'Distressed Investing' Can Yield Healthy Returns for Savvy Backers

By John M. Collard

Investing in underperforming companies can be lucrative for those who know what to look for and how to execute. You 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 simply stated, it is tricky to implement.

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

Build an enterprise with the sole purpose of selling it at maximum value. Concentrate on exit strategies from the start. The key is to build properties that future buyers will want to purchase. 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.

Taking Control

Uncover underlying problems that caused a company's breakdown, usually two or three issues, and avoid focusing on symptoms of distress. Make certain that you have solutions that no one else has used. The answer is never to just add cash. New leadership is always required to implement lasting change.

Take active control of the entity. When an operational or revenue-driven turnaround is required, purely financial considerations are not enough to put value into a company.

While most investors have run financial institutions, few have run companies as well, and most are ill equipped to do so. Substantial value is derived from investors who also have senior operating leadership experience.

They can determine which strategy can affect revitalization, and why others didn't work in the past. Many private equity firms are adding operating executive talent to their ranks to compliment the skills of their managing partners.

Follow The Leader

Corporate renewal is a process. It involves using a set of skills to rejuvenate a company to a state where it can be sold. Only then can an investor realize returns. The renewal process involves:

1. Providing Leadership — Your advantage lies in bringing an objective focus, untarnished by the situation at hand. Move existing management out of the way. Because these executives guided the company during the mismanagement slide, why allow them to complicate the situation any further?

Bring in a CEO with transition experience in value-building situations. This leader must demonstrate expertise in managing crisis and rebuilding situations, shaping business strategy, developing management talent, and increasing sales and market share.

Rebirth and Returns

Hold the CEO accountable for performance, timely results, and getting things moving. On the "volume in" side (revenue), look at where and how revenue is generated and maintain that flow. On the "volume out" side (production), get products or services out the door. How else can you bill for this work?

2. Setting Strategy —In distressed investing, the goal is shorter-term, high multiple return commensurate with risk, while setting stage for ongoing longer-term returns for buyers who provide an exit. Implement long-term strategies that survive the exit.

3. Building A Quality Management Team —Company value 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 allow everyone to expect orderly change and new opportunities.

4. Acquiring New Business — There are only two ways to increase sales: sell new products to existing customers or sell existing products to new customers. Clearly promote what your products and services can do for customers, differentiate them from those of the competition, and adapt to changing market conditions.

5. Establishing Sound Capital Structure —Having a sound strategy in place, with a viable marketplace, efficient delivery and production vehicles, and a cohesive management team, will entice the investment community.

6. Implementing Processes — Systems and processes should be used to drive the business and control day-to-day environment, which allows management to address critical issues facing the company: controlling cash and costs, increasing sales, and enhancing value creation.

7. Nurturing Resources —The key resource is a company's workforce. Establish an incentive structure that pays only when employees accomplish goals set in the long-term strategy, and don't subsidize poor performance.

An investor's goal is to achieve a return when a sale occurs. The greatest return is achieved when the turnaround is complete and the company is ready for the next tranche to fund growth. At that point, many new investor/buyers want to participate.

Remember:

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

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