Turnaround and Recovery Plan for Detroit Michigan

Background

The City of Detroit has been mired in financial distress of a number of years. Quite recently, the issues have become serious enough that the governor of Michigan has appointed an emergency manager.

This outlines the best methodology to not only rescue Detroit from its past woes, but also put in place the success of the future. This methodology uses the best practices of a turnaround, but since it does not involve a private company, it will have some deviations. The standards of analysis, negotiation and decision making though do not change.

This is only an outline, a summary, of how a rescue plan could and should be developed.

Turnaround overview

Too often turnaround professionals, many of them from the legal profession, take immediate actions that are perceived to be a salvation for the enterprise. These actions include trying to take hard lines with creditors especially unsecured creditors by going for the "haircut" on what is owed right now. This usually gets one or two results: the creditor takes the cash and the hit and likely decides not to do business with the entity again; or there is a significant pushback from the creditor and the likely conclusion is either litigation or bankruptcy court – both signs of inability to negotiate.

Use of the consensus process in negotiation certainly takes longer than the traditional take it or leave it or compromise methods, but is proven to be more successful, long lasting and satisfying to all parties.

The keys to any turnaround are concluding there is value to save and time/patience. The entity must prove to creditors, vendor and customers there is sufficient value to save and the need for the all important time to get there. Most creditors, notably bankers, are not in the business to provide time to a poorly performing customer so it will take great skill and knowledge of creditor needs to "buy the time". Any plan that requires time (short or long) will need to include how the creditor's position will not get worse, but prove that staying with the entity will result in higher long term returns for the risk assumed – very few in the business know how to do this process.

Finally, one must know the recovery process is slow and many times painful. It often takes multiples of the time it took to create financial distress to get to financial health. So by way of example: if the slide began three years ago, the full recovery, that is getting back to the place before the slide, could take 5-15 years. This timeframe must be considered when deciding on whether it is best to begin a turnaround or move to closure or liquidation.

Phase I – Assessment

There has never been a client we have worked for that has not come to us too late; believing that "things will get better" or "if we ignore it, it will go away" each getting in the way of taking action. This delay is what causes the greatest harm since it usually accelerates the demise of capital, value and critical cash. Management in this phase normally shifts behavior to panic mode and customer service, product development and reasoned business decision-making are not performed, or at least not done well; and things get worse.

In this phase, all stakeholders should be identified and a preliminary risk assessment be assigned. A complete valuation analysis is performed to determine whether there an entity to save or whether liquidation is the best path.

In the case of Detroit, the option to liquidate or "go out of business" is not an option.

Phase II – Resource Assessment and Stabilization

An entity in this condition found its way to this point because, in almost all cases, it is out of, or soon will be, out of cash. Cash, therefore, becomes king. All liquid resources need to be ascertained and sought out. These cash resources should be sufficient to get the enterprise through this phase and to the next.

It is also important to make sure the losses (and their underlying causes) and demands on cash be limited. This process usually leads to reduced or rescheduled payments for the next 90 to 180 days as well as any other commitments that could negatively impact cash and liquid assets.

Customarily lenders will not allow an enterprise to exceed 60-90 days to develop an analysis and plan for restructure, so an eight week detailed cash flow plan needs to be prepared and be solid. The likelihood of added bank financing or even the use of current credit lines is not realistic. For this reason, it is important to keep close contact with major trade supplies so the enterprise can

be sustained. This is the time to begin to build confidence with lenders and key stakeholders to buy the sufficient time to produce the short term, intermediate term and long term plans for restructure and ultimate success.

Two very key documents come out of this work. The first is the resource availability report. This details the cash and near cash resources available to the entity to be able to sustain operations during the turnaround planning. A sister document, the cash and liquidity plan uses the resource plan and details it use over time. Both of these planning pieces lead to a run rate analysis for both short term and intermediate term. The run rate and the break-even plan become the tools for determining the suitability of any financial plan.

It is ABSOLUTELY CRITICAL that the run rate be based on historical data used to create forecasts. Forecasts are not budgets and budgets, in this phase CANNOT AND SHOULD NOT be used.

In Detroit's case, re-negotiating bond payments, secured creditor agreements, select labor contracts, and other creditor demands must be made in the short term to provide the time needed. As a sign of support, it would be appropriate for the State of Michigan to provide a short term credit line to make up for any cash shortfalls and to provide symbolic support to the world of Michigan's support for its largest city.

Finally, the need for more than 60-90 days is likely since the complexity of city finances along with the huge number of creditors and stakeholders. Depending on the reception from creditors and cash levels, the stabilization period could be extended, or sometimes even shortened.

It is at this level and only after preliminary discussions and negotiations with stakeholders should any enterprise, including Detroit, consider bankruptcy. Bankruptcy is a LAST RESORT decision, not a tactic to be used early in the process. The reason it should not be used is that it sends a signal to all stakeholders that cash is not sufficient, or more important, that all parties will not be able to work out a mutually beneficial agreement to resolve the past and plan for the future. It sends a signal that communication will need the law and the court system to make decisions regardless of the greater good for all parties.

Phase III – Financial/Enterprise Analysis

This phase is likely the most important since it not only determines why the enterprise finds itself in distress, but whether the future, based upon the past will be better. Analysis must first be based on objective data. At this point in history, everyone, including stakeholders has an opinion of why the enterprise is in distress – this is subjective data based on opinion, possibly backed by factual

data, but still subjective. Only after all objective data is found and analyzed should subjective data be used to make conclusions.

From this analysis, recommendations can then be made that will avoid the precise events that caused the distress in the first place. If it is determined, that management and/or other stakeholders are unable or unwilling to make the changes needed to create success, the enterprise returns to the beginning of this process and instead of creating a turnaround, it plans for sale or liquidation.

In Detroit's case, to date, most of what has been discussed is all the reasons and opinions of why the city is in its present condition. So far, very little or no reviwable analysis of objective hard financial and managerial data has been provided publicly. This is very dangerous since decisions are then made on opinions that may or may not be based on facts.

Without adequate analysis, subjective decision-making leads away from consensus decision-making, the most powerful method of a turnaround, and to winner and loser decision making and its companion – blame, a very useless part of this methodology.

Phase IV – Stakeholder Assessment

While so much of the plan has focused on the entity in financial distress, the stakeholders equally involved, and likely facing their own distress for the situation, need to be heard and analyzed. Stakeholders are all those parties who have an interest in the enterprise. These include not just creditors (banks, trade suppliers, taxing authorities, etc.), but employees, customers, management, families of each, insurance carriers, other professional service providers, local governments, state government, federal government, municipal planners and political leaders and of course, shareholders. If stakeholders, and their needs, do not perceive they are listened to and/or part of the solution, the plan will either fail now or will fail in the not too distant future.

When an enterprise rushes immediately or too quickly to the bankruptcy courts, it acknowledges that it cannot or will not have stakeholders, at least all of them, be part of the financial solution. In such a case, the enterprise asks a court to help select the winners and losers among all stakeholders, a highly inefficient and waste of financial resources.

In Detroit's case, the blame game has started by attacking the problems with pension liabilities, bloated budgets, and leadership mismanagement. This is not only enhancing the current financial crisis, it makes the solutions through consensus virtually impossible.

In addition to traditional enterprise stakeholders, a city must face other stakeholders such as its citizens, bond holders and the effects on the municipal bond market, the neighboring communities, Wayne county, State of Michigan, federal government, existing businesses located in the city, schools, faith communities and all city employees and employees of vendors and creditors. There is likely more for be added to this list, but this demonstrates how extensive the plan must be to be successful in the long run.

Phase V – Turnaround Plan and Timing

After all information is gathered, and stakeholder assessments made, a plan (or plans) are created to return the entity to financial soundness and more important, puts in place the necessary metrics to measure and help avoid the problems in the future. Within this plan are the priorities in payments and cash usage.

In serious situations, multiple plans may be necessary to achieve long term success. This is especially true when significant stakeholders or multiple stakeholders prefer not to participate in the long term plan, but will be part of the short term and intermediate plan. Many stakeholders who prefer to exit will agree to a turnaround plan since it will be their best effort to recover their assets/investment. In some instances during the short and intermediate term turnaround, a stakeholder "wanting out" has a change of heart and wishes to be part of an enterprise that shows signs of recovery and positive growth.

The successful plan will not only return the enterprise to fiscal soundness, but will attract new stakeholders making the needs of the enterprise more cost competitive as well as attracting new employment talent and customers.

There are three key factors that need to be presented in a turnaround plan:

- The plan at any level should have a reasonable timetable. Long term stakeholders should be aware that a short term and intermediate term plan will use cash to take out other stakeholders and must confirm these decisions. (Normally those taken out early in the process do not, or at least are not, guaranteed 100% of their claims). It is important to get as many long term commitments from as many stakeholders as possible to ease pressure on the timetable.

- The plan must have easily identifiable and easily measurable metrics with fallback plans when metrics are not met. This is done with the risk assessment done after the turnaround plan is in place using pro-forma analysis.

- The plan must have a segment that outlines what will happen if the turnaround plan fails.

In Detroit's case, no firm turnaround plan can be outlined here and now since there is a lack of precise data and analysis, but the slide to financial distress came over many years and any plan will need to take into consideration a long term plan, yet a skilled turnaround manager can create unique plans to assist the entity in the short and long term period which can make for faster progress (more recommendations are below).

Phase VI – Financial Strengthening

After stabilizing the entity, the goal is to make decisions and use resources to strengthen the financial condition and allow management to focus on growing and building the future. In some cases, the growth strengthening phase will require new investments and commitments from existing or new stakeholders. Based on market and industry conditions this may either be impossible to delay and the entity will need to remain in a stabilization mode for a time until the ability to raise the external resources to meet growth is possible.

Even if outside resources are delayed or are not accessible, internally generated resources can be created for growth and strengthening albeit at very slow rates. Patience is absolutely paramount.

Issues to consider for Detroit

Detroit's real problem is population. While the decline in population and loss of businesses and commerce may have uncovered the troubles the current debt has imposed on the city, the need for "more people" is paramount. Future decisions need to keep this prime metric in focus.

If Detroit had 300,000 more people making median income levels of $34,000, the collective metro income would have been $10.2 billion higher. The resulting income tax, sales tax and property taxes would make significant and profound effects on Detroit finances. Population increase is key to recovery.

So if population and more enterprises need to be attracted to Detroit, unique methods will need to be employed. Detroit must be "dressed up" physically and image-wise to make outsiders want to come, live and hopefully raise families. Such a plan will not require direct funding from Washington or Lansing, but much needed financial support.

Business Growth…some ideas

1. The greatest financial asset the United States has is its credit rating. What Detroit does not have is a suitable credit rating or access to credit. Instead of direct funding, it is suggested that the United States will guaranty much of (but not all) of the financing plan. This will encourage private lenders, including banks to loan to Detroit long term with no fear of substantial risk. In return, the rates will be U.S. government rates aiding Detroit in credit access and lower financing costs.

2. Detroit will need to be designated a tax-free zone both at the federal and state level. For the next 15-30 years, businesses investing in Detroit will pay no federal or state income taxes. The exact timetable for this benefit will be determined after analysis and forecasting. Furthermore, it is suggested that any corporations with oversees profits that are trapped (due to current tax laws) will receive tax-free status to bring the monies back to the U.S. if invested directly into Detroit.

3. All business, entrepreneurs, venture capitalists and angel investors who invest in Detroit and create at least 200 jobs, will not only be relieved from income tax, but will receive a tax credit base on each job created and maintained for the same 15-30 years.

4. The federal and state governments will relieve these new investments of certain regulations for a pre-determined period of time – none of course placing the public at risk, such as those involving environmental, health and safety, etc. Notably, the regulations that need to be relaxed are those for bankers and equity investors. If banks can take on more risk in this new zone without the need for added capital requirements, they will be more apt to lend even to higher risk enterprises.

Infrastructure

If leaders want people to consider moving to and living in Detroit, the city, and all its neighborhoods need to be very attractive. The city should be carved up into sectors and offered to investors and real estate companies who devise plans to improve each neighborhood including any needs to improve or expand civic services including fire, health, police and recreation. Vacant or city owned property would be provided to such investors free of charge who will receive a tax credit on each investment made for single/multiple housing or commercial property built on such parcels.

Existing Debt

Each creditor will need to have its debt analyzed. Some debt will need to be reduced or extended being repaid from future revenues generated from new activity noted above.

Much discussion has been made of pension costs. It is unethical and immoral to advise a retiree that his/her pension will be reduced. Each is unable to make changes in income and/or life expenses to adjust. Those coming towards retirement may be in the same situation, but can more easily accept delayed payments and can more easily adjust to changes in pension obligations.

Current and future workers that have sufficient time to prepare for retirement can be offered a lump sum buyout of the pension obligation and future retirement plans can be negotiated in the normal course of collective bargaining.

Don’t forget about Detroiters

When a plan is considered to rescue any entity, especially a city, the incentives are provided to the new arrivals, but one can never forget all the companies, enterprise and people who have stayed and tried to make a go in Detroit or just call it home. The same tax benefits and credits will be made available to all existing businesses and investors offered to new investment. Those that have stayed will need to be rewarded.

All those real estate investors in Detroit who have property will also get tax breaks as long as each property is up to new standards that all real estate must meet, especially residential rental properties and apartments. Low interest rate loans will be made available with long term repayments that will allow each property owner to upgrade living conditions. Those failing to upgrade or maintain property to standards will face sanctions and fines. The carrot will always look better than the stick.

Governance

If outside parties, including the State of Michigan and the United States of America are going to provide substantial assistance to Detroit, then Detroit will need to give up some of its autonomy. Any fiscal decisions made by city council will need to be approved by a newly created Detroit Board of Directors. This new board will be abolished after the state and federal governments are repaid or relieved of obligations plus 10 years. The 10 year “probation period” monitored by the state will make sure the governing bodies of Detroit do not

unravel all the gains made and bring on financial distress again. This will also provide much needed confidence to private investors and lenders that the metrics developed for success are being followed as providing sufficient time for any investor wishing to wind down an investment to do so over a reasonable period of time without negatively affecting the city.

Conclusion

The methodology outline for a turnaround management is based on sound and proven business practice. The suggestions for a plan of action are simply ideas that do not include detail since analysis is lacking. The results will be long in coming, but should be defined and measurable. No timetable can be produced at this time with certainty, but any plan needs to include a short tem (less than two years), a five year and a 10-20 year plan with precise metrics that show successes and possible pitfalls. Anything less will result in winner and losers with the biggest loser being the Motor City.

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