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## Why I Stopped Drinking Milk: *The Impact of Commodities and Currency Pricing on Restructurings*

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# Why I Stopped Drinking Milk: *The Impact of Commodities and Currency Pricing on Restructurings*

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“**T**hese wheat prices are killing our company!” exclaimed the chief financial officer of a multimillion-dollar food products business. As I looked around the conference room, each board member nodded his or her head gravely. This was a company that had been in business for over 50 years. How could commodity price fluctuations be responsible for its dire situation?

Many companies whose cost of goods includes a substantial percentage of commodities simply pass along to customers any price increase. When the company is unable or unwilling to pass along the price increases, cash tends to become tighter, resulting in an eventual liquidity crisis.

However, the last few years have witnessed an almost unprecedented run-up in the price of many raw materials. For example, wheat prices were practically static for many years, hovering around \$4 per bushel from 2002 until 2006, when they began a steady climb which peaked in 2008 around \$15 per bushel before the price partially dropped back. It is noteworthy that other grain prices increased dramatically, as did virtually every major category of commodities: petroleum, petroleum-driven products like plastic, gold, and metals such as steel and copper.

So why the doubling, tripling, and more of wheat prices specifically? The causes were both man-made and natural. While there was some talk at first of decreased crop yields and

increased worldwide demand, farmers soon increased production accordingly. However, one of the most obvious man-made causes was an increase of government support for ethanol as an alternative to gasoline. When farmers chased the money by switching to corn from wheat production, wheat production was reduced, at least at first. Even steady demand would have driven up prices. Also, when one grain price increases, it tends to pull up other grain prices with it. For example, during this 2006 to 2008 period when corn doubled in price, both wheat and soy prices showed similar increases.

## **WHY INFLATION IS BIG TIME EVEN IN A RECESSION**

Looking back over the years, various commodities, including gold, oil, grain, and metals, have had their individual ups and downs. However, the most recent periods have witnessed simultaneous and substantial price increases in all these categories. For example, oil quadrupled in price and is unlikely to return to its previous levels.

Business leaders on the front lines of the battle believe they are seeing inflation of commodities prices and a loss of value in U.S. currency. Government officials are loath to admit this.

What's even stranger is that Federal Reserve policy seems to have ignored its traditional role of fighting inflation. As companies

have struggled with steeply-rising commodities, from the first interest rate reduction of the Bernanke Federal Reserve Board to the present, they have been puzzled by the Board's actions. Although the Board has characterized its actions as fighting recession, the timing of its actions with the successive stock market declines could lead one to suspect the Board was trying to prop up stock prices.

Investors did not agree that lowering interest rates would improve the financial outlook for publicly traded companies, as stock prices have continued their decline to date, losing more than half their value from a 2007 high and hitting their lowest level in 12 years. Along with these investors, Dallas Federal Reserve President Richard Fisher has consistently disagreed with the Federal Reserve Board's rate-reducing majority including Chairman Ben Bernanke and former New York Federal Reserve President (and current Treasury Secretary) Timothy Geithner. The poor stock market results would seem to validate the policy of Bernanke's predecessor Alan Greenspan, that influencing the stock market was to be eschewed by the Federal Reserve Board.

Given the severe recession the nation now finds itself in and interest rates at 0.25%, the Federal Reserve has left itself little room to maneuver without flooding the economy with more currency. Historically, printing more money would further the dollar's slide, thus contributing to more commodities inflation. With 2009 commodities prices only slightly moderating and still above historic levels, business owners view with dread the prospect of additional inflation.

Increases in commodities prices are not always easy to pass along to customers. As the foregoing food company was caught in a vortex of rising wheat prices, its way of doing business for the previous 15 years failed it. The company simply did not have the financial infrastructure to recognize and pass along the price increases. Its financial systems and controls were only adequate for the previous steady state that had characterized wheat prices over periods of years.

When wheat increases were followed rapidly by additional increases, there were suddenly too many pieces moving, both internally and externally, which had previously been static assumptions. As a result, it was necessary to work with the company to create new models that helped management track and control variables and capture costs in their customer pricing.

In addition to the inadequacy of their financial systems and controls, the company needed a new approach to management. As a large family-owned and

run business, sale of the business was not a desired option. Necessary changes had to be executed while retaining many family members in key management roles. Critical changes included creating a more functional management organization that reinforced and supported the way the company sourced commodities, produced food, and serviced customers. Once the new organization was agreed to, management slots were filled from within and outside the company. Severance arrangements were made for redundant positions, including several long-time employees.

## **SELL MORE, LOSE MORE**

In conjunction with the outdated management organization, this food company suffered from poor communications. After 15 years of the same people doing the same job in the same way, key managers engaged in minimal communication since they assumed everyone already knew what was needed to do their job. Unfortunately, this theory broke down when frequent price increases became the norm. Critical information fell through the cracks that top management needed in order to make key marketing and operating decisions. For example, wheat purchase contracts were agreed to without checking on the availability and timing of cash, thus exacerbating a tight cash situation. Terms of customer contracts other than price, which nevertheless affected overall delivered costs, created a negative cash flow situation. The more finished food goods the company sold, the more money it lost.

New procedures and checklists were put into place along with the new management team. In addition, management held regular meetings and opened the meetings to employees who were previously assumed to know what they were doing. The purpose was to keep affected personnel apprised of what was happening and solicit their input. Daily cash meetings were held to discuss cash availability and to prioritize and determine the critical payments and raw materials for that day and future days.

As the company edged back from the brink, rising wheat prices continued to plague its efforts. In order to avoid the higher additional costs of buying wheat on the spot market, the company traditionally bought futures contracts. These contracts locked in prices, but except for a small upfront deposit, typically did not require supplier payment until delivery. Further, customer contracts typically calculated the price based on futures prices, so there was not a penalty to the company if the

price dropped. However, a seldom-exercised call provision of the futures contracts surprised the company.

The contracts provided that wheat price increases above set levels called for additional deposit amounts. Given the unprecedented rise in the price of wheat, these deposit calls totaled millions of additional dollars that the company simply did not have. Fortunately, the company's lender was willing to cover the calls and add the cost to its existing loan. (Unfortunately for its competitors, other lenders around the country were not comfortable with these cash calls and were unwilling to advance much-needed funds.)

The decline in the value of America's currency and inflation of commodities prices were key drivers of turnaround engagements by several other industry clients, although inflation's impact on the business varies from company to company.

## **WHY COMPANIES DON'T RAISE PRICES**

"The lender is over-reacting. They just don't understand our business," explained the CEO of a plastics business. Plastic is a good example of numerous products for which petroleum is a key component. When oil prices increased, this multimillion-dollar injection molded plastics company began to experience cash shortages. However, when modeling the cash flow forecast over the future weeks, it became apparent that the company would hit a wall. Then it was the company's turn to react.

Research showed the company had a no-customer-price-increase policy. Management was holding its customer prices steady while absorbing increased commodities costs. They argued that they enjoyed long-term relationships with their customers and these customers were resistant to price increases. Unfortunately, the company would not be able to serve customers at any price if it ran out of cash and ceased doing business.

In a consolidating industry that is undergoing price pressure, there may be no room to insist on higher customer prices. In these industries customers may be able to shift to a lower-priced competitor, with the client losing revenue and ability to cover overhead. The only way the client can regain revenue in this scenario is to steal market share from another creditor by price cutting. If the price is so low that the client operates at a loss, it will eventually run out of cash and go out of business.

However, this injection molded plastics company was not in such a scenario. In fact, it controlled almost

90% of the market for this particular product. Under these circumstances, it became obvious that the company was setting the industry price and competitors were following this lead. With encouragement the company became more secure in its view of the business, realizing that price increases were a matter of survival.

Nevertheless, the company was still reluctant to proceed with raising prices. The management simply did not have the stomach for such difficult and unpleasant conversations and did not want to ask longtime business friends for a price increase.

"After receiving numerous price increases from our suppliers, we are reluctantly increasing our prices effective January 1," read a letter from a supplier to the plastics company. Realizing that virtually every business owner receives price increase letters like this from suppliers, the plastics client decided that customers would not be at all surprised to receive such a notice from them. The customers were all well aware of what was happening with oil prices. By writing a similar letter and having management fill in the appropriate blanks by product category, the management quickly brought smaller customers onboard. A discussion script was prepared for major customers and special long-term relationships.

## **WHY SOME COMPANIES CAN'T RAISE PRICES EVEN IF THEY WANT TO**

Sometimes rising commodities prices can whipsaw a company, especially if different commodities affect a company in different ways.

"Our company had been doing fine for seven years, but oil prices and food prices are killing us and our customers," stated the chief executive officer of a nearly billion-dollar food distributor. "Will you help us?" The chief financial officer and the chief marketing officer chimed in their agreement. The company was bleeding cash faster than it was able to bring it in. After years of steady state operations, twin commodity price increases created a perfect storm.

Sales to several multimillion-dollar revenue restaurant chains had fallen across the board, as first rising food prices and then declining customer counts hammered restaurant sales. Food prices were driven up initially as grain prices rose for wheat, corn, and soy. Although wheat drives bread prices, grains are also major feed items for many of the protein products sold in restaurants like milk, beef, chicken, and pork, so those prices went up also. Plus grains, especially corn oil and soybean oil, are an ingredient in

many processed foods used in restaurants such as flavored drinks, dressings, and margarine, driving those prices up too. As the economy worsened, many restaurant patrons moved downscale in search of lower prices, leaving the company's customers short as much as 20% in sales.

Falling sales to these restaurant chains meant the company's trucks were covering the same routes and the same distance, but with 20% fewer goods sold per truck. Unfortunately, rising oil prices drove fuel costs to double, triple, and almost quadruple recent fuel price levels.

Why didn't the company pass along the fuel price increase to its customers? Unlike the wheat-based food producer client, fuel surcharges were not the norm for food distribution. Customers fought fuel surcharges and would negotiate to split the difference. If the company had the contractual right to impose the full pass-through of fuel costs, many customers refused to pay.

Significantly, when customers agree to pay the full fuel surcharge, there is a very expensive cash lag common to the transportation and trucking industries. The time lag occurs between the time the company recognizes and pays the increased fuel costs and when these costs are billed to and collected from customers. The billing terms to fuel providers are shorter than the total time to collect from customers. Wouldn't this be a wash as the company gets into the cycle? Regrettably, the steep slope of the fuel price increase forced the company to advance ever larger amounts of cash.

Many of the company's restaurant customers were unable to sustain 20% revenue losses and closed their doors, leaving the company with uncollectible receivables on top of its other cash demands. Since the entire food distribution industry has been affected by the same factors, the industry is undergoing a consolidation, with the client liquidating some of its assets and selling other operations as a going concern.

Rising fuel prices have combined with the distressed economy to affect a company from another industry, a multimillion-dollar recreational vehicle (RV) dealer. Like the rest of the RV industry, this company was suffering from a 50% decline in sales.

While the company's customers were typically high-net-worth individuals who one would not expect to be put off by high fuel prices, it turns out that a \$1,000 fill-up takes the fun out of recreation when the customer is accustomed to \$250 fill-ups. To survive, the RV dealer cut overhead and operating costs to bring them in line with the new 50%-lower level of sales.

While most of the above companies were able to survive, or at least maximize realization of value on their businesses, the decline in the value of the dollar and the increase in commodities prices have presented challenges that require far more than simply cutting costs and increasing profitable sales. For several of the survivors it was a matter of timing. Had the turnaround assignment started later, there would probably not have been enough liquidity to keep the company from hitting the wall before the restructuring plan was completely executed.

## **THE CHEAP DOLLAR IS NOT YOUR FRIEND**

While economics textbooks typically discuss the potential inflationary spiral unleashed by passing along price increases, the results are actually much more complicated and much more destructive, regardless of whether the price increases are passed along. Companies are the engines of incomes for consumers as well as the products consumers want. Inflation of consumer prices is only one bad result of large currency and commodities swings. Government officials need to take seriously monetary policies as a public trust when the wrong decision can so suddenly throw entire industries into a tailspin.

No one should think these companies can be fixed simply by passing on price increases. Even if a pricing pass-through can be achieved, there remains the challenge of lag time, side effects, and perceptions outside the company's control.

Timing is particularly critical in these engagements. Although turnaround consultants would always like to get started earlier, the reality is that private equity sponsors and lenders typically avoid overreacting to the first covenant default. However, the above examples demonstrate how quickly the viability of a company is threatened by these inflationary problems.

The best approach for the portfolio manager when a default occurs will be to determine the key factors affecting the company. If the problems are commodities or currency driven, the portfolio manager should consider accelerating the referral of a financial advisor from the typical, sequenced pace.

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