By Dan Dooley[1]

Getting Fair Value When Selling a Financially Distressed Company

Coordinating Editor Dan Dooley
MorrisAnderson Chicago

Dan Dooley is a principal and CEO of MorrisAnderson in Chicago, where he manages the firm's Distressed Business Consulting Practice, and he is a past member of ABI's Board of Directors.

Selling a distressed business is a unique process that requires a vastly different investment banking/brokerage approach in contrast to selling a healthy, profitable business. Healthy and profitable businesses are sold with an optimism about the great opportunities that lie ahead for a lucky purchaser. Distressed businesses have various problems that must be worked on and fixed to create a positive economic return on investment for the buyer. A distressed business purchase requires investing new money, time and, most importantly, a turnaround-management approach to be able to harvest value from future potential profitability.

This article describes a sale process that can — and should — be used in selling distressed businesses, and explains why this process helps get fair market value (FMV) in the sale of a financially distressed company. Some distressed companies that must be sold will be sold at less than the value of the secured debt, meaning that the lender will be taking a loss. Most so-called "short sales" occur within the context of a legal proceeding, either in a chapter 11, receivership or Uniform Commercial Code Article 9 sale.

This article discusses six recommendations to achieve FMV in a distressed business sale. As we all know, an FMV sale typically only occurs when you can establish a competitive process involving two or more interested and active bidders. A single-buyer process rarely produces FMV because buyers, especially distressed-company buyers, will not pay any more than the minimum amount required to buy the company.

Take Immediate Action to Improve Profitability and Reduce Losses

This means immediately closing money-losing facilities and money-losing product/service lines, and firing low-profit/no-profit-margin customers. Firing customers means immediately communicating to the problematic customer that you need to reprice the product/service for profitability with short notice (typically 30-60 days), or that you can no longer provide the product or service. One must do this regardless of contractual obligation, as it does no good to fulfill the contract obligation if you are going to continue to lose money by selling to the customer at that price and subsequently go out of business.

Management and ownership often want to keep money-losing facilities and product/service lines alive under the wishful thinking that a buyer "may" find value in the money-losing situation. This is playing for a long shot and never worth the risk of burning through more cash to keep a money-losing situation alive. Taking the necessary tough actions now always improves the sale value of the business.

Get Real Estate, Equipment and Inventory Appraised by a National Appraisal Firm

Buyers of distressed companies typically calculate liquidation value when performing their due diligence on a distressed business because they realize that the option of liquidation competes with the option of a business sale in a distressed sale process. It is critical for the company, which has much better knowledge of its true financial facts, to spend the time and money calculating a liquidation value first, then laying this data point out with backup support for prospective buyers to review.

This can be accomplished by engaging nationally recognized appraisal firms to provide valuation reports on owned real estate, owned and leased equipment, and inventory. If your accounts receivable are complicated, then one should also engage a firm to complete a collateral audit. Utilizing these appraisals, one can then build a liquidation analysis that is heavily supported by knowledgeable third-party appraisal data.

This approach will obviously cost money and take a month or more to complete, but it provides a more accurate basis for calculating liquidation value and protects against prospective buyers underestimating liquidation value and offering lower sale price bid amounts. As previously mentioned, liquidation value is always a silent bidder when a distressed company is being sold. Sellers should include a liquidation analysis in the confidential information memorandum (CIM) and distribute it to prospective buyers who sign a nondisclosure agreement. Since sellers have more knowledge of the company than a prospective buyer, sellers can

1 Over my three decades of work in the financial restructuring business, I have been involved in about 50 business sales. In addition, I have been involved in these sales through a variety of roles, including as an investment banker, chief restructuring officer, independent director, financial advisor and bank group advisor. I have seen distressed sale processes go very well, and very poorly.

positively influence a buyer's view of liquidation value, which results in higher sale price bids.

Eliminate Inventory Value Risk

Buyers love to negotiate into their asset-purchase agreement (APA) the concept of a working-capital true-up post-sale. Typically, these true-ups are supported by a price hold-back escrow and represent the greatest risk for post-sale price loss due to disputes primarily around inventory valuation. There are three distinct categories of inventory valuation risk, including: (1) book-to-physical (Is the inventory all there?); (2) excess and obsolete (E&O) (Is the inventory useable and saleable?); and (3) valuation methodology (Are the values a reasonable calculation of product cost?).

Inventory true-ups create the largest value-loss risk on deals, as the buyer can argue post-sale that a large swath of the inventory is excess and/or obsolete, and therefore has no true value. This is why sellers should perform a thorough E&O analysis, setting up conservative inventory reserves (taking profit and loss write-downs and losses now), and developing action items to sell off or simply dispose of E&O items. Sharing these analyses with the buyer defuses post-sale true-up issues with alleged E&O and the associated price-reduction risk.

One also needs to assess the risk that physical inventory counts will not match the perpetual records. This risk can be mitigated by taking a targeted physical inventory count of those significant inventory cost shorts for SKUs that have the greatest economic risk if there is a book-to-physical-count error. If the targeted counts indicate a shrinkage, then set up an appropriate inventory reserve and book the loss now. It is better to assess the risks up front, take an inventory write-off, and mitigate them before the sale process than to have a buyer argue for a large working-capital adjustment post-sale.

For valuation purposes, it is important that the APA includes language indicating that the seller values inventory on a basis that is consistent with past practice, as well as being compliant with the Generally Accepted Accounting Principles. Past practice is a wonderful thing to buttress the seller's position on this item.

Clean Up Accounting Process

You should also perform a thorough review of the company's sales credit process, inventory accounting, accounts-receivable accounting and accrued-liability accounting to verify that account balances are reasonably estimated and supported by facts and detailed schedules. If the accounting is messy and hard for a buyer to confirm during due diligence, a buyer will assume that the seller is underreporting expenses, which means that historic profitability is overstated and, thus, the company is worth a lower price. I have even witnessed viable buyers walk away from a sale process because the company's accounting was so confusing and messy.

Highlight the Uglies

When writing the CIM, include a section of what is wrong with the business and its clear weaknesses. "Highlight the uglies" to pre-qualify that the prospective buyers are comfortable dealing with turnaround issues. Ugly facts usually become obvious during buyer due diligence, so highlighting them is a method of diffusing their adverse impact(s) on a buyer and prequalifying that a buyer is willing to tackle these issues should they buy the business.

Buyers often walk away from prospective transactions when there are too many problems to tackle. They prefer to learn of buyer fears up front rather than after extensive due diligence, which wastes time and money.

Structure Carve-Out Assets

Certain assets owned by a distressed company may have minimal value or use to a buyer relative to operating the purchased business. Attempt to carve these assets out of any sale from the start, and clearly identify the carve-out assets in the CIM. Some examples of carved-out assets include:

- *Owned real estate when that specific real estate is not necessary to operate the business*. This does not refer to a sale-leaseback-type situation. For example, I recently carved out a building in France from a U.S. company business sale. The company's business in France was small and *de minimis* to the overall business, but the French real estate was worth US$6 million.
- *Lawsuits that will take time and money to resolve but have the potential for significant financial recovery*. Buyers do not typically care that you have a litigation asset that has a long-term potential to provide real value. They want the business — not the litigation asset. They will take the litigation asset for free but will not pay for it.
- *Insurance cash collateral typically backing up workers' compensation claims*. Significant cash collateral or letters of credit often support the future costs of workers' compensation claims. My experience is that insurance carriers require approximately two times the amount of needed collateral vs. a more realistic estimate of future claim costs. Insurance carriers are simply protecting themselves against the rare worst-case scenario. It typically takes three to seven years to harvest all the excess cash out of these situations, and it requires active management involvement to resolve open claims. Historically, millions of dollars have been generated for sellers by retaining this asset.

Other Factors

It is crucial to keep the secured lender regularly updated on the sales process. This reduces any potential conflict over decisions that the seller may need to make when finalizing the price and terms of sale. The same is true for creditors' committees in a chapter 11 case.

Even after you have agreed and signed the APA, the buyer and seller need to negotiate and finalize a transition-service agreement to ensure the smooth transition of ownership. Most buyers will try to subtly take over the business prior to closing by influencing management, who often will be switching ownership teams from the seller's team to the buyer's team after closing. You must not allow that takeover to prematurely occur, as this is a fine-line area and requires

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daily communications with the seller's management team and the buyer.

Conclusion

Selling a distressed business is a unique process that requires a much different approach than a profitable company sale process. Many investment bankers who sell profitable companies do not like the complicated and messy distressed-company environment. Industry experience is far less important when successfully managing distressed sales, as your buyer base is not primarily strategic, but it does include numerous financial buyers who like turnaround opportunities. abi