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September 2004

ACCOUNTING & CONSULTING

Troubled company valuations

Corporate bargain hunters find hidden treasure in financially distressed businesses.
By James E. Travis and Kevin J. Hovorka

If you've ever rummaged through a yard sale, you've probably experienced the satisfaction of discovering a hidden gem amid the rubbish. In the corporate world, you can find similar bargains among financially troubled businesses -- if you know what to look for.

Despite the rebounding economy, many businesses continue to struggle. Numerous factors, both internal and external, can cause financial trouble. In the late 1990s, for example, many companies took advantage of readily available credit to finance acquisitions and other growth strategies.

When the economy declined, these businesses strained under the burden of excess debt. Other businesses are hurting for reasons ranging from management miscues to competitive pressures.

Just as with spotting a yard sale find, the key to distinguishing the business treasures from the junk is to figure out why a business is broken and determine whether you have the resources and skills to repair it.

Know what you're buying

Thorough due diligence is critical to any business acquisition, but when a troubled company is involved, the task can be particularly challenging. In a troubled business sale, there's pressure to close the transaction quickly, before the company runs out of cash. So you may have to accelerate the due diligence process.

You'll need to dig beneath the surface to pinpoint the

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causes of the company's financial trouble and evaluate whether there's a viable business. If the company is overleveraged or mismanaged, an infusion of capital or management talent may be all that's needed to turn things around.

But if demand for the company's products or services has dwindled, or if its technology has become obsolete, these obstacles may be insurmountable.

It's also important to investigate whether management's short-term survival tactics have done long-term damage. Has the company cut spending on marketing? Has it discounted its prices in an effort to hang on to customers?

These moves produce immediate cash-flow benefits, but may make it difficult for the company to recover in the long run.

What's it worth to you?

Placing a value on a troubled company raises issues that usually don't come up with healthy businesses. It's important, for example, to estimate both liquidation and going-concern value to see whether the company is worth more dead than alive.

Also, the process of normalizing operating results takes on added significance. The appraiser adjusts historical financial information to account for deficient or excess assets, nonrecurring income or expenses and other one-time or extraordinary items to develop a picture of the company's performance in the hands of another owner. Adjusting deferred repairs and maintenance on facilities and equipment is a common example.

When a company is experiencing financial trouble, conditions may be far from normal. It may have stopped investing in R&D, marketing or needed capital expenditures. Its working capital position may be distorted by inferior receivables, delinquent payables or obsolete inventory. Nervous vendors may have raised prices, tightened terms or both. The appraiser must perform an extensive analysis to project the company's earnings under normal conditions.

It's also important, in valuing the business, to consider the possibility of a bankruptcy reorganization. The availability of bankruptcy protections can have a large impact on the company's future performance and the buyer's ability to return the business to profitability.

One company's trash is another's treasure

Whether a troubled company has value depends, to a large extent, on who the buyer is. The buyer must have the ability -- through superior management expertise, access to capital or other advantages to correct the company's problems and get things back to normal. Often the best candidates are strategic buyers -- companies in the same industry as the target that can leverage economies of scale and other synergistic benefits.

Regardless of the buyer, thorough due diligence and sound valuation techniques are even more important for troubled companies than they are for healthy ones. Only through meticulous investigation and analysis can you separate the treasures from the trash. *James E. Travis and Kevin J. Hovorka are executives with consultants Crowe Chizek and Company LLC. Reach Travis at (630) 575-4250 or jtravis@crowechizek.com. Reach Hovorka at (630) 586-5129 or khovorka@crowechizek.com.*

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