



Turnaround Equity

In today's economic environment, distressed companies seek help from "non-traditional" sources of capital.

by Mark D. Working

Frequently, we are approached to assist in raising equity for companies that have encountered financial difficulties and are feeling pressure from concerned lenders. In today's environment, many firms find themselves over-leveraged, without adequate liquidity, and in default of their credit agreements. A seemingly obvious answer is an infusion of fresh equity capital from a new investor to pay down excessive debt and ease liquidity constraints. In truth, "turnaround" or "special-situation" investors are rarely willing to assume the problems of others and dole out capital to preserve the investments of existing capital providers (owners and bankers). They are, however, willing to participate in the restructuring of the balance sheet of a distressed company by supplying liquidity at a time when the current capital providers will not or cannot.

For serving as the capital provider of last resort, turnaround investors expect to earn returns on par with venture capital, which means that the business or assets will be conservatively valued going in. As a condition to becoming involved in a distressed situation, turnaround investors require recognition of economic reality on the part of all capital

providers and management. They will insist that all the current capital suppliers "mark-to-market" their positions; this may entail, subordination, cancellation, or conversion of debt to equity, and dilution of current shareholders' equity positions. Moreover, they are rarely hesitant to insist on control, in order to protect their investment. This gives them the authority to make the operating management changes they deem necessary to restore the business to financial health.

Special-situation investors can be likened to financial engineers, rather than business operators. They seek to invest in turnaround plans that are predicated on cost reduction, capital availability, capital investment and, in some cases, the introduction of new management. Turnaround situations, where success relies solely upon revenue growth, technology development, or the ability to complete subsequent acquisitions, generally are less attractive.

A well-known turnaround investor tells us that it is most often part of a financial engineering play designed to adjust the capital structure to fit the current circumstances, provide time to address the factors that caused the current distressed situation, and align

the interests of management, employees and capital. Lionel Boissiere of the turnaround investment fund of Doyle & Boissiere, LLC (www.DBLLC.com) says that it seeks fundamentally sound businesses that are burdened with over-leveraged capital structures, and cannot otherwise attract capital. The business must have a history of financial performance other than for an explainable set of conditions that can be rectified according to a concrete turnaround plan. The new capital that DBLLC invests is usually structured as common equity or preferred convertible equity, depending on the situation. Their fund expects to work with the company to "right the balance sheet" and demonstrate positive operating performance, after which it will often exit via a recapitalization or sale to a buyout fund.

Turnaround investors are short-term partners who provide, in essence, bridge financing until the circumstances that caused the distress are corrected and stability is proven. The expectation is that once the problem is corrected, the company will be able to support a more normal capital structure and will pursue its natural evolution. ♦



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