Trussway's Perfect Storm

by Libby Walters & SBC staff

For one WTCA component manufacturer member, the weather conditions fell in line for a perfect storm to expose operational faults and leave an "underwater" balance sheet in its wake.

What does it take to create a component manufacturer's perfect storm? And can a highly leveraged company weather such a storm? The management team at Trussway—a Houston-based component manufacturer servicing the multi- and single-family housing industry—could tell you. In fact, you may have heard of the tumultuous six-year financial tornado that swept the company into a tailspin resulting in operational correction and financial restructuring. As it turns out, a pre-packaged December 2004 Chapter 11 reorganization filing was in Trussway's forecast.

The years between 1995 and 2001 were marked by steady growth, a strong domestic stock market and widespread prosperity for American business. Leading the charge was a robust homebuilding market, which in turn spurred demand for structural building components. With conditions like these, you might expect a company like Trussway to flourish. You may be surprised to learn that "flourish" is exactly what they did and precisely why a financial restructuring proved inevitable.

Elements of the perfect storm:

- Acquisitions
- High debt load
- Centralization
- Increased capacity and thus competition
- Dissimilar nature of the single and multi-family markets and production processes
- 9/11
- Low interest rates
- Rising and volatile lumber prices

In this article, we'll lay out the "the perfect storm" of conditions that set the stage for the company's need for financial restructuring (the details of which will be disclosed in part 2 of this series in the August issue). We'll look at building construction market trends generally during that period, the company's operational structure and business model, falling interest rates, raw material price volatility, and a major historical event that provided the perfect storm dynamics for Trussway.

at a glance

- Trussway provides a perfect industry business case study on the high energy acquisition craze of the 1990s, what can go wrong and what one can learn from it.
- Centralization, thought to be a cost savings business approach, can potentially hurt a company's customer service.
- Listening to and serving customer needs fully is always a great business strategy.

Trussway Business Model Pre-1998 & the Late-1990s Consolidation Rage

Consolidation activity in the residential and commercial building construction industry was all the rage from 1995 through the end of the decade, remembered Bill Adams, Trussway's president and chief executive officer. "Consolidation was the name of the game," he said.

Trussway's current vice president of marketing (then sales manager) Mike Estes concurred: "The U.S. was in an expansionist mindset. There was a large movement to become a corporate conglomerate in all business segments, which was a trend Trussway as a market leader in the component manufacturing industry followed."

"Back then, there were virtually no truss companies that could compete with Trussway's multiple locations and high-volume production capabilities," Estes noted. "We had tremendous value in the market as one of the only multi-family suppliers who could accept a job in Boston and ship it to California. Also, we had just completed consecutive years of high sales and earnings. All signs indicated the market was ready for us to expand," he said.

The fuel for the Trussway expansion would be funds, or capital, from a new equity partner/owner. This additional capital would be used to provide for even greater multi-family capacity and market share as well as a single-family production and distribution platform modeled after Trussway's historically successful multi-family theme.

After completing a recapitalization transaction under which affiliates of an international equity capital fund became the controlling shareholder of Trussway in October 1998, the Trussway management team proceeded with plans to expand. More than $28 million was expended to buy up single-family manufacturing operations in Michigan, Indiana and the Carolinas. This followed a $7 million wall panel plant acquisition in Kentucky just four months earlier. Having not fully digested their earlier acquisitions, 15 months later Trussway completed the $9 million acquisition of a single-family Arizona plant. In addition, the October 1998 recapitalization transaction positioned Trussway with a sizable working capital line of credit for: (1) the newly acquired plants and existing multi-family plants in Ft. Worth and Houston, Atlanta, Fredericksburg, VA, and Orlando; and (2) lumber and building material distribution facilities in Dallas and Houston.

Overnight, the transaction left Trussway with a high debt load—almost $140 million over and above what they had prior to the recapitalization. This transitioned Trussway from being a company with very little debt to one that was highly leveraged. And while Trussway had considerable equity on its balance sheet prior to October 1998, the leveraged recapitalization resulted in negative balance sheet equity of almost $40 million.

The notion of loaning money to a company that could only be paid back in full out of future earnings was made possible by Trussway's historic and projected future earnings and through the implementation of a web of financial covenants. These covenants or promises were designed to measure Trussway's future financial performance. The covenants were tied to well-defined ratios such as a leverage ratio that establishes a maximum amount of debt that a company can have relative to the amount of operating cash flow it generates. For example, a company with $100 million in debt and $20 million of operating cash flow would have a leverage ratio of 5 to 1. (Although this was an acceptable ratio in 1998, it is considered high in today's credit environment where lenders expect a ratio more in the 3 to 1 range.) From October 1998 to September 2001, Trussway successfully operated under the "financial radar" associated with being over-leveraged. In other words, the ratios were met and the financial covenants were never triggered.

Centralize & Save

Along with the newly-acquired plants came the view of centralization. "As it stood," Estes recalled, "each of our 13 manufacturing plants were essentially in control of their own destiny." Plant management, sales staff and truss technicians

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T I M E L I N E

Mid - late 1990s: Expansionist mindset in U.S. business

Oct 1998: Recapitalization

- A high-profile equity capital fund became controlling shareholder through a recapitalization transaction.
- Trussway debt load increased to $140 million.
- Company transitioned from very little debt to highly leveraged.
- Covenants were imposed.

Late 1998 - 2000: Acquisitions & Growth in Single-family Markets

- $44 million in plant acquisitions (AZ, IN, KY, MI, and NC/SC).
- Trussway centralized in Houston, causing poor customer service.

Late 1998 - 2000: Disappointing financial results

- Previously-acquired plants not performing as projected.

Sept 2001 - Fall 2004: Perfect Storm Brewing

- 9/11 impacted consumer confidence.
- Interest rates fell.
- Price of lumber dropped, then spiked.
- Competitors ventured into multi-family markets.

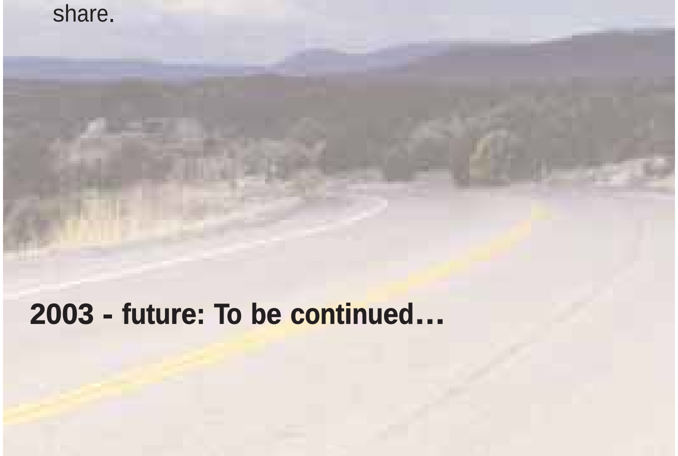
Sept 2001: First Financial Covenant Broken

March 2002: Bill Adams joins Trussway as CEO

- Adams facilitated the move back to a decentralized operational structure.
- Trussway named three regional VPs: Mike Estes, Cris Raines and Jim Thomas.

Early 2003: Turnaround in Customer Satisfaction

- Renewed focus on customer service caused turnaround in sales, customer satisfaction, and increased market share.



2003 - future: To be continued…

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were attached to each facility. That changed in 1999 when Trussway's management team decided to abandon the single-unit-stands-alone approach, centralizing many of the company functions. "It was just another trend in corporate America at the time," Estes said. "Consolidate and centralize to save money."

With the new model in mind, Trussway expanded their central headquarters in Houston by adding a new 12,000-square foot office building and arranged for a mass convergence of managers, sales and design staff to Texas. According to Kent Pagel, WTCA's outside general counsel and a regular columnist for ***SBC Magazine,*** "Consolidation in the industry usually meant savings in accounting, and reduced administrative and insurance costs. Some companies were also able to enjoy decreased lumber and plate costs and software licensing fees given their post-consolidation size increase. With respect to Trussway, prior to their acquisitions, they were the largest truss and component manufacturer in the market and already enjoyed significant savings in all these areas. Not only did the concept of centralizing not produce the cost savings Trussway forecasted, it led to unanticipated operational and customer service problems."

Capacity Increases in the Industry, Competitors Venture into the Multi-family Market & Trussway's Deaf Ear to the Customer

Trussway wasn't the only U.S. component manufacturer to catch the wave of growth in the 1990s. It seemed like all their competitors were likewise getting larger and increasing their design and production capacity, according to Estes. "No doubt healthy competition is good for a company, but it leads to margin compression, which was problematic for us as a highly leveraged company," Adams noted. "Not only were our competitors increasing capacity through acquisitions and 'greenfielding' (growing a business internally instead of through acquisitions), but some of our single-family lumberyard customers ventured into component manufacturing and thus began buying from themselves instead of us," said Adams. Trussway also saw many component manufacturers begin to use their increased manufacturing capacity to sell for the first time into the multi-family market. "We were no longer the go-to multi-family manufacturer," said Estes.

To only complicate matters, the acquisitions made from late 1998 through the first month of 2000 weren't as fruitful as originally planned. "We acquired businesses outside of our core structure and didn't understand what it would take to run them successfully," Estes admitted. "We paid top dollar for these plants as they had historically produced good earnings, yet in many instances we were trying to turn plants that were originally designed and had successfully accommodated single-family manufacturing into multi-family facilities," Adams said.

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"On top of increased capacity on the part of our competitors and their tending to our regular customer base," said Adams, "the company's attention to our multi-family customer service fell to an all-time low, and the culprit without a doubt was our centralization." The Oregon Trail-like move to Houston left Trussway less customer-friendly. "In the middle of major multi-family projects, key members of management, sales and design were yanked out of their surroundings and separated from their customers. That really disrupted business operations," Adams said. The perfect storm of almost hurricane proportions was brewing on the customer side of the business as well.

Terror, Interest Rates & Price Volatility

Three additional factors rounded out the perfect storm scenario, albeit out of Trussway's control. The events of 9/11 dealt Trussway a significant blow: an already weak multi-family market was further injured by shattered consumer confidence, as the nation climbed from the ashes of tragedy. Trussway's single-family business was also affected, as many builders delayed planned starts due to uncertainty for the economy.

Storm clouds rolled in when the company reported disappointing financial results from mid-2001 into 2002. By September 30, 2001, the company was in technical violation of certain of the bank group financial covenants. "Although in technical default with our banks, we continued to make money and pay our debts, including timely payments of principal and interest due to our bank group," said Adams.

In addition, mortgage rates plummeted in late summer 2002, which is great news for single-family housing starts, but served as a bad omen for the Trussway business model based largely on multi-family construction. "Lower interest rates encourage those who could not have previously afforded a home to make a first-time home purchase; they would otherwise opt to live in a multi-family project, Adams stated. "The statistics proved this out as we saw rental vacancy numbers go up in those markets we served," continued Adams. Census figures confirm this development as in October 2002, multi-family housing starts fell 29 percent from the previous month as 30-year mortgage rates hit historic lows.

Finally, late 2003 marked a period of unanticipated rising and volatile lumber prices across the U.S. that continued throughout 2004. Volatility of that magnitude is a battle for any component manufacturer. Estes explained why it was especially problematic for a multi-family manufacturer: "Single-family [manufacturers] can turn around manufactured product in a very short period of time compared to multi-family. [Multi-family manufacturers] have to hold prices for the length of the project. When you consider that a typical multi-family project ranges between 15 and 20 buildings and can last up to 12 months, that's a huge volume of product to be protected on a guaranteed price, particularly when raw material lumber prices are rising," he explained. "Prior to the price spike in 2003, lumber prices had fallen to an all time low and we had a ton of business in our backlog based on those lower prices," Estes remembered. "All of a sudden, there were numerous spikes in lumber prices, and we had no choice but to honor our quoted prices through the duration of those jobs." With margins squeezed like a lemon, Trussway's perfect storm cloud was poised to burst.

Operational Turnaround: Saving Customer Service

Bill Adams arrived at the Trussway campus in the midst of the storm. In March 2002, the new Trussway CEO championed some significant operational changes. First, the need to refocus efforts on customer service was unmistakably clear. "When I first came here, I asked about customers. I got 'they love us, but they are very angry with us.' We weren't performing. I visited ten of our biggest customers, and heard the same from each. 'You used to be our only supplier. But we've had to look to other vendors because we aren't getting design work on time and no one is returning our phone calls.' It wasn't about price or quality; it was strictly a customer service issue. We had to fix it," he recalled. During the first half 2002, Trussway reversed the alleged "money-saving" centralization model, dispersing design and sales staff back to their home base manufacturing and design facilities and closer to the customers.

The management team decided to readjust their focus and "dance with the girl we came with," said Adams. That is, they rededicated their focus to multi-family customers in particular. "While we would continue to work with some larger single-family customers from our larger multi-family plants, we consciously decreased that percentage of our business. We also converted our Arizona plant to a multi-family facility, making us truly a national supplier," he added.

As early as 2003, Adams' insistence on decentralization was paying off. Three vice presidents—including Estes, Cris Raines and Jim Thomas, longtime Trussway executives—divided the nation and oversaw sales, design, production and customer service in their respective regions. "Salespeople and truss technicians were re-deployed in short order. This created a turnaround in sales, our margins and market share," said Estes. "All of this was driven by our soaring customer satisfaction," he added. We shipped on time all the time—even if it meant we had to transfer volume between plants to ensure our customers got their trusses when they wanted them.

Adams described additional measures taken to ramp-up customer satisfaction. "We added fifteen technicians around the country to be sure that our lead times on design were shortened. We dressed up our bid packages to be more customer friendly. We went back to close communication with our customers from beginning to end of projects, addressing problems before they got out of hand. We also worked closely with our customers to lower costs where possible while making for a better job," he said. Basically, the company went back to the blocking and tackling that made Trussway a great company in the first place. "Our market share began a slow recovery in 2003. We made major share gains in 2004 and we are on track to be ahead of the curve in 2005," said Adams.

Throughout the acquisitions and the attempt to integrate all of these businesses, Trussway and its management team

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learned that from a production and customer service standpoint, a single-family plant must be run differently than a multi-family plant. "In analyzing our single-family plants, we determined we needed to accommodate design, manufacturing and delivery for our custom homebuilder customers. At the same time, we concluded that those multi-family plants that produce trusses, components and wall panels for single-family construction needed to focus on high production builders where we could take advantage of our high-volume production capabilities," said Estes. "We now understand the balance of each of these two types of businesses and their impacts to each individual plant and have successfully balanced a good percentage of both single- and multi-family as to best benefit Trussway and ultimately allow us to provide our customers the service they deserve," Adams pointed out. Trussway's single-family plants in Sparta, MI and Michigan City, IN proved integral to the company's chi-like notion of balance. Both plants have weathered the storm, thriving on superior customer service and quality in the single-family markets they serve.

The Road to Chapter 11

With the operational overhaul nearly complete, had their perfect storm finally blown over? Not so fast. There was just one more thing that needed fixing, and it isn't what you might expect from a company who had turned customer relations around 180 degrees. "The only thing hanging over our heads was a disproportionate amount of bank debt on our balance sheet. The banks got tired of us repeatedly being out of compliance on our financial covenants; we had to do something to fix it," said Estes.

Because of the recurring technical violations under its credit agreement with its bank group from September 2001 through the fall of 2004, Trussway had virtually no choice but to undergo a bankruptcy court assisted process to reduce their high amount of bank debt. "We were making money, able to pay our vendors on a timely basis, able to pay principal and interest to our bank group when due, and operationally we had made drastic improvements. We still had one major problem—we remained an overly leveraged company. Our bank debt still exceeded what Wall Street viewed as acceptable for a company producing the sales and earnings that we were producing," said Adams.

Trussway has emerged from their perfect storm a healthier company in terms of customer satisfaction, employee morale and as we will see in the August article, financially. Filing for a pre-packaged Chapter 11 status was an essential part of their rebalancing their balance sheet and ultimate success in the end. In an article in ***SBC's*** August issue, we'll discuss the Chapter 11 process and hope to dispel the many myths associated with many bankruptcy cases, including Trussway's. SBC

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