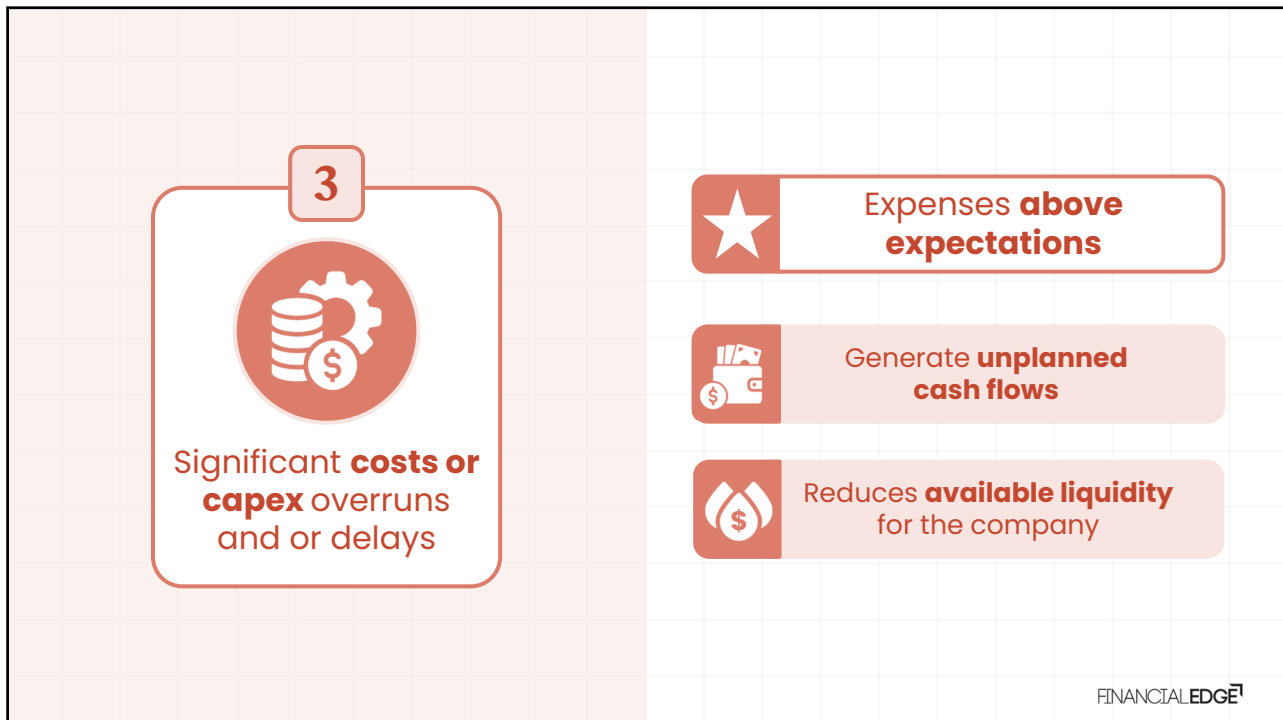
 **Reduces the generation of cash** for the company


 Detrimental in a **distressed situation**

FINANCIALEDGE⁷

© 2023 Financial Edge Training

6



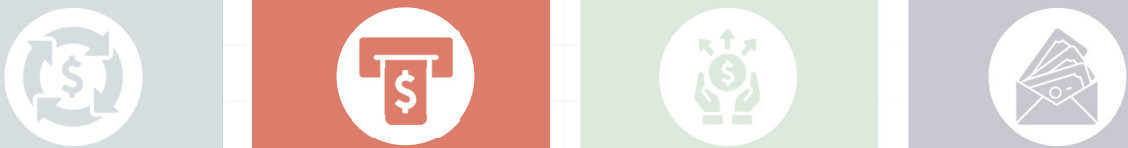


Consistent **limited** or **negative free cash flow** generation over the years

Commonly known as a **"zombie" company**

Requires special attention since this is **not sustainable in the mid- to long-run**

FINANCIALEDGE⁷



Constant use of **overdraft** or being **fully drawn** on revolving facilities

The company **needs much more liquidity** than usual

Therefore, **not having access to additional funds** might interfere with normal day-to-day operations

FINANCIALEDGE⁷



Limited availability to raise additional financing

Disposing of assets or raising equity is **more complex and time-consuming** than using pre-arranged lines of financing

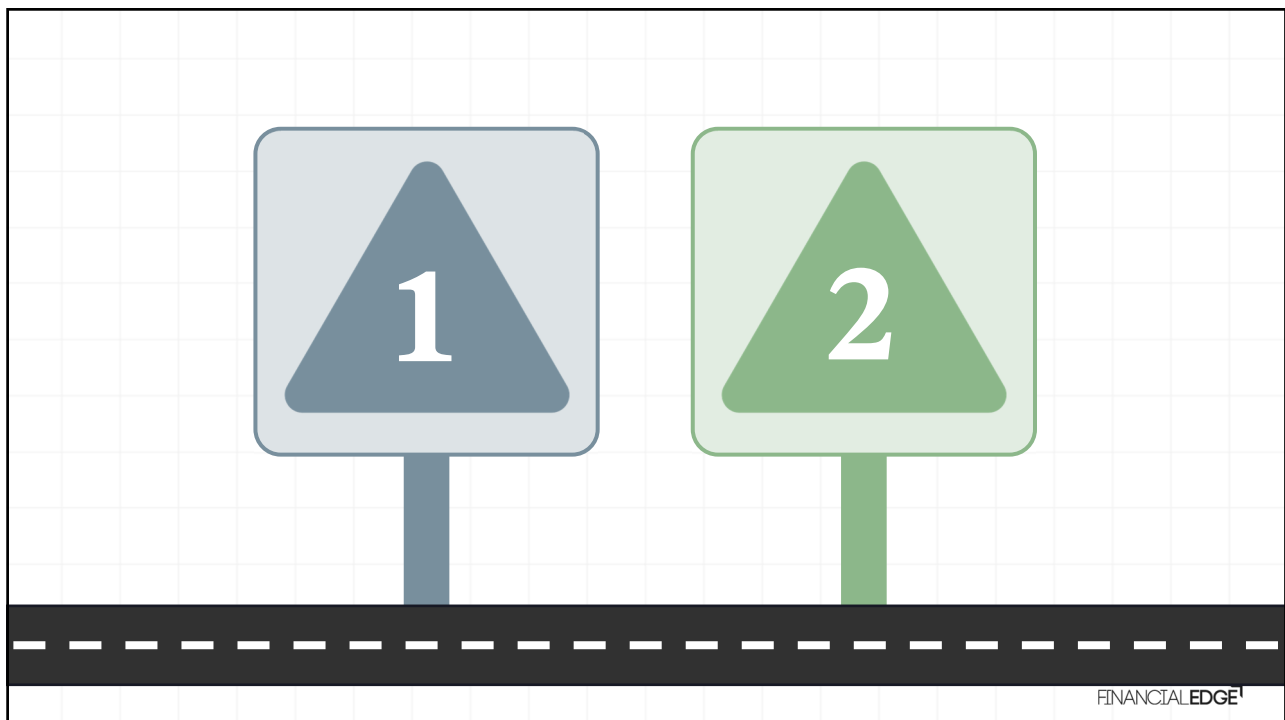
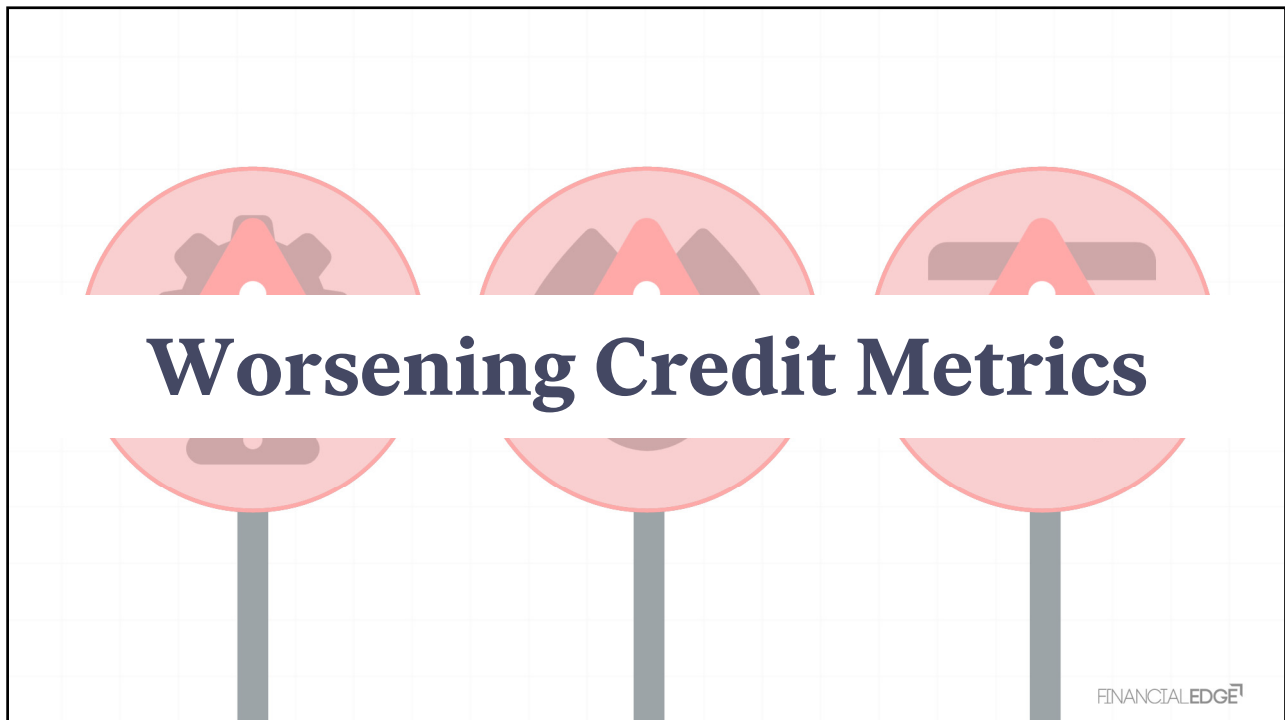
A company in distress, running out of cash, **doesn't have much time to play with**

FINANCIALEDGE⁷

Constant delays in paying **salaries, taxes** or suppliers' **invoices**

Key indicator that they are trying to **preserve as much liquidity as possible** and therefore could be in distress

FINANCIALEDGE⁷



Significant Levels Of Leverage

1



Net Debt / EBITDA ratio

Leverage ratios above 8x Net Debt / EBITDA might **indicate a very risky and unsustainable capital structure**

FINANCIALEDGE¹

Limited and Declining Interest Coverage Ratio

2



EBITDA / Interest Expense ratio

Company is **less able to afford its interest expense**
– the usual threshold for concern is when this ratio
drops below 2x EBITDA / Interest Expense

FINANCIALEDGE¹

Care must be taken when analyzing these credit metrics
as they **fluctuate together with EBITDA**.



Restructuring Costs

OR



Impairments

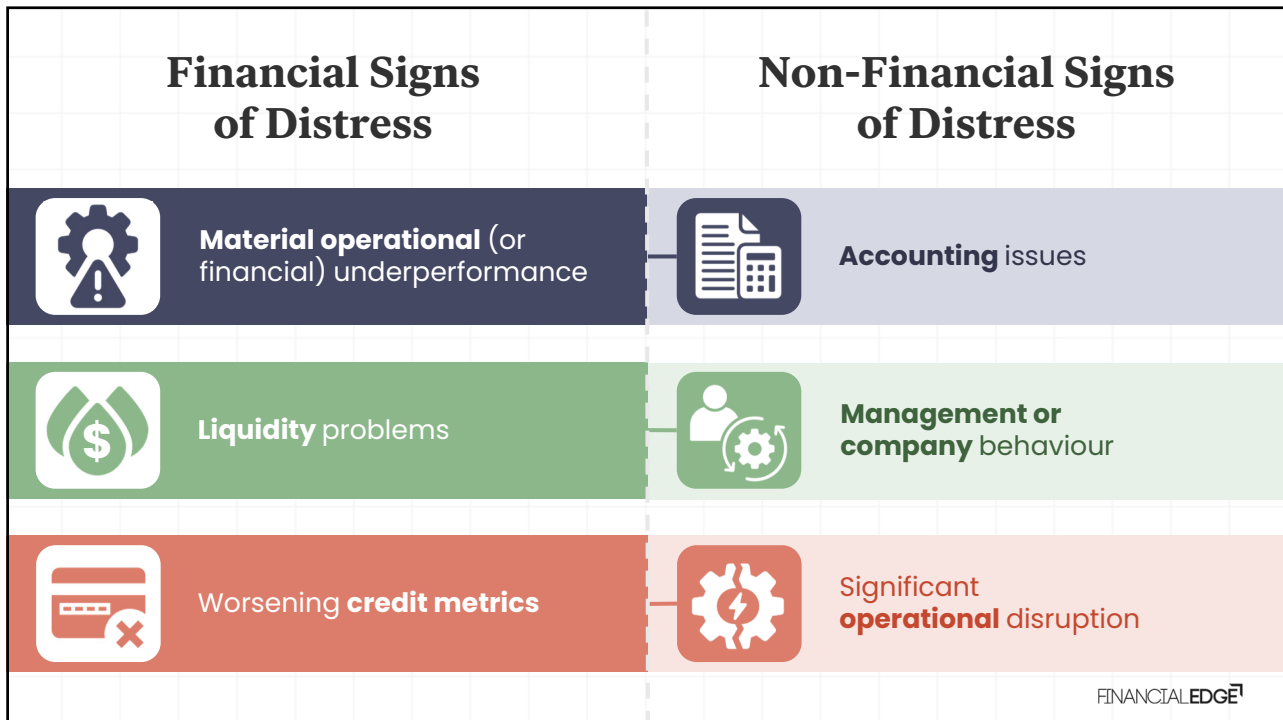


Using a **normalized EBITDA** for these ratios is **very important**

FINANCIALEDGE⁷

Accounting Issues

FINANCIALEDGE⁷



Constant Restatement Or Delays In Filing Financial Accounts



Company's finance function
doesn't have control over the
company's financial records



Might have
something to hide

FINANCIALEDGE⁷

Company's real leverage
might be **significantly higher**



This was one of the key
problems at **Enron**



They made extensive use of
special purpose entities

Hiding Or Understating Liabilities

FINANCIALEDGE⁷

Management or Company Behavior

FINANCIALEDGE⁷

High Turnover Or Loss of Key Staff

Can be **significantly detrimental** due to the loss of people with knowledge

Also has the effect of **demotivating remaining employees**

FINANCIALEDGE⁷



Frequent Changes in Auditors

A company has
something to hide

The auditors are not
confident about the
accuracy of the numbers

FINANCIALEDGE⁷

Nervous, Unresponsive, or Evasive Management

If management becomes
increasingly uncooperative
with analysts' requests

Might indicate they are
unavailable as a result of trying
to find **emergency funding**

FINANCIALEDGE⁷






Misrepresentation or Outright Lies

This usually happens when **management doesn't want to disclose** what truly is happening within the company


FINANCIALEDGE⁷

Significant Operational Disruption

FINANCIALEDGE⁷






Significant Operational Disruption



Products **lose relevance**

Due to **technological obsolescence**.






Kodak


Highly profitable market leader for many years before being **disrupted** by digital photography.

Kodak ultimately filed for **bankruptcy protection** in the US in January 2012.

FINANCIALEDGE⁷






Loss of Key Operating and Distribution Licenses



Companies **lose access** to products

- Leading to **significant drops** in revenue and cash flows.
- This may lead to a **company ceasing to operate**.



Port Operator

- Would have to **halt its business activities** and would not be viable as a going concern.

FINANCIALEDGE⁷



Litigation Issues

Threaten the company's **operating license**



A mining company being sued for **environmental damage** may lead to its operating license being revoked.



May result in liabilities that are **too expensive** for the company to afford.



FINANCIALEDGE⁷

FINANCIALEDGE⁷
www.FE.training

Please do not redistribute these materials without the express permission of Financial Edge Training.