Buyouts
The newsletter for management buyouts, leveraged acquisitions and special situations

PUBLISHED BY VENTURE ECONOMICS, A THOMSON FINANCIAL COMPANY
VOL. 17, NO. 11 • MAY 24, 2004

When Bad Things Happen To Good Buyouts

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You thought it was the best deal you had closed last year. After all, it had come to you through one of your best referral sources—an attorney in the Midwest who had referred several previous deal leads to you. You pursued two of the leads actively and the one that you closed, has become your firm's most profitable deal to date. So when the same attorney called about a client of his firm—a family-owned manufacturer of proprietary solvents—you jumped at the opportunity. The deal had just the right mix of technology and smokestack industries.

It had seemed like a clear shot: The company's advisor had been instructed by the family shareholders that one of the main concerns was their loyal employees, who were nonunion with decades of service. The family wanted to be sure that the buyer would keep the company intact and continue to give back to the community as they had. Rather than sell out to one of the industrial giants that competed with this niche producer, the advisor sought a buyer that had a track record of closing the deals they pursued, and keeping companies intact and in their portfolio for at least five years.

The company had met all of your parameters. It had $250 million in sales for the most recently completed fiscal year, with respectable EBITDA, especially after adjustment for "add-backs." Five years earlier, the shareholders had effectively transferred management to a professional team of non-family members, led by a former GE division manager with more than 20 years experience. There were no spendthrift nephews to deal with, and the family members who remained on the board planned to resign after the sale.

You closed the purchase in record time. The family liked your presentation, and your appraisal indicated a fair market value

that was within a few percent of what they were asking. The bank that had led the financing of your last four deals had readily stepped up to this one, committing to hold at least a third of the loan itself. At the closing dinner, the family founder and patriarch had recalled the company's origins with tears in his eyes, and toasted your future success.

Sound like a familiar tune? How many of your portfolio problems began with such promise, such high expectations? So what went wrong? Had you gotten so caught up in "the chase" that there had been gaps in due diligence? Had a major customer or vendor gotten into its own financial problems, creating a domino effect? Perhaps the EPA, OSHA, SEC .s>r some other alphabetic boogeyman unexpectedly appeared. Key personnel may have defected. It almost doesn't matter. The roll-up didn't roll, the LBO didn't "L". The cows wouldn't give and the hens wouldn't lay. All that's clear is that you're here and it's now. What do you do?

The historical reaction among acquirers was to dispatch one or more fresh faced MBA's from HQ to gather information, impose discipline and get things back on track. Maybe the deal's champion within the firm (you?) camped out at the company in a show of contrition and personal accountability. The business plans got revised and re-revised, you changed management, you coughed up funds as "shareholder loans" to avoid having to go back to the bank. But the situation didn't respond, and the formerly friendly bank (which had since been merged or consolidated several times) advised 1) there would be no additional financial support without a substantial equity injection from your (maxed-out fund), and 2) please look around for another bank. The lender also suggested that you engage a turnaround professional and thoughtfully provided you with a list of three firms whose names you recognized from some of the most recent spectacular business scandals in the news.

What could have been done differently?

First, as the proverb goes, "to clean the river, you must begin upstream." How was

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due diligence handled? Did your firm get too caught up in "The Mating Game," sacrificing profits for pheromones in the heat of the chase? Investment is all about identifying, monitoring, reducing and managing risk. Did you correctly identify the sources of risk, ensure that the metrics were established to monitor and manage risk? What was done to reduce risk? Too many deals go awry because the buyer lacked the core competencies to manage change, or too easily believed in roll-ups and other mythical phenomena. Perhaps you did see the need for change in the company, but too much change was required. You may have failed to heed the advice of dating websites that warn of the dangers of expecting to change *Rana Muscosa* into Prince Charming. Extrapolating past performance, or anticipating substantial improvement, is a common delusion. Were the risk factors on which such performance depended properly identified and managed? Were early warning signs ignored? If sensitivity analysis was performed at the outset-"How bad does it have to get before we agree it's bad?"—were such signposts ignored? Perhaps the likely responses of competitors were ignored, and you were playing "solipsist chess," where you get to choose your opponent's moves. Were the clues to competitors' actual responses already evident but overlooked?

Was the problem in the deal structure, or did the deal structure exacerbate more fundamental problems? Too many deals have been done because the acquisition debt was available—the siren song of easy credit. Debt leverage is a two-way street, and yesterday's lender/golf partner can become tomorrow's workout fire-breather.

Was an alignment of interests created between the investor and those upon whom success depended? Perhaps there was too much reliance that existing management would continue to achieve goals instead of decorate their newly acquired condos and work on their golf swing. How was the valuation performed, and would it have been computed differently if you were selling rather than buying? Frequently, an acquisition is part of a series of transactions using a "platform" to "roll-up" similar or related businesses. While the conception may have been blindingly brilliant, the implementation of such serial deals is often substandard. The successful integration of strategies, management teams and systems can be quite elusive. The only animal that likes change is a wet baby, so don't expect change to come easily to entrenched management. Those impressive consolidation savings often don't seem to materialize, nor does the expected increased market power of the combined enterprise, shedding further doubt on whether size really does matter. All too often the acquirer is off to the next deal, leaving behind quarrelsome Balkanized roommates in the Tower of Babel.

The safest assumption is not that post-acquisition problems may occur, but that they will occur. The first step to solving problems with buyouts is to identify them early.

The second step is to recognize that the skill sets for managing a turnaround are different than for managing under "normal" conditions. Few management teams have been through a turnaround. Hardly any management teams have successfully been through a bankruptcy reorganization. The topsy-turvy world of bankruptcy is nearly always the backdrop against which turnaround management is carried out, even if it is only a contingency plan.

Turnaround management requires special skills, such as ability to create change with a tempo of controlled urgency, a knowledge of insolvency and bankruptcy, and an understanding of the bargaining leverage that putting in additional equity gives you and how to use it. The leading buyout firms turn to outside turnaround professionals for assistance. These "temps" know how to steer through the waters that are unfamiliar to management, and can serve as a lightning rod for the inevitable tough and unpopular decisions that will be required. Before you consider possibly throwing good money after bad, get help, or at least an outsider's opinion.

One should select a turnaround professional based upon track record, qualifications, and the professionals who will be staffing the engagement. Whom will you be getting? You might select a turnaround firm, but be sure there's an understanding about staffing. The Turnaround Management Association (www.turnaround.org) has created a respected certification credential, the Certified Turnaround Professional (CTP) that differentiates those professionals who have made turnaround management their career and have committed to a standard of excellence and ethics (www.actp.org).

What are the deliverables? What is the scope of work, fee budget and timetable? Avoid "consultant's creep" the tendency of consulting engagements to expand unproductively if not controlled.

Avoid the tendency of your management to look at turnaround management as just an exercise to keep the bank quiet. If your management team cannot be accountable for its failure and cannot "get religion" about the need for change, then you have to change the bodies.

Finally, have an open mind. Turnaround management is seldom about restoring the business precisely to its previous condition. In fact, that "condition" resulted in the current problems, right? More accurately, turnaround management is about optimization: achieving the best result under the circumstances. That might mean making drastic changes in the business and the way it is operated. Sale of all or part of the business may be the best alternative. Perhaps the original business model needs to be seriously questioned. Let your turnaround professional present to you all of the available alternatives, together with the risk and resources associated with each, and make a recommendation along with how the professional can assist in implementation.

One thing is for certain: Analyze your buyouts' problems carefully, not to apportion blame, but to learn for the future. Ignore Santayana at your peril: "Those who cannot remember the past are condemned to repeat it."

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