Valuing a company is the easy part; creating that value in the first place so that you can measure it is a more formidable task. Determining value is more art form than science. True value can only be established at the time of a transaction, where willing buyer tenders payment and willing seller accepts it in exchange.

Investing in under-performers and rebuilding value 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 and investors are finding out.

You must:
- Ascertain if a company is turnable;
- Know how to fix the problems;
- Avoid spending money on past-sins;
- Obtain at the right price;
- Manage the turnaround; and
- Sell at increased value.

This is simply stated yet tricky to implement. But there is a process to provide positive results.

The key to returns from investing in under-performers is to build properties 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. Build 'going concern value' to yield peak results. Provide what future buyers look for:
- Consistency of business 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.

There is great value in shining up or rebuilding an entity and setting it on a path toward long-term growth — then making 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 enticing for your buyers.

**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 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. The current owners have the opportunity to repair the damage and rebuild value into the company. When the entity is at a precipice there is opportunity. 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 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 the two or three things wrong within the company causing 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 you have solutions to fix the real problems that 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”, and always requires new leadership guidance 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, or the price 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 alone is like a placebo, and you will lose your investment. Passive positions are only acceptable if they contribute to an investor pool with an active lead participation. New leadership is a key.

Many equity investors approach an underperformer 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 salvageability or whether it’s a candidate for sale or liquidation. When sold, which is often the case, they write-off their investment. The scenario reveals 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 them.

Substantial value is derived from investors with 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 complement their managing partners.

Thomas Paine 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 in this mismanagement slide. Why allow them to further complicate the situation?
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.

Build Quality Management Team.
The value of a company increases sharply with a strong, permanent, credible team who 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.

Acquire New Business/Sales.
There are only two ways to increase sales: 1) sell new products to existing customers or 2) sell existing products to new customers. Most under-performers 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; differentiate why your product stands apart from the competition.

Set Strategy.
Your investing goals are a shorter-term high multiple return (for the risk) while allowing investors to buy. 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 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, managed or not. Focus on the important things — controlling cash and costs, increasing sales and enhancing value creation. Manage these.

Process 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. When results are recurring this stimulates value.

Nurture Resources.
Leverage all resources — people/facilities/advisors — to complete a turn. Often the key resource is the employee. Set up an incentive structure paying only when they accomplish the goals set forth in your long-term strategy. A robust incentive structure shares the risk; if successful all will gain. If not, you’re not subsidizing poor performance. Your incentive for investing is return when the sale occurs. Their incentive should be based on performance that will take a 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 investment to fund growth. At this point there are 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 X^2 growth in revenues can yield many X^3 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.

Bay, invest, manage, renew with one thing in mind — maximizing X^2 returns. When the process is completed, only one result can occur: Value creation and X^n multiple returns.

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