



*Journal of Corporate Renewal*

# Competition for Good Distressed Deals Is Intense

## *Investors Warn: Be Skeptical, Hands-On, Disciplined*

*Editor's Note: This piece is excerpted with permission from "Buying and Managing Distressed Companies," a panel discussion at Thomson Venture Economics' 2004 Buyouts Symposium. Panel discussion was moderated by John M. Collard, chairman of Strategic Management Partners, Inc., Annapolis, Maryland.*



*Participants included Robert D. Denious, managing director of Questor Management Company, Southfield, Michigan; Michael Psaros, a managing principal of KPS Special Situations Funds, New York; Mark J. Schwartz, president and CEO of Gordon Brothers Group, Boston; and Bhavin B. Shah, vice president of Ewing Management Group, L.P., Dallas.*

**Collard:** *There is a distinct advantage to using professionals who bring C-level operational, transactional, and turn-around expertise together to determine what's wrong, how to fix it, and how much to pay for it...*

**How much pressure is there within private equity funds to put capital to work? How does this affect competition for deals?**

**Shah:** There is an incredible amount of money out there and sometimes there is a perception that you need to ... put \$200 million a year out of a \$1 billion fund to work. Otherwise, in five years you may not have invested all of the money. Sometimes we do four or five deals a year. Some years we don't do any. It's a matter of instilling that type of approach, not just in people, but also in the strategy of the firm.

**Denious:** Look at the multiples that are being paid. Whether it's pressure to invest because there is a lot of dry powder or whether it's because there is liquidity in the market and you can borrow debt again at healthier levels, multiples are going up.

**Shah:** Most of us are not necessarily used to paying eight, nine, or 10 times multiples for most companies ... that would go for four, five, or six times multiples. People who have not done turn-arounds and restructurings before suddenly have emerged in this marketplace and paid seven, eight, nine times multiples for companies that I would believe

necessarily are not worth that much. Maybe that is setting us up for two or three years from now, when ... they hit their covenants and the distressed debt market is not strong. Maybe we can restructure them.

**Schwartz:** There is talk of 30 or 40 companies showing up at auctions. When you see some of the investment banks providing staple-on financing now of four or five—we are seeing in excess of five times leverage—clearly you will see people paying higher multiples.

I think one of the things that is driving it is that as larger funds have been raised ... you see certain groups getting content with lower returns on their investments. So before, if someone had a minimum hurdle of 30-plus percent per investment, we are seeing a lot of the pure private equity funds looking at transactions...that can generate returns in excess of maybe the high teens or low 20s, which from our perspective really changes the risk/reward ratio.

**Collard:** *Where are the good deals? Please describe the characteristics that you look for.*

**Psaros:** We look for great companies with strong market shares, competitive advantages, and strong franchises that have encountered a series of very material operating problems and, in most cases, financial problems. We get excited about an opportunity when we can go in and concretely identify the problems from an

operating standpoint and the solution to those problems.

We try to avoid, as a turnaround fund, businesses with rapid technological change. So, we tend to avoid, obviously, high-tech, biotech, media, and telecom. We like to focus on the more mundane aspects of the manufacturing and service economy, where we can go and implement a cost-based versus a revenue-based turnaround.

**Schwartz:** You see companies coming around once, twice, three, or four times. When you start seeing a fourth or fifth time around, you realize in some situations that people are getting realistic, and it might be the right time to start looking at a restructuring or turnaround. We look at companies that are in some level of distress but have a definable brand, product, or service that gives them a competitive advantage. To effect the turnaround, in our experience, will take 12 to 18 months, and you don't want to have the whole product shifting from you during that time period, as you are trying to improve the cash flow and make some of the necessary changes. From our perspective, it's trying to find a good company that is being managed ineffectively, as opposed to something that purely has been overleveraged.



**John M. Collard**

**Collard:** *How do you ensure that money put into a company as equity will be used to fund future needs as opposed to pay for past sins?*

**Schwartz:** Even though it may end up as equity, we don't always look at putting in equity right away. Also, obviously, the ownership, in terms of whether or not we have control, is a big issue.

If it's a company you would like to own, you want to get in there as quickly as possible before the business deteriorates.

We have to resist that urge because you don't want to put money into a situation prematurely. If you are putting it in either before you have control or before you have the right structure,

money can quickly disappear to existing creditors. In a lot of these situations, people are looking to the distressed investor as a solution to their problem. It is their problem before you get in. As soon as you write the check, it becomes your problem, too. We are very sensitive about when we get in there.

It is critical for us to analyze the cash flow in terms of what the company needs, short term and long term. Who can afford to take a hair cut? Who do you need long term? Where is the cash going to be going once we complete the restructuring, and what's going to be needed during the time frame? We also critically look at how much cash is needed, not just initially but also in a long-term view. We don't want to find ourselves invested and—if the process takes six months longer than what we thought—not be in a position to reinvest.

To make sure the cash flows the right way, there are two different approaches. If we need to put money in quickly, we often try to come in as a secured lender. We will try to attach some type of collateral so ... at least we are protected if the whole thing blows apart. We are very sensitive to things like standstills and availability and what some of the other lenders can do in terms of affecting our collateral base. When we come in as an equity investor, if we have control that is easy because then, obviously, you're affecting the decisions so you can make sure you put in the right management team.

We will also invest in situations in

which we don't have control. There, we use fairly typical structures. Whether it's preferred stock or even when it's convertible debt, we make sure that we have negative control so that nothing can be done without the approval of the securities we control, whether it's changes in management, budget, capital, any type of expenditure, or additional debt.

**Psaros:** We try to structure in some protection, despite the fact that we are control investors. We have done a lot of deals ... in which the capital we have invested has gone into the company in the form of senior secured securities... so I agree with you that the structuring is very important. I think the most important thing that you said was that you always need that cushion, especially with the kind of companies that we invest in, no matter how well the execution of the plan goes.

**Shah:** I think there are a couple operational structural components that are pretty important as well. We find two big dynamics of companies in the distressed world, or especially for companies that are deeply distressed. One, they are just bleeding cash like crazy...and two, there either are significant holes in management or the management is not correct for that company...Half of our guys are deal guys and the other half are guys who will roll up their sleeves and go into the companies four or five days a week and take on positions within the company, from CEO to the head of purchasing, ... to really take control of the cash. We put into place aggressive management and in-depth, heavily involved management, whether a combination of the existing management, new management and ourselves, or whatever.

The second big piece from an operational perspective is to take control of all of the cash, in terms of a managed cash flow from day one. We develop rolling cash flows for the company as soon as we buy it. Every cash disbursement that's spent and every cash item that is collected is something that we control pretty carefully, from capital expenditures on the high end to checks that are written to pay for new improvement to the office, whatever that might be.

**Schwartz:** We find this is critical, even if there are some good management teams within the company. Over time, we will promote from within and try to find out who is good and who is bad, but we think it's critical to be able to have our

own people with operational expertise go in there and analyze everything, whether it's real estate, information technology (IT), cash flows, or even just what the projections look like. What we are not willing to do is just rely on the management team...because we have found in those situations that we come up short most often.

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

**Denious:** Obviously leadership is key. When you are investing in a company...with negative cash flow, it is pretty obvious that time and momentum are your enemies. There is a law of physics that I once learned. As things start in a certain direction, they continue in that same direction, unless some significant force changes the outcome. We all face going into a distressed property and trying to figure out very, very quickly who will lead the company through significant change and drive the operational turnaround.

One of the dangerous things that we confront is looking at a company and not being sure in our heart of hearts whether the current management team is up to the task. Very often, we feel they're not. Indeed, that's **Robert D. Denious** why the company is where it is. If we don't have somebody on a bench that we clearly have identified as being appropriate to drive a company forward, do we still move forward, buy the company, and do something temporarily? Do we put somebody in on a temporary basis, do a search, and then bring in a long-term manager? We decided in most cases that's a dangerous road to go.

Right when you buy a company, basically the field of workers, right down to the guy on the assembly line, is ready for change. Change is difficult; it's a human condition. Right after an investment is made is the appropriate time to go in and shake things up, not only because you are going to have a hemorrhaging cash flow statement, but also because people are ready for it. If you don't do it as an owner, you will lose your audience, so to speak.



**Mark J. Schwartz**



**Robert D. Denious**

I am pretty convinced as an investor in an operational turnaround, it's important not to be totally out of that process. We sit down with our management teams and devise what we call a 100-day plan. I think it's important to be side by side with your management team, understanding at a very granule level what will happen or should happen.

**Schwartz:** I think it's critical when you are investing in a company that whoever you pick—whether it's an outside manager or an inside manager—someone has to be there full-time. It can't be that someone is flying in, spending two days, and then going to do something else. We will only go forward when we have identified who that person is. We want to make sure that person will be there five days a week working with a team trying to in fact change because things are happening probably three or four times more quickly than in a normal company that is operating well.

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

**Shah:** Sometimes the timing in which we get involved in potentially buying a company is pretty tight. We either will buy it in four weeks...or in four weeks the company might run out of cash. We're almost viewed as the equity of last resort because our capital is very expensive. That means you have to deal with it very quickly. If you can get your hands around valuation of the assets quickly, and if you can get a sense of how you will improve the operations of the company and with what resources very quickly, that's one way to manage an obstacle.

Another obstacle we have come across is competition. The fact of the matter is, there are a lot more people in this industry now looking at the whole turnaround, restructuring, and distressed space, from funds that don't necessarily do turnarounds and restructuring...to a lot of distressed debt funds.



**Bhavin B. Shah**

I think there is more than \$100 billion focused on distress debt today. So by the time you buy this company, will the value of the up side be something that you are comfortable with,

and will you have any up side?

Also, you are going to be dealing with multiple parties to try and get a deal done, as opposed to just the original equity holder. You have to find out what the fulcrum security is in the capital structure. Is it the equity? Is it unsecured debt holders? Is it the secured debt holders? Is it the guys that were providing the debtor-in-possession (DIP) loan to the bankrupt company? You must negotiate with all those parties because any one of those guys could put a roadblock in front of you to make sure the deal doesn't go your way so that they can get their money out to whatever extent they want to.

**Denious:** Visibility is another obstacle. Broken companies have broken systems—always. The information that you are getting, the profit and loss statement (P&L), the balance sheet, the cash flow statement—all of it is probably wrong to a greater degree than you will find in other companies. I guess the solution that we all come to is...to over-equitize. You have to be ready to absorb more hemorrhaging than you expect or hope to find.

**Schwartz:** As the distress continues, obviously, there is a loss of confidence, not only internally with employees in the company, but also, most often, externally with customers, vendors, and service providers. How do you quickly get your arms around the different constituencies and regain that trust? Sometimes we've found that a company has deteriorated to a point that, no matter what you do, you will not regain that confidence quickly enough to get the product flowing again. You can fix everything financially, but people have moved on and they now have alternatives.

**Psaros:** Another competitor is how the creditors perceive—and I use that term "perceive" very, very selectively—liquidation value. We will spend six months developing a turnaround plan to know what our cash flows are, we will know what our returns will be, if we'll be able to finance for X. But some bank has it in its head that the liquidation value is 2X. We have lost on a lot of opportunities to save companies, save jobs and create value for our investors because the bank has chosen—and I am using the bank generically—for the secured creditors pulled the plug and liquidated it. And invariably instead of getting 2X, they get less than what we were prepared to pay—in some cases 10 or 20 percent of what we were prepared to pay.

**Collard:** *What is the single-most important attribute a distressed investor needs to have?*

**Denious:** When you are talking about a deep operational turnaround, you have to have an appreciation for operations and how you fix them. It's one thing to identify a problem. I think that can be done pretty easily sometimes, but it's quite another thing to identify the fix... How will your management team fix it? And is it really realistic that they will move the dial as much as is needed to create value?

**Schwartz:** You have to have a fair degree of humility and also realize that you will make some mistakes in these situations. No matter how well you plan and how much you think you know about what's going on, Murphy's Law will come into play in all these situations. What you can't do is freeze and not act because I think that is even worse. A lot of different things go wrong, but people need the leadership. If it starts getting to be more than three or four things that we have to fix, you have to start thinking, "Can I really fix all of those things?" Not all of them will go according to plan. And depending how much, one of them can drag the company down.

**Psaros:** We have been in deals where we have done everything right. We had a turnaround plan where we just shot the lights out—where we did absolutely everything right in executing the plan—and there was some third-party unforeseen event that led to results that weren't what we anticipated. You always have to be prepared to recover when that happens.



**Michael Psaros**

We go into businesses that have no management because management has failed, earnings before interest, taxes, depreciation, and amortization (EBITDA) is negative, operating in bankruptcy, but we see value. In many instances by bringing in new management, by perfecting a turnaround plan, by buying the thing out of bankruptcy or an out-of-court restructuring, you, the sponsor or general partner, really exert a force of will. In many cases, we have just willed a lot of these companies back to profitability through good execution.

**Collard:** Coming from a turnaround perspective with 35 years in this business, what I've learned is to always expect the unexpected. Just when I think that I have seen everything that could happen, I am surprised when something new manifests itself and I find myself dealing with it.

**Collard:** *How do you influence the exit process to maximize your ROIs, and are we seeing trends in this area?*

**Psaros:** We want to sell when we've actually effected the turnaround and, when the turnaround has been reflected in the financial results of the company we seek to sell. We are not growth investors. In many cases we have been very lucky in terms of how rapidly we were able to effect our turnaround plan. But in the last three years, ... we have a manufacturing depression in this country—not a recession, a depression—and it has not been the time to sell manufacturing companies.

My impressions are that there will be an avalanche of exits over the next 24 months out of funds like ours that have been disciplined and sophisticated buyers of distressed companies through this recession. The trends are all there. With the economy recovering we now will be able to sell the investments in our portfolios.

I'd like to thank the capital markets for manufacturing today the opportunities for those of us at this table to take advantage of 24 months from now. People are drinking the Kool-Aid again. I don't think I have ever seen anything quite like it.

We were at a company two weeks ago—a \$500 million company with negative EBITDA, serious Cap-X requirements—that needed a fix. If you fixed it, maybe it would do \$30 million 24 months from now after a lot of blood, sweat, and tears. Usually we are the only guys involved in a situation like that. There is a group, we've been told by the seller, of what I would call vanilla leveraged buyout funds that were talking about paying \$100 million for this company. Our offer to the seller was not \$1, but some upside in the form of warrants or something after we put our capital in and fixed the business.

**Shah:** We may complete a turnaround from an operational perspective in 18 or 24 months, but sales and renewed confidence in the company will not show up for another 18 months after that. You could think about exiting... but if you potentially want to realize full value, you may want to wait another couple of years and really realize that renewed confidence in the business.

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## Investing in Underperforming Companies

By John M. Collard, June Guest Editor

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**I**nvesting in underperforming companies can be profitable if you know what to look for and how to execute. The fundamental premise to distressed investing involves obtaining at the right price a company that can be turned around, managing a turnaround to increase the value of the business, and selling the company at a price that reflects its increased value.

Determining turnaround viability requires understanding what caused a company's breakdown. One shouldn't misinterpret symptoms or listen to current senior management. After all, if these executives knew what was wrong, they would have fixed the problems in the first place.

A distressed investor should always take active control of the business. Perhaps the investor can bring in new non-cash resources or applications to influence the revitalization or take advantage of mispriced material inputs, labor, assets or capacity, and intellectual property.

A distressed investor should never just add cash and should always implement new leadership. Being a passive investor and trusting prior management to handle a turnaround is a placebo that may cost the entire investment.

While many investors have run financial or investing institutions in the past, few have operated other kinds of companies, and many are ill equipped to do so. Investors who also have senior operating leadership experience add substantial value to an investing process. Many equity firms are adding C-level operating executive talent to complement their managing partners, even when resources are tight.

The prescription to renewed health and returns is to bring leadership, set strategy, build a quality management team, acquire new business/sales, establish a sound capital structure, implement processes to drive the business, and prepare to exit.

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

This issue of *The Journal of Corporate Renewal* features comments from a panel discussion, "Buying and Managing Distressed Companies," that occurred at the Thomson Venture Economics 2004 Buyouts Symposium. In addition, Christopher West, a principal with Semmes, Bowen & Semmes, discusses structuring investments to protect assets. Anthony DiSimone, a managing director with HIG Capital Management, discusses restructuring debt as a strategy. Terry Lee Brubaker, vice chairman and chief operating officer of Gladstone Capital Corporation, offers an article about using boards to implement strategy.

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