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## Cosmolab: Leading a Successful Turnaround in an Economic Recession

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Cosmolab, a \$70 million, 100-year-old manufacturer of color cosmetics and skincare products, was a prosperous, thriving company that never dreamed it would find itself in a turnaround situation. In 2003, the company was acquired by Specialty Packaging Holdings Inc., a company that manufactured more than 150 different styles, sizes and shapes of cosmetic packaging with custom decorative capabilities. After the acquisition, Cosmolab continued to operate independent of Specialty Packaging Holdings as a contract manufacturer of color cosmetic and skincare products for the eyes, lips and face.

Based in Lewisburg, Tenn., a town of approximately 25,000 people with 18 percent unemployment for the greater part of 2009, Cosmolab is a privately held business with a century-old history. Originally founded as a manufacturer of wood-case pencils, the company has grown to include tube products for lips and eyes, specialized eye liners, eye shadows and a variety of other cosmetic products. Today, Cosmolab is the only remaining contractor of wood-case cosmetic pencils in the United States. Cosmolab services customers in all major retail distribution channels, creating color cosmetic products for numerous multi-national brands distributed via drug stores, department stores and direct sales, including Procter & Gamble (Cover Girl), L'Oreal (Maybelline), Estee Lauder (Clinique/MAC), Avon, Mary Kay and Arbonne International.

### The Challenge

Like many of the companies, Cosmolab's financial distress began long before the recent economic recession.

### About the Author

*Steve Agran is a managing director at MorrisAnderson in the firm's New York office and has more than 15 years of experience in leading companies through turnarounds, providing interim management for distressed companies and implementing revenue-optimization programs for complex organizations.*

In 2006, Cosmolab and Specialty Packaging Holdings realized more than \$55 million in annual sales revenue. Soon after, Cosmolab's new CEO shifted to a strategy of expansion and accelerated revenue growth. Simultaneously, major customers began aggressively pur-

China. The company invested more than \$1.8 million in the new facility, in part because management believed that lower labor costs at the China facility would reduce production costs. Simultaneously, key customers threatened to stop doing business with Cosmolab without cost reductions. Management provided these price concessions to customers for products that could be manufactured in China, believing that the lower manufacturing costs would result in no financial loss for the company. These price concessions were negotiated more than a year before the facility's projected opening and greatly affected product margins, since the facility never actually opened. These simultaneous events drove the wood-case pencil category, which com-

## Turnaround Topics

suing pricing concessions as large retailers began facing quarterly earnings pressures and demanding cost reductions.

In late 2007, Cosmolab added multiple new products and more than 200 new vendors. Vendor payables increased from \$5.8 million to \$10.7 million while excess inventory approached 50 percent. This extremely fast, uncontrolled expansion quickly exceeded Cosmolab's operational capacity and management expertise. In addition, selling, general and administrative (SG&A) expenses grew to exceed more than 20 percent of sales revenue (historically at 17 percent of revenue) due to hiring new sales representatives and international sales leadership, moving into expensive office space and developing new sales segments.

During 2008, in an attempt to improve declining margins on wood-case eye pencils, Cosmolab invested in a new manufacturing facility in Suzhou,

prising 35 percent of Cosmolab's total sales, to a mere 2 percent profit margin.

In an attempt to offset declining profit margins at the core of its business, Cosmolab entered the high-gross-margin retail cosmetic business in late 2008 under a licensing agreement with Your Best Friend (YBF), a brand sold through television stations HSN and QVC. To successfully launch this "new" brand, Cosmolab faced additional expenses from adding more than 75 new products, significant overhead costs from office space in New York and several new employee salaries. These new overhead costs more than offset the brand's high gross margins and caused major supply chain issues, requiring more than \$4.8 million to be spent launching the brand and consuming management focus. In addition, Cosmolab created more than \$1.5 million in future liabilities for unpaid

royalties and inventory. This expansion activity left Cosmolab's management team little time to focus on its other core assets, including Cosmetics Specialties Inc. (CSI), an injection-molding facility in Oxnard, Calif.

By mid-2008, Cosmolab faced significant liquidity issues and financial distress. Its ill-timed expansions, over-diversification and subsequent operational issues were further exposed by the crippling economic recession. By March 2009, Cosmolab's profit margins had deteriorated to 6 percent, with more than 37 percent of its products sold below manufacturing costs. The company's failed expansions (both geographic and product lines) had reduced revenues by 35 percent to \$45 million. Cosmolab's debt had grown to \$31.8 million, including \$19.8 million to its secured lender, unsecured subdebt of \$1.3 million and accounts payable of \$10.7 million. Cosmolab soon violated multiple loan covenants, and its senior secured lender suggested that the company seek the counsel of an operational and financial advisory firm.

## The Solution

Cosmolab took several steps during its turnaround process, which included hiring a financial-advisory and interim-management team in mid-2009.<sup>1</sup> The team conducted an initial assessment that revealed several contributors to the company's significant financial distress and deteriorating financial position.

### Financial Operations Issues

- The senior secured lender had not filed a borrowing base in 1.5 months, and once filed, the document showed an over-advance of \$3.2 million;
- The senior secured lender refused to extend its exposure, meaning that the company had little availability to purchase raw material;
- Nearly 37 percent of Cosmolab's products were being sold below manufactured cost; and
- The company had exceeded its credit limits with most vendors and could not receive product.

### Production Schedule Issues

- Cosmolab had an order backlog of \$3 million with minimal ability to fill orders due to a lack of the correct raw materials;
- The company was operating on a modified production schedule

to serve only its top six customers (though not being done very well);

- Production regularly missed scheduled delivery dates and the top six customers required daily calls to understand the timing of shipments;
- There was no ability to provide an accurate production schedule due to the open-order backlog and no ability to forecast raw material receipts; and
- Reactionary/emergency production schedule caused production inefficiencies while eroding gross margins to single digits by May 2009.

### Management Issues

- SG&A expenses had expanded by 10 percent during the past 18 months, with 765 employees on the payroll;
- The CEO commuting from New York had extremely limited middle-market operating experience and did not understand the nuances of the business;
- New management employees were not integrated into the planning process; and
- There was a lack of communication within the management team.

Following this analysis, the financial-advisory and interim-management team developed a multi-faceted strategy to deleverage the company, improve liquidity, strengthen operations and guide the company back to profitability. The turnaround plan included five key components:

1. Expense reductions: workforce reduction and restructuring;
2. Gross margin improvement: price increases and direct labor costs;
3. Non-strategic asset liquidation: China facility, Cosmetics Specialties Inc. and YBF;
4. Working capital emergency actions: customer term changes/advances and vendor negotiations; and
5. Lender negotiations: forbearance and principal payment delays.

## Implementation of Plan

The financial-advisory and interim-management team presented its recommended actions to Cosmolab's board of directors, who supported and approved the plan to move forward. The management team was realigned and began regularly scheduled morning meetings to discuss issues facing the company. Cosmolab's strong management team and loyal customers were engaged and supportive of the turnaround process, which proved extremely helpful. Their buy-in allowed the implementation of a

complex turnaround strategy that resulted in success for all parties involved.

First, Cosmolab's workforce was reduced by 284 employees, trimming the company's annual payroll by more than \$5 million and cutting annual operating expenses by almost \$2 million. For the remaining employees, a company-wide four-day work week was implemented for three months, which reduced payroll expenses by \$150,000. A 10 percent wage reduction was instituted for all staff, with the corporate management team taking a salary reduction of 20 percent.

In late May 2009, all of Cosmolab's vendors were sent a letter to request a 90- to 120-day moratorium on paying past-due invoices, while promising to pay in advance for all purchased materials moving forward. While there was concern that the letter and the financial-advisory and interim-management team's position could exacerbate the vendor situation, the working capital was not available to pay down past-due balances. Every vendor supported the plan and was updated with constant communication. The vendors understood the position of the company and worked with it.

Soon after, strategic price increases were instituted on 65 percent of Cosmolab's products, which brought the company's product margins up to 21 percent. To build goodwill with Cosmolab's major customers, the team met with them to explain the long-term strategy behind the price increases. Through these conversations, approximately \$2.5 million in customer advances were secured to purchase raw materials, allowing the company to catch up on backlogged orders and generate new sales and profits.

In July 2009, new customer order requirements were issued, including a 50 percent deposit on orders for most tier-two customers, tighter credit policies and a 2 percent early-pay-discount incentive. An aggressive program was also started to sell overstocked products to liquidating companies while substituting non-spec-approved items in some customer orders. By fall 2009, Cosmolab's accounts receivable was reduced by \$2 million, decreasing days sales outstanding (DSO) from 45 to 30 days while reducing inventory by \$5 million since December 2008. These steps were necessary to provide the additional working capital needed to sustain the turnaround.

During all of these vendor and customer negotiations, the team also worked with the secured lender to negotiate a

<sup>1</sup> Cosmolab hired MorrisAnderson to provide financial advisory and interim management expertise. The firm, including the author, served as the primary financial adviser for Cosmolab during its turnaround process.

forbearance agreement and worked to sell one of Cosmolab's non-strategic assets, CSI, to generate liquidity to fund investment in the turnaround plan. The deal was closed in November 2009, selling all of CSI's assets for \$5 million, (seven times its EBITDA). An agreement with the lender was also secured to allow the use of \$1 million from the proceeds for working capital for Cosmolab. Around that same time, the financial-advisory and interim-management team ceased investment in the facility in China and negotiated a termination of the YBF license, reducing future liabilities and stymieing potential legal action for unpaid royalties.

### **The Result**

By December 2009, Cosmolab had been successfully turned around, leading to a profitable 2010 financial forecast. During the course of 2009, the turnaround plan improved Cosmolab's EBITDA from negative \$1 million to positive \$2.1 million, with a 2010 revenue forecast of \$42 million and full-year EBITDA forecast of \$5.5 million.

Although Cosmolab was once again profitable, the private-equity firm that had been investing in the company was winding down and did not have the ability to make further investments in the company. With the exit of its equity sponsor, Cosmolab had little room to maximize its turnaround without additional investment.

At this point, it was recommended to the Board of Directors that a sale of the company would be the best exit strategy if they did not support the additional capital requirements. The board agreed, and a buyer was secured. More than 100 possible investors were reached out to and received considerable interest, especially with strategic investors. The largest cosmetic contract manufacturer agreed to purchase Cosmolab. Once a stalking-horse bidder was finalized, Cosmolab filed for chapter 11 and a subsequent sale of the company's assets. Through a chapter 11 § 363 sale process, Cosmolab was sold in a formal auction process held in March 2010 to All4 Cosmetics (the stalking-horse bidder), a division of Schwan-Stablio, for \$16.6 million. The auction comprised four bidders, including three strategic buyers and one financial buyer, with the winning bid 25 percent above the stalking-horse bid. The final sale closed in early April, just 78 days after the company filed for bankruptcy.

### **Conclusion**

As a result of the turnaround and subsequent sale of the company, the secured lender was able to recoup 85 percent of a \$20 million loan. This was a tremendous recovery given that the lender had been prepared to write down the loan by 50 percent before the financial-advisory and interim-management team got involved. All4 Cosmetics allowed Cosmolab to continue to operate independently in the Lewisburg, Tenn. community, saving 410 full-time jobs and maintaining its core management team.

The future looks bright: Cosmolab has secured new business for 2011 and is looking forward to expanding further. Customers that had stopped doing business with Cosmolab have returned, while fill rates in 2010 increased to 95 percent. Cosmolab is once again a trustworthy company.

Who doesn't love a happy ending? ■

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