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Of Lenders & Workouts:
Moving from Defense to Offense

Although the lending environment has only loosened up moderately in the last two quarters, one can almost feel the pressure starting to increase "to grow that portfolio." The big questions remain: Will we repeat the sins of past? And, what should be the lessons learned?

By Daniel F. Dooley

It's time to do M&A deals. Equity funds are under strong pressure to deploy committed capital or return the dough to the investors. Deal multiples are increasing, and serious bidders for distressed and profitable businesses are driving up prices. "Distressed Asset" investment bankers are shifting resources back to more traditional M&A because deal flow is back.

Although the lending environment has only loosened up moderately in the last two quarters, one can almost feel the pressure starting to increase "to grow that portfolio." The signs include a major decrease in Fortune 500 bankruptcy run-rate, improved loan quality ratings across the board, bank workout group sizes being reduced, loan portfolios down 10% to 20%, major workout consulting firms rediscovering the middle-market, and BofA buying Fleet, an action that will likely reignite what Ted Koenig of Hilco Capital calls "The Great Bank Consolidation."

The big questions remain: Will we repeat the sins of past? And, what should be the lessons learned?

Sins of the Past

• Industry roll-ups are not necessarily accretive to value

Simply putting together a group of similar businesses — in terms of market and industry — to form a bigger business doesn't create accretive value unless more cash is generated by the new business. We have witnessed too many roll-ups with somewhat similar businesses where no cost take-outs were planned, cross-selling between the businesses was unrealistic, and roll-up management was only capable of adding overhead — and not up to the task of managing the much larger and diverse business resulting. Typically, these roll-ups have failed, with many of them "un-rolled" and the original sellers buying them back at a fraction of the sell price.

• Weak or non-existent operating due diligence

It is amazing how little due diligence investors and lenders were performing on deals in the late '90s. Just because the numbers add up on an Excel spreadsheet doesn't mean that a management team can execute a business plan.

• Obvious market opportunities are, well, obvious

When a market or industry has a major change — whether due to technology, legislation or other forces, many potential competitors observe the same market opportunity and invest to exploit it. Telecommunication and energy changes are the most obvious legislative examples from the last few years. And it appears that every new entrant in these emerging markets grossly underestimated the impact of other new competitors on sales volumes, capacity and pricing levels.

• Increasing valuation and multiples are unsustainable because business is cyclical

EBITDA valuations of 7 to 8 or more in mature industries, accompanied by senior debt leverage of 3.5 to 4 times, were common in the late '90s. Investor and credit returns are only possible at these prices if the specific industry involved has perpetual growth prospects, which is highly unlikely.

• Valuations of new industries based on top-line measures

People were using sales, website hits, customer counts, market share and other non-monetary factors to value businesses, ignoring the obvious fact that businesses only have economic value if they generate cash. As we are all painfully aware now, many Internet businesses never even developed a spreadsheet plan showing positive cash flow, opting instead to get bigger and bigger by consuming OPM (Other People's Money).

• Great times make for great crooks

The extent of corporate greed and corruption seems to be directly related to how a business is doing financially. In great times, stakeholders are ecstatic and outside oversight is greatly relaxed, leaving some leaders to believe they single-handedly created all this value and "to the victor go the spoils." In leaner economic times, there is much more oversight.

Lessons to Remember

• Employ operators, not accountants, for due diligence

Yes, one still needs to verify the inventory, receivables and financials; however, the critical due diligence questions remain: 1) is the business plan attainable, 2) is management on top of its business issues and taking action, and 3) are there critical business issues that management hasn't identified or allocated resources to attack? These are areas where workout consultants succeed because we have witnessed — and cleaned up — strikingly similar management messes.

• M&A integration is mission-critical

Whenever acquiring a business, one should have a plan detailing how it should be run and integrated into an existing business. Existing management is rarely good at managing an integration project, simply because of inexperience; much like a typical IT project, integration takes twice as much money as planned, twice as long and only delivers half the planned benefit. Successful M&A integration is best handled by focused, full-time consultants who specialize in the process.

• Be careful of long-term sales growth plans

This is not to say that substantial sales growth can't happen. Rather, one must analyze — through operational due diligence — the specifics of the sales growth planned and the competitive landscape that could adversely affect the plan.

• *Morality cannot be legislated, so make sure the leaders have guts*

Sarbanes-Oxley is a classic attempt to regulate morality and, despite being well intended, it simply won't work. That being said, investors and lenders should bet on two critical personnel when backing a company. Offensively, bet on the CEO to achieve the business plan. Defensively, bet on the CFO to be brutally honest and raise the red flag when needed. I have always thought that a CFO should be hired more for personal character and guts than technical skills, and have found that the best acquirers of businesses always put in their own trusted CFO or make very sure they're willing to take a risk on a new one. abfj

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