Buyouts
The newsletter for management buyouts, leveraged acquisitions and special situations
Published by Venture Economics, a Thomson Financial Company
Vol. 16, No. 6 • March 17, 2003

Preventive Maintenance by Private Equity Funds Can Provide More Options When Portfolio Companies Fall Short - By Mark E. Chesen, President, SSG Capital Advisors

It is not unusual for private equity funds to wait too long to hire turnaround specialists and investment bankers to address the needs of a distressed portfolio company. By procrastinating, a fund may significantly narrow its options to save an ailing company and/or extract the maximum possible value from it.

When the private equity bubble of the 1990s burst in early 2000, it became painfully apparent that the high valuations of many portfolio companies were based on unrealistic assumptions, and that these companies, going forward, would be unable to meet revenue and earnings expectations. As a result, many private equity funds were compelled to address a relatively large number of distressed situations.

The market decline, economic slowdown, and contraction in liquidity in 2000-2002 created an extremely problematic environment to "rescue" or "salvage" challenged companies. However, a further reason why many of these efforts met with minimal success is that private equity funds often relied upon internal staff, who possessed strong financial backgrounds, but had little or no hands-on experience with turnaround situations.

Furthermore, certain private equity funds opted to wait for an economic rebound or a dramatic (if unlikely) sales or product event that would rescue the portfolio company. Unfortunately, this strategy had an extremely low rate of success, and increased the probability that the value of a portfolio company would continue to deteriorate.

Identifying and Addressing the Core Problems
To increase the chances of turning around or extracting value from a troubled portfolio company, private equity firms should closely monitor a set of leading indicators that gauge when a company begins to experience financial problems. These include the inability to meet budget; stretched account receivables; being out of compliance with bond covenants; over-extended positions with banks and lenders; suppliers refusing to ship on an openterm basis; and/or sudden departure of an intregal manager.

The emergence of one or more of these signs is often an early warning to PE funds that some form of intervention is warranted, before a heretofore manageable problem grows and triggers further problems. At this point, it may be prudent for a private equity fund to quickly retain a turnaround and/or crisis management consultant and an investment bank. At a minimum, these professionals can identify the specific core challenges and the most appropriate solutions from an operational standpoint, before the portfolio company's condition worsens.

The in-place management team of a distressed portfolio company may resent or resist the use of outside specialists. However, the private equity fund should bear in mind that if the current managers had the know-how and the capabilities to successfully turn the company around, they would have already taken appropriate action.

The Need to Work Closely with Creditors
By avoiding or delaying the engagement of a turnaround specialist and an investment banker, the fund increases the chances that the portfolio company's bankers or other creditors will take this step unilaterally. If creditors lose confidence in the fund's ability and/or inclination to take prompt, corrective action, the fund and portfolio company may be given little or no choice in the selection of outside professionals. It is therefore advisable to have a rational dialogue with the creditor group as soon as possible to assess a distressed situation.

A common mistake is to regard the creditors as adversaries. The private equity fund should treat the bank and other senior creditors as partners and cooperate with them to find the most viable strategies to save the company and protect its stakeholders. The worst course of action for a fund is to conceal from creditors that a portfolio company is in financial trouble, or to block attempts by creditors to influence the solution.

Some private equity funds may instinctively shy away from keeping creditors well-informed, because they assume that the financial lenders will expect the fund to automatically commit capital to the distressed company in question. That is rarely the case. However, creditors justifiably demand to be immediately informed when a company is experiencing significant problems, to be provided with timely updates, and to see a plan of action that seeks to protect senior lenders and/or bondholders.

When a portfolio company becomes financially vulnerable, the role of a private equity fund changes from being a mere investor to being a fiduciary, whose primary responsibility is to maximize recovery for all stakeholders. These include secured lenders, unsecured creditors, customers, employees/unions, landlords, and government agencies such as EPA, the Department of Labor and ERISA-related agencies.

Five Strategic Alternatives

In general, private equity funds can consider five strategic alternatives to address the challenges of a distressed portfolio company. Two of these alternatives (#1 and #5 below) are essentially counter-productive. The other three can help to limit financial hemorrhaging and perhaps even position all or some of the segments of the company for future growth.

1. The private equity fund can wait and hope that the economy will rebound or that a special event (a contract with a major buyer, a competitor that leaves the business, a breakthrough product, etc.) will save the day. More often than not, this strategy is wishful thinking.
2. The fund can prompt management to restructure the balance sheet. This may entail renegotiation of the existing senior and subordinated credit facilities, restructuring of unsecured creditor obligations, restructuring equity tranches that will facilitate a turnaround and long-term recovery, reorganization of the equity base, and/or renegotiation of union contracts. A wellconceived restructuring can "buy" considerable time.
3. The fund can encourage management to sell the company in its entirety or by division, in order to maximize value to all concerned. This can save jobs and ensure that viable, existing products and products in development do not disappear without an opportunity to find a market and generate revenues.
4. The ailing portfolio company can also attempt to attract new financing. Once the company has determined the level of debt that can be privately placed and properly serviced, it can look for a minority equity infusion from strategic investors or others. In this situation, the private equity fund and the company's senior management may have to be prepared to sacrifice a significant amount of ownership.
5. In the end, total liquidation may be the sole course of possible action. This is the worst outcome for all parties.

An Example of Action Taken Promptly

Chadmoore Wireless Group Inc., (Nasdaq: MOOR), a publicly traded company and the country's largest holder of specialized mobile radio licenses, sought to fund its negative cash flow. However, its major shareholder, a substantial US-based private equity fund, made the strategic decision not to infuse additional capital into Chadmoore. Chadmoore immediately sought the assistance of investment bankers to explore all strategic alternatives, including senior debt refinancing, equity infusion, a merger partner or a sale to a strategic acquirer.

The investment bankers identified Nextel Communications Inc. (Nasdaq: NXTL) as the most suitable counterpart for a solution. Nextel initially provided bridge financing and subsequently acquired Chadmoore for $130 million, which represented a substantial premium over Chadmoore's market value prior to the acquisition announcement.

At the time that Chadmoore signed the definitive agreement with Nextel, the company was out of cash, and was hemorrhaging more than $2 million of negative cash flow per month. The Nextel transaction provided substantial value to the Chadmoore stakeholders, in excess of the $28 million of Chadmoore's secured debt. If Chadmoore had waited to retain an investment banker, six months later the telecom industry would have been in the middle of a severe downturn, and Nextel would not have been in a position to proceed with the Chadmoore acquisition. At that point, in all likelihood, Chadmoore would have had to seek bankruptcy court protection from its creditors.

An Example of Delayed Action

A small manufacturer (name withheld) of components for the technology industry was caught completely off-guard by the severity of the 2001 slowdown in their industry. Like its competitors, the firm had assumed significant debt to expand manufacturing capacity to meet unrealistic demand expectations.

By the end of 2001, sales had deteriorated severely. Combined with the cash constraints resulting from the expenditure on a new manufacturing facility, this left the company with little choice but to file for protection under Chapter 11 of the U.S. Bankruptcy Code in early 2002.

Even after filing for bankruptcy, the company's management and the private equity fund that was its major investor were slow to assess its alternatives and retain professional guidance. When the fund and its portfolio company finally sought the assistance of investment bankers, the only viable alternative was to sell the company in order to obtain maximum value for secured creditors.

If the company and the private equity fund had explored alternatives in mid-2001, when it was clear that the telecom industry had far too much unused capacity and would not make a rapid recovery, it is possible that a company-saving restructuring or refinancing could have been implemented.

Conclusion

By immediately responding to a portfolio company's early distress signs, private equity funds can consider a range of "rescue and salvage" strategies, and significantly increase the likelihood of extracting maximum value from an ailing company.