Distressed acquisitions sometimes boast an uncanny resemblance to Three-card Monte...you can lose the moment you decide to enter the game!

By Harry Gray, Chad Greenway and Don Bibeault

You buy low, with hopes of a multi-bagger return, but you may already be the mark of the dealer and his shills. These days, surely many first-time distressed investors will rush to scoop up incredible opportunities without apprehension. It must be easy. We’ll just buy low, operate our way through the upturn, and sell high. Plus, multiples will be higher at exit and we can refinance when credit eases. Everything will go according to plan. After all, control investments in troubled companies just need a new management team and some cost cutting, right? Caveat emptor...there are many tripwires and pit falls in the distressed investing jungle.

Certainly part of navigating the go-ahead decision involves “how best” to acquire a distressed business—through an in-court bankruptcy or out-of-court process. Keeping it simple, bankruptcy sales can be accomplished either under Section 363 of the Bankruptcy Code or as part of a Chapter 11 plan. In general terms, the key differences between buying under Section 363 of the Bankruptcy Code and under a Chapter 11 plan relate to timing, bid competition, structure and the role of parties other than the seller. The Section 363 process tends to be quicker (in an emergency, a sale can be accomplished in a matter of days, although six to ten weeks after submission of the buyer's bid is more typical) and almost always involves the opportunity for competitive bidding, though the practical ability of competitors to bid varies greatly. The Chapter 11 plan process generally takes several months (although a prepackaged or pre-negotiated plan may be quicker), and does not always involve competitive bidding.

Concerning structure, most bankruptcy sales involve assets rather than stock; however, a Chapter 11 plan may effectively provide for the buyer to acquire the seller as an entity, free from liabilities. The bases for other parties to oppose the sale can be different under Section 363 and under a Chapter 11 plan, but whether opponents of the sale will have greater “blocking power” under one process or the other will vary depending on the situation.

While it is critical for any prospective distressed investor to understand the in-court/out-of-court processes and to develop a strategy best calculated to serve the buyer's goals, these important and unavoidable elements of a distressed acquisition sometimes muddle the most central issues: valuation and turnaround plans. So, what lessons have “journeymen” private equity and turnaround professionals learned from success and failure in the distressed investing game?

Venues and mechanics may obscure the view. Initially, “restructuring speak” can be an intimidating and foreign vernacular. In the end, however, the exotic and complicated techniques involved in this venue are just paths to investing in an anticipated series of cash flows. Whether a short-term trade pivoting on senior debt recovery, a middle-tranche approach that targets a fulcrum position, or a deleveraging equity infusion, the commitment hinges on the crossing of two continuums; first, the range between going-concern and liquidation values; and, second, the gamut between asset-backed protection and anticipated upside that may yield from expected cash-flows. In other words, it all boils down to “buying low and selling high”...so keep perspective!

History is a proxy...only for Darwin Awards. You have read it before in every prospectus: past performance is not indicative of future results. This aphorism is understood by money managers, but close study of historical performance is fundamental to the research process. While a return to past glory is often the aim of the distressed investing landscape, a critical question is: Is it really a “good” company with “bad” balance sheet or is it a bad company with...
no viable core? Cash reserves notwithstanding, often the weakest industry participants are first to fall. Here is precisely where first-mover advantage may be an oxymoron.

**Traditional benchmarks can be poor targets.** Past glories can be too good to be true. You build sensitivity models, speculate on value along the fire-sale to going-concern continuum, and conjecture what this company will look like after it stabilizes and eventually grows. Ultimately, you have to triangulate your fix on various performance benchmarks. Before the business was troubled, and certainly in “good company, bad balance sheet” situations, it sustained certain levels of gross- and operating-margins. Along with industry mean and median comparatives, that past glory is pinpointed as one of the goals in the turnaround, yet here is where history can backfire and distressed investors can learn from experienced early-stage venture capital investors: many times and for many reasons past margins may not be achievable.

**Vultures should leave carrion for the next feeder flock.** A world-class predatory investor may be better inherently on the buy-side than the sell-side. We have seen this scavenger tendency before. The mindset of digging under couch cushions to find lose change often translates into riding the investment too long—especially in cyclical industries. You have to leave some upside for the next owner.

**Grit your teeth and ride the “J”.** In most instances, you cannot enter with perfect timing. Although you may avoid catching a falling knife, you are likely to ride the performance down a bit before the turnaround, as costs and programs could be in flux as the business is transitioned. Furthermore, you should be prepared to plug the financial gap with rainy day funds.

**The Pareto phantom may be a lurking.** Unfortunately, the acquisition of a distressed company does not typically afford an opportunity to perform due diligence at the molecular level. In a turnaround, you must find the enterprise’s viable core, and prudent analysis may involve microscoping critical areas such as backlog and stock turn. However, the molecules of these fundamental sales and inventory measures are easy to mask by aggregating numbers. This also holds true in a number of other fundamental areas. If not in due diligence, you must identify and address Pareto conditions soon after the deal is consummated.

“**My Fair Lady**” does not work. Pygmalion thinking that a company in a “blue collar” sector can be professionalized with a “white collar” approach is dangerous. We have seen this fail over and over. Business models heavily influence culture and attract certain types of employees. Indeed good leadership and capable managers can improve a company’s performance, but be careful if you are trying to push "fork and knife“ tactics in a “cafeteria tray” industry.

**Make money when you buy...if possible.** That adage is half the battle in commercial real estate; but, in distressed operating companies, integral post-acquisition strategic and operating plans can easily go fallow. It is problematic to change areas such as product mix, but much more difficult—sometimes impossible—to change the business model. If the troubled company’s investment return hinges on shifting the entire business model, do not buy. For instance, how many job shops have successfully shifted into process flow firms? Likewise, how do you predict with certainty the realization of economies and synergies through post-merger integration? On the other hand, if a portion of the return hinges on a moderate- to intermediate-level transition through initiatives such as mix alterations, a practical plan executed by capable managers can achieve this goal. For example, if a company pursues shifting the mix from lower-volume, higher-change work streams to a higher-volume, minimal-change blend, or vice versa, this could be accomplished as long as margin capture (or loss) was properly anticipated. In any event, the axis of the investment return should not involve changing everything, but reasonable mix changes and the like may be low-hanging fruit for plucking.
Sometimes sticky can be too viscous. Ironically, as long as the company provides competitive products or services, purchase orders can be better than contracts in a distressed acquisition. This is not intuitive, but depending on the degree of product inelasticity, the troubled company might enjoy the agility of optimizing price and profits through sale-by-sale methods. On the flip side, if the troubled company is a contract-centric provider of products or services in a sticky arrangement, the dependent customer may be forced into being part of a solution.

Brand resuscitation is expensive. A full glass that leached by half has lost 50%; yet, topping off that half-full glass requires 100% more. In our experience, this phenomenon is extant when investing in distressed brands. It takes years of consumer conditioning and plenty of investment to secure a lasting positive image of a brand. A real brand, versus a fashion, can be refurbished from its tarnished state; however, the cost of customer acquisition can be very high.

The ricochet is rarely a “V”. Generally, there is gravitational pull on earnings recovery, and performance will not typically “bounce” back. We are shocked by the projection models we encounter that imply a rapid return to desired performance in a very short period of time. Many of these are built by non-operators. In our experience, it is more precise to anticipate a “U” shaped stabilization process...sometimes a long, flat “U”.

Have you found Radar O’Reilly? Frequently, troubled middle-market companies feature a crackerjack “company clerk” who is somewhat subordinated in the hierarchy, yet possesses revealing and reliable information apropos to the situation. If possible, seek out these focal employees who are generally obliging to the new investors with their surreptitious knowledge. You might find this is the best due diligence.

Don’t skimp on investment insurance. This is not a recommendation to hedge in the traditional sense. This is a recommendation to “pay-up” for a proper Viability Assessment and Turnaround Plan developed by experts. Unfortunately, this should be axiomatic...but it is not. Experienced distressed investors conduct due diligence that is as much focused on identifying opportunities as it is on risks and rely on these tools.

A lifeless marionette needs a puppeteer. Unless the objective is traditional securities trading, we believe longer-term distressed private equity investing is best done through controlling interests. When transforming a troubled company, control of economics and governorship is a powerful catalyst—it is the steel hand sheathed in a velvet glove...the very hand that holds the puppet strings.

External debate...Leader or Expert? When selecting the distressed company CEO, factor in EQ as much as IQ. Troubled companies often have demoralized cultures that would benefit from a great communicator and motivator. The real challenge is deciding between a proven leader with no direct sector experience and a less inspiring industry expert with superior technical skills. Ironically, more often than not, it was a “domain expert” who drove the company into its demise. This eternal debate pivots on several elements, including the company’s size, layers of bench strength, sales force, product position and operational health.

When “free” is expensive. Hurrah, we stole the company for only 2x! Not so fast. We are aware of a number of “low-multiple” on “positive EBITDA” deals that have liquidated. In the Kung Fu series, Master tutored Grasshopper that equilibrium occurs only when a fulcrum rests at center; and to this day, practical and no-nonsense martial arts senseis teach their students to avoid massive power imbalances imposed by enormous and formidable adversaries. This maxim is analogous to the dangers of power concentration in business, especially in troubled company
circumstances. In fact, it can be extremely difficult to tip the balance of power when small- and middle-market companies "win" business from titans. So, take heed when management cheers "hurrah, we landed Wal-Mart!"

**Get a coach, not a crony.** It can sometimes be a bad thing to have too many friends. In other words, too many sycophantic board cronies can weaken the company. Ironically, in many companies we see, "no board" would have been better than the complicit "bad board". You are buying a company that got into trouble. Just before it was legally bankrupt, it was financially bankrupt and just before that, it was managerially bankrupt. At precisely this precursor stage, there was a board of directors. In the world of troubled company investing, high-quality board composition and healthy dynamics are paramount. This is a time for unrelenting coaching, tempered by a milestones-driven, solutions-oriented, but empathetic board of experienced and committed directors.

**Reps and warranties leave you naked.** In traditional acquisitions, one of the most heavily negotiated portions of a purchase agreement is that covering representations and warranties of the seller. Well-drafted representations and warranties (backed by a strong indemnification clause and escrow) are a way for buyers to limit risk. In most transactions, a financially capable party will stand behind the representations and warranties. In distressed acquisitions, certain representations (e.g., that the seller is paying its debts as they become due) may be unavailable and typically no financially capable party will stand behind the representations. Hence, the buyer of a distressed company may have to accept that representations will provide little or no protection once the closing has taken place, placing tremendous importance on due diligence.

**Who ya gonna call?** Good lawyers can be Ghost Busters! It is not uncommon for a buyer to be haunted by specters of the seller's past. In a traditional acquisition, the buyer will receive protection because the liabilities may remain with the corporation in an asset sale, assumed by the buyer in a stock sale, satisfied with sale proceeds, or will be paid when due from the seller's remaining operations or assets. In a distressed acquisition, the buyer must evaluate the risk of being sued by the seller's creditors if the seller's liabilities remain unpaid, since creditors may seek to collect their debts under the doctrine of successor liability. Furthermore, the creditors (or even a subsequent bankruptcy trustee) may attack the sale as a fraudulent transfer. Moreover, the sale could be deemed a breach of fiduciary duty by the directors and officers. Because the legal risks can potentially be severe, the purchase may only be prudent through a bankruptcy or receivership process, and there can be significant benefits for the buyer in a bankruptcy purchase, including the reduction of legal risk. If you pursue an out-of-court purchase of a troubled company, you will need excellent and experienced legal counsel.

We have shared some tidbits gathered along our journey as both corporate performance experts and distressed private equity professionals. Certainly we have not accounted for the full catalog of tripwires and pit falls in the distressed investing jungle—such terrain is neither for the novice nor the fainthearted. Furthermore, when all things considered, there are no guarantees barring one: your financial model will fail clairvoyantly and will not predict the future with complete precision. Even so, when invited to improve performance, turnaround professionals time and again discover recurring problems, many of which are inveterate and checklist worthy. In other words, alternative perspectives and due diligence techniques may have identified these problems.

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September 2009