

RECOVERY INVESTING: HOTTEST NEW MARKET OF THE '90s

by Daniel M. Morris

The recovery industry's time has come. In fact, during the next five to eight years, it promises to be the fastest-growing investment market around.

If you find that statement surprising, take a critical look at the unprecedented leveraged acquisition market of the '70s and '80s. After going full throttle throughout the last 15 years, the LBO bandwagon is still not running on empty, but the fuel mixture is definitely getting thinner.

Particularly in the middle market, the supply of good LBO candidates has become scarce, while the prices of these companies have been bid up to higher and higher multiples of their book value and free cash flow. At the same time, the demand for leveraged investments has intensified among big players such as investment and merchant banks, insurance companies, venture funds and private investor syndicates.

Numerous leveraged buyout and venture capital funds also have accumulated enormous amounts of investment capital from profit sharing and pension funds and overseas sources. In short, there is currently a great deal of money chasing a dwindling number of good deals, and much is going uninvested.

However, institutional investors now have sighted a promising new target: recovery investing. That is, the investment in substantially undervalued companies that are experiencing difficulties which can be rectified in a relatively brief period and resold at prices yielding annual returns of 35 percent or better.

Filling the void

The underlying difference between recovery investments and other types of leveraged transactions is that they require managed corrective action taken by the investors and/or their agents. In fact, the new breed of active recovery investors will acquire control of, or purchase outright, troubled companies with the purpose of doctoring them back to financial health and then reselling them at substantial profits.

Specific units have been set up by several money center banks and commercial lenders with allocated capital for passive investment in recovering companies. In

addition, at least one specialized investment fund — Recovery Equity Investors, headquartered in San Francisco — has been formed to make active equity-oriented investments and provide management to undervalued medium-sized companies which have been unsuccessful in obtaining needed capital because of actual or perceived business problems. Undoubtedly, other active recovery investment groups will be in the offing.

Recovery investment funds that offer both money and active management to troubled companies are timely at present and will prove even more appropriate in the future. Historically, few financial institutions have invested in companies that require hands-on involvement by the investor. Investment bankers, insurance companies and venture funds have customarily avoided investments in



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companies that involve active investor management, except to protect earlier investments with follow-on financing. Accordingly, most commercial banks and others do not commonly lend to distressed businesses unless they are already creditors.

Recovery investment targets

Generally speaking, target companies for recovery investing will be established middle-market businesses having developed technologies with existing products and markets. Middle-market companies can be broadly defined as those with annual revenues of \$25 million to \$500 million. Industry type and geographic location are less important than the correctability of the company's problem, usually within a time frame of 18 to 36 months.

Prime targets are companies that:

- ▶are financially and managerially neglected divisions or subsidiaries of larger corporations,
- ▶are considered sub-standard performers or poor fits in the portfolios of venture capital or leveraged buyout funds,
- ▶have exhausted their sources of needed working capital,
- ▶are limited by the unpredictability of the initial public offering or venture capital markets,
- ▶are beset by estate, divorce, tax and other liquidity pressures,
- ▶need image cleansing because of legal or regulatory infractions or reputational mistakes,
- ▶have stagnated due to creditor, management or owner intransigence, complacency, ineptitude or politics,
- ▶are immobilized by struggles, misunderstandings or mistrust among shareholders, lenders, managements, vendors or others, or
- ▶are overleveraged with excessive or expansive debt which can be renegotiated in conjunction with an infusion of new capital by recovery investors.

Not surprisingly, many LBO companies fall into one or more of these categories. In gauging the performance of middle-market LBOs over the past 10 years, Morris Anderson & Associates estimates that 70 to 80 percent have not measured up to their original expectations, and 25 to 35 percent have ended up in financial distress. Moreover, if the economy slows significantly, or interest payments on floating-rate loans rise, many highly leveraged companies will rapidly become recovery investment candidates.

Since considerable debt financing has been available on favorable terms over the past several years, many public and private businesses have replaced equity capital with assorted debt. The prevailing climate of economic uncertainty will cause some corporations to divest themselves of potentially promising divisions or subsidiaries outside their core businesses, in order to reduce their debt. Those that have recently made LBO purchases may delay plans to refinance their acquisition loans or may "cash out" in the public securities market. All these factors will afford attractive recovery investment opportunities.

Investment advantages and approaches

Active investing in the recovery of troubled companies offers clear advantages to institutional investors. For insurance companies, venture funds and the like, recovery investing will provide portfolio diversification. Because of its heavy exposure to the securities market, real estate and leveraged buyouts, an active recovery investment fund offers a counter-cyclical opportunity in an unexploited niche, with substantial potential for upside equity profits.

Recovery investing also substitutes deal risk for market risk and provides opportunities for senior lending and co-investment with the funds.

Another timely development allied to active recovery investing is the emergence of a secondary market in troubled bank debt. Recovery investment funds, and their institutional investors, can help facilitate this process by providing operating capabilities in situations where banks prefer to avoid management involvement for historical reasons or to avoid legal liabilities. In other words, the funds will be able to take control positions in order to implement recovery programs and protect cash flows.

Recapturing goodwill

In essence, the success of the recovery investor's mission hinges on recapturing the goodwill value of the troubled company. Hard assets maintain their market value, which may be greater or less than book value. But goodwill dissipates if tangible assets cannot earn an appropriate rate of return to sustain the business. In this context, goodwill can be defined as the value of the business over and above net assets and, attributable to its sustained earning power and positive cash flow.

Broadly, goodwill is valued in multiples of a company's free cash flow, which can translate into hefty returns for recovery investors. The classic recovery investment scenario, therefore, is to purchase a basically viable company at book value or less, then operate it in a recovery mode until it regains its goodwill value. Once that is achieved, the company's market worth increases dramatically.

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Principal ways in which investors might realize returns on recovered companies include:

- ▶sale or merger of a portfolio company
- ▶sale of the company's securities through public or private offerings
- ▶repurchase of securities by the company
- ▶management fees and other banking fees earned in connection with refinancing or reorganizing the company.

(Continued on page 96)

Recovery investing

(Continued from page 46)

Although the potential rewards of recovery investing are great, so, too, are the risks. In this respect, many big players have one main hang-up: they are essentially "white collar" investors without the skills of "blue collar" operators, to turn around the troubled companies they may acquire. Most bankers and money managers are more familiar with growth risks than recovery risks. They are uncomfortable dealing with Chapter 11 situations, unsecured trade creditors, hostile unions or a marketplace that may not view them as serious players. Therefore, some white collar investors look for managers before targeting a candidate for acquisition; others seek to use the expertise of turnaround consultants.

The basic ingredients of a successful recovery investment are the same in all cases. Prior to making an investment decision, the viability of the target company must be established, and a workable operating plan must be developed for its revitalization. Following these two steps, a decision can be made as to whether to invest the neces-

sary capital resources to restructure the company financially and implement the business plan.

What distinguishes an active from a passive fund is the degree of direct control sought by the fund, with the owner's consent, over the company's turnaround. Accordingly, active fund managers, usually backed by a turnaround consultant or captive management, may undertake such hands-on duties as those normally associated with the chief executive or chief operating officer, as well as those associated with other senior managers.

Clearly, recovery investing is a trend whose time has come, and it has already gained considerable momentum within the institutional investment community. Both the need for assistance by troubled businesses and the demand for leveraged investments are intense in today's marketplace. And turnaround management know-how is close at hand. It is a phenomenon which should be closely watched by secured lenders. ▲