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Tick Tock

Turnaround firms and distressed buyers are facing ever-shorter windows to salvage a company

By Chris O'Leary

IN JUNE, THE PRIVATE EQUITY FUND **MONOMOY CAPITAL Partners** purchased clothing retailer Missy Group, from Redcats, a unit of France's PPR SA. Renaming the unit the Women's Apparel Group, Monomoy is now busy turning around the underperforming unit to prepare it for an eventual sale. But to make the deal, Monomoy made an end run around the banking sector, funding the entire purchase by itself.

For Monomoy, that's no longer an unusual move in today's deteriorating economy. "We are in essence bridging the purchase of many of our companies now," says **Stephen Presser**, one of Monomoy's founders. "We're funding the entire purchase price, though we may re-finance the transaction after we close." Self-funding its acquisitions is in part strategic, he says. "If you can tell the seller they don't have to deal with any bank, you get a boost with them, and you often get a discount on the sale. There have been one too many private-equity buys in which the banks have pulled out at the last minute."

Up in the Pacific Northwest, the paper manufacturer Pope & Talbot can attest to the pain of a last-minute deal failure. In desperate financial shape (it filed for bankruptcy in October 2007), Pope & Talbot set about restructuring its operations and planned to sell off three of its paper mills. It received an offer from Indonesia's Sinar Mas Group, which put a deposit down on a proposed \$225 million purchase. At the last minute, however, Sinar Mas got cold feet and walked away. "Now we have to remarket the same properties, but

we're getting nowhere near the same offers," says **Bill Skelly**, co-chair of the lending and restructuring group at the law firm **Heenan Blaikie**, which is advising one of Pope & Talbot's creditors. For Pope & Talbot, the game is up—the firm converted to a Chapter 7 bankruptcy filing a few months ago and is now liquidating all its remaining assets.

In the world of turnaround management, in which specialist firms seek to stabilize distressed companies, often with the intention of readying the company for a future sale, players are learning to improvise at a moment's notice. The economic downturn experienced over the past 12 months is likely to worsen this year, with no relief in sight expected until possibly 2010, many turnaround specialists say. This increases opportunities (as more distressed companies become available) but also ratchets up the level of difficulty.

"There are a lot of turnarounds that have occurred over the past three years that really could not get done today," says **Margaret Good**, president of Pittsburgh-based **The Meridian Group**.

Bank financing, for one, has nearly dried up for corporate lend-



ing, let alone financing turnaround plans for distressed companies. “We’re working with companies that we could’ve financed at a drop of a hat 24 months ago, but there’s nowhere to take them today,” Good adds. “It’s much, much tougher.”

Turnaround specialists are also feeling the pinch in terms of time. As recently as mid-2007, distressed company owners and turnaround specialists typically would have six months to a year to get a company in shape. Now that window is compressing, as pressure is growing on stakeholders to liquidate a company rather than spend time and money attempting to stabilize it. And there is the “X” factor of inflation and commodity price increases, which can eat up any savings achieved by an improvement plan.

The result is a harsher, far more constrained world: while deals are still getting done, the turnaround process is more fraught with tension than ever before. The basic steps that a turnaround specialist takes to get a distressed company ready for sale remain fundamentally the same. The difference lies in the external factors: a harried secured lender, a nervous prospective buyer or simply a jolt in oil prices that can lay waste to months’ worth of turnaround plans.

A Race Against the Clock

Good, who, with her partner **Thomas Von Lehman**, won the Turnaround Management Association’s “turnaround of the year (mid-sized company)” in 2006 for her work rescuing Dearfoam Slippers, says that while she believes the Dearfoam turnaround would still be feasible in today’s environment, many other turnarounds would not be. One key difference is the lack of room for any hesitation, misstep or unforeseen problem.

One of the first things a turnaround artist needs is breathing room from creditors in order to do the restructuring work necessary to get a company stabilized. That time is no longer always there. “It typically takes six months to a year to get the right strategic fit for a company. But you’re not going to get that [window] in this market right now, as there is too much pressure on the banks to resolve situations more quickly,” she says.

Becky Roof, a managing director at restructuring and advisory firm **AlixPartners**, says one reason for the reduced timespan is that over the past few years, a number of companies had managed to get loans with very loose restrictions. For example, take the increased use of “covenant-lite” loans, in which borrowers have to do less routine reporting to their lenders. A number of credit agreements made in 2005 and early 2006 did not require borrowers to have Ebitda minimums or provide monthly leverage ratios to their creditors.

What has happened, unsurprisingly, is that under-performing companies aren’t aware of their deteriorating state until they reach a sudden crisis point. “Now, by the time a company realizes it is in trouble, it is also out of cash and out of options,” Roof says.

In light of this, turnaround pros stress that speed is crucial if a company is going to dig itself out of a bad situation. Whether it is reducing headcount, raising prices, or shuttering money-losing subsidiaries, struggling companies can’t afford to be indecisive.

“The key to a successful turnaround is that it is not tied to either the macro economic environment or the Wall Street credit cycle,” says **Michael Psaros**, co-founder and managing partner of **KPS Capital Partners**. “But if you’re going to attempt a turnaround, time is always of the essence... We would force the pace of change at a company irrespective of what’s going on in the economy or the credit markets. For these

companies, there is no tomorrow.”

Keep to the Basics

Psaros says the fundamentals of stabilizing a failing company remain the same regardless of the economy. A detailed analysis should identify its salable assets and its cost centers, then buyers need to stop the bleeding.

“We put our defense on the field first: that means we will not put our limited partners’ capital into a transaction unless, prior to closing, we have a concrete plan effective immediately that transforms a company’s cost structure to enable it to become a going concern,” Psaros says.

For KPS, its turnaround plans typically entail a strong push to reduce fixed costs (everything from shop floor redesigns to improving employee productivity) and an overhaul of the management team. “We’d never invest our LPs’ capital behind a management team that caused the original train wreck.”

Arthur Perkins, co-head of **Deloitte Financial Advisory Services’** Western Region Reorganization Services, and the 2008 president of the TMA, says that the first thing his firm looks at when undertaking a turnaround is to see how much liquidity the distressed company has left. “First we find out if we can get enough liquidity to get through the sale process. We look at all strategic initiatives.” Deloitte conducts a market analysis and profitability review simultaneously, and explores all potential scenarios—such as whether it makes more sense for shareholders to do a debt-for-equity swap rather than a sale.

Turnaround specialists add, however, that much of the game is to realize when the opportunities aren’t worth the risk. Over the past year, the weakest and most overleveraged companies in various business sectors have been those most likely to fail, and these companies typically aren’t turnaround material—they have more value being liquidated than in being rescued and sold off.

“In the past 12 months, we have been presented with a large body of opportunities that you just knew, after the first phone call, were companies that would end up liquidating or going away,” Psaros says. “We’ve also seen some companies acquired that just mystified me anyone would commit their capital to them.”

Companies with exposure to commodity prices are in a particular bind. In many cases, there is little chance of stabilizing such companies and readying them for sale if every month the fuel or raw material costs increase exponentially. KPS is avoiding prospects in the restaurant and retail sector, believing such industries are “pretty toxic, considering everything going on with the consumer,” Psaros says.

Monomoy, meanwhile, is steering clear of companies that cannot pass commodity price increases on to their customers. Presser, for example, cites molded plastics manufacturers, which are being pummeled by rising resin costs (30% to 40% increases over the past year). These businesses are especially hard to salvage if they are locked into long-term price contracts with wholesalers and other customers.

“You can fix their labor costs, you can improve the product mix, you can get \$10 million in savings, and then in the next month all of that could be eaten up by resin cost increases,” Presser says.

Tighter Pockets

In addition to rising costs and cratering customer bases, another factor hindering successful turnarounds and subsequent sales is a newly-conservative lending base. After the excesses of the mid-2000s, when many lenders were throwing money at any deal that

crossed their desks, the well-publicized woes of most Wall Street banks and the implosion of lenders like IndyMac have created a chastened, wary universe of lenders. One turnaround specialist said that a colleague recently was trying to place a \$115 million facility in a syndicated loan deal, and was rejected by 60 different lenders.

For one thing, it's become more difficult to get creditors out of a distressed company. Turnaround pros say that two years ago, a turnaround specialist could take over an ailing company and get it refinanced in 90 days or so, thus getting the original creditor out of the deal if they so desire. That is no longer guaranteed. "The lending market is so tight right now that often you don't have the opportunity to find another lender," one banker says. As a result, creditors are growing more eager to liquidate a company simply to get something back, rather than wait and hope for a turnaround shop to salvage the assets and sell the business. "Companies are having a harder time convincing banks to sit still and allow them to go down the strategic path and not be liquidated," Good says.

Add to the recipe the fact that many distressed or deteriorating companies are already buried in debt. "Part of the problem is that because of the recent liquidity glut many of these companies are over-leveraged," says Deloitte's Perkins. "Most of their debt is secured. That leaves them very little room in terms of unpledged assets to get financing to get them through a restructuring."

So turnaround specialists are now finding that lenders are unwilling to give them much in terms of new leverage, even for short-term improvements. "It used to be that a business had Ebitda of X

and they would get financing of say 4.5 times X. Now leverage is down to 3 or 3.5 times X," says AlixPartners' Roof. "Buyers have to put in more of their own money and resources as equity, so returns are not quite as high."

Skelly, who is the 2008 TMA chairman, says that he believes capital is still attainable, though far less for weakened companies looking to refinance. "It almost seems like it's more difficult to refinance an existing loan than to finance the acquisition of a distressed company," he says.

There also are distressed debt funds and other private equity funds that are looking to strike bargains with desperate companies. One turnaround pro has recently been negotiating with some private equity funds over a possible purchase of a stabilized, though weakened company. The funds calculated the firm's liquidation value, then offered \$2 million less. Such bargaining could weaken resolve among a firm's senior creditors—if the creditors hear they might only get liquidation value minus a few million, the creditors might be compelled to try to liquidate the company themselves.

Still, even amid such uncertainties, there remains a sense by turnaround specialists that good-if-underperforming companies are available. "We've been surprised at the breadth of opportunities in the market in just about every industry you can think of," says KPS' Psaros. Nor will the market close down any time soon. "I think we're about a year into this crisis, and I think it's going to last another two years or more." **MA**