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Fixer-Uppers: Rebuilding Company Value To Prepare For Sale

By John M. Collard

Valuing a company is the easy part; creating that value in the first place so you can measure it is a more formidable task.

It can be done, however.

Take a $59-million systems integration and networking firm serving the federal government. The owner of the company, which had 660 employees, wouldn't delegate any responsibilities. The firm had a 42% turnover rate, hadn't won a major contract in four years, was losing money and had no cash.

Some strategic recommendations included:

- Build management and business development teams to operate in new competitive commercial and international marketplace.
- Increase sales-win rates.
- Reposition company in new areas to get greater value for the owners.

The outcome: The firm started winning competitive bids. Following realistic growth expectations of $120 million in five years, with 40% to come from commercial market, the company was sold.

Investing in under-performers and rebuilding value 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.

To do this, you must:

- Ascertain if a company can be turned around.
- Know how to fix the problems.
- Avoid paying down debt in lieu spending on growth.
- Obtain at the right price.
- Manage the turnaround.
- Sell at increased value.

This is simply stated yet tricky to implement. There is a process to provide positive results. This niche market allows investors to capitalize on initial positive results, which may 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 and guiding board with a sound strategy and a return-on-equity goal in mind can be a powerful motivator.

The key to returns from investing in underperformers 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.

Provide what future buyers look for:

- Consistency of business 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 or a portfolio property gone bad, the recovery cycle is much the same. This cycle starts with a mismanaged slide into trouble, determination of viability and investment, renewing the entity's health, and ultimately selling 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 in 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 guidance 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 alone, 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. New leadership is a key.

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.

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 the 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 new 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 — you manage "change control."

This leadership must get directly involved in making decisions to achieve the ultimate goal — sale at increased valuation. They must be held accountable for performance and timely results. Most importantly, they 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?

Install CEO or board with experience in value-building situations. Demonstrated 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.

The final step to complete the turn is to hire a marquee manager to lead the enduring team. This permanent team adds to 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 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 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 direction into concrete goals and objectives and create a guide for everyone to follow. Rebuilding momentum is critical to success.

Build a 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 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 product to existing customers or sell existing product to new customers. Most under-performers have forgotten, or never had, the basics of marketing. 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, and improve your competitive position. Deliver only what customers are willing to pay for.

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

Processes define guidelines and expectations — watch 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. Recurring results stimulate value.

Nurture resources. Leverage all resources — people/facilities/advisors — to complete a turn. Set up an incentive structure for employees awarding only when they accomplish goals set forth in long-term strategy. A robust incentive structure shares the risk and if successful, all will gain. If not, you're not subsidizing poor performance. Your incentive for investing is returned 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." A great ROI comes when the turn is complete and the company is ready for the next tranche investment to fund growth. At this point there are new investors who will want to participate.

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