Buyouts
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# Investing in Underperforming Companies

## *An $R_x$ for Renewed Health and Asset Recovery*

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Investing in underperforming companies can be profitable if you know what to look for and how to execute. The fundamental premise is to get a company that is turnable, know how to fix the problems, be able to not spend money on past sins, obtain at the right price, manage the turnaround and sell at increased value.

First, seek enterprises with critical capital shortages and future potential. 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.

The key to returns from investing in underperformers is build an enterprise with the sole purpose of selling it at maximum value — concentrate on exit strategies from the start.

Provide what future buyers look for:

- Consistency of businesses that create value.
- High probability of future cash flow.
- 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 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, 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.

All troubled entities reach that state through a progression of mismanagement. When the entity is at a precipice there is opportunity. The present owners will have little choice but to bargain. However, be cautious, because many investors wait too long, allowing the value to deteriorate completely. Avoid the pitfall of investing in an insolvent company; as surprising as this sounds, many investors do.


Determine turnaround viability by truly understanding what 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 non-cash 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 turnaround 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 certainly lose your investment. Passive positions are only acceptable if they contribute to an investor pool that has an active lead management participation.

While many investors have run financial or investing institutions, few have also run companies as well, and are ill equipped to do so. 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 equity firms are adding operating executive [CEO] talent to compliment their managing partners — even in times when resources are tight.

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

**Bring Leadership.** Install a CEO with transition experience in value-building situations. They bring an objective focus and new perspective to complete the cycle.

## GUEST ARTICLE

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 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 and 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 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 revenue; growth cannot occur without more sales. The strategy must address problems plaguing the company, and provide a roadmap to revitalization. If all you can do is think of strategies tried before, don't invest. 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 value of a company 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 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.

Additionally, leverage all resources to complete the turn. Usually 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, the employees are the assets that your buyer is looking for.

**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; differentiate your product from the competition.

Become market driven, adapt to changing conditions, and improve your competitive position. Deliver what they are willing to pay for and no excess.

**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.

As important to infusing cash for working capital needs is to make certain that cash won't be diverted to past commitments. Establish relationships with creditors so they will work with the new management team — 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.

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

## 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.

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.

Success in investing recognizes that a small $X^r$ growth in revenue can yield many $X^n$ 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. When the process is completed, only one result can occur — Value Creation and $X^n$ multiple returns.

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