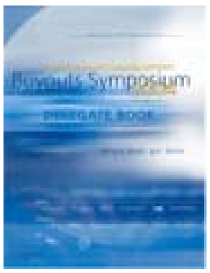

# Buying and Managing Distressed Companies



*This article is excerpted with permission from a panel discussion presented at the Thomson Venture Economics' 2004 Buyouts Symposium conference entitled 'Buying and Managing Distressed Companies.'* ***The panel was moderated by John M. Collard, Chairman, Strategic Management Partners, Inc.,*** *Annapolis, Maryland. Participants included Robert D. Denious, Managing Director, Questor Management Company, Southfield, Michigan; Michael Psaros, Managing Principal, KPS Special Situations Funds, New York; Mark J. Schwartz, President, Gordon Brothers Group, Boston; and Bhavin B. Shah, Vice President, Ewing Management Group, L.P., Dallas.*

***Collard: How much pressure is there within Private Equity Funds to put capital to work? How does this effect competition for deals?***

There is an incredible amount of money in the market representing a perception that you must do three deals, or invest some number of dollars each year or you may not become fully invested in the time allotted.

During the last several years many mega funds have evolved to invest in not-so-underperforming companies, and seem content with lower returns on their investment. The desired 30% return hurdle is giving way to returns in the high teens. Companies that would trade at four to six times EBITDA multiples are going for more. People that have not done turnarounds and restructuring before have suddenly emerged in this marketplace and paid eight and nine times multiples for companies that are not worth that much.

New trends are taking place: thirty buyers are showing up at auctions, investment banks are providing staple-on financing to increase leverage, and people are paying higher multiples. These dynamics really change the risk/reward ratio.

There appears to be a dichotomy of funds; those looking for pure profit dollars, versus those seeking higher returns to compensate for the risk. On the true distressed turnaround side where significant work is to be done you still have maintain the right discipline to get the 30% return.

We all try to be disciplined, but the multiples are escalating, leverage is more available and whether it's pressure to invest because there is dry powder or there is liquidity in the market to borrow debt, the multiples are going up. Robert D. Denious, Managing Director, Questor Management Co. said; "The distressed investor community is realizing that in this cyclical world we are laying ground work for a cycle of two to three years from now. It is good news frankly for this panel and people like us that this is happening in the marketplace."

It's a matter of instilling that the strategy of the firm is to invest when it makes good investment sense. Bhavin B. Shah, Vice President, Ewing Management Group, L.P. said: "This is a discipline-based argument, while a lot of people believe there is pressure to put money out, we only invest in opportunities that fit our criteria. In our fund, twenty percent of every check we write is actually from people around the table."

***Collard: Where are the good deals? Describe characteristics you look for?***

Buyout funds get excited about an opportunity when they can concretely identify the problems from an operating standpoint and the solution to those problems because they can create equity value for investors by fundamentally changing the business operations of a company. Financial restructuring alone is a more commodity product that won't really generate excess returns for their investors.

The real focus is on a great business that has had failed management and a core cost structure that they can fix. They like to take that business, which many times is EBITDA negative, and turn it into a vibrant, profitable going concern.

Opportunities that have great reason to exist but have otherwise failed, allow introducing new management to affect immediate material reductions in operating cash costs, which yield the greatest results. If you have a management team that can't pull the trigger and make hard decisions then you have the wrong management team.

Michael Psaros, Managing Principal, KPS Special Situations Funds said: "We look for great companies with strong market shares, competitive advantages and strong franchises that have encountered a series of material operating problems and in most cases, financial problems. We avoid businesses with rapid technological change like hightech, biotech, media and telecom. We focus on the manufacturing and service economy where we can implement a cost-based versus revenue-based turnaround."

Look for highly complex multi-constituency restructuring and turnaround transactions, because they don't lend themselves to auction environments, but yield higher returns. Consider creating new companies to purchase assets in and out of bankruptcy. While bankruptcy is a relatively inefficient market, it does have advantages, particularly in changing the look of the balance sheet.

Some companies come around three or four times, and you realize in these situations that people are getting realistic and it might be the right time to start looking at a restructuring or turnaround.

Mark J. Schwartz, President, Gordon Brothers Group said: "We look at companies that are in some level of distress but have a definable brand or product or service that gives it a competitive advantage. We want to invest working capital into a company necessary to support new management, and avoid purely overleveraged situations. Our investment never becomes a cash consideration back to a seller."

***Collard: What structures work to protect your investment? How do you control that money put into a company as equity will be used to fund future needs as opposed to pay for past sins?***

The timing and structure of your investment are both critical. While investments may end up as equity, they don't always go in as equity right away. When the investment is equity, the big issue becomes ownership control to protect what the cash is to be spent on.

Often the business is deteriorating rapidly, and if it's a company that you want to own, there is a tendency to rush to get in too quickly. Resist that urge, because you don't want to put money into a situation prematurely. If you put it in before you have control or the right structure, equity can quickly disappear to creditors. Avoid being the solution to existing creditors' problems — As soon as you write the check it becomes your problem, too.

Mr. Schwartz said: "It's critical to have our own people with operational expertise go in to analyze everything before we invest, whether it's real estate, IT, cash flows, or what's the buying plan for next season."

In order to make sure cash flows in the right way — there are alternative approaches. Consider becoming a senior secured lender with conversion rights, that way collateral is in place if you can't get control or the thing blows apart. Be sensitive to things like standstills and availability and what other lenders can do in terms of affecting your collateral base.

If you come in with equity initially, be certain to have control so you can bring in the right management team and take control of the cash. You can invest in situations where you don't have control, like preferred stock or convertible debt, but make sure that you have negative control rights so that nothing can be done without the approval of your securities. You obviously want to be at the table when any major decisions are being made. Always structure in some protection if you are not the control investor, then you can act in the best interest of your security. It is quite possible in bankruptcy to buy companies that are debt free from the start, which clearly helps the issue of protecting your investment.

Mr. Shah said: "You need strong aggressive management to stop depleting cash like crazy, implement the turnaround plan, and direct expenditures to only approved working capital needs. While it's a combination of some existing management, new management and ourselves, that is determined by the company situation."

***Collard: How do you address the issue of leadership during a turnaround? Is it better to handle the operational aspects in-house or get outside help and focus on your next acquisition?***

Leadership is key. When investing in a company, not simply deleveraging the balance sheet, time and momentum are your enemies. There is a law of physics: things will continue in a certain direction unless some significant force changes the outcome. We all face the dilemma going into a distressed property of figuring out very quickly who is going to lead the company through significant change and drive the operational turnaround.

When you buy a company there really is a window of opportunity for change in leadership. While change is difficult, and it's a human condition not to want to change, the feel of the workers right down to the guy on the assembly line is ready for change. Take the opportunity to shake things up, not only because you are hemorrhaging cash, but because people are ready and thirsty for it, and if you don't do it as an owner you are going to lose your audience.

Mr. Denious said: "Do we buy the company, install someone temporarily, which we can do through our sister firm, or do we do a search, then bring in a long term manager? What we decide in most cases is that temporary is a dangerous road to go, we want committed management."

Is it appropriate to outsource? Investors in an operational turnaround find it very important not to be totally out of that process. It is important to be side-by-side with your management team, understanding at a very granular level what's going to happen. Sit with management teams and devise a hundred day plan. This gives you an appreciation for the deal as you are looking at what will work, and what won't. If you bring in outside people alone to do it and you are just the front investor you are in dangerous territory.

Mr. Schwartz said: "Irrespective of whether you choose an internal resource, permanent hire, or turnaround firm, it's critical that they must be there full-time. You need to have someone on the ground that you are working with closely, it can't be fly in, spend two days and then going to do something else."

Only move forward if you have identified who the lead person is going to be and they have committed to a full-time engagement. Make sure that person is going to be there five days a week working with a team to affect change because things are happening three or four times more quickly than in a normal company that is operating well. You can plan for transition to bring in new people latter on, but it is critical to get your arms around it and have someone there, not just have someone who is parachuting in.

Mr. Shah said: "Approach a decision as if it were your own money. Who are the right resources to make the investment appreciate? More often than not we found that you do need outside involvement, somebody to stand as a big roadblock so that that ball stops falling lower, and to stop the deterioration. Then you can focus on other things, such as the top line."

***Collard: What are some of the most common obstacles that you run into when buying a distressed company, and how do you overcome them?***

Timing is always tight. You are either going to buy it in four weeks or the company might run out of cash, file bankruptcy, or be gone. Equity Buyout Funds are viewed as buyers of last resort because their capital is very expensive. To cope with this timing issue you must perform due diligence very quickly, get your hands around asset valuation, determine how you are going to improve operations, and what resources you will utilize. Mr. Collard said: "There is a distinct advantage to utilize professionals that bring C-Level operational, transactional, and turnaround expertise all together to determine what's wrong, how to fix it, and how much to pay for it."

Competition for deals is increasing. There are a lot more people now looking at the turnaround restructuring distressed space, from funds that don't necessarily do turnarounds and restructuring paying higher multiples, to distressed debt funds. Newcomers are investing in debt, but want an equity type return. Expect to deal with multiple parties to try to get a deal done as opposed to just the original equity holder. Find the fulcrum security in the capital structure. Is it equity, unsecured debt, secured, DIP financier? Negotiate with all parties, because any one of them could put a roadblock in front of you to make sure the deal doesn't go your way.

Internal competition in the form of a creditor who has come to their own valuation, which is significantly higher than you are willing to pay, is a formidable obstacle. Be prepared to lose those opportunities when they have decided to pull the plug and liquidate. Here you are competing against a standard of perceived value that that company has to its creditors. Mr. Psaros said: "Don't underestimate the 'creditors perceived liquidation value', they believe that they can realize their appraised result and may be a real obstruction if they don't see equal or greater results in your approach."

Valuation is always tricky. You want to rely on EBITDA improvement as a basis for your returns. Conversely, a good banker, and seller want the company to benefit from the improvements. What the EBITDA can look like if this thing is fixed depends on the future success in improving the ongoing cash improvements in this business. Negotiate the operative 'can look like' because it hasn't occurred yet, to come up with a strategy, and good transaction structure that gives you almost all the upside.

Visibility to accurate information is another obstacle. Broken companies have broken systems, always. The information that you are getting, P&L, balance sheet, cash flow statement, all of it is probably wrong. Bring in the pros with experienced eyes to sort out the situation behind the financials. Over-equitize, and be ready to absorb more hemorrhaging than you expect to see. You must have cushion in your capital structure to absorb the surprises because you are not going to see it all no matter how much due diligence you do.

Employees, customers, vendors, service providers and others have lost confidence in a distressed company. Assess how do you quickly get your arms around the different constituencies and regain their trust. Spend a lot of time internally with employees, on the road with vendors and customers. Because you may not regain that confidence quickly, be prepared to stay the course after fixes are in place.

***Collard: What is the single-most important attribute distressed investors need to have?***

Mr. Denious said: "That's hard to single out, it depends on the deal. When you talk about a deep operational turnaround you must have an appreciation for how to fix operations. It's one thing to identify the problem, but it's another to identify the fix. And is it really realistic that management is going to make the difference to create value."

Mr. Schwartz said: "You must have a fair degree of humility and realize that you are going to make mistakes. No matter how well you plan, Murphy's Law will come into play. Correct mistakes and move on. If it gets to be more than three or four things that you have to fix, question whether you can really fix them all or are you against insurmountable odds."

Mr. Psaros said: "Every day I go home a little more humble. We have been in deals where we have done everything right, and there was some exogenous factor, some unforeseen Six Sigma event that lead to results that weren't what we anticipated. Be prepared to recover when the unknown happens. We have many times willed companies back to profitability through good execution. It's the iron fist of tenacity and the velvet glove of humility."

Mr. Shah said: "I think the 'secret sauce' is patience and discipline. You must plan extensively and perform rapid aggressive nonstop execution once you have a deal. It's really, turn this bus around and keep it going in the right direction."

Mr. Collard said: "Coming from a turnaround perspective with 35 years in this business, I have learned to *always expect the unexpected*. Just when I begin to think I have seen everything that could possibly happen, I'm surprised when something new manifests itself and I find myself dealing with it. You will find this in investment properties, be prepared as investor to change."

***Collard: How do you influence the EXIT process to maximize return on investment and are we seeing trends in this area?***

Mr. Psaros said: "We want to sell after we actually affect a turnaround, and when the turnaround has been reflected in the company financial results. My impression is that there will be an avalanche of exits over next 24 months out of buyout funds that have been disciplined and sophisticated buyers of distressed companies through this recession. The trends are all there, the public markets have refloated."

Most buyout funds are not growth investors. They are very good at taking a troubled company, fixing it, then selling it to either a strategic or financial buyer that can use the company as a platform for growth. Often, they can rapidly affect a turnaround plan, but that is not always the case. During the last three years there has been a manufacturing depression in this country, and it has not been the time to sell manufacturing companies.

The trend is positive with the economy recovering so funds are now able to sell the investments in their portfolio. The extraordinary liquidity in the high yield markets desperate to go to work, and lock-up periods expiring after the capital raising in the late '90s has created a bubble of opportunity.

Mr. Denious said: "When you have a successful turnaround you are driving a lot of value in the first two years. At that point you have to say to yourself, do you want to EXIT? As a turnaround guy you face that moment of truth and you must understand that you are there."

You have an option; sell now, or hold for future. Even though the value growth will slow or plateau, it may make sense to let confidence catch up and compound your money to the next value increment. At that point you look a little bit more like a growth investor. In cases where sales and renewed confidence in the company may not return for 18 months, to realize full value you might have to wait before you sell.

In this market some acquisitions are getting done where people are counting on the capital markets to take them out. However, capital markets aren't always there, so you must be prepared to wait out different cycles in the capital markets.

Mr. Collard said: "Manage your exit. It is critical to establish a permanent team and build support infrastructure so portfolio companies can stand on their own after exit. Set up a compensation structure to induce the top management team to be there through and after a transition. Buyers will ask; if you are not going to be there how is that going to affect company value?"

Mr. Collard said: "Know when to 'cash out'. Remember: ***E***arnings and cash capacity *plus* achieved ***X*** multiple on investment *plus* demonstrated ***I***mprovements *plus* functioning management ***T***eam in place *equals* time to sell."

"Thank you, panel members."

*John M. Collard, is Chairman of Annapolis Md.-based Strategic Management Partners, a nationally recognized turnaround management firm specializing in investing equity in underperforming companies and interim executive leadership. He is Past Chairman of the Turnaround Management Association, and brings 35 years senior operating leadership, $85M asset recovery, 40+ deals worth $780M, and $80M fund management expertise to advise company boards, institutional and private equity investors. To reach Strategic Management Partners, call 410-263-9100, or go to* www.strategist.ws