Causes of the crisis, management and turnaround – case study

Lesson 4

Contents

1 Background

2 The plan

3 The reality

4 The situation – *group discussion*

5 The development of the turnaround plan

1

Background

Background

Noè brief profile

- Largest manufacturer/distributor of safety footwear in Europe
- Merger of 2 companies through a highly leveraged LBO in 2000
- Annual revenues of €180million from 10 million pairs of footwear
- Over 4,000 staff employed
- Across Italy, France, Spain, UK, Germany, and Tunisia
- Head-quartered in Italy, 90% of production in Tunisia
- CEO centric organisation, with CEO also a minority shareholder
- Company managed with informal processes
- Complex capital structure, especially considering size
  - Senior bank syndicate of 15 banks (5 of which Italian)
  - Mezzanine led by another global institution
  - Various shareholders loans

Corporate decline causes and trigger of restructuring process

- Revenues growth lower than planned
- Competition increase, also from LCCs, led to falling margins
- Breach of covenants in Q1 2004
- Critical cash issue - €7.5 million Senior debt repayment due on 20th June 2004

The "Strategy": a PE Firm, with Company 1 in Portfolio, Decided to Buy Company 2, to Create the European Safety Shoe Market Leader

The Original Strategy	Supporting Evidences
•C1 is a French-based safety shoe manufacturer with top range products made in Europe •C2 is an Italian-based safety shore manufacturer with low and middle range products made in Tunisia •The PE firm wants to relocate C1's operations in Tunisia and using C2's production system to manufacture C1's shoes •The merger would have cost benefits for C1's operations	•C1 has a reputation for top range products while C2 is a low to middle market player in the safety shoe industry •The European safety footwear market is expected to grow at around 3% a year in volume, with the highest growth in the middle and low range segments •C2 is best positioned to compete in a European market with increasing competition •Relocation of C1's manufacturing to Tunisia, with the help of C2, is the best option •Manufacturing C1's products to current standards through C2's production system is feasible with minor adaptations •C2 and C1's projections of sales seem to be achievable and relocation costs are rather conservative

Three Distinct Product/Price Segments with Specific Key Success Factors

	LOW	MEDIUM	HIGH
Price range (Euro/unit)	8-13	13-25	> 25
Volumes (ranges by country)	30-60%	30-60%	10-20%
Key Success Factors	1. Price 2. On time delivery 3. Delivery time	1. Quality / price ratio 2. Logistic service 3. Design 4. Innovation (weight, comfort)	1. Brand image 2. Performance for specific use 3. Logistic service
Price trend	↘	↘	→

Competitive Intensity in the European Market

Supplier Power | Med | →

- Manufacturers of high quality toe caps are not numerous, but those can be easily manufactured in-house
- Raw materials are plentiful. Leather (90% production), is by far the most important component, followed by rubber and synthetic materials (polyurethane)
- There are many suppliers of rubber and polyurethane

New Entrants | Med | →

- New entrants are entering the European market, although low-cost advantage is offset by duty tariffs and high inventory requirements when long transportation is required
- Unit prices are expected to decrease in the middle and low-price segments due to foreign imports
- Barriers to entry are low, as a result of no long-term contracts with distributors and limited need for R&D, however there are norms

Internal Rivalry | High | →

- The globalisation of the safety footwear industry creates a highly competitive environment
- The industry remains fragmented on a country basis but consolidation is leading to the emergence of large national and multi-national companies
- The growing trend to offer a full range of PPE* products (head-to-toe protection) leads to horizontal integration of PPE manufacturers across all segments

Customer Power | Med/ High | ↑

- Strong supplier competition
- Customer flexibility because of no long-term contracts with distributors, which negotiate prices on a semester or yearly basis
- Distributors account for 70–90% of industry sales and have strong customer power
- Several e-commerce propositions are currently being developed in the shoe industry, although the safety shoes sector may take longer. This could increase customer power in the future

Overall Competitive Intensity

Medium/High | ↑

New Technology Substitution | Low/Med | →

- The latest achievements in new materials and design technology may help expand the customer base to new industries and applications (notably composite toe caps)
- No innovation is, however, expected to have a major impact on competition

Key

↑ ↑ ↑	= increasing rapidly
↑ ↑	= increasing moderately
↑	= increasing slowly
→	= little change
↓	= decreasing

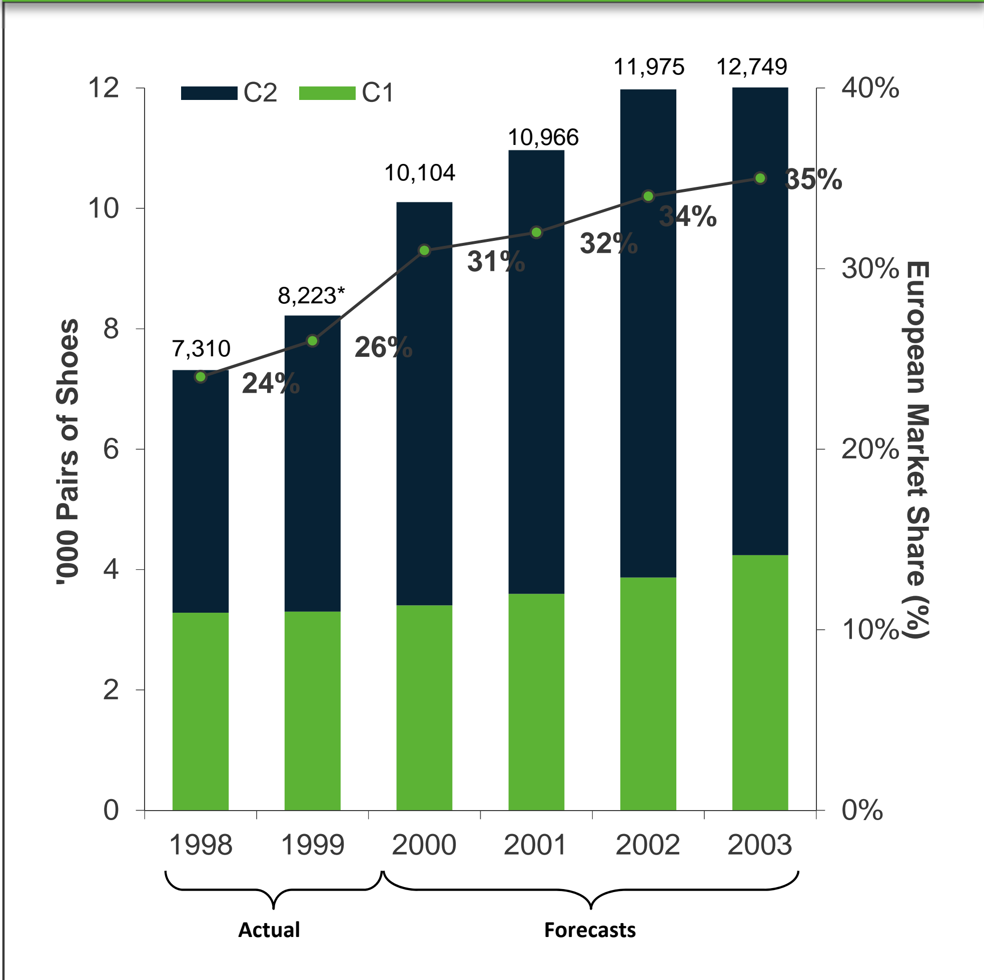
*Personal Protective Equipment

2

The plan

Consolidated Sales of C2 and C1

Consolidated Sales Forecasts (1998–2002)



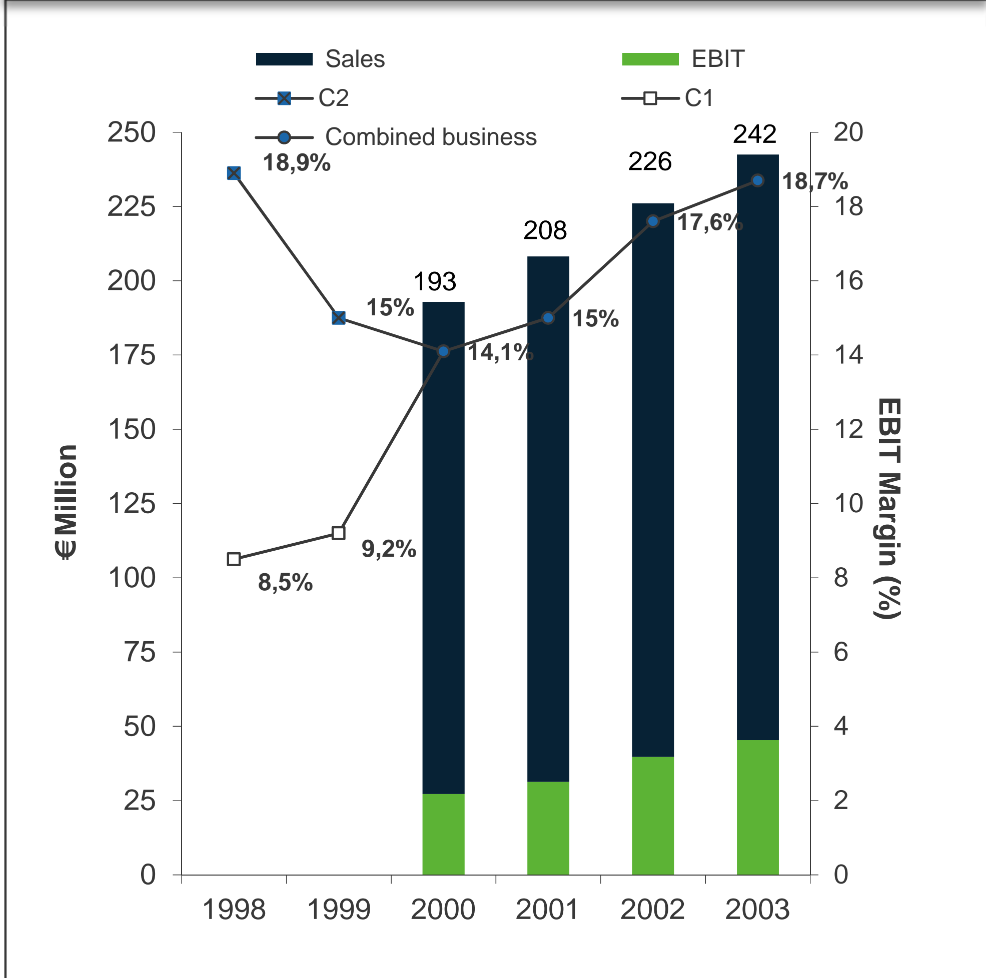
Comments

- In 1999, C2 and C1 had 16% and 11% market share of the European safety footwear market, respectively (estimated at 31 million pairs in 1998, growing at 3% p.a. between 1998 and 2003)
- Based on market forecasts, forecasted sales of the combined entity will represent 35% market share in 2003
- C2 forecasts sales to grow at 14.7% p.a., while C1 plans a growth rate of 5.5% p.a. between 1999 and 2003
- C2 revenue forecasts are more consistent with import growths in Western Europe countries than with overall market growth
- C2 expects to gain market share against small and less competitive players in the European market

Operating Margin of the Combined Business is in Line with C2's Historic Margins

The Plan

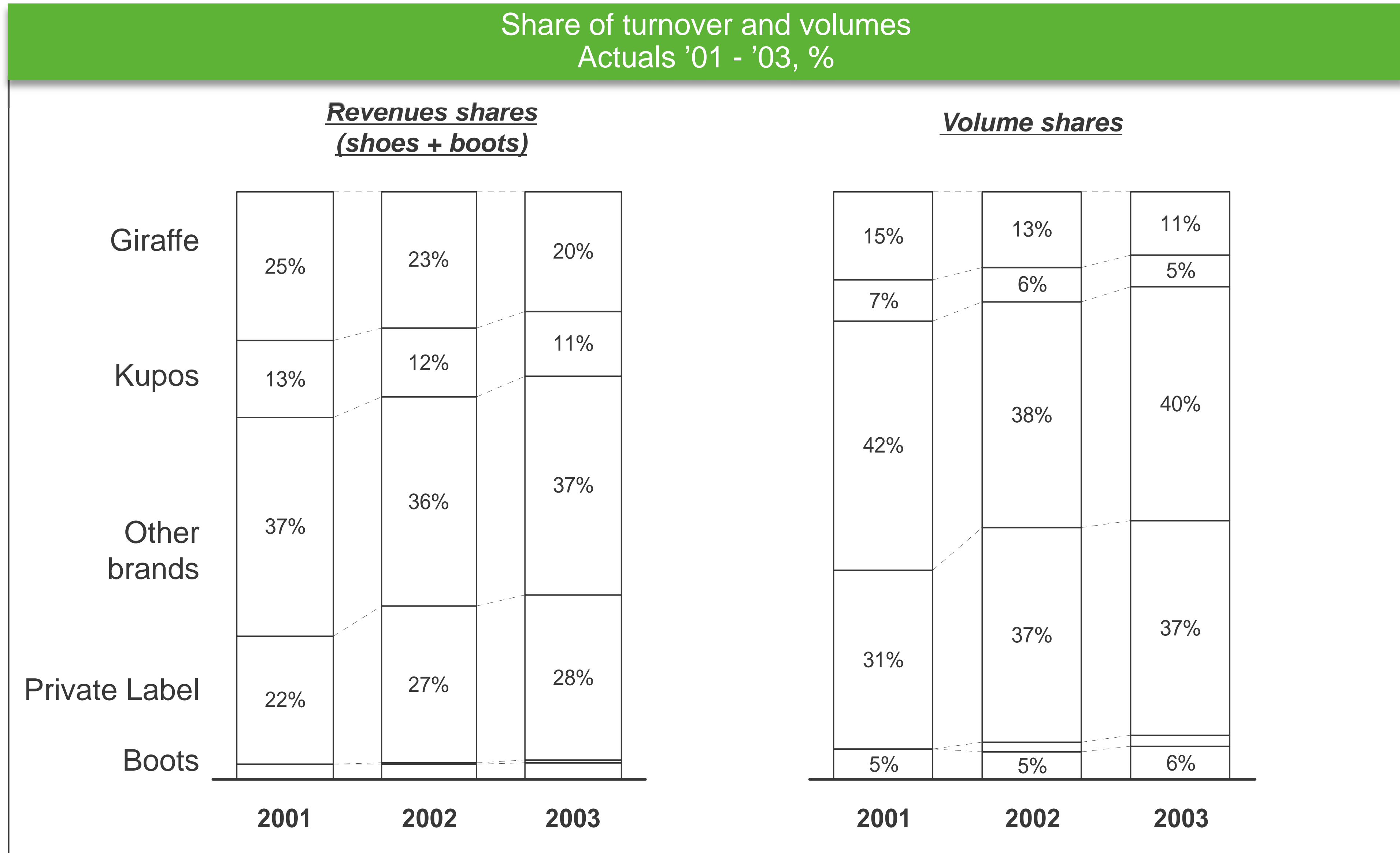
EBIT(1998–2002)



Comments

- 2000 and 2001 operating margins will be affected during the transition phase by overhead costs due to dual operations in France and Tunisia
- The effects of the relocation process having disappeared, we believe that operating margin should have similar levels to C2's operations prior to the merger
  - Manufacturing operations applied by C2 will be implemented across all the production
  - Raw material and transportation costs should be similar to C2's, with some possible decrease due to higher volume

Revenue Participation of Top Group Brands Decreased, with a Further Development of Private Label



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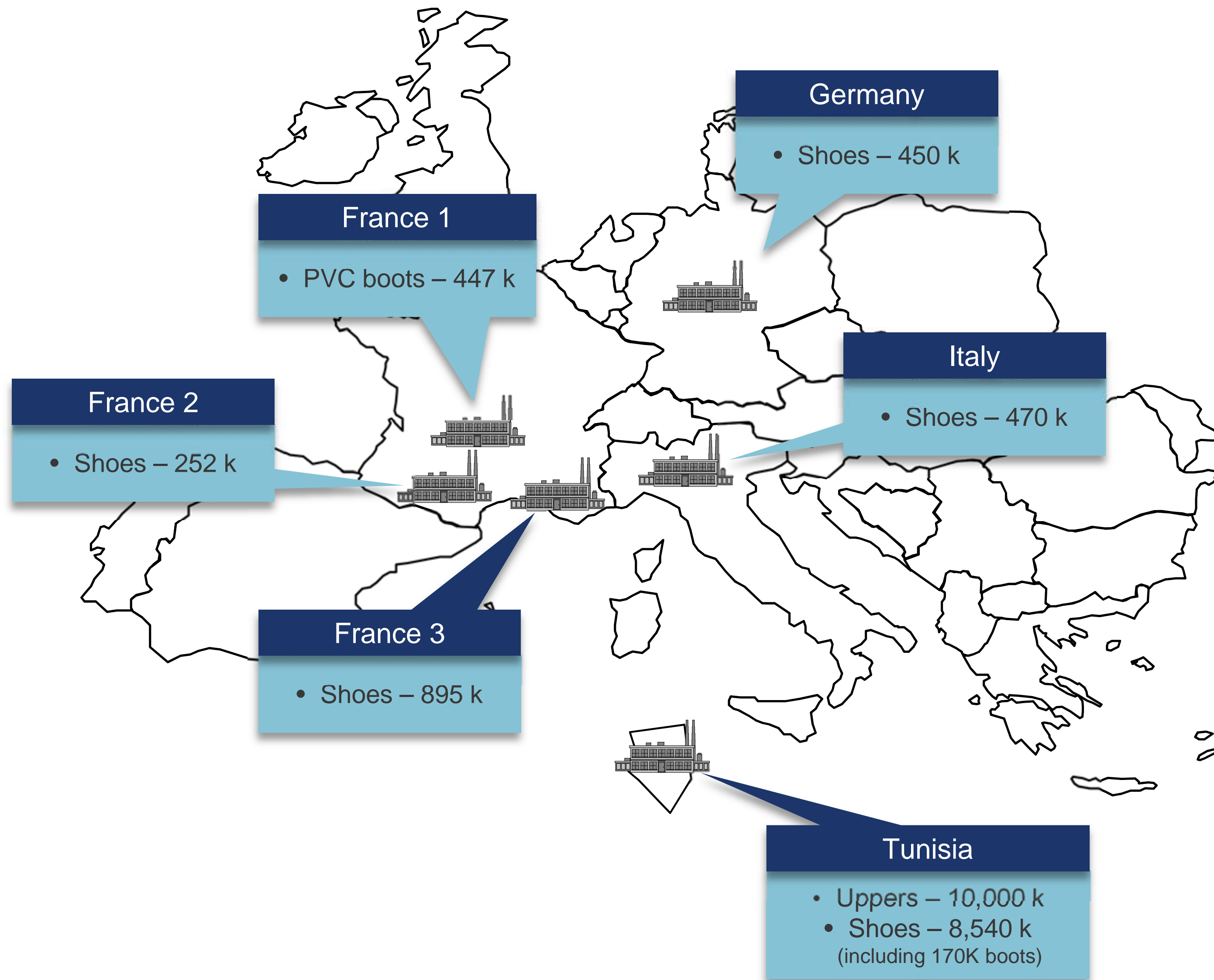
3

The reality

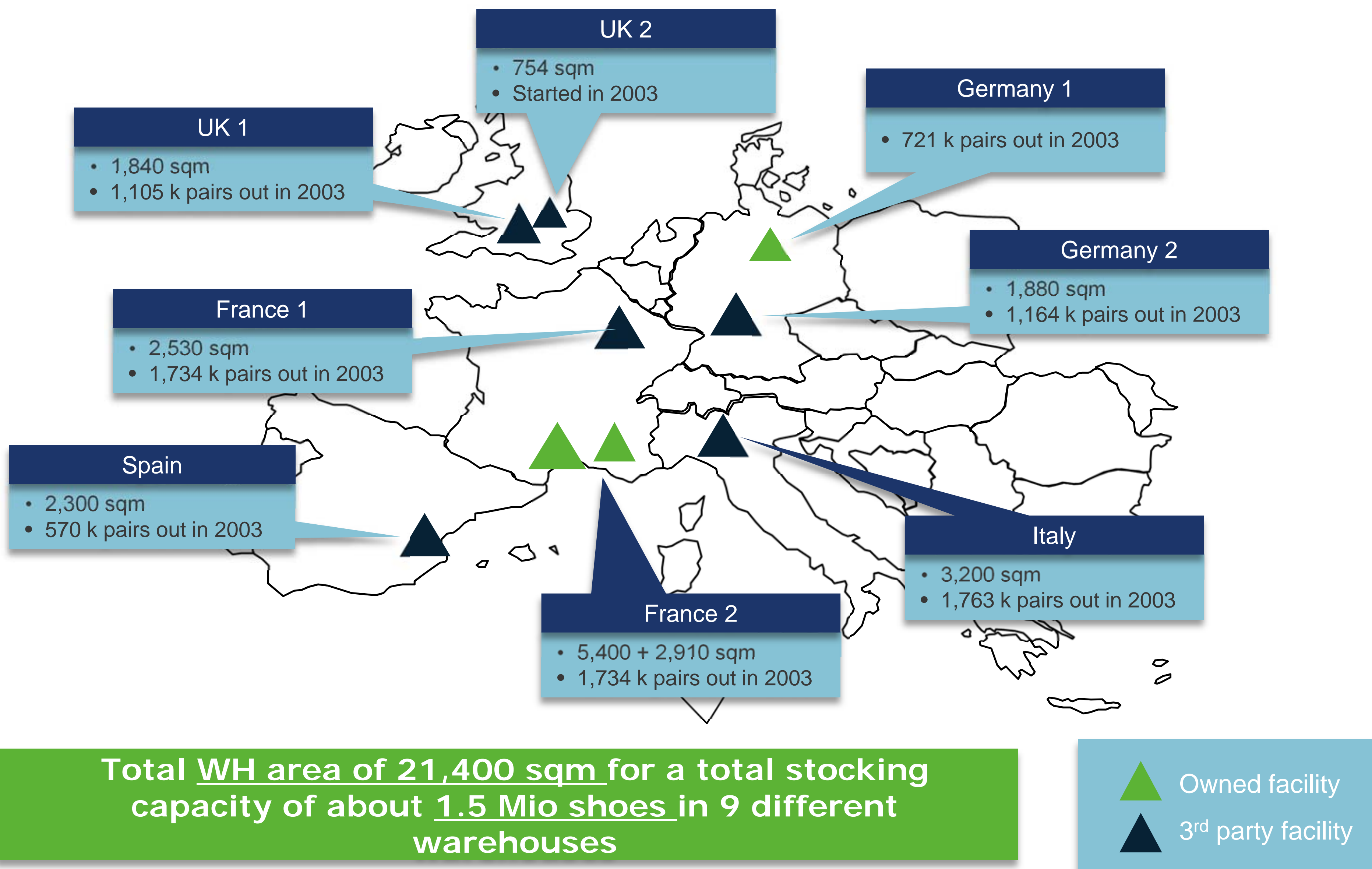
Manufacturing Footprint

Volumes 2003



Distribution Footprint

End 2003



Total WH area of 21,400 sqm for a total stocking capacity of about 1.5 Mio shoes in 9 different warehouses

Note: 2,640,00 pairs delivered to clients directly from production, (1) Sold in 2004

Fabregas Business Performance in 2002-2004 (€ Million)

	Actual 2002	Actual 2003	Budget 2004	CAGR%
Volumes (mil pairs) [1]	10.4	11.0	11.6	5.9%
Average price (euro)	17.4	17.2	16.9	-1.4%
Revenues (net)	180.0	193.8	200.4	5.5%
COGS	(124.6)	(138.4)	(143.4)	7.3%
Gross Profit	**55.4**	**55.4**	**57.0**	1.4%
	30.8%	**28.6%**	**28.4%**	
Selling Costs	(11.0)	(10.7)	(11.3)	1.4%
G&A	(24.0)	(21.6)	(20.1)	-8.5%
EBIT	**20.4**	**23.1**	**25.6**	12.0%
	11.3%	**11.9%**	**12.8%**	
EBITDA	**26.3**	**28.2**	**31.6**	**9.6%**
	14.6%	**14.6%**	**15.8%**	

2004 budget subject to comprehensive review

(1) Shoes + boots, Source: Budget 2004 V13

4

The situation

2004 Q1 update – on the face of it, trading was to budget

	Q1 Actual	Q1 Bdg	Variance
Volumes (mil pairs)	2.58	2.55	0.03
Average price (euro)	17.1	17.4	-0.30
Revenues (Net)	45.0	45.0	0.0
COGS	-34.6	-35.2	0.6
Gross Profit	**10.4**	**9.8**	**0.6**
	23.1%	**21.8%**	
Selling Costs	-2.8	-2.8	0.0
G&A	-4.9	-5.0	0.1
EBIT	**2.7**	**2.0**	**0.7**
	6.0%	**4.4%**	
EBITDA	**4.4**	**3.5**	**0.9**
	9.8%	**7.8%**	

- **Banks and shareholders had significant concerns over accuracy of accounting records**
  - (e.g. **significant un-reconciled materials cost,** generally attributed to **'overconsumption rates'** within the main production facilities in Tunisia)

Cash generation swallowed up by debt repayments, interest and restructuring costs in 2003

		2003	Q1 04
Sources	EBITDA	28,2	4,4
	Working Capital	10,0	-8,1
		38,2	**-3,7**
Applications	Repay banks	13,0	0,4
	Restructuring	10,0	0,7
	Interest	13,0	3,0
		36,0	**4,1**
Unapplied cash / Absorbed		**2,2**	**-7,8**

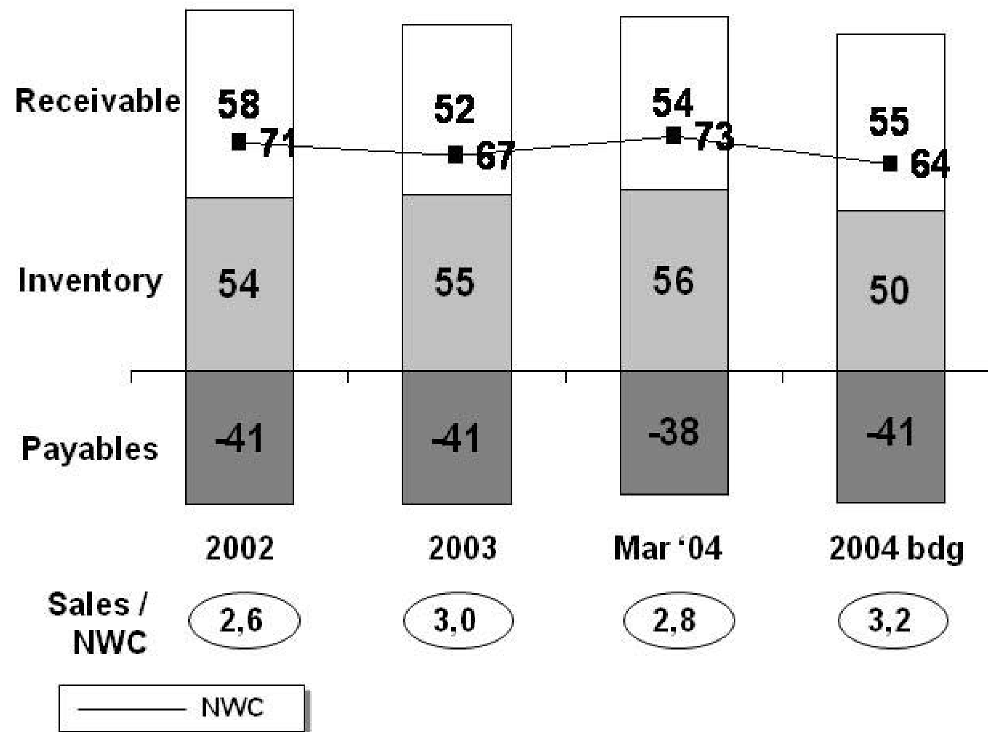
- **Cash absorbtion in Q1 2004 mainly due to Working Capital increase, effectively reversing Q4 2003 position**

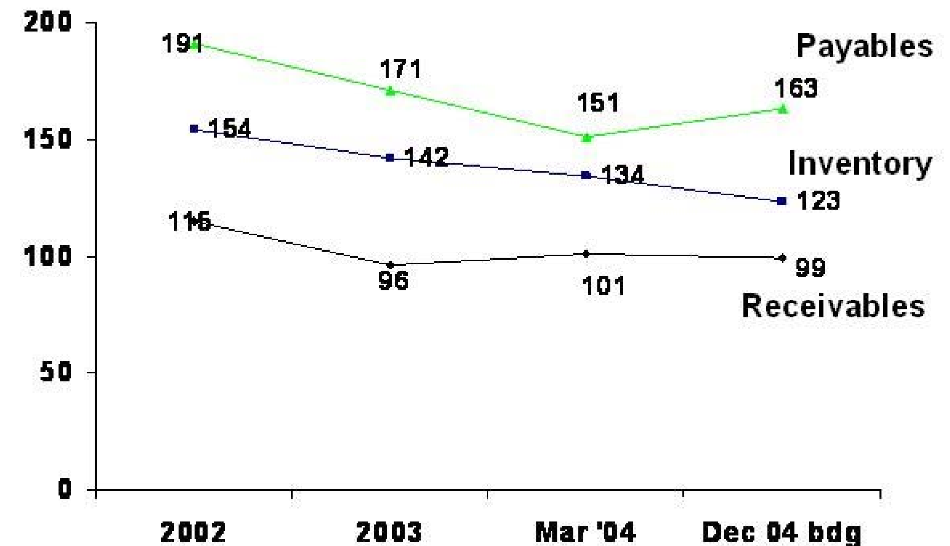
Critical cash issue: € 7.5 Mio Senior Debt repayment coming due

Cash position as at 29th April and forecast 31st May 2004

Euro Mio	Actual At 29 April	Forecast At 31 May	Number Of Banks	Number Of Countries
Cash at Bank				
Current Accounts	4,1	1,1	23	7
April Bills of Exchange not yet credited	0,2	-		
	4,3	**1,1**		
Local Overdraft Lines				
- Facilities	5,2	5,2	3	1
- Utilisation	(3,2)	(4,2)		
Headroom	**2,0**	**1,0**		
Revolving Facility				
- Facilities	**15,0**	**15,0**	12	3
- Utilisation	**(15,0)**	**(15,0)**		
Total Availability	**6,3**	**2,1**		
Note:				
Amount in Escrow for interest on Bonds	2,4	2,4	1	1

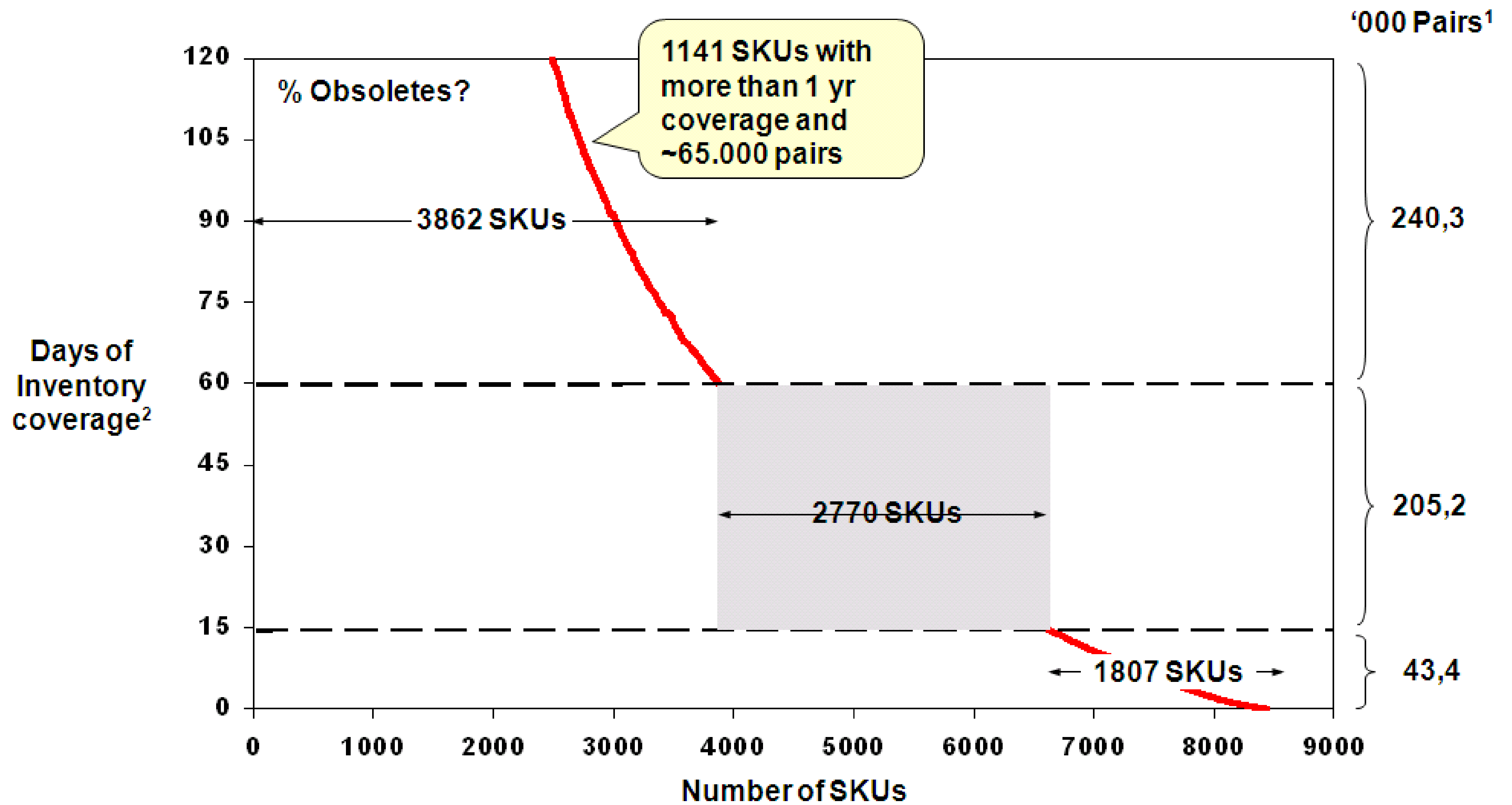
Operating Working Capital evolution (€ milion, days)



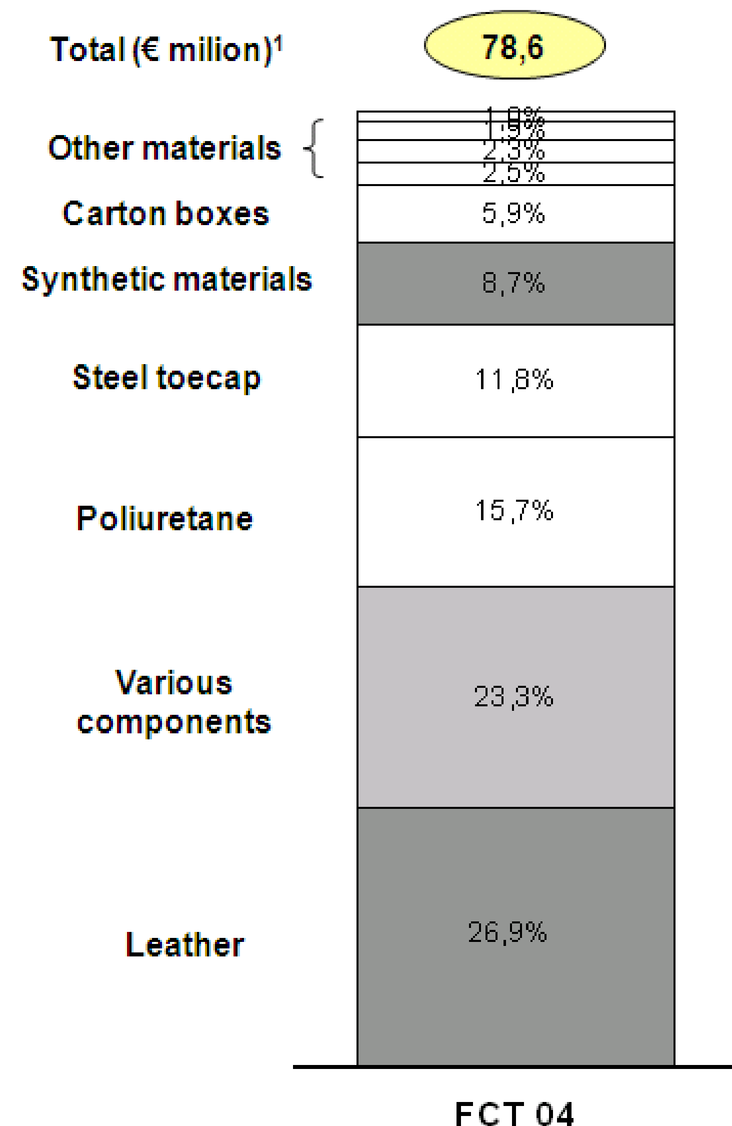


- Net Working Capital turnover improving, according to budget '04, from 2.6 in 2002 to 3.2 in 2004, by March '04 still no progress
  - Main actions planned on inventory (euro 5 million reduction in 2004)
  - Receivables are planned to increase by euro 3 million
  - Payables almost constant (about euro 40 million)

Inventory levels



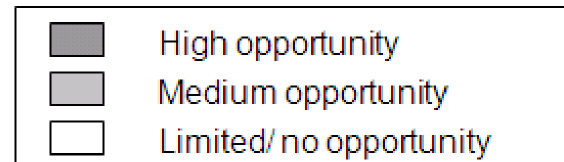
Material costs – initiatives to address real consumption vs standard consumption and assumed improvement



(1) Based on 2004 anticipated sales mix

Direct materials overconsumption

- Analysed '03 **actual consumption vs expected consumption** has **led to** identify **significant unreconciled 'overconsumption** rates' mainly attributable to the Tunisian production facilities
  - **Fabregas has no mean to reconcile those differences** with the available systems and tools; we believe that only **few materials** (leather, various components and synthetics) **and processes generate these differences** (leather cutting, WIP)
- Within the Business plan the impact has been estimated in **~2.3%** increase in material consumption
  - **No correction** expected **in '04**
  - **0.5% decrease** in the overconsumption rate in **'05** and further **0.8% in '06** due to specific high priority project already started (first implementation results expected by 3Q '04)
- Additional cost reduction opportunities in materials could be captured through a strategic sourcing program



SG&A: addressable cost base

	Budget 2004 ('000 euro)	Discretionary costs	Addressable ('000 euro)
Selling costs	11,274	• Travel & subsistence • Marketing • Other selling costs	4,000
G&A	17,904	• Maintenance • Travel &subsistence • IT • Professional fees • Other G&A costs	7,000
			11,000

Your recommendation

Given the information provided, make recommendations to the Fabregas Board :

1. What are the short term challenges and what the long term issues/opportunities?
2. Identify immediate priorities to be addressed and how you plan to tackle them
3. Identify potential operational improvements and the other main points on which you would base an industrial plan to complete a successful turnaround

- **Break-out Session:**
  - **Small groups (3-5 students)**
  - **Each group must answer to the question in max. 3 slides**
  - **I will pass around the groups to facilitate discussion and answer questions**