

Investing in Distressed Businesses

We are constantly approached by parties seeking to invest in distressed businesses, be it by way of acquiring debt, equity or assets.

A large number of investors are experienced in their approach, others see the opportunity, but lack the experience in assessing value and separating the wood from the trees.

In this article we present some practical advice on selection criteria and pitfalls to guard against when considering an investment in a distressed business. It is not intended to be all inclusive, but more as a basis of gaining an understanding of a number of the key issues that should be considered.



A company under financial stress will incur costs related to its situation. In an effort to manage short-term obligations, profitable long-term projects may be passed up, supply chain management may deteriorate resulting in inventory disruption, discounts on payments to suppliers are missed, employee morale declines, good employees seek employment elsewhere, and productivity declines. The art in distressed investing is the ability to identify situations where the core business is basically intact and the operational problems can be reversed.

Reasons for investing in distressed businesses vary and include financial gain, synergy of business, vertical integration, niche or complementary offerings. However, the one common factor is that the investor expects a bargain.

The growth of private equity, which has permeated all levels of the market, has added complexity, sophistication and strong competition for value propositions in the distressed market. This adds to the pressure in terms of both acquisition cost and timelines to consummate a transaction.

There are two principle rules that one should keep in mind when considering a distressed investment:

1. In general the return on a debt acquisition or highly leveraged equity acquisition is statistically greater than a pure business/equity acquisition
2. The average ratio of success (obtaining a satisfactory positive return) to failure on distressed acquisitions is in the range of 25% to 35%.

Choose wisely and ensure the fundamentals behind the business are sound.

Acquisition Criteria

There are several characteristics that distinguish potential distressed investments that should be assessed and, if unsatisfactory, avoided. Each characteristic contributes to the enterprise's ability to survive, resolve its issues and succeed.

Key characteristics to consider include:

1. Core Business

Beneath the financial stress facing the enterprise, there needs to be a core business capable of being re-established and built on, possibly a product with strong demand or an extensive customer base.

Any assessment should include:

- The enterprise's positioning in its industry sector
- Demand for its products
- Loyalty of customers
- Strength of competitors
- Operational capacity
- The markets into which it sells
- Risks that may impact the business (environmental, regulatory, etc.)

2. Asset Value

The assets of the underlying business are of critical importance. They will generally comprise of assets that support operations (plant and equipment) and working capital assets (cash, accounts receivable and inventory). Assets attaching to operations need to be assessed in terms of their relevance to support and build the core business. Consider state of repair, technology and attaching liabilities.

Working capital assets need to be assessed in terms of their ability to support cash flow. Consider aging and likely collectability of accounts receivable. Assess the general thrust of complaints for non-payment. Inventory needs to be assessed in terms of its relevance to current operations: look for slow moving or obsolete levels of inventory. It is also wise to consider the business's warranty policy and history. Warranty claims can have an impact on cash flow.

3. Work Force

Generally the work force is one of a business's most valuable assets. If you have excellent products and assets but only mediocre people, the results will predictably be only mediocre. Assess the suitability of the work force (skill base) by division and match it to the anticipated level of production or output. Consider the impact of unions if changes need to be made to the workforce and to what extent employee entitlements have to be preserved.

4. Management

A sound management team is essential to any successful restructure of a distressed business. Effective management should demonstrate a multitude of business skills (finance, marketing and production), an ability to see beyond the obvious, experience and an ability to work, motivate and negotiate with others.

It will not always be possible to find the necessary skills for top management from within the existing management structure. Ideally, the executive chosen should have solid industry knowledge together with a history of having successfully restored profitability in previous distressed or underperforming situations.

5. Operational Performance

The restructuring of a distressed business requires a plan to be in place that addresses improvement in sales, costs and profitability. Historical results may not provide a proper indication as to future performance. Consideration needs to be given to changes that may have occurred in the business in prior periods, in particular whether assets have been sold off that may affect results (divisions, outlets, etc.), whether major customers have been lost or whether changes have occurred in senior management.

To determine whether improvements can be made to improve operational performance, it is necessary to establish that skills are available and action can be taken to address:

- Sales and marketing strategies
- Driving efficiencies
- Reducing costs
- Correcting deficiencies in Management Information Systems

Valuation and Negotiation

In assessing valuation of a distressed business, consideration needs to include:

- The underlying real value of assets including any goodwill or intangible assets
- The extent of liabilities impacting the business and how they arose
- Available working capital
- The likelihood of achieving projected profitability and cash flows
- The ability of management to deliver the forecasts
- Capital costs required to deliver the forecasts
- Assessment of contingent liabilities that may impact the business

Pricing and negotiating the offer will largely depend on how distressed the enterprise is. It is not uncommon to find that the funds required to meet creditor claims exceed valuation, in which case consideration may need to be given to positioning creditors or particular classes of creditors for a moratorium or compromise.

Negotiations may involve a broad range of stakeholders including, in addition to shareholders, unions, landlords, licensors, lenders, creditors and government.

Negotiations need to be handled strategically, and it is important to continually re-assess valuation criteria based on progress made. Where possible, avoid revealing any indication as to final price until negotiations are well advanced.

Structuring the Acquisition

Generally, an acquisition will proceed through either acquiring equity or acquiring the business (asset purchase). Whichever course is taken consideration needs to be given to the level of funding required to support the business case. This should include an adequate level of working capital to allow for unforeseen contingencies.

Risks attaching to uncertainty surrounding possible unknown prior liabilities may be adequately managed through the use of a Deed of Company Arrangement. Where a formal process is required to extinguish or compromise claims, it is useful to pre-package the arrangement by ensuring that the business case and implementation plans are prepared and agreed with all key stakeholders in advance.

Funding is best structured through a mix of appropriate debt and equity. Raising debt, in certain situations, may prove difficult and require third-party security to support it.

Equity in any acquisition will have a degree of risk attaching to it. That risk may possibly be minimised by structuring the injection of new funds via secured shareholder loans or secured convertible notes.

Exit Strategy

A part of any acquisition strategy should include consideration of an eventual exit plan. This should encompass consideration as to when and how



the exit opportunity will arise. Will the business represent an attractive acquisition opportunity? What factors may impact both value and ability to sell?

This assessment should also consider the likely opportunity cost of foregoing other alternate investments.

Sanity Check

When investing in distressed businesses, it is important to remember that not all distressed businesses are equal. Some will be beyond help. Some may confront additional troubles that foil efforts to save them. But there will be others that will progress, with help, safely on the road of recovery.

For potential investors, the ultimate test of whether or not to invest is to step back and apply a rule-of-thumb sanity check by comparing the risk and anticipated benefits to the average return that could be expected from investing in a soundly structured, well run non-distressed business.

About Us

Ferrier Hodgson Corporate Advisory partners with its clients to improve value. We work with you to enhance performance and drive strategies that deliver growth.



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