



Rebuilding a company's value to prepare it for sale, part 1: Finding a viable fixer-upper investment

By John M. Collard



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.

You must:

- Ascertain if a company is turnable
- Know how to fix the problems
- Avoid spending money on past sins
- Obtain the right price
- Manage the turnaround
- Sell at increased value.

This is easy to say, 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 may have become stalled investments. Seek enterprises with a critical capital shortage, but 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 can be a powerful motivator in the hands of a leader and a guiding board with a sound strategy and a return-on equity goal in mind.

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, which means concentrating on exit strategies from the start. You'll want to build what future buyers look for:

- Consistency of business that create value
- High probability of future cash flows
- Marketing-oriented management team
- Track record demonstrating the 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 polishing 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.

Determine the viability of a turnaround

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 slide into trouble due to mismanagement. 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 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 make this mistake.

Determine turnaround viability by truly understanding the two or three things that are causing the company's 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." New leadership guidance is always needed 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 is 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 invest-

ment. 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 under-performer 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 whether it's salvageable or whether it's a candidate for sale or liquidation. When the company is 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, and they are ill-equipped to do so. This certainly leads to opportunity for those who do have the skills to run a company.

Investors with senior operating leadership experience in their background can provide substantial value. 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.

Ultimately, successful investors recognize that small growth in revenues can yield a lot of returns on invested equity. Revenue in excess of controlled, fixed costs drops substantial incremental profits — i.e. cash — to the bottom line, which in turn drives valuation.

Watch for part 2 of this series, where we will discuss the process of recovery, rebuilding the company, and when to exit to achieve the best returns.

smart CEO



About the Author

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