GUEST ARTICLE

Keeping The Ship Afloat During A Distressed Sale

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Your next sale or purchase of a distressed investment can be derailed and its value destroyed by numerous pitfalls that can pop up during the sale process. To avoid a disaster, crisis managers should play leading roles in a distressed sale setting, given their ability to quickly understand a company's value drivers, react to immediate threats to those drivers, anticipate problems that could emerge, and identify and implement creative solutions to preserve value.

Prior to a decision to sell, distressed companies are typically under severe stress and strain. A sale process adds another layer of complexity, increasing the stress and strain and making companies more susceptible to potential hazards that can reduce value. The case study below, based on a real company whose identity is confidential, illustrates some of the difficult issues that can be encountered during a distressed sale process and the role a crisis manager can play in successfully resolving them to maintain value and consummate the sale.

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Background

Company X was a manufacturer of industrial products through U.S. and foreign subsidiaries that were controlled by a corporate parent. The company had been in financial distress for a number of months, in part because one of its foreign subsidiaries was a former state-owned enterprise that was losing money and absorbing funds from cash-generating parts of the company. The company completed a financial restructuring in August 2006 to reduce its debt burden. That provided short-term breathing room, but did not address the company's underlying operational issues. A liquidity crunch ensued, leading to a bankruptcy filing in February 2007. In December, shortly before the bankruptcy filing, Company X hired my firm to assist with cash management and operational issues. An M&A advisor was subsequently hired to explore sale options.

When the crisis management team came on board, the operations of Company X's primary cash generating business unit had slowed dramatically. Most production workers had been laid off to conserve cash, there were no parts available, and support staff had been reduced to the bare minimum. After preparing cash flow projections and a liquidation analysis, two conclusions were reached: A going concern sale was the best option to maximize value, but it was unlikely that the sale price would provide a recovery to unsecured creditors given the company's condition. The crisis management team, having identified Company X's value drivers (product, intellectual property, customers and critical vendors), was now challenged to effectively manage the value drivers to positively impact value.

Operational Issues

The crisis management team's initial focus was on generating cash to bring production back to normal levels. The team's knowledge of Company X's long production cycle and the importance of its products to its customers were used to advantage in negotiating and accelerating large advance payments from customers that had orders in production and in collecting outstanding receivables from repeat customers. This approach was very successful. Company X quickly generated enough cash to begin recalling workers and purchasing essential parts, while buying time to negotiate a DIP loan for additional financing as working capital needs grew. The DIP loan was secured in April 2007, two months after the bankruptcy filing.

Vendor Issues

Due to the nature of Company X's products the company was not able to replace vendors without extensively testing their parts. That would have required time and money that was not available. Therefore, the crisis management team's next step was to negotiate with Company X's most critical trade vendors to restart the flow of critical parts. This proved to be difficult, since Company X had lost all credibility with its vendors during the cash crisis because finance employees had either stopped communicating with vendors or made promises that they were ultimately unable to keep.

Company X had one important leverage point with its critical vendors: For most of them, Company X was by far their largest customer, so keeping the company operating was essential. With this knowledge, the crisis management team scheduled phone calls and meetings. Vendors appreciated the frank assessment of the company's situation and future prospects that the crisis managers provided, and were especially grateful to speak to a party that had more credibility than management. Vendors realized that Company X needed parts to continue as a going concern; otherwise their own survival would be threatened. This round of communication enabled Company X to regain a substantial amount of vendors' confidence, and paved the way for agreements to resume shipping critical parts and to provide some payment flexibility.

Buyer Due Diligence

The M&A advisor, hired in March 2007, was charged with the typical sale process functions (preparing a teaser, contacting buyers), relying on help from Company X's management and employees (i.e., preparing projections and presentations, assembling due diligence documentation). Everyone would need to work quickly in order to keep potential buyers interested in the process. Since the M&A advisor concluded that value might be maximized by selling each subsidiary separately, there would be more work for all.

The auction began in May. When employees, particularly in the finance area, realized the amount of work the sale processes entailed, especially the volume of information needed for the data room, a morale meltdown ensued. In order to get employees focused and back on track, the crisis managers formed a transaction SWAT team and enlisted the head of the IT department to lead it. The SWAT team quickly developed a process, supported by technology, to provide the initial data that the M&A advisors requested and to subsequently provide additional information based on requests from potential buyers. This minimized the disrupting effect of the due diligence process and kept employees focused on running day-to-day operations.

Management Issues

The majority of Company X's employees had been with the company for many years. However, this implied loyalty started to crack under the stress that had built up from months of financial distress and fire-fighting, as well as the recent bankruptcy filing. Neither employees nor management were willing to stay late or work overtime when their assistance was most needed, and it was unlikely that the judge would approve retention bonuses given recent changes to the U.S. Bankruptcy Code.

Management began to crack once the decision to sell the business units had been made. For the lenders, creditors, equity holders and professionals in the case the major objective of the sale process was to maximize proceeds for the estate. However, the primary objective of each subsidiary's management team turned out to be signing up a buyer they favored to ensure both their job security and the business's growth potential. They tried to get their way by leveraging their perceived importance to the subsidiary's success and the related impact on the subsidiary's value in a sale. The subsidiary management teams started to lose focus on day-to-day operations, leading to declining business performance. In addition, almost simultaneously, they attempted to manipulate the sale process. For example, one management team openly declared its dislike for certain buyers, tried to sabotage presentations, and later threatened to quit if they didn't get their way. Another management team wanted to do a management buyout and tried to stall the due diligence process for other potential buyers so they would lose interest.

At that time, the crisis management team had been involved with the company and its subsidiaries long enough to have a solid understanding of each business and how integral each senior manager was to successfully running his/her business. This provided corporate management with the option to terminate certain senior managers and insert temporary CEOs/CFOs/COOs, if necessary. Company X's corporate management, assisted by its legal advisors, confronted each management team and threatened termination if they continued to try to manipulate the sale process. This tactic was effective—the senior managers backed down and subsequently refocused on day-to-day operations.

Knowledge of management teams' biases against certain buyers became crucial information later on during the sale process for one of the domestic businesses. In the course of negotiations with the successful bidder (which was one of the companies that the management team did not like) the crisis managers explained that winning over employees and management was critical. The buyer opened a dialogue with employees and management, and after extensive meetings and discussions, earned their trust and averted an exodus of people prior to closing.

Customers And Competitors

When the company's distress was turning into crisis, customers began to experience delays in product shipments. Previously, Company X had a good reputation for on-time delivery performance, despite the complexity and long production cycle for its products, so customers became alarmed at the degradation in performance. The alarm became widespread once Company X filed for bankruptcy—many customers became concerned about the company's reliability and survival. Upon hearing of the bankruptcy filing, competitors began to spread rumors of Company X's imminent demise, exacerbating the situation.

Company X was concerned that a significant number of customers would cancel orders, even though its products were often critical components and not easily replaced. Once funds became available to ramp up production, Company X's employees realized that the company had a good chance of surviving. The crisis managers rallied the sales force and sales reps, which called and met with customers to assure them of the company's survival. This communication blitz helped to minimize order cancellations, but did not encourage customers to place new orders. Subsequently, once Company X was able to obtain approval for DIP financing, a second communication blitz was initiated to persuade customers to place new orders, rather than going to competitors. The second blitz was successful, and customers started to place new orders.

Summary

Ultimately, the sale of Company X and its subsidiaries in July 2007 yielded enough cash to make a sizeable distribution to unsecured creditors. However, the issues encountered prior to and during the sale processes could have significantly reduced going concern value or derailed any of the business unit sales if it weren't for Company X's experienced crisis managers, dedicated employees and a little bit of luck.

Distressed or underperforming companies going through a sale process are under tremendous pressure and stress, and therefore are especially sensitive to internal and external shocks. Crisis managers can effectively shepherd a company through a sales process by understanding a company's value drivers, anticipating potential shocks, and reacting quickly when they appear, unencumbered by responsibility for day-to-day management of the business. Owners, boards, and senior management teams should view a crisis manager as an indispensable part of the sale process to maximize value. ❖

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