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Evaluating How and When To Fund Under-Performing Companies

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During the last six years, we have witnessed an unprecedented flow of venture capital and private equity into startup and established companies, followed by an equally remarkable number of distressed companies and bankruptcies. This shift in market dynamics has been exacerbated by the current wave of accounting fraud and inaccuracy that may only be in its infancy, and the resulting lack of confidence in senior management.



In this economic climate, it is not surprising that companies are turning again to venture capital, banks and private equity for additional funding to carry them through a very difficult market. It is also not surprising that such investors, having lost vast sums in many cases, are more carefully evaluating whether or not to invest more capital into distressed companies.

The main problem facing investors is how to evaluate whether or not additional funding makes sense. While banks are familiar with this problem, as they invest conservatively for interest income, this is a rather new problem for venture capital firms. During the 1990s, VC firms were more willing to simply dump an under-performing company knowing that others in its portfolio would succeed and often provide spectacular profits. Today, however, the odds of this happening in the

current market have changed. The best way for investors to do this is to insist that portfolio companies engage an objective, unbiased third party, a turnaround management firm, to perform an evaluation. In this article, I'll outline steps that turnaround management firms use to help investors determine whether, and how much, to invest.

It is common for management to say, "If we just had the capital, we could get through this," or, "We'll maintain our head count, cost structure, overhead structure, and weather the storm." It is definitely not enough for them to say, "We did our best, bear with us." It is only after determining the cause of distress, convincing management of what needs to be done, and ensuring that any necessary changes are made that serious consideration of additional funding should begin. The first step is to assess the cause of under-performance. This includes evaluating a company's core business, its management and key employees, its competitors, its technology and engineering and its auditors and legal counsel. Additionally, it includes evaluating a company's finances, its breakeven point, and its going concern *vs.* liquidation values.

Pick Your Problem

The cause of under-performance is not always lack of capital. It may be the result of over-expansion, incorrect market growth projections, unsuccessful new products, management denial, management inaction or inappropriate action. It is imperative that all possibilities be examined, including whether or not management has made the tough deci-



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sions required to cut its cost structure and solve critical problems. The tough decisions include layoffs, selling assets and pruning product lines, as well as changes to the management team itself. Turnaround management firms are able to evaluate businesses in an unbiased manner. Their experience allows for the pragmatic, yet forceful actions necessary for each situation. They can also temporarily staff key executive positions in order to minimize the impact of management changes and to help take the under-performing company to its best outcome.

The second step is determining whether the business is indeed viable. Money should not be invested if it is likely the company will continue to struggle in the

foreseeable future. If this is the case, the best outcome may be a merger, sale or liquidation. However, if the business is viable, and if the causes of under-performance identified in step one can be addressed, then the company can be recapitalized.

Questions about a company's potential for bankruptcy can be addressed by measuring the company's Z-Score. Edward Altman, a financial economist and professor at New York University's Stern School of Business, developed the Z-Score from extensive work with companies involved in the bankruptcy process. It is a powerful diagnostic tool that, along with other procedures used by turnaround professionals, can forecast the probability of a company entering bankruptcy within a 12-to-18 month period. This tool has recently been revised to include service and emerging growth companies as well as traditional manufacturing concerns (see www.scotlandgroup.com to perform the Z-Score Analysis on your portfolio company).

If management makes any necessary changes to cost structure, and investors decide to provide additional funding based on the above criteria, the next steps are to determine the amount of the investment and choose the investment vehicle. The investment amount should be calculated based on the needs of the company as it works toward reducing its cost structure. This amount will likely be lower than the company's initial request, as a result of identifying ways it can save money. If investors have learned one lesson since March 2000, it is that unsecured collateral is the worst form of investment. While performing the assessments and evaluations described above reduces risk, it does not eliminate it. Therefore, investors should use some form of debt instrument, secured by collateral, even if in a subordinated position, wherever possible. Use of preferred stock or common stock investments in these environments represents high risk, particularly in the event of a subsequent bankruptcy filing. In some instances, as described below, there may also be opportunities to share in the available collateral with the secured lender, which should always be the first negotiating strategy.

Set Milestones

The final step is to establish cash flow forecast milestones that must be reached in order for portions of the total investment to be allocated. This will ensure that manage-

ment and investors are working toward the same goals. Equity investors and management must agree upon these milestones. The first milestone should be within 13 weeks. If the company reaches that milestone, equity investors should not renegotiate the deal. It is not acceptable for investors to ask for more time or for approval from other partners at that point. Late infusions of capital often cause companies to miss payments to critical creditors or to postpone other financial obligations that will only derail creditability as well as the entire restructuring process. Each side must adhere to its commitments around the milestones in order to ensure success.

Now that the steps for evaluating whether or not to fund under-performing companies have been outlined, let us consider a few options available to private equity professionals.

Turnaround professionals can detect "red flags" in proposed investments as a final checkpoint for due diligence. In one case, a private equity group identified a \$15 million transaction in the wireless service sector. The investors had completed virtually all of their due diligence and were prepared to acquire the company. Fortunately, they asked a firm of certified turnaround professionals, with an operating orientation, to complete a quick assessment of the opportunity. The professional work undertaken identified several operating deficiencies involving customer service and systems integration that required substantial post-acquisition investment. As a result of this assessment, the private equity group renegotiated the purchase price to reflect the time and capital required to correct the shortcomings. The professional fees incurred were more than paid for by the savings resulting from the reduction in purchase price ultimately negotiated.

Unfortunately, however, professional turnaround help is often sought out too late. In one example, the private equity group agreed to provide a \$3 million preferred equity funding round as well as a \$3 million guarantee to the secured creditor. Management could not achieve cash flow breakeven and completely dissipated the funding round.

Finally, the private equity group asked for professional turnaround help. By then the options available to the company were extremely limited. But through its quick action, the turnaround management firm revamped the cost structure, eliminated unprofitable

product lines and sought out a strategic buyer. Additional capital was required to get to the "finish-line" with a strategic acquirer. The secured creditor and private equity group agreed to negotiations, with the turnaround management firm acting as intermediary, for the additional capital provided. The private equity group shared *pari passu* in the collateral above specified levels. This funding enabled the deal to close. As a result of the sale, the private equity group obtained full release of its \$3 million guarantee and received partial payment of its investment. By sharing *pari passu* in the collateral, the private equity group obtained secured creditor rights in the event of a bankruptcy, certainly preferable to an equity position that would have been completely wiped out under a Chapter 11 proceeding.

Better Investing

If a turnaround management firm evaluates an under-performing company according to the above steps and determines with investors that more money should be invested, the following will likely occur: The company will be better positioned to succeed; the company will be more likely to receive the investment; the money will be better invested and better protected; and the company and equity will be aligned along the same goals and required to fulfill their commitments as defined in the milestones.

In today's challenging economic climate, investors must be more discerning as they evaluate a company's balance sheet, management structure and overall chances for success. Turnaround management firms can help ensure a company is financially and structurally sound so investing can be less of an art and more of a science. The mantra for VCs and private equity groups should be to call for professional turnaround help early, before an under-performing company becomes distressed.

David Auchterlonie founded The Scotland Group Inc. in 1986. The firm is a corporate turnaround management organization that has served over 100 under-performing and distressed public and private companies, in over 30 different industries, both domestic and international. Auchterlonie is a Certified Turnaround Professional and past Chairman of the internationally recognized Turnaround Management Association. He can be emailed at dla@scotlandgroup.com.