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Fixer-uppers: Creating pre-sale company value



By John M. Collard

Outlines a process for building value into companies and the role of a turnaround specialist in asset recovery and valuation preservation for troubled companies. How to invest in underperforming companies.

Valuing a company is the easy part; creating that value in the first place so 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 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.

This niche market allows investors to capitalize on initial positive results, which have become stalled

investments. Seek enterprises with a critical capital shortage, with future potential. Selectively acquire companies that can provide quality products at competitive prices that are severely undervalued due to ineffective management, and/or lack of market direction and unacceptable penetration. There are opportunities that require capital, yet lack competitive market experience and essential managerial skills where the economy is masking the real situation. Take advantage of distressed level asset pricing and invest cents on the dollar in exchange for large returns. The infusion of capital put into the hands of a leader with a sound strategy and a return-on equity goal in mind can be a powerful motivator.

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 businesses 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 enticement for your buyers.

Recovery cycle

Whether you invest in a new entity, a portfolio property gone bad, or a DIP opportunity, 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 the 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 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 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.

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.

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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 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.

Bring leadership

Focus on value creation and guide the company to a new plateau. Your advantage is that of an objective focus, untarnished by the situation at hand. You bring a perspective that does not reside within the company because the players lack experience with their new situation. You are the teacher, the stakeholders are the pupils and together you rebuild in a new direction. You effectively manage "change control."

Install a CEO with transition experience in value-building situations. This leader will demonstrate expertise in:

- Managing crisis, transition, and rebuilding processes;
- Shaping business strategy and financial structure;
- Developing management talent, building caliper 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 revenue/sales side, look at where and how revenue is generated and keep it coming. On throughput/production, get product or service out the door. How else can you bill for it?

The final step to complete the turn is to hire a marquee manager to lead the enduring team. This permanent team adds to the value equation.

Set strategy

Your investing goals are a shorter-term high multiple return (for the risk) while allowing ongoing longer-term returns for the buyers providing you an exit. Implement long-term strategies which will survive that exit.

While situations differ, one essential strategy is to drive revenues; growth cannot occur without more sales. The strategy must address the problems plaguing the company and provide a roadmap to revitalization. If all you can do is think of strategies tried before — don't invest.

An effective strategy is key to implementing change. You must establish a new vision, distill this direction into concrete goals and objectives and create a guide for everyone to follow. Rebuilding momentum is critical to success.

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.

Capitalize on available under-utilized human capital — those remaining middle managers. 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.

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 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.

Become market driven, adapt to changing conditions and improve your competitive position. Deliver only what they are willing to pay for.

Establish sound capital structure

Create reasons for investors to invest and buyers 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.

As important to infusing cash for working capital needs is to make certain cash won't be diverted into 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 to keep them plugged in and participating. Pre-packaged bankruptcies are also available to ensure cooperation. You can always purchase assets out of bankruptcy to ensure a clean structure, a strategy being utilized more often as buyout funds get more comfortable with the process. In many ways this approach can be considered alternative and complimentary financing.

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

Remember:

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

and costs, increasing sales and enhancing value creation. Manage these.

Processes 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 the 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 the 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 to fund growth. At this point there are many new investors who will want to participate.

Summary

Success in investing recognizes that a small X^r growth in revenues 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.

Leverage opportunities to take advantage of distressed level asset pricing in distressed situations; the risk to reward ratio is high. Take operating control in all entities to make certain that those decisions that few understand are made to influence the X^n multiple outcome. Install leadership with extensive experience and success records revitalizing and restructuring entities, operating and executing financially successful exit strategies.

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

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