Financial Statements Do Not Tell the Whole Story

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Abstract

The lenses of an attorney will look beyond the standard financial statements. A review looks beneath the covers and with a view of ratios, debt structure, trends, cash, and offers insight into the shorter-term viability of a firm.

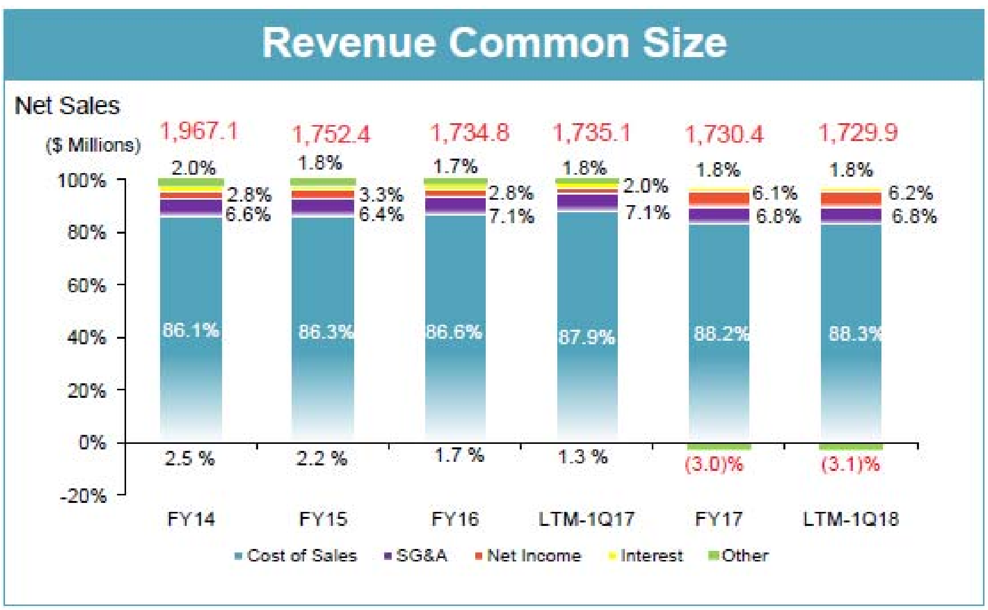
In this article, the author reviews the financial analysis of a fictitious company to highlight what financial statements sometimes do not reveal, what detail is reviewed through the lenses of legal, and to highlight where the analyst should ask more questions.

Bankruptcy attorneys often are asked to review financial information regarding a debtor. Merger and acquisition attorneys may look at deal terms with an eye on the opportunities for profit and growth in value. Bankruptcy attorneys review deals with an eye on what is the worst that can happen.

Insolvency attorneys expect that a turnaround takes time. M&A attorneys know that promised synergies when companies come together do not happen overnight. Insolvency attorneys want to understand what happens if the optimists are wrong.

Accrual based numbers are important; but, a bankruptcy attorney will focus on liquidity and cash flow. Accrual income can be deceiving because of losses due to ramping up, due to winding down or due to turnaround time. The question is whether losses really will subside, whether profit will increase will the trend be reversed or will the trend increase. And, debtors do not always timely denominate assets on their books as being held for sale or disposition.

Revenue Observations:



- During LTM-1Q18, ABC Company's (fictitious name) revenue decreased by $5.2 million (0.3%) to $1,729.9 million as compared to $1,735.1 million during LTM-1Q17, mainly due to:

- A $4.4 million (0.3%) decrease in sales to $1,730.4 million during FY17 compared to sales of $1,734.8 million during FY16 primarily due to decreased shipments in the

Company's consumer products segment, largely offset by increased shipments in the pulp and paperboard segment, and a favorable sales mix in both segments.

- A decrease in sales of $0.5 million to $437.0 million during the first quarter of FY18 from $437.5 million during the first quarter of FY17, primarily due to lower parent roll sales in the consumer products segment, offset by favorable pricing and product mix in the pulp and paperboard segment.

- SG&A* expenses decreased by $4.9 million (4.0%) from $122.7 million in LTM-1Q17 to $117.8 million in LTM-1Q18. The decrease was largely driven by lower expenses on sales and administrative personnel, as well as a strategic plan (implemented from the beginning of 2018) to lower SG&A expenses.

- During LTM-1Q18, operating income decreased by $3.0 million (3.4%) to $84.3 million from $87.3 million during LTM-1Q17. The decrease was primarily due to lower gross profit, partially offset by lower SG&A expenses. The lower gross profit was due to a gross profit margin percentage of 11.7% during LTM-1Q18 versus 12.1% during LTM-1Q17.

- The decrease in gross profit margin was mainly due to higher transportation costs and higher input costs for sawdust, logs, purchased pulp and chemicals. The decrease was partially offset by lower wage and benefit costs due to automation and layoffs.

Cash flow can be negative for at least three reasons - operating, financing and investing activities. To determine if the debtor has a business worth saving, initial focus should be on operating activities. If operations do not generate cash, then the debtor may be "covering" with additional borrowing. This is borrowing from Peter to pay Paul. When will it stop? Debtors cannot borrow their way out of a failing business.

Highlights	LTM-1Q18 ($ Millions)	LTM-1Q17 ($ Millions)
Net cash (used in) provided by:		
▪ **Operating activities**	163.1	169.3
• **Investing activities**	(204.6)	(233.7)
• **Financing activities**	37.7	78.1
• **Cash and cash equivalents at end of period**	12.1	16.0
Observations		

Cash Flow Observations:

Operating Cash Flows and Liquidity Needs:

- Cash flow from operating activities decreased by $6.2 million to $163.1 million during LTM-1Q18 from $169.3 million during LTM-1Q17.

- The decrease was mainly due to negative cash flows from other operating activities and negative cash flows from changes in taxes receivable, partially offset by higher net income, higher depreciation and amortization, and positive cash flows from changes in other net operating assets.

- Low Liquidity – At the end of LTM-1Q18, the Company had total liquidity of $136.0 million, consisting of cash and cash equivalents of $12.1 million and $123.9 million available under the Company's revolving credit facilities.

- As of December 31, 2017, the Company had $1,531.2 million in contractual obligations, with $576.6 million due in 2018 and $137.3 million due in the subsequent two years (2019 and 2020). As of March 31, 2018, the Company was in compliance with all the covenants related to its debt.

- The Company relies on a combination of cash flows from operations, cash on hand and borrowing capacity under its revolving credit facilities to fund debt service requirements and provide cash required to support ongoing operations, capital expenditures and working capital needs. The Company had working capital of $11.2 million as of LTM-1Q18.

- Cash Flow Ratios – The cash debt coverage ratio decreased marginally to 0.21X as of LTM-1Q18 versus 0.23X at LTM-1Q17, primarily due to a decrease in cash flow from operations, as well as an increase in total debt.

- The cash flow coverage ratio increased to 0.27X as of LTM-1Q18 compared to 0.18X as of LTM-1Q17, primarily due to an increase in net income plus depreciation and amortization, partially offset by an increase in total debt.

Borrowing became rampant when interest rates were extraordinarily low. Acquisitions became easier to consummate and low interest rates masked operating deficiencies. It has been attributed to Warren Buffet saying, "When the tide goes out you learn who has been swimming naked." When interest rates increase, you learn which companies have been masking their problems with low costs of borrowing. If interest rates are on the incline, then it is critical to know when a debtor's loan maturities occur and whether the debtor is likely to be able to absorb the increased cost of debt service without stumbling.

Contractual Obligations as of December 31, 2017 ($ Millions)

Payments due by period	Within 1 year	1 – 3 years	3 – 5 years	After 5 years	Total
Revolving lines of credit	155.0	--	--	--	155.0
Long-term debt	--	--	--	575.0	575.0
Interest on long-term debt	28.5	57.0	57.0	46.5	189.0
Capital leases	2.6	5.4	5.4	24.2	37.5
Operating leases	12.1	18.5	15.2	29.6	75.3
Purchase obligations	280.9	40.0	3.6	5.4	329.9
Other obligations	97.5	16.4	10.8	44.8	169.5
Total contractual obligations	**576.6**	**137.3**	**91.9**	**725.4**	**1,531.2**

Observations:

- Contractual funding obligations change with time.
- The book-end years (less than 1 year and greater than 5 years) have a significant impact on the cash needs of the business.

- Debts due within year one are significant and require the capability to be funded through operating and/or financing means.

Sometimes a decline in sales is a good thing rather than a bad thing if the debtor is intentionally shrinking the company in order to exit business segments and if the debtor is using the sale or liquidation proceeds to pay down debt.

Financial statements have less meaning if the debtor has a runway before being obligated to pay full principal and/or interest. Mergers and acquisitions do get done based upon the debtor having sufficient time to increase revenues and cash flow – until they fail to do so. So, a question for creditors and investors is: When does the debtor hit the wall if the synergies do not bear fruit?

Debt maturities are critical. Always keep a calendar. Income may be positive. Sales may be inching up. But, will the debtor be able to make the upcoming principal and/or interest payment? Or, is the debtor likely to be able to refinance existing debt at maturity? Prudent creditors may want to begin ratcheting down a customer in terms of amount outstanding long before a critical maturity date if there is a concern with refinancing. Wait too long and the debtor will not be able to bring you down by "borrowing" from another vendor.

Observations:

- Moderate Leverage – As of LTM-1Q18, the Company was moderately leveraged.

- The Company had total common equity of $580.7 million, total assets of $1,811.9 million and total debt of $765.4 million.

- Covenants – The company's debt covenants pose restrictions regarding the Company's ability and the ability of its subsidiaries to undergo a change in control, sell assets, pay dividends and make other distributions, make investments and other restricted payments, redeem or repurchase capital stock, incur additional debt and issue preferred stock, create liens, consolidate, merge, or sell assets, enter into certain transactions with affiliates, engage in new lines of business, and enter into sale and lease-back transactions.

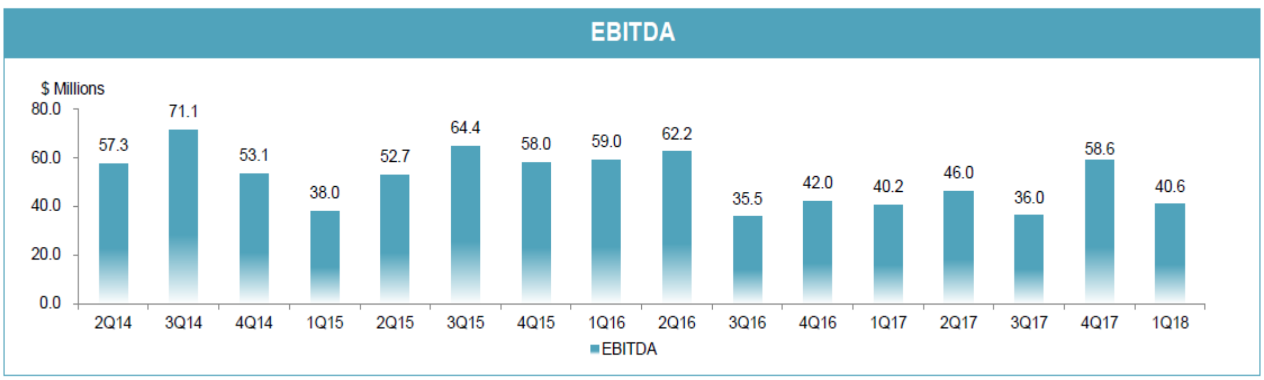
- As of March 31, 2018, the Company was in compliance with all the covenants related to its debt.

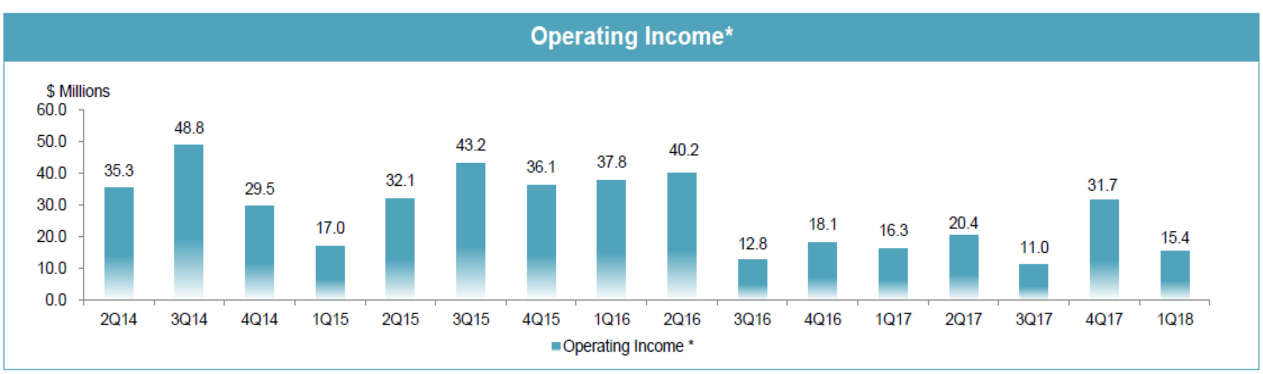
- Leverage Ratios – As of LTM-1Q18, Debt/Equity was 1.3X, compared to 1.5X as of LTM-1Q17.

- Total Debt/Assets remained stable at 0.4X as of LTM-1Q18 and LTM-1Q17.

Positive net worth, positive income and positive cash flow are good news. But, the bigger question is whether those positives are sufficient in the eyes of the secured lender or bond holders. What is the debtor's valuation when EBITDA is multiplied by a market multiple? Is the valuation adequate to support replacement financing? Or, will there be a default when the loan comes due?

Observations:





In distressed situations probably the most significant factor is liquidity. How much cash is on hand and how much is the availability? If the debtor has a lot of "headroom" in availability, the follow up question is whether the bank lender has sought or is likely to seek a reduction in advance rates or in the loan "cap." Has there been an event that would enable the lender to do so? Advance rates are a stated percentage of value, but the lender typically has discretion to increase reserves or to reduce advance rates under certain circumstances. Such reductions may cause the debtor to have to stretch out vendor payments.

Financial statements are a good analytical starting point, but what is the marketplace saying? At what price are bonds trading and at what price is bank debt trading? This information is relatively easy to obtain from Bloomberg and from applications such as Markit. If bank debt is trading below par, it is evident that the marketplace does not expect (or, at a minimum is uncertain) that secured debt will be paid in full. Secured creditors eat before unsecured creditors are fed.

In Chapter 11, most financial reporting is done on a cash flow basis. Chapter 11 costs can distort the true picture of performance. Lenders obtain additional fees and increased interest rates. Professional fees are burdensome. Management attention is diverted from operations, and losses may be incurred on sales of assets. So, it is important to "normalize" the financial reports in order to glean how the debtor would be doing absent the baggage of Chapter 11. This will reveal whether there is a core business to salvage.

Recent financials will be revealing, but look at trends. Many debtors assert that with more time and with more money, they will be able to achieve a turnaround. Or, they assert that the turnaround already is happening. However, reviewing trends in EBITDA, revenues, SG&A, etc. over several quarters and over several years will tell whether the debtor is being candid or whether the debtor is just hoping for a life raft.

Ratios always tell a story. When the debtor states that it has been reducing expenses, look at SG&A as a percentage of revenues over several quarters. If the debtor's business is seasonal, look at the same quarters for several years. If assets as a percentage of revenues is increasing without a concomitant increase in revenues, then it is taking an increasing amount of assets to generate the same or less income. Something is very wrong. The debtor is becoming less efficient.

Dollars spent on capital expenditures may be increasing. And, it even may be stable as a percentage of revenues or income. But, how does it compare to the debtor's competitors? If competitors are spending a higher percentage, there probably is a reason. The marketplace is changing and the debtor is not keeping up, which will cause pain later on. Probably, the debtor is burdened with too much leverage and cannot keep up, or else the equity owners are withdrawing too much cash to satisfy their current demands rather than having a longer-term perspective on value accretion.

The lenses of an attorney will look beyond the standard financial statements. A look beneath the covers and with a view of ratios, debt structure, trends and cash offer insight into the shorter-term viability of a firm. While other factors are important, a legal review will look at the worst that can happen when reviewing a distressed company.

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