

Private Equity Strategist

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Strategic considerations for distressed investing

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To say that times are tough and getting tougher may be the understatement of the decade. By every conceivable measure, the global economy is facing unprecedented challenges. Stock prices have plummeted around the world, consumer sentiment is at a historic low, job losses are mounting and companies are faced with declining margins, excessive leverage, slowing demand, increasing liquidity constraints and an uncertain future.

In the United States, this economic downturn is particularly difficult because it is cutting across our enormous consumer economy. Retailers, restaurants, housing, the automotive industry, financial services and the hospitality industry are particularly vulnerable. For more than a decade, companies focused on growth and increasing market share – a strategy fueled by the catalyst of easy credit. Over the past several months, access to easy and inexpensive credit has all but disappeared.

It is difficult to conceive of a more uncertain or daunting environment. Of course, it is in these trying times that opportunities present themselves. In January of this year, David Rubenstein, co-founder of the Carlyle Group, the world's largest private equity firm, commented, "The most attractive deals and the highest returns come when there is uncertainty in the market."

To be certain, these times present buying opportunities for investors looking to purchase and restructure companies in financial distress. In assessing distressed opportunities in this economy, thorough due diligence is increasingly important.

At a time when equity values are declining by the day—sometimes irrationally so—how does a private equity investor know when the time is right to issue a term sheet to a troubled company? Obviously, it's important to buy at or near the bottom of the market, but pricing is the product of due diligence and assumptions about a company's future cash flow stream. There are numerous strategic considerations, including market opportunities, product positioning and acquisition structure, but at a minimum, good due diligence of an underperforming company includes a thorough assessment of its current and historical financial position and its operating capability.

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"The most attractive deals and the highest returns come when there is uncertainty in the market."

David Rubenstein
Co-founder of the Carlyle Group

Strategic considerations for distressed investing (continued from page 1)

Financial Position

In evaluating the financial health of a target, the most important metric has changed from revenue or EBITDA (accrual based metrics) to actual cash flows. That's not to say that investing in distressed companies with lumpy cash flows or unusually protracted cash conversion cycles, or those competing in growth industries should be avoided, but their true cash needs must be understood in order to properly evaluate the real cost of capital and resulting IRRs. A lucrative government construction contract, for example, might include six-month credit terms. EBITDA, in that example, doesn't meet a weekly payroll. With appropriate credit facilities in place, liquidity can be bridged at a cost that must be evaluated in the pricing analysis. Of course, the opposite is true as well. In evaluating the financial condition of a company, and understanding that its cash flows are negative as a result of onerous credit terms, a savvy investor could improve potential returns by negotiating more favorable credit terms with major suppliers and large customers. Engaging in those conversations with key customers and suppliers is important in validating assumptions.

With skittish banks less willing to provide capital under favorable terms, understanding near-term liquidity and long-term assumptions about cash generation or cash needs is exceedingly important, or private equity investors could be faced with a situation requiring additional equity or subordinated debt investments, both of which reduce expected returns. Aggressive growth plans must include realistic assumptions about working capital needs, often a voracious use of cash in the business cycle of a growing company. If debt or equity will be required to fund working capital associated with growth over a five-year horizon, the price and duration of that capital must be taken into account.

A good starting point in the due diligence process is to understand the liquidation value of a distressed company in order to establish a floor in pricing the distressed business. By assigning liquidation values to various asset classes and using the sum of those values as a starting point, the private equity investor understands and quantifies risk associated with a failed turnaround plan. Experienced restructuring advisors always assess liquidation value to understand the starting point and evaluate upside potential when crafting a plan of reorganization. Liquidation value is a key consideration in investing in a distressed business.

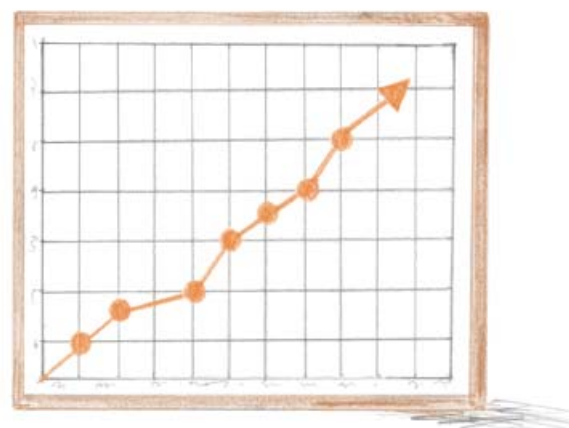
In the process of conducting due diligence, it's critical to evaluate the quality of the information, financial reporting processes, internal controls and the effectiveness of the company's strategic planning and budgeting processes. Is information timely, accurate and actionable? In many companies, the budgeting process is a time-consuming exercise focused on unrealistic growth targets and equally unrealistic cost assumptions. In many distressed companies, financial reporting is unreliable, and strategic planning and budgeting are non-existent.

“The budgeting process at most companies brings out the most unproductive behaviors in an organization, from sandbagging to settling for mediocrity.”

Jack Welch, General Electric

Operating Capability

When assessing a target's operating capability, it's important to determine if internal operations and processes are necessary, efficient and optimal. As with a liquidation analysis, it's important to understand the company in comparison to its competitors in order to evaluate relative risk and establish a floor on metrics such as operating margin, working capital, sales per employees, etc. If the company's competitors have fewer employees, does that signal an opportunity for cost-cutting, or is the difference a factor of manufacturing platforms? Why is the median operating margin of competitors higher on average, and can value be unlocked by restructuring the business to generate baseline margins? How vulnerable is the business to foreign or domestic competition, and can it effectively protect itself through improved efficiency or other operational measures. For example, in a slow selling season, can a retailer move inventory from marginally performing, low-traffic stores to more profitable, high-traffic stores?



Grant Thornton in the news

This assessment should be evaluated in the context of the company's strategy. Strategy is about identifying, building and protecting competitive advantage. To properly articulate a company's strategy, it's important to understand why the company exists and how its purpose, goals and mission are aligned within its operating model, and at the same time understand competitive rivalry, market dynamics, elasticity of demand and technological advances.

More often than not, successful turnarounds involve changing cultures and inspiring people. Successful companies are built on bonds of trust, moral courage and leaders who don't manage around a problem. The essence of success is an alignment of the goals of the organization so that everyone is relentlessly focused on achieving a common purpose and understands their value and contribution to the organization's overall mission. Restructuring the balance sheet and operational platform requires technical skill, experience and perseverance, but execution is in the hands of the management team. A strong management team is at the heart of a successful turnaround.

Conclusion

A global recession seems likely. In the best case, it's a pretty safe bet that 2009 will bring with it more opportunities for investing in distressed companies through debt or equity securities. There are bargains to be had, and deals will get done. Effective and thorough due diligence are more important than ever. Understanding downside risk and being able to plan for and mitigate worst case scenarios with contingency plans are fundamental to the investment thesis of a successful investment in a distressed company. •

“Private equity firms have the potential to wind up being true asset managers, with large private equity firms leading the charge. Using just the most recent example, private equity firms like The Carlyle Group, Blackstone and TPG have raised funds in anticipation of investing in the troubled banking industry. But it's not just the banking industry, Carlyle has over 50 funds to invest in all different areas. However, like with anything new, there will be a period of resistance before private equity can become mainstream, but with time private equity firms will be more and more accepted and trusted to take on additional assets.”



Harris Smith
Managing Partner, Private
Equity and Strategic
Relationships
MarketsMedia
November 12, 2008

“Sen. Obama is coming into a very fragile economy, and will probably have to rethink the reality of what he would like to do. He's got to step back and realize this is a negotiated process, even among members of your own party.”



Paul Beecy
Partner, Tax
CFO Magazine
November 6, 2008

Sector focus: Energy, health care and technology



Harris Smith Assumes Private Equity Leadership Role

Grant Thornton recently announced that Harris Smith was named to managing partner of Private Equity and Strategic Relationships. Smith was previously the West Region managing partner.

In this new role, Smith oversees a team of dedicated professionals who provide services to private equity firms, professionals and portfolio companies. He is also responsible for the development and enhancement of strategic relationships, working to further elevate the firm's reputation, build the Grant Thornton brand, and create relationships with key organizations to aid in Grant Thornton's growth.

Smith has a long history at Grant Thornton, having begun his career in the firm's Baltimore office before heading up the Assurance practice in Southern California and then becoming office managing partner of the Greater Bay Area offices.

By **Harris Smith**, Managing Partner, Private Equity and Strategic Relationships

The Grant Thornton/ACG/Nasdaq white paper, *Top Trends in Middle-Market Private Equity*, noted, "It's no secret that noncyclical sectors are the best ones to invest in right now." The white paper identified three sectors, energy, health care and technology, as among the most promising for dealmaking in the first half of 2008. In the midst of a financial crisis that is impacting dealmaking across industries, the investment spectrum and the globe, we take a fresh look at these sectors to identify how they are faring, and where new opportunities might be found in today's unsteady markets.

Energy

As reported in the white paper, the U.S. Energy Department projects energy consumption in the United States to rise 31 percent by 2030. And private equity firms have taken advantage of growth opportunities in the sector. According to Thomson Reuters, energy was ranked second in dollar value for worldwide M&A for the first nine months of 2008, with \$411.3 billion in deals. The U.S. figure was \$104.8 billion.

Respondents to the May 2008 ACG/Thomson Reuters Dealmakers survey expected energy to be the most active sector for M&A in 2008. That sentiment has changed somewhat, with the

November survey indicating dealmakers are a little less bullish on the sector. That said, survey takers rank energy third for expected M&A activity in the coming six months and second for the most organic growth expected during that time.

As David Leuschen, Managing Director, Riverstone Holdings, noted in the white paper, "It's a great industry to be in. It's huge, and there's a large food chain. The opportunities are growing, there are more assets to buy, and there's more volatility."

While many sectors within energy saw activity in the first half of 2008, alternative energy was perhaps the most active, thanks to high commodity prices and regulatory requirements that didn't exist a number of years ago. State-by-state renewable portfolio standard requirements in the electricity space, ethanol blending targets in the biofuel space, and technologies that were completely nascent or didn't exist 10 years ago have been approaching commercialization.

Recently, investment in renewable energies has slowed, in response to the credit crisis and, more recently, the collapse of oil and gas prices. According to New Energy Finance, a provider of information and research to investors in renewable energy, low-carbon technology and the carbon markets, venture capital and private equity investing in the sector fell from \$5.8 billion in the second quarter,

to \$4.4 billion in the third quarter, a decline of 24%. That said, alternative energy still attracted significant cash in the last quarter, and there is a great deal of private equity money in the pipeline.

“The third quarter figures show that finance for renewable energy assets was fairly resilient, with many big wind and solar projects on both sides of the Atlantic getting the equity and debt they need,” said Michael Liebreich, Chairman and CEO, New Energy Finance. “The reassuring message of these latest figures is that investment in clean energy is continuing at a high level. However, it is clear that the sector, despite its exciting medium- and long-term growth fundamentals, cannot be immune to the problems in the wider economic world.”

Many see long-term opportunities given pledges in the U.S. and Europe to reduce dependence on foreign oil and to lower greenhouse gas emissions. The financial bailout package recently passed by Congress extended federal tax credits for wind energy by one year, geothermal by two years and solar energy by eight years.

“Energy-based tax incentives can often make a proposed transaction more compelling, as a target business that throws off energy tax credits to its investors can effectively provide an immediate or short-term return on the investment,” said Paul Beecy, Tax Partner & Transaction Advisory Tax Services Practice Leader, Grant Thornton. “Transactions in this space generally price the energy credits into the deals, either through direct participation in the tax credit or indirectly through enhanced cash flow on full-priced product sales. If the government didn’t extend and expand the energy tax credits in its recent legislation, it’s likely a number of proposed transactions would have met pricing difficulties.”

As the white paper noted, while transactions in alternative energy can vary, sector fragmentation is the single attribute that remains constant. Dan Reid, National Managing Principal, Transaction Advisory Services, commented in the white paper, “You have a lot of highly fragmented services in the energy sector, especially in oil field services. This industry was depressed for 15 years prior to the last couple of years and many entrepreneurs are considering exiting or retiring. In addition, we have seen a significant trend that children don’t want to take over family businesses anymore, so these businesses will likely be sold. This creates an incredible opportunity to roll these companies up.”

The tight credit markets could fuel further consolidation and provide additional dealmaking opportunities for private equity firms. With the public markets closed for the time being and bank funding all but shut off, large state-owned utilities or private equity firms with large reserves or access to credit could acquire renewable energy firms looking for much-needed cash.

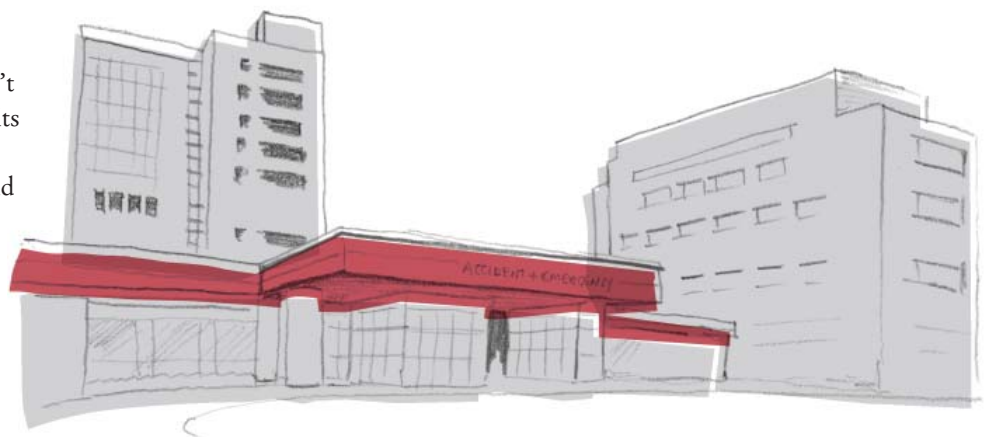
Health Care

Health care M&A is certainly not ailing. With the oldest of the 78 million baby boomers nearing retirement, the need for health care products and services continues to grow by the day. As noted in the white paper, the industry was an especially popular destination for buyout firms in the first half of the year. That trend has continued.

“This is one of the most robust years in recent memory in terms of size and number of deals, with pharma, biotech and medical devices leading the space,” said Jeff Benton, Partner, Corporate Advisory and Restructuring Group, Grant Thornton. “People are always going to need health care and services, and private equity is in a great position to take advantage of the growing demand.”

According to Thomson Reuters, the sector was ranked second in dollar value for mergers and acquisitions in the U.S. for the first nine months of 2008, with \$147.9 billion in deals. This figure represents a 3.9 percent year-over-year increase, and health care was one of the few sectors to experience growth compared to 2007. Worldwide, health care M&A through the third quarter was valued at \$185.4 billion.

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Grant Thornton at NASDAQ

Sector focus:
Energy, health care and
technology
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Regarding fundraising, while the number of new funds targeted for health care investments is down considerably this year compared to 2007, the dollar value is up. For the first nine months of 2008, new health care funds totaled \$18.9 billion vs. \$16.3 billion for all of 2007, according to Thomson Reuters.

“A lot of firms are interested in investing in the health care industry. It’s historically been considered recession-proof,” commented Jonathan Goldstein, Managing Director, TA Associates. “And unlike many industries where you can have a short product lifecycle, health care companies tend to have a longer life span. The pace of change is not excessively rapid.”

That said, health care M&A is not completely immune to downturns in the economy. A squeeze on health care benefits from underperforming companies, increases in out-of-pocket spending by the general population, and growing Medicaid and uninsured populations are just some developments that could negatively impact private equity dealmaking in the sector in the face of the global financial crisis.

“Private investment must stay ahead of how the sector adapts to the new realities of a slowing economy,” noted Benton. “Middle-market to smaller deals could have challenges obtaining financing and certainly will be less leveraged when they do close. The larger deals will continue forward.”

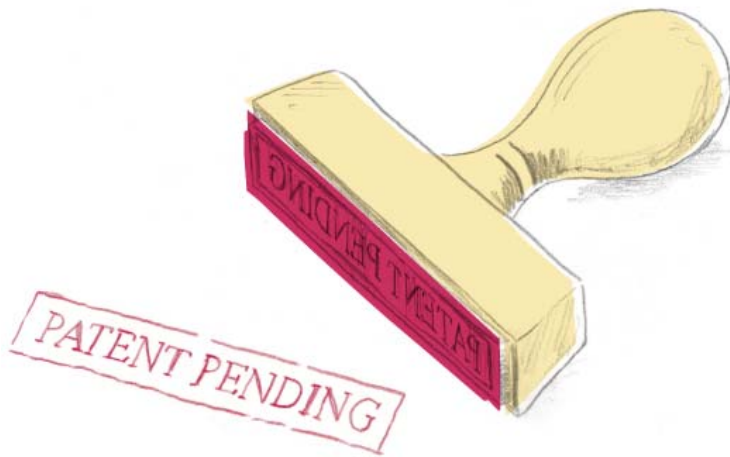
Medicare and Medicaid reimbursement rates also remain a significant source of concern for private equity firms investing in health care. A change in rates will adjust any company’s earnings, in most cases not for the better.

In conjunction with publication of the *Top Trends in Middle-Market Private Equity* white paper, ACG, Grant Thornton and NASDAQ co-hosted a roundtable discussion on the top trends in middle-market private equity at the NASDAQ MarketSite in New York’s Times Square on October 14.

Welcoming remarks were provided by Harris Smith, Managing Partner of Private Equity and Strategic Relationships, Grant Thornton, and Gary LaBranche, ACG President and CEO. The panelists were Mark Jones, Partner, River Associates Investments LLC; Robert McCooley, SVP Capital Markets and New Listings, NASDAQ OMX; Dan Reid, National Managing Partner, Transaction Advisory Services, Grant Thornton; Bela Szigethy, Co-CEO, The Riverside Company; and Dennis White, Partner, McDermott Will & Emery LLP. Scott Wapner of CNBC moderated.

The roundtable was followed by a closing bell ceremony led by Harris Smith and Gary LaBranche. The ceremony was broadcast live on CNBC, Bloomberg TV and other outlets, and appeared on the NASDAQ Tower in Times Square.





Congress is likely to make adjustments to the federal health care entitlement programs in 2009, with leaders on Capitol Hill stating that strengthening Medicare and Medicaid will be a top priority. And President-elect Obama has stated he would seek to expand the current entitlement system.

“A significant risk in health care investing is exposure to change in reimbursement rates or regulatory requirements,” said Goldstein. “These tend to occur infrequently, but a new administration can be a catalyst for significant changes in the economics of your investment.”

Technology

Earlier this year, technology M&A looked particularly promising. As noted in the white paper, “Many tech investors believe they are going to see another vintage year, reminiscent of 2000 and 2001, when tech buyouts, on a dollar volume, accounted for 14 and 21 percent of all transactions, respectively, according to Thomson Reuters.” In the first quarter of 2008, the \$19.7 billion in closed tech deals accounted for 31 percent of all buyout transaction deal volume involving U.S. sponsors.

The first nine months of 2008 saw significant activity in the sector, with technology ranked first in number of M&A deals in the U.S. and second globally, according to Thomson Reuters. (The sector trailed energy and health care in dollar value of deals - \$75.5 billion in the U.S. and \$133.7 billion globally.)

Most recently, however, the worldwide financial crisis has begun to take its toll.

“Things have changed significantly, especially in the last couple of months,” said Marc Chiang, Director, Transaction Advisory Services, Grant Thornton. “Technology is getting hit hard by the financial meltdown and many private equity firms are having difficulty closing deals.”

Chiang noted that on the whole, technology-focused private equity firms have significant cash on hand for investments. However, many of the larger middle-market firms have either become very selective or chosen not to pursue new deals until the credit markets stabilize. In addition, many potential sellers have decided not to begin the selling process until the markets are more favorable. And Chiang predicts technology companies will be hard hit as purchases decline in the face of slashed corporate IT budgets.

There are bright spots within tech, of course. Among these is Software as a Service (SaaS). Some believe the current environment benefits this tech subsector, given the relatively low adoption costs of its platform.

“I’m working on the acquisition of a SaaS business, and the target’s management thinks the recent cutbacks in corporate IT budgets will create new sales opportunities as they are the low-cost provider,” said Chiang. “SaaS providers generally have more stable revenues than their software counterparts.”

And of course there’s clean energy, which, as previously noted, has been quite promising and will benefit from the recently extended federal tax credits for solar, wind and geothermal energy. According to Chiang, “One fundamental long-term driver behind Cleantech is that the growing world economy will require massive new supplies of energy, and most do not believe these will be from carbon-based sources. As such, many private equity firms are looking past the current temporary drop in oil prices and the financial crisis to a longer-term horizon.”

“The thing about tech is that you always have to be thinking about the future, the next thing,” noted Chris Nicholson, a partner at Vector Capital, in the white paper. “Even a boring tech company needs to be looking ahead. And just like in the early 2000s, now is a good time to be working on the next thing so companies are ready when the market comes back. Now is the time to buy: Valuations are low; you can make changes and be ready with a sales effort when things pick up.”

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Sector focus: Energy, health care and technology (continued from page 7)

The second factor that makes tech strong is that competition for deals has eased, due in part to the departure of generalist firms scared off by the lack of credit. However, for firms that play in the tech space, the lack of leverage is common; market conditions aren't so far off from what they were prior to the past few years. In general, these companies use less leverage than a typical buyout.

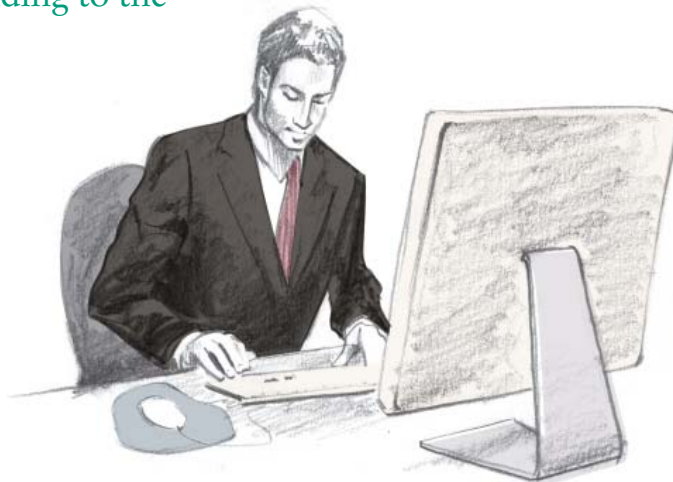
"Tech companies are made up of IT and people, so lenders have always been skittish about lending to the industry," said Nicholson in the white paper. "We are used to this; generalist funds may not be. We have always had to look at all the ways to get a deal done, and sometimes it's with less leverage."

Also helping the tech buyout scene: Corporate

orphans are easier to buy these days because companies are looking to shed noncore assets. Though prices have not yet fallen as low as they did in the aftermath of the 2001 tech wreck, now is still a good time to pick up assets. Furthermore, the industry has matured, making it easier for private equity firms to understand the business propositions. Additionally, because of their maturity, these firms now have an operating history, making them easier to understand and more attractive to private equity investors than ever before. •

"Tech companies are made up of IT and people, so lenders have always been skittish about lending to the industry."

Chris Nicholson
Partner
Vector Capital



Questions?

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