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# Survey

*Investment in Middle-Sized Troubled Companies*

February 15, 1993

Volume 3, Number 1

## ***Buying a troubled mid-sized company: Essentials for middle-market turnaround investing***

*by Daniel M. Morris*

One savvy recovery investor has told this author on a number of occasions that the only way to consider investing in and running a mid-sized troubled company is to start with a "clean slate." According to him, one simply finds a whole team of managers and professionals to assist in the assessment and acquisition and then to run the company.

Clearly, acquiring the assets of a troubled mid-sized company at the right price is a critical element of success. However, what one does with those assets once acquired is an equally important part of the success formula. The investor referred to above makes no bones about it. Troubled companies represent the mistakes, poor

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## Mid-Sized Troubled Company Investing

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The Survey is published irregularly by Beard Group, Inc., P.O. Box 9867, Washington D.C., 20016, 301/951-6400, and is distributed with Turnarounds & Workouts, News for People Tracking Distressed Businesses.

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judgments and unsupported biases of previous owners and managers. Experience has led this investor to conclude that anyone associated with the troubled company is much more likely to have been part of the problem as opposed to being part of the solution.

The investor makes it perfectly clear that if chosen as the successful offeror, his first agenda is to terminate all or substantially all of the managers and professionals who were associated with the failure and replace them with a brand new team.

As ruthless as the approach may sound and as inflexible as the "rule" may appear, that particular investor believes that assets and markets are determinable, measurable, subject to management and in most cases their operation predictable.

However, managers (or professionals) who cannot or who are unable to approach troubled situations with a completely open mind untainted by the past add a significant additional risk to any investment opportunity in mid-sized troubled companies far beyond the standard "management risk" one would normally encounter in an ordinary deal.

Investing in troubled companies most certainly requires special deal and underwriting skills. There are numerous pitfalls and traps. At any juncture in the investment process surprises can spring out of "nowhere" and frighten even the most sophisticated investor, either killing a potentially good deal or reducing the upside potential.

Making equity oriented investments in companies that are experiencing financial and operating difficulties requires approaching a wide variety of difficult and different problems objectively. The focus is the achievement of return on invested capital not how to bail someone out of a troubled situation.

Successful investing also requires locating the opportunities amidst the problems and staying locked on them. Just solving problems will not ordinarily bring the necessary return on investment.

It is most surprising in that light to find so many individuals and firms seeking to make such investments. Clearly, in order to be able to deal with the challenges successfully, one must:

- a) Possess unusual skills for making deals;
- b) Have a ready team of managers and professionals with turnaround personalities and skill sets;
- c) Develop a plan that maximizes the investment opportunity quickly and eliminates problems;
- d) Have capital.

The deal skills required are not ordinarily possessed by the standard investment underwriter. Recovery investing, by definition, means that the target company has opportunities which require immediate sponsorship and operating and financial difficulties which appear to be surmountable in a relatively short period of time.

It is vital to know which problems can be corrected and which cannot. As a deal person, recognizing opportunities and understanding how problems can be solved, by whom, where and for how much, makes him or her formidable.

A typical target will not look anything like a conventional company seeking new financing or an equity infusion. Opportunities are usually hidden. Troubled companies look terrible, problems are abundant and viability almost always appears speculative or at best is dependent on events outside the target's control. In addition, because successful turnarounds are as much an art as a science, it is usually the case that some period of time will pass before all the remedies can be applied and losses usually will continue.

Most typically, the investor should expect some extraordinary costs and be prepared for a business plan that does not show overnight success. Speedy, yes—overnight, however, is probably unrealistic.

In conventional investing, the concept of changing management is rare as is the notion of the investor being pro-active. Even though some investors go all the way and opt for clean slates, most knowledgeable turnaround investors assert that "fallen angels" invariably need managed, corrective action and aggressive opportunity developing programs. The pro-active investor should play a strong part in the planning and rejuvenation process.

Operating and financial fixes are determined and planned in detail before investments are made. To accomplish this type of program, investors must have a well-rehearsed and well-oiled team of turnaround managers and professionals. Deal risk is minimized in recovery investing because an exceedingly thorough due diligence process is conducted,

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and a workable turnaround/operating plan is developed and agreed upon by all members of the investment and turnaround team before the first investment dollar is spent. All of that being said, recovery investing still requires capital. Many would-be investors, however, believe such is not the case. They contend that if the investment and turnaround process is being managed carefully, real capital is not required.

On the contrary, recovery investing is not any different in this respect than any other type of investing. Capital is required to acquire good assets, fund start-up costs and potentially cover extraordinary expenses. A carefully managed process will help keep the capital required at low levels and may even stimulate a bargain purchase, but the old adage that one has to spend a little money to make money is still generally applicable.

Many would-be investors who believe that troubled company investing can be accomplished without capital are still seeking their first deal, or are struggling through extended "sweat-equity" turnarounds. Successful investments in troubled middle market companies occur when investors gain and maintain control of the investment/turnaround process.

Four essential components of that control are:

- a) A unique deal skill set;
- b) An experienced team of turnaround managers and professionals; and
- d) Capital.

Our experience suggests returns are typically in the plus 35 percent category.