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## Mining 'the Gold' in Troubled Companies -- How to Build Properties Future Buyers Will Want

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The ABF Journal Magazine, published an Article of Interest by John M. Collard, turnaround specialist and equity investor.

Mining 'the Gold' in Troubled Companies
How to Build Properties Future Buyers Will Want

By John M. Collard

Investing in underperformers has become a more acceptable practice. It can be very profitable if you know what to look for, and how to execute, as many buyout firms are finding out. While this is simply stated, yet tricky to implement, there is a rewarding process to provide results.

How? The fundamental premise is to ascertain that a company is turnable. Then you have to know how to fix the problems, try not to spend money on past sins, obtain the company at the right price, manage the turnaround and sell it at an increased value.

This niche market allows investors to capitalize on initial positive results, which have become stalled investments. Seek enterprises with a critical capital shortage and with future potential. Selectively acquire companies, which can provide quality products at competitive prices, ones that are severely undervalued due to ineffective management, and/or with a lack of market direction and unacceptable penetration. There are opportunities that require capital, yet lack competitive market experience and essential managerial skills, where the economy is masking the real situation. Take advantage of distressed-level asset pricing and invest cents on the dollar in exchange for large returns. The 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.

The key to returns from investing in underperformers is to build properties that future buyers want to invest in. Build an enterprise with the sole purpose of selling it at maximum value — concentrate on exit strategies from the start. To yield peak results, build “going concern value.” Provide what future buyers look for, such as:

* Consistency of businesses that create value
* High probability of future cash flows
* Marketing-oriented management team
* Track record demonstrating the ability to sell and compete, develop, produce and distribute products to thrive and grow
* Realistic return potential from their fair entry valuation

There is great value in rebuilding an entity and setting it on a path toward long-term growth — this is the time for your exit. There are many buyers who accept lower return rates for stable growth and shy away from underperformers until they have been fixed — leave some future enticement for your buyers.

Recovery Cycle

Whether you invest in a new entity, a portfolio property gone bad or a DIP opportunity, the recovery cycle is much the same. This cycle starts with a mismanagement slide into trouble; you determine viability and invest, renew the entity’s health and, ultimately, sell the property.

All troubled entities reach that 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 will have little choice but to bargain, and deals can be made. Be cautious, however. Many wait too long, and while doing so, allow the value to deteriorate completely. Avoid the pitfall of investing in an insolvent company with no fix available; as surprising as this sounds, many do.

Determine turnaround viability by truly understanding what is wrong within the company [usually two or three things] that has caused its breakdown. Don’t be fooled by symptoms, and never listen to current senior management; if they knew what was wrong they should have fixed it before now.

Make certain that you have solutions to fix the real problems no one else has used, perhaps because you can bring new non-cash resources or applications to influence the revitalization. Take advantage of mispriced material inputs, labor, assets or capacity, and intellectual property. The answer is never, “just add cash,” but always requires new leadership to implement change.

Negotiate acceptable terms that allow for substantial upside when your work is done. Now you can invest. If there are no solutions, creditors won’t cooperate. If the price is unrealistic, go on to the next deal. Finding good turnable deals is fundamental to success.

Take Control

There must be a successful turn before the entity can be sold. Never leave this to chance. Always take active control of the entity — passive investing if managed by prior management is like a placebo, and you will lose your investment. Passive positions are only acceptable if they contribute to an investor pool that has an active lead participation.

Many equity investors approach an underperformer scenario in their own portfolio by applying strictly financial considerations. These same (financial) investors compound their problems when they take control of their company to determine whether a company is salvageable or a candidate for sale or liquidation. When sold, which is often the case, they write off their investment. Inherent in this scenario is a fundamental problem; purely financial consideration is not enough when an operational or revenue-driven turnaround is required. While many investors have run financial or investing institutions, few have run companies as well, and are ill equipped to do so. This certainly leads to opportunity for those who can run companies.

There is substantial value derived from investors who also have senior operating leadership experience in their background. 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 (CEO) talent to compliment their managing partners.

Someone once said, “Lead, Follow, or Get Out of the Way.” When there is an underperforming entity, it is time for existing management to “get out of the way.” They guided the company during this mismanagement slide, why allow them to complicate the situation any further?

Process of Recovery

There is a process to guide an entity through corporate renewal. It involves utilizing a transferable set of skills to revitalize the property and restore it to a sale-worthy state. Then sell the entity and realize returns.

Bring Leadership.

Focus on value creation and guide the company to a new plateau. Your advantage is that of an objective focus, untarnished by the situation at hand. You bring a perspective that does not reside within the company because the players lack experience with their new situation. You are the teacher, the stakeholders are the pupils, and together you rebuild in a new direction. You effectively manage "change control."

Install a CEO with transition experience in value-building situations. This leader will demonstrate expertise in:

* Managing crisis, transition, and rebuilding processes
* Shaping business strategy and financial structure
* Developing management talent, building high-caliper teams, utilizing and growing existing resources
* Growing sales and market share
* Maximizing return on capital
* Linking management performance to ultimate goals
* Developing incentive-based compensation programs

This leader must get directly involved in making decisions to achieve the ultimate goal — sale at increased valuation. He must be held accountable for performance, and timely results. Most importantly, he must get things moving. On the volume in (revenue/sales) side, look at where and how revenue is generated, then keep it coming in. On the volume out (throughput/production) side, get the product or service “out the door.” How else can you bill for it?

The final step to complete the turn is to hire a “marquis” manager to lead the enduring team. This permanent team adds to the value equation.

Set Strategy.

Your investing goal is a shorter-term high multiple return (for the risk) while allowing the ongoing longer-term returns for the buyers who provide you an exit. Implement long-term strategies, which will survive your exit.

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. If all you can do is think of strategies tried before — then don’t invest.

An effective strategy is key to implementing change. You 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.

Build Quality Management Team.

The value of a company increases sharply with a strong, permanent credible team that can demonstrate their ability to produce consistent sales, profit and cash flow results. Establish continuity in the organization to allow everyone to expect orderly change and opportunity.

Capitalize on available under-utilized human capital such as those middle managers that remain. Chances are they are dedicated to the company and its success. Guide them to their next level, and they will take the company the next big step.

Acquire 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, or never had, the basics of marketing and promotion. Clearly promote what your products and services can do for your customer to satisfy their needs, and differentiate why your product stands apart from the competition.

Become market driven by adapting to changing conditions and improving your competitive position. Deliver only what they are willing to pay for with no excess cost.

Establish Sound Capital Structure.

Create reasons for investors to invest. A sound strategy with a viable marketplace, efficient delivery and production vehicles, coupled with 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 as infusing cash for working capital needs is making certain that cash won’t be diverted to past commitments. Establish relationships with creditors so they will work with the new management team, and give them upside when the turn is complete. Consider a “Creditor’s Committee” approach (out of bankruptcy) to keep them plugged in and participating. Pre-packaged bankruptcies are also available to ensure cooperation. You can always purchase assets out of bankruptcy to ensure a clean structure — a strategy being utilized more often as buyout funds get more comfortable with the process. In many ways this approach can be considered alternative and complimentary financing.

Implement Processes.

Use systems and processes to drive the business and control the day-to-day environment, which allows management to run the critical elements of the company. Many managers waste time on tasks where results would be essentially the same whether they managed them or not. Focus on the important things — controlling cash and costs, increasing sales and enhancing value creation — and manage these.

Processes Define Guidelines and Expectations

Watch for the benefits derived from communicating what is expected. This will re-establish delegation of authority and expectation to those who can turn the events of the company, and more importantly, will demonstrate the value of this recurring phenomenon. When results are recurring this stimulates value.

Nurture Resources.

Leverage all resources (people/facilities/advisors) to complete the turn. Often the key resource is the employee. Set up an incentive structure that pays only when they accomplish the goals set in your long-term strategy. A robust incentive structure shares the risk — if successful then all will gain. If not, then don’t subsidize poor performance. Your incentive for investing is return when the sale occurs. Their incentive should be based upon performance that will take the company beyond its sale. After all, they are a key asset your buyer is looking for.

Exit

Know when to “cash-out.” The greatest ROI comes when the turn is complete and the company is ready for the next tranche to fund growth. At this point there are many new investors who will want to participate. Remember:
Earnings and cash capacity + achieved X multiple on investment + demonstrated Improvements + functioning management Team in place = time to sell.

Summary

Success in investing recognizes that a small Xr growth in revenues can yield many Xn returns on invested equity. Revenue in excess of controlled fixed costs drops substantial incremental profits (cash) to the bottom line, which in turn drives valuation.

Leverage opportunities to take advantage of distressed-level asset pricing in distressed situations; the risk to reward ratio is high. Take operating control in all entities to make certain that those decisions that few understand are made to influence the Xn multiple outcome. Instate leadership with extensive experience and success records revitalizing and restructuring entities, operating and executing financially successful exit strategies. Buy, invest, manage and renew with one thing in mind . . . maximizing value for resale.

When the process is completed, only one result can occur — value creation and Xn multiple returns.

Reference:
Library: Mining ‘the Gold’ in Troubled Companies

www.StrategistLibrary.com

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About the Author
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