Arthur D Little

Private Equity

The Accidental Distressed Investor

Effecting a Positive Outcome in a Challenging Economic Environment

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Management Summary

As the credit and economic crisis deepens, many investors are suddenly finding themselves in possession of assets or portfolio companies that are closing in on default scenarios. Managerial under-performance and over-leveraged balance sheets coupled with the economic downturn now pose significant pressure on cash flows, making debt service an issue for even reasonably healthy businesses. Furthermore, spikes in commodity prices for raw materials and cash poor customers have created a working capital strain that is impacting operations. Companies are now significantly overleveraged by virtue of reduced cash flows to service debt.

Even senior secured lenders are finding themselves in increasingly impaired situations relative to the liquidation values of their investments. This places greater pressure on subordinated investors and equity holders to lead the rightsizing of balance sheets and the preservation of capital to generate long-term value. These subordinated debt holders did not seek to invest in distressed assets and find themselves unexpectedly holding a stake in a non-performing asset. In order to influence change and recoup their investment, they often need to alter their positioning in the capital structure such that they get an equity participation to gain influence and share in the upside of the restructured entity.

Whereas private equity owners are typically well versed in active portfolio company management and should utilize their skills in financial or operational turnarounds to preserve their interests, mezzanine lenders are often unprepared for this task. Given the current economic environment these subordinated participants will need to acclimate themselves to taking a more active role in the restructuring of their investments. This requires a shift in mindset and a willingness to extend the holding period of the investment. This paper seeks to provide a playbook for such investors to de-lever their investments and rebuild the underlying businesses under different capital structures.

De-levering Your Investment

1. Understand the Levels of Exposure in the Capital Structure

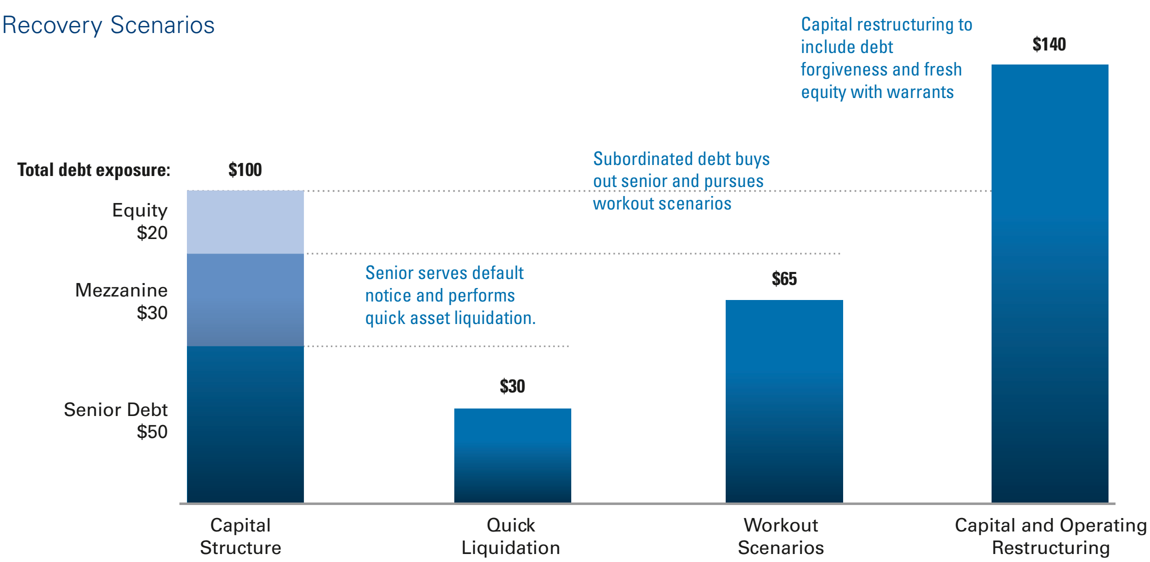
In a near default scenario, it is crucial to immediately understand to what extent the investment is impaired and to evaluate the potential downside. Depending on where the investor sits in the redemption hierarchy, a subordinated investor may not see a dime in recovery as senior shareholders act to optimize the speed and amount of recovery they can receive in a quick liquidation process.

A senior lender primarily looks at downside risk and execution cost of a liquidation. Typically, the senior will first approach the subordinated investors soliciting a buy-out out based on the subordinated investor's motivation to workout a total recovery beyond the current face value. However, senior lenders are willing to accept a below-par recovery and do not necessarily have the complete information to evaluate the level of recovery acceptable in the distressed liquidation, particularly in this economic environment. This puts tremendous pressure on equity and subordinated debt investors facing a complete write-off of their investments.

It is incumbent on the subordinated investor to provide a convincing case to the senior debt holders in order to maximize recovery potential. In the event that the senior and the subordinated cannot agree on valuation, the risk exists that the senior will sell their investment to a distressed investor who will likely aggressively drive a restructuring that will be prejudicial to the subordinated investors.

An equity investor with an information advantage views the investment with greater clarity in weighing the downside risk against the upside potential. The subordinated investor should consider the fundamental prospects of the company in the short term (to facilitate a refinancing) and long term (to participate in upside) and create an optimal total recovery plan. Although many subordinated debt lenders are not comfortable taking an active or control role in distressed investments, today's environment of widespread defaults, bankruptcies and write-downs necessitates flexible debt restructuring and often equity conversion (exhibit 1).

Exhibit 1: Recovery Scenarios



Source: Arthur D. Little

2. Understand the Underlying Business Model and Market Dynamics

Prior to taking management action, the subordinated investor must understand the operations of the company and the surrounding market dynamics. In particular the analysis should include:

A. Industry Dynamics: This analysis should focus on understanding how the industry functions and how the company creates value within its industry. The lender should seek to understand why the company is in this financial predicament. A thorough analysis of the competitive landscape and industry trends will help to validate the feasibility of long-term survival. This will prevent the lender from throwing good money after bad and recapitalizing a company which has an unattractive market position and limited upside potential.

B. Root Causes of Historical Under-performance: A clear understanding of the cause of top line and cost miscues is critical in assessing whether the situation can be remedied and what actions are required to do so. If pure mismanagement is the culprit, managerial changes may be sufficient. If the downturn in the market is the primary reason, then an assessment of the further downturn and breakeven drivers must be established (e.g., minimum units sold, cost pass-throughs, collections, etc.). If the root causes of failures cannot be identified or are beyond a company's control, it is almost impossible to implement effective improvements.

C. Validation of Company Capabilities: A quick assessment of the company similar to a buy-side due diligence of the capabilities and operations of the company is also essential in the process of forming an investment thesis. During the process of evaluating the company, the lenders should also reach a consensus on the strength of the management team.

D. Identification of Value Creation Levers and Exit Strategies: In the absence of value creation opportunities and a path to an eventual investment exit, there is little reason to recapitalize a struggling company. Identifying value creation opportunities in a struggling company is not difficult a priori; often, glaring weaknesses are the most obvious opportunities to create value. However, it is not sufficient to merely identify the value creation levers. They must be validated and a realistic action plan must be agreed upon prior to the investment. A thorough plan takes into account the realistic timeframe and investment that must be undertaken to realize these opportunities. Achievement milestones and metrics must be agreed upon with management and included in restructuring terms. Through this method, the rollout of value creation initiatives can build up to an eventual profitable exit from the investment (exhibit 2).

Exhibit 2

	REGAIN DEBT SERVICE	REALIZE VALUE CREATION OPPORTUNITIES	PREPARE FOR INVESTMENT EXIT
TIMEFRAME	1 week – 6 months	6 – 9 months	1 – 3 years
GOALS	Control costs, assess value of company	Achieve target cost reduction through lean manufacturing and process flow improvement	While continuing profitable growth, attract potential buyers
MEANS	Identify root cause of problems & initiate selective operational opportunities Revise projections with downside and upside	Expand operational improvements with milestone financial & operational goals Capital infusion to secure asset productivity	Continued attention to cost control & sales growth Exploration of market opportunities to leverage for future sale
OPPORTUNITY	Restructure to optimal cost structure, align incentives	Optimize operational and management efficiencies	Create efficient capital structure & upside potential for exit

Source: Arthur D. Little

3. Develop Restructuring Options

The third step in evaluating a recovery strategy is to create details around restructuring schemas that address the root causes of the distress, changes to capital structure, downside risks and upside potential. Discussion with the senior lenders and the equity owners should center on:

A. Alignment of incentives: Ultimately, management needs investors that understand the business dynamic and the need for a new capital structure with the flexibility to meet changing working capital needs and provide additional capital based on potential episodes of cash shortfalls or operational improvement needs. Management and investors have to believe that cash flow scenarios in the turnaround period are realistic and meaningful to create value and to avoid "throwing good money after bad."

   The investors should align the incentive structure of the organization going forward. In order to do this, allowing management to co-invest is essential. The extent to which management is willing to inject fresh equity should be taken as a signal of their inherent faith in the company – which is one of the best measures of business viability.

B. Debt Reduction and Capital Infusion: Based on the revised valuation and outlook of the company through a deeper analysis of finance and operations, the investors may find that changing the capital structure of the company requires some or all of the investors moving to a risk profile outside of their typical investment thesis or skill sets.

   If the subordinated investor is not comfortable taking a control position in the company or forgiving a significant part of the debt – then the avenue to refinance at a discount with an investor class more comfortable with the restructuring efforts is required.

   Ultimately, the company will need to return to a debt level more inline with direct peer companies and peers with similar business and market dynamics. The recapitalization must consider the short term cash burn of the company needed to weather the turnaround as well as fresh capital needed to generate future value.

C. Speed of Restructuring: Beyond measuring risk and evaluating the internal rate of return or return on capital, the investor must consider the speed at which the restructuring needs to be executed. A protracted restructuring process creates further cash bleed and adds additional hurdles such as a potential credit hold from suppliers. Fixing the situation with a revised 13 week cash flow projection only buys the company 13 weeks before another potential cash raise if the company cannot stabilize in such a period of time. The implementation of a turnaround plan needs to be speedy and very pragmatic to create a sustainable positive cash flow situation. While there will be numerous obvious improvement projects, investment needs to be carefully scrutinized in the short term (one week to six months). Focus needs to be very selective to ensure short term positive cash flow impact before long term value creation projects are commenced.

D. Creating the Right Turnaround Partners: Evaluating the situation, executing a short term turnaround, and driving long term value require a variety of skill sets. However, in selecting any service professional it is important to coordinate the efforts to the immediate goal of evaluating the impairment of the company and developing restructured financial and operating options. Audit, forensic accountants, certified turnaround professionals, lean experts, cost cutting consultants, investment bankers, lawyers and bankruptcy trustees – all play a role in the potential turnaround. However, selection of turnaround partners should be decided depending on the needs to the situation. Most importantly, the financial sponsor should choose a professional services firm with a holistic view on value creation and value preservation.

Conclusion

The next several months promise to be trying times for investors in all parts of the capital structure. In particular, mezzanine and subordinated debt holders will find themselves compromised in their existing positions. In order to preserve value and participate in the upside of their investments, these lenders should be mindful to:

1. Use capital structure positioning to maximize the payout on invested capital
2. Conduct an assessment of the asset from a market and internal capabilities point of view in order to gauge the risk factors associated with participating on the equity upside
3. Quickly execute on a restructuring and turnaround plan to maximize exit valuation

The current economic climate does not support passive investment mentalities. Investors who normally would not exert active portfolio management are finding that they must change their approach in order to recover / maximize the payout of their investment. In the end, times of crisis are opportunities for true persistence to shine and diligent investors will use this environment to widen the gap between themselves and their competition.

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