Status quo at the abyss?

By Henry F. Owsley and Peter S. Kaufman

Faced with some combination of impending liquidity and capital-structure crises, companies and their boards of directors may consider multiple options. One option is to maintain the status quo and do nothing.

This is roughly analogous to the physician's credo of "first, do no harm." In effect, this strategy plays for time (liquidity permitting), in the hope that market forces or operational initiatives can adequately address the capital structure challenges that have arisen because of the mismatch between leverage and operational performance.

In this scenario, the company will monitor the situation, perhaps trying to improve liquidity internally but without seeking new financing. It may not hire restructuring professionals (in our view, a mistake) and is not likely at this juncture to develop, much less implement, a financial restructuring plan.

Maintaining the status quo must always be considered in conjunction with other potential courses of action, in part because the company and its various constituencies will have different perspectives on the rewards and the risks of the status quo approach.

Management teams and boards of directors are never eager to admit to problems and never excited about the prospect of interviewing, engaging, and paying high-priced investment banking and legal talent specializing in distressed company problem-solving. Moreover, because capital structure and liquidity issues are almost invariably linked directly to operational challenges, management must spend all its time on operations — leaving precious little time, and likely having little inclination, to focus on capital structure issues.

Thus, to these parties, the advantages of maintaining the status quo are:

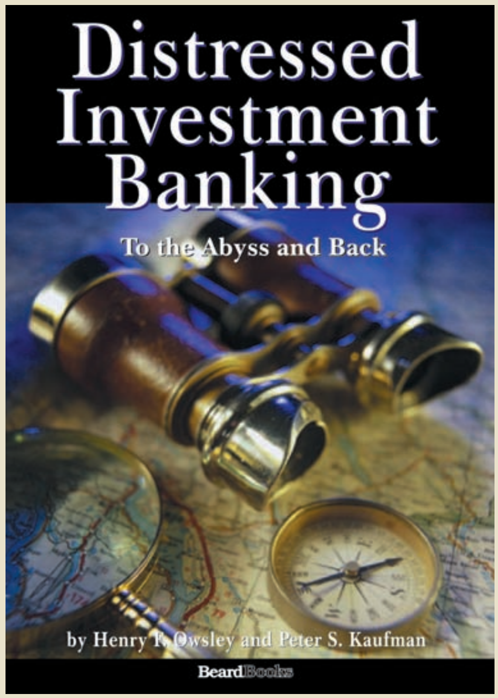
• Management's time can be spent solely on operations, and not on the development, negotiation, and implementation of a financial restructuring.

• The company can avoid the expense of hiring restructuring professionals.

• If the company's operations do turn around in a dramatic fashion, this alternative (which involves no dilution) can result in the best outcome for old equity.

Here are some of the disadvantages of the status quo approach:

• Sticking with the status quo too long may preclude a later sale process, or it may delay a sale beyond the point of peak value. "The sooner the safer," heavyweight champion Jack Dempsey once said when asked why he sought to knock out his opponents as quickly as possible. The sooner a company begins to address these financial issues, the more financial restructuring options it will likely have.



• The status quo approach can turn into a "bet the ranch" strategy, as the company risks waiting too long to act and losing the ability to maximize its value, and perhaps save itself.

• It does not take advantage of the mismatch between the market's pricing of the bonds and the company's implied enterprise value and prospects.

• The company is likely to find itself at a competitive disadvantage with rivals that have greater financial wherewithal.

• Management will be functionally working for the benefit of creditors until and unless the company can grow back into its capital structure.

Companies rarely make a proactive decision to pursue the status quo alternative. Instead, they end up maintaining the status quo as a result of not making a decision. Unfortunately, this places the company in a reactive mode, necessitating the adoption of one or more restructuring strategies in a crisis atmosphere.

It does not have to be that way. Ideally, a company (or its advisers) should be able to identify early signs of trouble. And, having recognized the symptoms, leaders should analyze the alternatives available — starting with maintaining the status quo.

Depending on the circumstances, we can be big fans of a status quo approach. We just think that a company should make a deliberate and well-reasoned decision to pursue it — rather than choosing that approach out of simple inertia.

Henry F. Owsley (left) and **Peter S. Kaufman** are with Gordian Group LLC, a New York-based investment bank (www.gordiangroup.com). Owsley is a founding partner and CEO of the firm, and Kaufman is managing director and head of its restructuring and M&A practice. This article is adapted from their book, *Distressed Investment Banking: To the Abyss and Back,* copyright ©2005 by Beard Books, Washington, D.C. (www.beardbooks.com).