Mining Value From Distressed Companies

Building Properties in Which Future Buyers Want to Invest

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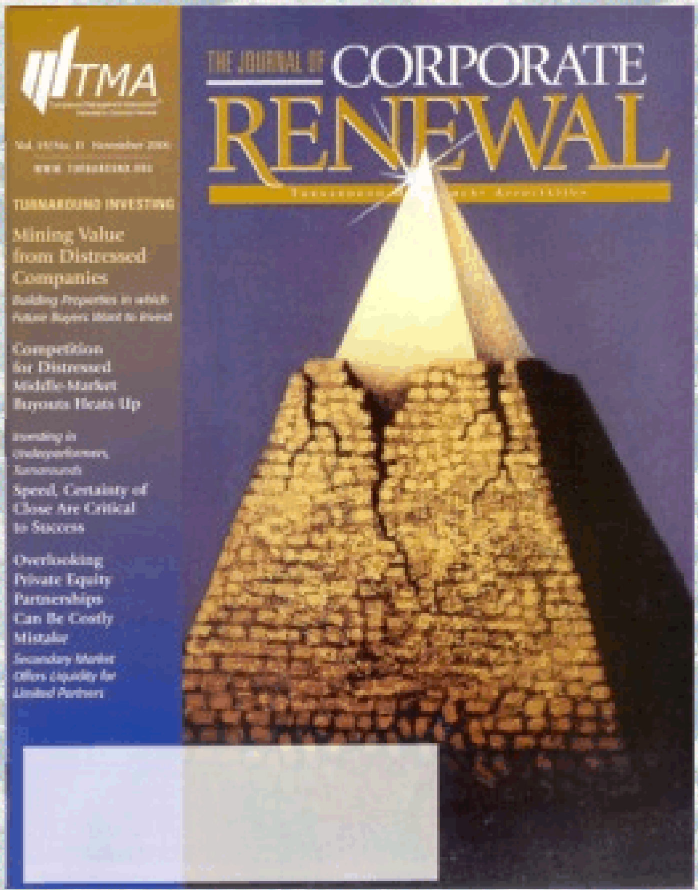

Turnaround Investing

Mining Value From Distressed Companies Building Properties in Which Future Buyers Want to Invest   *Text*

By John M. Collard, CTP

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Turnaround Investing

Mining Value From Distressed Companies
Building Properties in Which Future Buyers Want to Invest

By John M. Collard

Investing in underperforming companies can be very profitable for those who know what to look for and how to execute, as many buyout firms are learning. To be successful, a distressed investor must ascertain that a company can be turned around, buy it at the right price, know how to fix the problems, avoid spending money on past sins, and sell at increased value. While this is simply stated, it is tricky to implement.

This niche market allows investors to capitalize on once-positive results that have become stalled. Distress investors should seek enterprises that have critical capital shortages but future potential. They should acquire companies that can provide quality products at competitive prices but that are severely undervalued because of ineffective management and/or lack of market direction and unacceptable penetration.

Savvy investors can take advantage of distressed-level asset pricing by investing ¢ (cents) on the $ (dollar) in exchange for large returns at the end of the process. An infusion of capital put into the hands of a leader with a sound strategy and a return-on-equity goal in mind can be a powerful motivator.

A distressed investor should build an enterprise with the sole purpose of selling it at maximum value. Therefore, the investor should concentrate on exit strategies from the start. The key to achieving returns from investing in underperformers is to build properties that future buyers will want to purchase. An investor should build going concern value to yield peak results and should provide what future buyers look for:

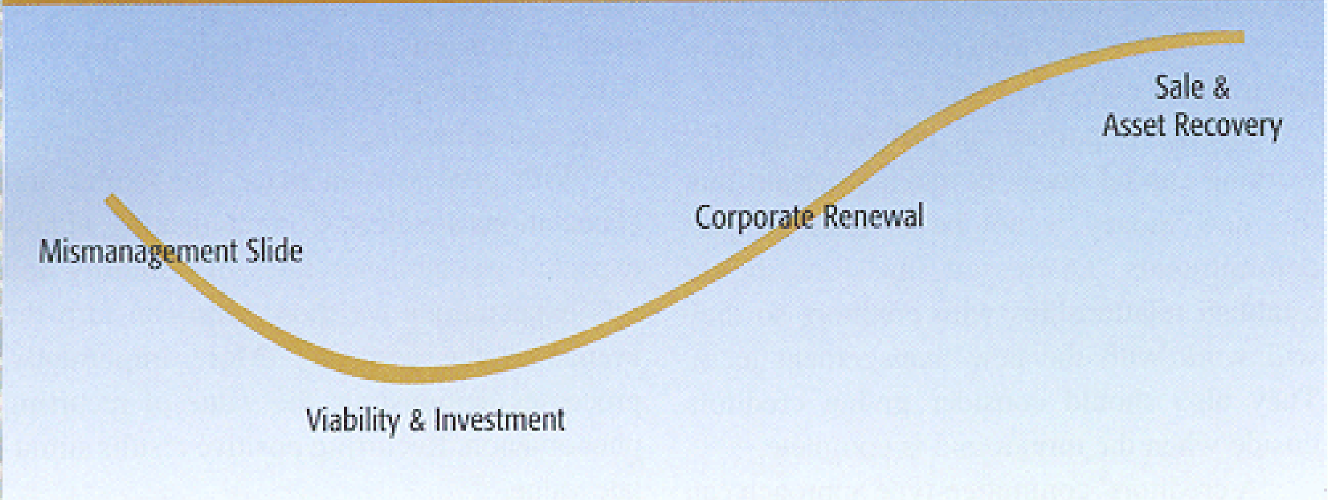
- Consistency that creates value.
- A high probability of future cash flows.
- A marketing-oriented management team.
- A track record demonstrating the ability to sell and compete; develop, produce and distribute products; and thrive and grow.

- Realistic return potential from their fair entry valuation.

Great value is realized from rebuilding an entity and setting it on a path toward long-term growth. This also is the time to exit. Many buyers will accept lower return rates in exchange for a company that shows stable growth, but they shy away from underperformers until they have been fixed.

Whether one invests in a new entity or in a portfolio property in decline, the recovery cycle is much the same. Because of mismanagement, a company slides into trouble. A distressed investor assesses viability and puts capital into the company. After turning around the company, the investor ultimately sells the property.

Figure I: Asset Recovery Cycle



All troubled entities reach a distressed state through a progression of mismanagement - from officers to board members to investors. When the entity is at a precipice, there is opportunity. The present owners, lenders, and other stakeholders have little choice but to bargain, and deals can be made. Potential investors should be cautious, of course, but many wait too long, allowing the value to deteriorate completely. Another scenario to avoid is investing in insolvent companies that cannot be fixed. As surprising as it may be, many investors do just that.

Determining turnaround viability requires truly understanding what has caused the breakdown within the company, which usually can be traced to two or three issues. Investors shouldn't focus on mere symptoms of distress but should dig down to uncover underlying problems. One should never seek advice about problems from current senior management. After all, if these executives knew what was wrong with the company, they should have fixed the problems earlier.

Distressed investors must make certain that they have solutions that no one else has used to address a company's underlying problems. Perhaps an investor can bring new non-cash resources or applications to influence the revitalization. Although an investor should take advantage of mispriced material inputs, labor, assets or capacity, and intellectual property, the answer is never to just add cash. New leadership is always required to implement lasting change.

Before investing, one should negotiate acceptable terms that allow for substantial upside when the work is done. If there are no solutions to a company's problems, creditors won't cooperate, or the price is unrealistic, a potential buyer should go on to the next deal. Finding good turnaround opportunities is fundamental to success.

Recovery Process

Before an entity can be sold, it first must be turned around successfully. This should never be left to chance. A distressed investor always should take active control of the entity. Investing passively and allowing prior management to oversee the process may result in the investment being lost. Passive positions are only acceptable as part of an investor pool led by an active participant.

Many equity investors apply strictly financial considerations to underperformers in their own portfolios. These same financial investors then compound their problems when they take control of a company to determine whether it is salvageable or is a candidate for sale or liquidation. When, as often occurs, the company is sold, these investors are left to write-off their investments.

Inherent in such a scenario is a fundamental problem - purely financial considerations are not enough to save a company when an operational or revenue-driven turnaround is required. Many investors have run financial or investing institutions in the past. Yet, few have run other types of companies as well, and most are ill equipped to do so. This creates opportunities for investors who possess the skill sets necessary to run companies.

Substantial value is derived from investors who also have senior operating leadership experience. They can determine whether one strategy or another can affect the revitalization, and why others didn't work in the past. Many private equity firms and hedge funds are adding operating executive talent to their ranks to compliment the skills of their managing partners.

When a distressed investor takes over an underperforming entity, it is time for existing management to get out of the way. Because these executives guided the company during this mismanagement slide, why allow them to complicate the situation any further?

Corporate renewal is a process. It involves using a transferable set of skills to revitalize the property and restore it to a state in which it can be sold. At that point, the investor can sell the entity and realize returns. The renewal process involves:

Providing Leadership. A distressed investor must focus on value creation and guide a company to a new plateau. The investor's advantage lies in bringing an objective focus, untarnished by the situation at hand. The investor provides broader perspective, effectively managing "change control." The investor is the teacher, and the stakeholders are the pupils. Together they must rebuild in a new direction.

A CEO with transition experience in value-building situations should be brought in to guide the effort. This leader must demonstrate expertise in:

- Managing crisis, transition and rebuilding processes.
- Shaping business strategy and financial structure.
- Developing management talent, building caliber teams, and making use of and growing existing resources.
- Increasing sales and market share.
- Maximizing return on capital.
- Linking management performance to ultimate goals.
- Developing incentive-based compensation programs.

This leader must get involved directly in making decisions to achieve the ultimate goal of selling the company at increased valuation. The CEO must be held accountable for performance and timely results. Most importantly, this executive must get things moving quickly. On the "volume in" side (revenue/ sales), the person should look at where and how revenue is generated and work to maintain that flow. On the "volume out" side (throughput/production), the company must get its products or services out the door. How else can the company bill for its work?

The final step in completing the turnaround is to hire a marquis manager to lead the permanent management team. Having a permanent team in place adds to the value equation.

Setting Strategy. In distressed investing, the goal is a shorter-term, high multiple return commensurate with the risk, while setting the stage for ongoing longer-term returns for the buyers who provide an exit. Investors should implement long-term strategies that survive their exits.

While situations differ, one essential strategy is to drive revenues. Growth cannot occur without more sales. The strategy must address the problems plaguing the company and provide a roadmap to revitalization.

An effective strategy is key to implementing change. To turn around a company successfully, one must establish a new vision, distill this direction into concrete goals and objectives, and create a guide for everyone to follow. Rebuilding momentum is critical to success.

Building A Quality Management Team. The value of a company increases sharply when a strong, permanent, and credible management team, that can produce consistent sales, profits, and cash flow results is in place. Such a team establishes continuity in the organization to allows everyone to expect orderly change and new opportunities.

A distressed investor also should capitalize on available underutilized human capital among the middle managers who remain with the company. Chances are these individuals are dedicated to the company and its success. Once they are guided to their next level of responsibility, they will help a company make its next big step forward.

Acquiring New Business/Sales. There are only two ways to increase sales: sell new products to existing customers or sell existing products to new customers. Most underperformers have forgotten the basics of marketing and promotion or never applied them in the first place. The company must clearly promote what its products and services can do for customers and differentiate them from those of the competition.

The company must become market driven, adapting to changing conditions and improving its competitive position. It should deliver only what customers are willing to pay for - with no excess - to avoid incurring extra costs.

Establishing Sound Capital Structure. Having a sound strategy in place, along with a viable marketplace, efficient delivery and production vehicles, and a cohesive management team, will entice the investment community. Securing new capital becomes much easier when investors see a high probability of return and a viable exit strategy.

Just as important to infusing cash for working capital needs is to make certain that this new money is not diverted to past commitments. Distressed investors should establish relationships with creditors so they will work with the new management team. They also should consider giving creditors upside when the turnaround is complete.

A creditor's committee-type approach can be implemented outside of bankruptcy to keep creditors plugged in and participating. Prepackaged bankruptcies also are available to ensure cooperation. An investor can always purchase assets out of bankruptcy to ensure a clean structure, a strategy being used more often as buyout funds become more comfortable with the process. In many ways, this approach can be considered alternative and complimentary financing.

Implementing Processes. Systems and processes should be used to drive the business and control the day-to-day environment, which allows management to address critical issues facing the company. Many managers waste time on tasks for which results would be essentially the same whether they or a subordinate managed them. Management should focus on pressing issues - controlling cash and costs, increasing sales, and enhancing value creation.

With processes in place, guidelines and expectations are clear. Communicating what is expected reestablishes lines of authority and sets expectations for those who can turn the events of the company. More importantly, processes demonstrate the value of recurring phenomenon. Recurring positive results stimulate value.

Nurturing Resources. Resources, including employees, facilities, and advisors, should be leveraged to complete the turnaround. Often, the key resource is the company's workforce. An incentive structure that pays only when employees accomplish goals set in the long-term strategy should be established. A robust incentive structure allows employees to share in the risk. If the strategy is successful, all gain financially.

If the desired results are not achieved, poor performance is not subsidized. The incentive program should reward performance that will take the company beyond its sale.

Cashing Out

A distressed investor's goal is to achieve a return when the sale occurs. To accomplish this, a distressed investor must know when to cash out. The greatest return on investment is achieved when the turnaround is complete and the company is ready for the next tranche to fund growth. At that point, many new investors will want to participate. An investor should remember that:

> ***E*** arnings and cash capacity +
> achieved ***X*** multiple on investment +
> demonstrated ***I*** mprovements +
> functioning management ***T*** eam in place = time to sell.

Successful investors recognize that a small X^r growth in revenues can yield many X^n returns on invested equity. Revenue that exceeds controlled fixed costs drops substantial incremental profits to the bottom line, which in turn drives valuation. 

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Guest Editor, Journal Of Corporate Renewal

Turnaround Investing Is Attracting Attention

By John M. Collard, CTP, Guest Editor

Investing in underperforming and distressed companies has become a more acceptable practice of many buyout shops. While there may have been only a handful of such firms in the 1990's, there are perhaps 100 or more today. The dynamics of the market have changed, allowing more buyout funds to become comfortable with the process.

This trend presents both alternative sources of liquidity and investment into underperforming assets and sources of exit once companies have been turned around. The equity investing community is recognizing that infusing operating talent and expertise into challenging situations can make the difference in the value proposition and produce substantial returns on investment. Many buyout shops and hedge funds are employing in-house senior operating professionals with experience in distressed situations to differentiate their approach in the marketplace.

In "Mining Value From Distressed Companies," I share a methodology for building enterprises in which future buyers want to invest. When the turnaround is complete and the company is ready for the next tranche to fund growth, those who have provided the investment have a point of exit.

Michael Goodman of NatCity Investment Banking shows why consideration may not be king in distressed mergers and acquisitions (M&A) in "Competition for Distressed Middle Market Buyouts Heats Up." The competitive sale process has forced decision makers to consider speed and certainty of transaction close as alternatives to override purchase price.

In "Investing in Underperformers, Turnarounds," Jason A. Leach of Sun Capital Partners, Inc. shares that a key to generating substantial internal rates of return in distressed environments is to acquire companies that present opportunities to create enterprise value through operational improvements post acquisition. He suggests finding "good companies in bad situations."

In "Overlooking Private Equity Partnerships Can Be Costly Mistake," Stephen Harris of Midcoast Capital describes an asset class that is sometimes misunderstood, always holds potential hidden risk, and can provide an alternative source of liquidity.

For more information on such topics, be sure to attend TMA's Distressed Investing Conference in January 2007 in Las Vegas, where we will explore this subject area in more detail.

Each month TMA past chairman and other leadership are asked to be "Guest Editor," and locate authors to write an article to support the theme of the issue, which this month was "Turnaround Investing."

About the Author

John M. Collard is chairman of Strategic Management Partners, Inc., a turnaround management firm based in Annapolis, maryland, and specializing in interim executive leadership and investing private equity in underperforming companies. He is past chairman of the Turnaround Management Association and brings 35 years senior operating leadership, $85M asset recovery, 40+ transactions worth $780M, and $80M fund management expertise to advise company boards, institutional and private equity investors, and governments. For more information about Strategic Management Partners, call (410) 263-9100 or log on at www.StrategicMgtPartners.com

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About the Firm

Strategic Management Partners has substantial experience advising corporations and individuals on the strategic and mechanical issues of corporate development and governance, operating management and turnarounds for asset recovery. Our principal has over 30 years experience in P/L Management, Strategic Planning and Repositioning, M&A for Strategic Advantage, Finance, Investing, Raising Funds, Sales/ Business Development, Building Selling and Marketing Teams, and Operational Auditing = In Public & Private companies = In healthy and crisis situations. **Strategic Management Partners** has substantial experience advising corporations and individuals on the strategic and mechanical issues of corporate development and governance, operating management and turnarounds for asset recovery. Our principal has over 30 years experience in P/L Management, Strategic Planning and Repositioning, M&A for Strategic Advantage, Finance, Investing, Raising Funds, Sales/Business Development, Building Selling and Marketing Teams, and Operational Auditing = In Public & Private companies = In healthy and crisis situations.

We work with and support the equity capital community to provide assessment studies to determine the situation, planning and strategy development to direct the company, crisis management to oversee that assets are not squandered away, workout teams that recover assets, and board level oversight to keep the client headed in the right direction.

We seek strategic alliances with private equity and recovery funds.

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