Viewpoint

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Investment-Banking Challenges In The Lower Middle Market

By Michael J. Gorman

The sale of a company through a Chapter 11 bankruptcy process is a personally stressful and emotionally taxing time for any management team to experience. The stress is heightened for a lower middle-market debtor because usually the debtor is a closely held, family owned company that still has multi-generational involvement in day-to-day business operations. The various stakeholders—involved lenders, independent board members and third-party professionals—can create a situation in which the debtor's owner feels isolated in the process as the business is scrutinized and subjected to the rigors of a bankruptcy process. The debtor's investment banker has the responsibility to conduct a sale process that creates maximum value for all stakeholders. However, when working with a lower middle-market debtor, the investment banker's role often blurs the line between financial adviser, part-time and unofficial member of the senior management team, confidant and psychologist.

The investment banker's role in structuring the sale and advising a lower middle-market debtor is nearly identical to the role played when working with debtors in the upper middle and large-cap markets. Principally, the investment banker is responsible for structuring the sale process, including developing offering materials, conducting the marketing effort, helping to negotiate the asset purchase agreement (APA), securing a stalking-horse bidder, conducting the re-marketing process and running the auction.

One of the consistent themes of conducting any successful sale process is that open lines of communication, even over communication, are maintained throughout the process. This takes on paramount importance with a lower middle-market debtor because often there are not additional professionals involved in the process on a daily basis and the investment banker must ensure he is in constant contact with all stakeholders so that they are aware of the process dynamics. Throughout the process, the investment banker should provide regular updates to all key stakeholders so that they are aware of market feedback, valuation and potential auction participation.

The investment banker should clearly communicate the dynamics of the process and responsibilities expected to the debtor's senior management team. Ensuring that the debtor's management team understands the competing nature of various stakeholders, for example, secured creditors and unsecured creditors, and how those competing interests play against the interest of the equity holders should help structure sound, constructive interactions among all stakeholders and lay the groundwork for crafting a fair APA with regard to releases, indemnification provisions and other points of negotiation that an out- of-the-money equity holder should focus on given the pressures exerted by the other stakeholders to maximize value. Also, the investment banker should work with the management team to develop a script that the management team can deliver to its employee base. A script will help disseminate the appropriate information to employees and should help alleviate concerns about the goals and objectives of the process.

It is critically important that the investment banker clearly defines to all stakeholders the highlights and challenges involved in presenting the debtor for sale to the market. Lower middle-market companies are often challenging to sell due to a lack of dominant market share for their respective industries, need for additional capital investment and potentially a thin management team; these issues are by no means unique to the lower middle-market, but they become heightened in most cases. For example, a debtor with revenues under $150 million that generates little or no Ebitda may trade at only a premium to its liquidation value. Even if a debtor is performing well in a relative sense (i.e. an overleveraged debtor performing fairly well operationally and financially), it will most likely trade several multiples below standard market multiples for upper-middle and large-cap debtors. It is imperative that the investment banker properly communicates the appropriate challenges to key stakeholders so that expectations are managed accordingly and all stakeholders can appropriately plan for the sale process. Conversely, the investment banker must bring to the market the various highlights a lower middle-market debtor offers to

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potential buyers. These reasons can range from niche product offerings to regional location advantages to complementary business line additions.

Once the post-petition bankruptcy process begins, the investment banker's role usually expands when working with a lower middle-market debtor. An investment banker often performs supplementary tasks since lower middle-market debtors may not have as robust a management team compared to middle and large-cap counterparts. Those tasks may include helping to prepare APA schedules, assisting in the development and updating of cash flow projections, preparing due diligence documentation for review by potential buyers review and preparation of a key employee incentive plan (KEIP).

An investment banker should be a strong advocate for management in the negotiation of the KEIP. If a debtor was compelled to file by a secured or unsecured creditor, there can be an air of hostility between the debtor's senior management and the stakeholder who forced the filing. It is therefore essential that the investment banker acts as a dispassionate adviser and communicates the appropriate message to the debtor's owner with regard to its fiduciary duties; the value of certain key managers is crucial to maintain uninterrupted operations. If a lower middle-market debtor does not have management contracts in place with its key senior managers, the specter of what is to become of their jobs can become an all-encompassing concern and stifle the process. Therefore, ensuring these key personnel are taken care of post-closing will help the sale process run smoothly.

The challenges of conducting a sale process for a lower middle-market debtor are not foreign to those encountered by its larger counterparts. However, the additional roles often undertaken in a lower middle-market case demand an investment banker with the flexibility and experience in this space to help ensure a successful outcome. If an investment banker develops a good rapport with management, effectively communicates the process dynamics across the stakeholder spectrum and is willing to go "outside the job description" to ensure the process gets completed, it can lead to a productive outcome in which all stakeholders benefit.

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