Buying a Distressed Business: The Why, Where, How

BY JACQUES HOPKINS

Why buy a distressed business?

Hopefully your answer is because you (i) understand why the business is currently in trouble, (ii) know how to turn it around, and (iii) have an exit strategy… if you are right in your assessment and, equally importantly, if you are wrong. The universal starting point is to dispel the myth that the purchase of a troubled business is a bargain. The old adage that "if it looks too good to be true, it usually is," applies here.

Wooden buckets in a plastic-bucket world… many industries have a life-cycle that ultimately comes to an end. If the product or service is no longer required at a level of need that enables you and your inevitable competitors to make a reasonable profit, why take on that struggling company and try to beat the odds? Profitable investing in a distressed company is no different than investing in any other business and requires selecting a business that, once stabilised, has a demonstrable demand for its product or service going forward, for at least long enough to maximise your return on investment prior to or at your intended exit.

Why do I want to be in this business?

A seeming bargain is not a bargain if you have no justifiable reason for making the purchase. From a startup to a distressed company purchase to the purchase of a consistent winner, the road of future distress is littered with failure resulting from buying for the wrong reason. Vertical integration, industry roll-ups, dotcoms, etc. seemingly have more failures than successes. If the reason for buying is flawed, the purchase is almost certainly doomed. Previously high-flying dotcom companies have, since their purchase for mega-money and subsequent demise, often been purchased back by the original founder. Why? More often than not, the original founder did not start the business with an exit in mind but because there really was a fundamentally sound idea that captured a marketplace. If that need still exists, there is always a buyer for the business. Is the business in trouble because (i) it is so cash-consuming that it can never make a return, (ii) because it was structured incorrectly in terms of capital, (iii) simply is being run poorly or (iv) has been stripped of profit? If the capital structure and management can be improved to the point of sustainable profitability, there is a buyer for that business. Before you buy, decide why you are buying and what it is about that business that you can improve. If you cannot see how to improve the current situation and sustain that improvement, do not buy.

Where to buy?

International markets differ vastly in the available forums in which to buy, mainly because of the different legal approaches to distress. In the US, with its "debtor-in-possession" Chapter 11 proceedings, businesses usually remain in the hands of existing management until they are reorganised, sold or liquidated. In the UK, management is almost certainly taken out of the hands of the original managers.

There is no one perfect approach as to where to buy… but let us take the US as an example and consider possible sources of knowledge of availability of a particular business: (i) trade association membership lists [when a whole industry is in trouble], (ii) bank workout departments, (iii) bankruptcy law firms, (iv) on-line Government and commercial databases of bankruptcies, (v) newspaper notice of public sale, (vi) specialist intermediaries. Without exception, these sources all require nurturing and research.

Sources (i) trade, (ii) bank, have by far the largest pool of candidates but require the most work to gain useful access. Sources (iii), (iv) bankruptcies, are a deceptive pool because, in the US at least, more than 90% of the business bankruptcies filed are either too small for consideration as acquisition candidates or are effectively liquidated at the time of filing. Source (v) public notice, is a useful area, usually for smaller liquidation sales and does not cover many going-concern sales of businesses. Source (vi) specialists, is a particularly interesting source if the firm is not just an intermediary, but also a turnaround firm. If you are known to them, as with bank workout departments, chances are you will be treated as a important buyer prospect… particularly if you have previously demonstrated the ability to react decisively and close a transaction in a timely manner. Depending upon the source of the opportunity, investors should be prepared to sift through many bad opportunities and also accept, for the good ones, that they may well be in a competitive bidding environment, often in multiple rounds of bids, depending on the forum.

How to finance?

The source of financing depends in part upon the relationship of the price paid to the debt that attached to the business when it was in trouble. For example, if the secured lenders have to provide a huge discount on their debt in a sale of the business, they are unlikely to remain in the deal going forward. On the other hand, if you effectively finance a bankruptcy reorganisation of a business (as opposed to just an outright purchase of assets) because it has critical vendors you cannot do without, those vendors provide a partial source of financing for the purchase, as may secured lenders (because their debt is likely being paid, nearly in full, with new terms under the reorganisation). A distressed business that was perhaps a startup a few years ago and incurred debt over and above traditional bank type may well be eligible for financing by a traditional asset-based lender if subordinated debt is extinguished or previously converted to equity. If the issue is interim financing whilst the company is stabilised there are higher-priced (perhaps "vulture" rate) lenders; these should normally be used only by an existing owner who has no other recourse. There are also "pooled funds" raised solely to invest in distressed situations, but these usually invest on their own account, as opposed to backing an outside investor.

How to maximise return?

Morris-Anderson & Associates, for example, conducts almost all its sales of distressed businesses under a sealed bid deadline procedure, which requires all prospective purchasers to put in their best offer by a specific date with no price or minimum bid specified. Countless times prospective bidders have asked how are they to know what is the "right price" to bid? There is only one appropriate answer– to bid at the price that is right for the bidder going forward. There is no way for anyone other than the bidder to know what that price is because no two bidders: (a) plan to run the business in the same way, (b) will effect a turnaround and stabilise the business in the same manner, (c) know how the business will integrate with other businesses they may hold, (d) have the same cost-of-capital structure, (e) have the same growth plans, and (e) share the same exit strategy.

Two examples immediately come to mind of how not to maximise return on investment. First, a bidder who is too generous to past creditors because the bidder fails to properly determine whether or not those vendors are truly critical going forward and further misses the point that, in most cases, the vendors need the business as much as the business needs them. Second, the bidder who lets ego take over and gets caught up in the acquisition and a refusal to be outbid once in the game.

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Conclusion

The distressed company arena is neither the battlefield nor the "easy pickings" often depicted in the media and business folklore. Buying a distressed business has two fundamental advantages over alternatives. Startups always require more investment, both in time and money, than is usually budgeted and there is no track record of acceptability of the product or service from that particular business unit.

Profitable businesses have few reasons to sell other than to generate fast cash in excess of the net present value of the anticipated stream of future cash. There is always a premium buried in the price of a standalone profitable company, and only if there is truly an achievable synergistic benefit from integrating with another entity is there perhaps a reduced premium.

The acceptable reasons to buy a distressed business are: (1) there is a real need for the business, (2) it would cost you more to start a new company to compete or to buy a profitable one, (3) you know why the business is in trouble and further know the methodology and monies to turn it around, and (4) you have an exit strategy if you are successful and, equally importantly, if you are not. ■

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