



VIEWPOINT

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DISTRESSED COMPANIES: WHAT BUYERS & SELLERS NEED TO KNOW

By Jamie Grant

Despite an improving economy and broad-based growth, opportunities abound to acquire distressed companies in out-of-favor sectors such as automotive components and textiles, as well as industries that have suffered from the high cost of oil. As prices for well-performing companies spiral skyward due to stiff competition for the most attractive deals, hundreds of private equity firms and hedge funds are putting capital into distressed companies and distressed securities in search of better returns.

WHY THIS MATTERS:

- *The market for distressed companies is becoming more and more active, so knowing how this game is played is increasingly important for buyers and sellers.*
- *Timing is everything in the distressed market; you need to understand the impact of moving too fast or too slow, and how timing can be used to gain advantage in the process.*
- *No matter which side of the transaction you're on, you should be aware of the roadblocks that commonly get in the way of such deals.*

The distressed market is a new arena for many investors who historically paid little attention to "story deals" and turnarounds. For their counterparts on the sell-side, being distressed is usually a new experience as well. Being faced with the prospect of selling a business into which they've invested their time, energy and financial welfare is stressful enough without being pushed into the process by creditors.

To get a better handle on who is playing in this market and what strategies are being pursued, Mirus Capital Advisors surveyed over 150 private equity firms and hedge funds in May 2006. In this article, we present key lessons on buying and selling distressed securities, as well as some interesting observations from our survey.

TAKE-AWAYS FOR BUYERS

- Hire **competent, experienced advisors**. First step: insolvency counsel. Distressed companies typically follow a playbook well known to work-out specialists, bankruptcy attorneys and their ilk, but completely foreign to even the most experienced M&A attorney. Other key advisors include a turnaround professional or investment banker with experience in acquiring distressed companies. Distressed assets, equity or debt can be acquired in myriad ways, each with advantages and disadvantages for the buyer, the seller, and their creditors. The better you understand the individual motivations of the constituencies, the more likely you are to succeed.
- The **early bird gets the worm**. Buyers who move aggressively in distressed situations can gain significant advantage. If your intention is to treat distressed situations like a typical acquisition process (complete with exclusivity periods and detailed due diligence), your efforts will be frustrated by more agile buyers who are willing to accept more risk.
- Leave **no stone unturned**. Sometimes the best deals are the hairiest. Don't be afraid of getting your hands dirty. That \$200 million business that's burning a million per month might actually conceal a profitable subsidiary somewhere on the balance sheet.

TAKE-AWAYS FOR SELLERS

- The **first step towards getting out of a hole is to stop digging**. Ergo, something needs to change about the way you are doing business. We often find that restrictive loan covenants cause businesses to continue to operate unprofitable lines of business in order to avoid a covenant default, or avoid layoffs. When these practices endanger the future prospects of the business, they need to be stopped.
- Once **again, hire experienced advisors**. Sure, when your business is burning cash, you probably think the last thing you need is to shell out another \$10,000 per week for a turnaround professional. You're wrong. A good turnaround professional will often slow or stop the bleeding within a week or two, and will become the lightning rod for your angry vendors, creditors and employees. Let them do their job so you can do your job – and focus on revenues.
- Recognize **that selling is just one of many ways to restructure a business**. As noted above, each restructuring alternative comes with advantages and disadvantages for the business and its creditors. The better you understand the individual motivations of the

KEY RESULTS OF MIRUS SURVEY ON DISTRESSED MARKET ACTIVITY

- 75% of respondents have participated in an auction for a distressed security in the past 12 months. Of those who have been active, over 50% have bid on at least five opportunities in the past 12 months.
- Of these transactions, 37% were resolved out of court, 40% went through bankruptcy court, and 15% were resolved through Article 9 proceedings or foreclosures.
- 70% of respondents expect that the distressed companies they've invested in will have a liquidity event in the next 24 months. 55% expect to liquidate a business, and 65% expect to assume control and improve a distressed company for future sale. (Percentages add up to more than 100% because many surveyed have invested in multiple companies and have differing expectations for these businesses.)

constituencies, the more likely you are to successfully resolve the crisis.

- Be decisive. Don't wait for a crisis situation to improve before taking action. Keep in mind that every business has multiple constituencies to serve. Employees are important, shareholders and customers are important, but so are lenders and vendors.

EXPERIENCE IS CRUCIAL

From our survey we gleaned that the path to getting an individual transaction closed depends on the unique circumstances of the distressed company involved. In fact, although 82% of respondents stated that their most successful opportunities come out of bankruptcy restructuring, not a single firm stated that going through the bankruptcy court was their preferred acquisition mode. In fact, "running a company through bankruptcy" is expensive, and over 90% of firms we surveyed said their preferred deal structure depends entirely on the situation.

So what is the road map that connects situations with solutions? Unfortunately, there is none. That's why it is crucial to have experienced advisors who understand the conflicting and often contentious interests of the company's creditor constituencies, and who can advise management on the most prudent course of action.

HARE 1, TORTOISE 0

In Mirus' extensive experience in working in the distressed market, one of the biggest determinants of success we've identified among buyers is a willingness to complete a transaction without having all the facts in hand, i.e., a willingness to take on more risk. For distressed businesses, the clock is ticking, especially if they've already entered bankruptcy. Buyers who feel compelled to have all the boxes checked off their list prior to close will typically lose out in competitive situations. In fact it is not uncommon for sellers to accept a lower price from a buyer that can provide a higher degree of confidence that the deal will close. We recommend determining how much risk you're able to tolerate and how fast you're going to be able to drive the process before you even enter this market.

Michael Epstein, a principal in the Boston office of TRG, a firm that provides turnaround management and restructuring services for mid-to-large cap businesses, agrees that speed often wins out over money in the distressed market. "In the turnaround world, I place a lot of value on speed and certainty of closing," he said. "For distressed companies, time is often more important than obtaining the last dollar. It's easy for a board of directors to put two offers next to one another and determine which one has the most dollar value, but you always have to be cognizant of whether that dollar value can be achieved. That's a function of the buyer's credibility and reputation. You also want to determine if, once they're selected, they will draw out the process to gain price concessions. In the end, the valuable buyer is the one that is capable of concluding the purchase despite negative issues that arise during due diligence...not the one who has made the highest bid."

HOW MUCH IS THAT HAIRY DEAL IN THE WINDOW?

Often times potential buyers are so focused on bottom line earnings that they fail to see the huge diamond in the middle of the scrap heap. If a business has four failing units and one growing unit, a successful sale of the growing business may yield enough cash to pay off all the creditors. So when investors do their situation-by-situation evaluations of distressed businesses, how do they discern the ones with hidden potential from the ones that are too risky to touch?

"For us, it's got to be a value buy," Ben Procter, a partner at Watermill Group, a private strategic investment firm in Waltham, MA, says. "The multiple of cash flow has to be low enough to be attractive relative to the company's prospective opportunity. We want to understand where we could add value, what is holding the company back from becoming a better company, and what can we bring to the equation that can help the company get over that

hump. For example, maybe we have specific industry knowledge or maybe we have relationships that will open up new opportunities for the business. Fifty percent of the opportunity is in how you buy the company, and 50% is in what you can then do with it.

"Companies that are under-performing need a lot of TLC, so you have to have a lot of skills and experience in these kinds of situations to be able to help these businesses," Procter added. "You can't have a traditional private equity perspective on managing a business in this market. You have to be much more oriented towards helping a company both through operations and strategy rather than the traditional approach of investing capital and active monitoring."

Michael Epstein seconds Procter's advice about how deals in the distressed market differ from typical private equity deals. "It's important to recognize that the immediate issues that face troubled companies are not first and foremost issues of strategy," Epstein said. "They are issues of tactics. Typical private equity investors are extremely well versed in managing through strategic issues that face a company, but their experience is less suited for the tactical and operational issues that often face a company in a financial crisis.

"The most obvious issue to focus on up front is the company's top management and their responsibility for bringing the company into a distressed situation," Epstein added. "Look at whether the downturn is so recent that management hasn't had time to affect a turnaround or perhaps hasn't had investor support to affect a turnaround. Determine whether they may be capable of doing the job with your guidance. Also, always allow for the unexpected because when a company is in financial difficulty, all surprises are negative surprises. Allow sufficient capacity for the unexpected to occur."

STOP DIGGING

Things look different—much different—from the seller's side in the distressed market, of course. As Doug Rosner, a partner with Goulston & Storrs in Boston, who specializes in bankruptcy, notes, sometimes management is in denial of the company's true situation, which can lead to mistakes in both operating the business and in working with potential buyers.

"In mid-market companies, it's not unusual to have management teams who haven't been down this road before," Rosner said. "They're often not willing to listen to advisors and they're not willing to let go, particularly if it's a family-owned company that's been around for generations. They have heard that there is a lot of capital available out there, and often they have been courted by lenders and private equity firms for years. They think they can

	COMPANY X	COMPANY Y
AT TIME OF SALE		
Revenues	\$24.7 Million	\$21.5 Million
EBITDA	\$5.9 Million	\$1.0 Million
Senior Debt	\$17.0 Million	\$16.0 Million
AT TIME OF INITIAL DEBT FINANCING		
Revenues	\$30.0 Million	\$45.0 Million
EBITDA	\$7.1 Million	\$7.0 Million
Senior Debt	\$28.0 Million	\$28.0 Million
OUTCOME		
Total Liabilities at time of sale	\$22.0 Million	\$26.0 Million
Insolvent?	Yes	Yes
Bankruptcy Sale?	NO	Yes
Sale Price	\$24.0 Million	\$29.9 Million

TIME IS MONEY

In 2005 Mirus represented two distressed companies with similar attributes, but the outcomes were quite different, and it all came down to timing.

Company X was a manufacturing firm with a significant market share in a niche market that was not growing. Company Y was a professional services firm in a rapidly growing industry sector.

Despite the fact that the total debt in each case was in excess of \$20 million, and both companies were sold for more than the total liabilities, Company X was able to sell to outside of bankruptcy but Company Y was not.

Why did one company have to go the expensive route of filing for bankruptcy while the other did not? Too many creditors and too little time.

Company X's lender was more aggressive, and therefore the business was still generating significant free cash flow at the time of the default. They hired an investment bank and started the sale process approximately six months before the company would be insolvent. In contrast, Company Y waited longer to decide to sell, and was just 60 days away from insolvency when they retained an investment bank. By being proactive, Company X gave itself more time to work with creditors on a plan to sell the business and avoid bankruptcy. In contrast, Company Y didn't have time to negotiate a settlement with creditors. They were forced to file for bankruptcy so the court would compel a settlement and enable the sale to occur.

recapitalize their way out of the problem, forgetting that the root cause of the problem may be a broken business model. Contrast management's desire to remain in control and retain a meaningful ownership interest with that of most buyers who don't want to buy a minority stake in a troubled company; they want to buy [a controlling interest in] the company and maybe keep some of the existing management and give them a few percentage points of the equity. Not an easy sell."

Ben Procter advises sellers to make sure they hire an investment bank that will know how to tell the company's story. "You want an investment banker that does their homework and due diligence well enough to really

understand what a potential buyer's opinion of the business is going to be," he said.

LOOKING AHEAD

With bank financing more available than ever, many of the highly leveraged companies of today will become the insolvent companies of 2007, 2008 and 2009. This will create openings for investors who are skilled at getting value out of distressed companies. With many market researchers predicting that the next three years will offer many of such opportunities, it will be important to keep abreast of activity in the distressed market and be ready with experienced advisors to assist you in your efforts.

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