Looking for the Exit: An Approach to Investing in Underperforming Companies

By John Collard

Categories: (Member Articles | Finance | Turnaround | Private Equity)

Professionals guiding investors or looking to invest in underperforming companies themselves should be aware of what to look for and how to execute. The key to returns from investing in underperformers is building an enterprise with the sole purpose of selling it at maximum value - to concentrate on exit strategies from the start.

First, seek enterprises at a precipice, not those that have already fallen off the edge. Look for those with critical capital shortages and future potential, but avoid the pitfall of investing in an insolvent company. Acquire companies that can provide quality products at competitive prices but are severely undervalued due to ineffective management and/or lack of market direction and penetration.

Take advantage of distressed-level asset pricing and invest in exchange for large returns. The infusion of capital put into the hands of a leader with a sound strategy and return-on-equity goal in mind can be a powerful motivator.

Provide what future buyers look for:

• Consistency of businesses that create value

• High probability of future cash flows

• Marketing-oriented management team

• Track record demonstrating ability to sell and compete, develop, produce and distribute products, thrive and grow

• Realistic return potential from their fair entry valuation

Recovery Cycle

Whether you invest in a new entity or a portfolio property gone bad, the recovery cycle is much the same. This cycle starts with mismanagement. Then you need to determine the viability, invest, turn and ultimately sell the property.

Determine turnaround viability by truly understanding what has caused the company's breakdown. Don't be fooled by symptoms, and never listen to current senior management. If they knew what was wrong, they would have fixed the problems.

Make certain that you have solutions to fix the real problems that no one else has used, perhaps because you can bring in new noncash resources or applications to influence the revitalization. Take advantage of mispriced material inputs, labor, assets or capacity, and intellectual property. Never "just add cash," and always implement new leadership.

Take Control

There must be a successful turn before the entity can be sold. 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. Install a new chief executive with transition experience in value-building situations. The executive should bring an objective focus and new perspective to complete the cycle.

This leader should demonstrate expertise in:

• Managing crisis, transition and rebuilding processes

• Shaping business strategy and financial structure

• Developing management talent, building caliber teams, utilizing and boosting existing resources

• Increasing sales and market share

• Maximizing return on capital

• 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. 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 strategies. Implement long-term strategies that will survive your exit. One essential strategy is to drive revenue by addressing the problems plaguing the company and provide a roadmap to revitalization. You must establish a new vision, distill this direction into concrete goals and objectives, and create a guide for everyone to follow.

Build a quality management team. The company value increases sharply with a strong, permanent, credible team that can demonstrate its 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 underutilized human capital - those dedicated middle managers who remain. Set up an incentive structure that pays only when they accomplish the goals set in your long-term strategy. Their incentive should be based upon performance that will take the company beyond its sale. After all, the employees are the assets for which your buyer is looking.

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. Become market driven, adapt to changing conditions and improve your competitive position.

Establish a 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 high probability of return and a viable exit strategy.

Implement processes. Use processes to drive the business and control the day-to-day environment. Focus on the important things - controlling cash and costs, increasing sales and enhancing value creation.

Exit

Know when to "cash out." The greatest return on investment comes when the turn is complete and the company is ready for the next tranche to fund growth.

Remember that there's a distinct advantage to using professionals who bring C-level operational, transactional and turnaround expertise together to determine what's wrong, how to fix it and how much to pay for it.

About the Author

John M. Collard is Chairman of Annapolis, Maryland-based Strategic Management Partners Inc., a turnaround management firm specializing in interim executive CEO leadership, asset and investment recovery, corporate renewal governance, private equity advisory, and investing in underperforming distressed troubled companies. John is a Certified turnaround Professional (CTP) and a Certified International Turnaround Manager (CITM). 410-263-9100 www.StrategicMgtPartners.com

View John's Profile

Read Interview