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Is the Distressed Industry Distressed?

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So—is the distressed industry distressed? The question has emerged at a time when the turnaround-management industry is in one of its typical down cycles, which has unexpectedly occurred in the midst of the country's "Great Recession." While some people shrug off the current difficulties as just another down cycle, others see a unique strategic issue emerging and perhaps a fundamental change in our industry.



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In the turnaround world, we regularly advise clients to adapt as old ways of doing business become obsolete and new opportunities (or risks) open up. We need to do the same.

While many within the business believe the turnaround industry is shrinking or never will be as big as they thought it would be, the change is less a matter of size than of focus. By addressing that change in focus, we can take advantage of new opportunities and better meet clients' needs. By most accounts, the overall distressed industry is still growing, albeit heavily fueled by international growth, making it worth our time and energy to explore these changes.

A Sea Change from Plans to Transactions

Almost from the industry's inception in 1978, driven by a dramatically revised Bankruptcy Code and the concept of rehabilitating a debtor in possession, the creation of plans of reorganization (PORs) formed a dominant activity. Distressed companies hired turnaround experts usually at the request (or demand) of secured lenders to help them

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manage through crisis, workout or bankruptcy proceedings, or to close down operations through liquidations. Lenders looked to turnaround professionals to mitigate their losses and improve recoveries. The market for distressed-business investors was small and poorly defined. Hiring a turnaround manager was often one of the very few options.

For the better part of the last decade, all of that has been changing. If the old era was the era of PORs, the new era is the era of transactions. The market for distressed companies has expanded

recession came to pass, hundreds of billions of dollars had been amassed worldwide to target distressed companies under a variety of strategies, all focused on leveraging information and timing to effect substantial returns. In essence, they traded on the commercial lenders' normal bias that their first loss is their best loss. Many investors expanded into the middle market over the same 20-year period, mimicking high-yield and distressed-debt investment strategies. Initially the distressed investors targeted the public-security markets, but in recent years, this category of investors has reached down into even the private-company lower-middle market.

At the start of the modern bankruptcy era when few companies could find liquidity, few corporations thought

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exponentially, in large part due to the rise of distressed private-equity and similar hedge fund strategies. The creation of this market has been unfolding since the invention of the high-yield market in the 1980s. High-yield was originally a high-risk/high-return product that often created more distress than anything else, but it allowed financial engineers to tinker with the concept of restructuring. The restructuring experts that emerged from the 1990s-era recession came equipped with ideas about how to invest in distressed companies. Some formed private-equity funds just for this purpose. Other financial engineers used hedge funds or more liquid strategies to trade in distressed products.

As the 2000-era recession approached, the fledgling industry was maturing. There were winners and losers, but there were mostly clear stories of fantastic returns paid on turnaround investments. By the time the most recent

it would be worth their time to buy distressed companies: They were messy, few people really knew how to fix them, and they could be career-killers. For many executives in the 1980s, bankruptcy was a place where companies went to die, not a place for management advancement or shareholder-value enhancement. As the art of the turnaround has become more of a science and as more financial advisers have developed relationships with companies both healthy and sick, the bridge between advisers and companies has strengthened, opening up more avenues for transactions. Additionally, within industries, companies often seek to enhance shareholder value by purchasing weakened competitors in new markets, particularly international ones. This expands the liquidity options for distressed companies.

The result is that while for decades hardly anyone was interested in buying a broken company, today competitive § 363 sales are common, as are debt sales

or trades and asset sales using Article 9 of the Uniform Commercial Code and other processes. Lenders have followed this trend, reducing their involvement in traditional workouts and focusing increasingly on distressed-asset sales as a way of clearing their balance sheets of dreaded nonperforming assets, which can be a drag on a lender's stock price. Transactions are attractive for lenders because they require minimal administrative costs, can occur rather quickly and provide greater certainty as to outcome. Yes, such "dumping" strategies can cause a bank to take greater losses than perhaps necessary if it opted for a reasonable turnaround plan instead. However, as we have seen, a well-orchestrated sale can generate competition for distressed assets, yielding good prices. Engaging turnaround managers in a risk-laden situation, on the other hand, can be a calculated gamble. That sort of bet is better suited for patient equity capital than more impatient and risk-averse lender capital.

A New Role for Turnaround Professionals

This transaction-driven environment has had a dramatic effect on the role played by turnaround professionals. Instead of trying to fix companies so they can be sold, turnaround professionals are increasingly coming on the scene to facilitate or manage a distressed company through a sale or liquidation transaction or alternatively to maximize value on behalf of a new owner. Real "fix-'em-up" turnaround work occurs at most in 20 percent of the engagements on which turnaround firms now work. In fact, if we were to ever return to the good old days of real turnaround engagements, our industry would have a critical shortage of experienced turnaround managers; the turnaround industry today is mostly populated with financial restructuring experts.

Investors in distressed assets are generally indifferent as to turnaround professionals working on a distressed middle-market company before its sale to them as investors. They like turnaround managers on site because this signals a real desire by the lenders and likely acceptance by ownership that a sale will occur in the near term. Additionally, they like the data and ideas that we feed to them as prospective buyers. However, they do not want us to fix anything that they can fix because that will just increase the required purchase price. They want that value pick-up for themselves.

An ownership change alters the goals of the turnaround, shifting the focus from quick fixes to long-term growth, virtually eliminating pre-transaction activity or reducing it to a set of limited-scope evaluations. As a result, today's turnaround work requires not just general knowledge of how to manage costs and cash, but more critically the in-depth industry expertise necessary to strategically position the company going forward in terms of business model, channels of distribution, product-line decisions, sourcing strategies and much more. Purchasers of distressed companies are aware of this and are highly selective in hiring, looking for a team that can understand both the specific problems that led to the company's collapse and the particular demands of the industry. Investors are also looking for long-term management and forms of compensation for the turnaround managers that are more in line with long-term goals. This shift has caused investors to look past the traditional crop of turnaround professionals and focus more on seasoned industry veterans. While in pre-transaction turnarounds this would be a dangerous choice, it works post-transaction because many of the immediate issues that plague companies—right-side balance-sheet problems (*i.e.*, too much debt)—are taken care of as part of the sale. The buyer of a distressed company usually provides enough capital to give the NewCo a reasonable financial runway to implement the plan.

Whereas in the past a single generalist might have been able to handle all of the issues facing a typical middle-market company, today most turnarounds can be effected only by a team of specialists working in concert to leverage complementary skill sets.

In the pre-transaction phase, usually the top orders are managing working capital and keeping a steady flow of business activities while in that cash-constrained mode. Growth projects and even some otherwise critical long-term functionality often have to be sacrificed due to lack of liquidity. It is a set of hard decisions to make, and for those

not trained to manage these decisions, it is nearly impossible to hold a company together until liquidity returns. In post-transaction situations, on the other hand, a post-acquisition plan has usually been put in place. The plan might outline performance-improvement projects that will take months or a year to produce returns. Cash management does not go by the wayside, but there is more time and generally more liquidity in a post-acquisition plan, allowing for a more tolerant, longer-term view of activities. This allows for more strategic industry-executive-type thinking, which, in turn, allows managers who are less focused on working capital management to drive the projects.

At the same time as the shift from pre-transaction to post-transaction work has made turnaround professionals' goals more comprehensive, greater globalization has also made the problems they face more complex. Middle-market companies now are frequently involved in multiple jurisdictions and multilayered relations with vendors and customers. This increased complexity, like the move to post-transaction work, is best addressed through greater specialization. Whereas in the past a single generalist might have been able to handle all of the issues facing a typical middle-market company, today most turnarounds can be effected only by a team of specialists working in concert to leverage complementary skill sets.

This shift is pushing crisis managers to become much more like performance-improvement consultants—a skill that is a little foreign to most in our industry. For traditional turnaround managers, this is not likely a well understood or well-accepted development. As a result of these changes in the industry, performance improvement skills will have to play a greater role in the lives of corporate renewal professionals, requiring turnaround manager types to change as well.

A Changing Competitive Landscape

The demand for turnaround firms is relatively low today. Many in the insolvency industry say business today is the slowest it has been in the last 20 years. Additionally, the distressed market's competitive landscape has changed and the profession is full of turnaround professionals and firms. Investment bankers have entered the field, industry performance-improvement consultants have

entered the field, and of course, many employed executives have made the big career step of buying \$40 boxes of business cards that certify them as turnaround consultants.

Without the focus in bankruptcy on PORs, the turnaround industry has become more open to other skill sets. As more companies find buyers, skills in orchestrating bankruptcies and maximizing liquidation values are becoming less relevant. This change is similar to what occurred in the commodities market more than 100 years ago, and to what happened more recently in the areas of equity and general M&A. In each case, an industry that was once opaque moved into the mainstream, inviting new competition, greater speed and lower transaction costs as a result. This led to “efficient markets,” allowing for a higher frequency of transactions. In the turnaround industry, this has led the true orchestrators of insolvency—the attorneys—to shift their practices from POR processors to M&A practitioners focused on distressed M&A.

At the same time that the field is opening to more professionals, the pool of referral sources is shrinking. The number of banks has been declining for decades, resulting in more firms seeking referrals from each bank. The list of banks will likely continue to shrink as the trends toward higher banking regulation, growing complexity of capital-market operations for lenders and increasingly sophisticated back-office operations increase the already-high capital expenditure cost of just staying competitive.

Consolidation is also occurring with regard to filing locations, as a small number of courts that have strong records for efficiency and consistency account for a greater percentage of business filings. This consolidation has resulted in a convergence of competition on a small number of venues, making geography less of a boundary to selecting professionals. At the same time, it has shifted the nexus for certain types of professionals to aggregate around these more popular venues of Manhattan and Delaware. Those who are negatively affected by this, however, can take comfort in the fact that the debtor-side work is not as impacted by these venue migrations, leaving turnaround professionals still a geographically dispersed group for now.

Keys to Future Success

The key to success in this new competitive landscape is to pay attention to

the changing profile of available opportunities and to cultivate the deep expertise that post-transaction work requires. Working on longer, more complex engagements for more selective clients, in a broader field populated by more professionals, firms will need to distinguish themselves in order to survive. The homogeneity that once characterized the industry is a thing of the past.

Turnaround firms have two main options in positioning themselves within the changing field: seek to become larger, or adapt to a particular niche. The larger firms, which have increased in number in recent years, have many employees operating internationally and focusing primarily on larger company work, allowing them to develop a wide variety of highly specialized work groups all operating inside the larger firm. This makes it possible for them to offer both breadth and depth of experience.

Smaller firms that lack the ability to cover as many industries and service types in-depth may be tempted to compete across the market by highlighting general business understanding. However, in order to succeed, they need to instead compete on expertise by developing a narrower focus, building a reputation for specific types of services in a small number of key industries. They can then harness the power of networking with others to fill in the gaps.

How busy the industry is is important, but in the long-term, these changes in how we do business are what will persist and what we need to consider as we make decisions about the future. The shift in focus from PORs to transactions will have a permanent impact on our industry, calling for a new level of specialization. The jack of all trades is becoming a low card in the industry’s deck. ■

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