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Sink or Swim

A wave of bankruptcies shines a spotlight on distress—and the need to put a price on it.

By Meta Levin

The numbers are sobering. By the end of 2008, the American Bankruptcy Institute reported that 43,546 US businesses had filed for bankruptcy during the preceding 12 months—12,901 of them in the fourth quarter alone. During that same period, the US Small Business Administration stated that the economy suffered its worst decline since 1982. If that weren't enough, in December 2008 the *Financial Times* reported that German-based Allianz, one of the world's largest credit insurers, predicted that 62,000 US companies would fail during 2009.

Regardless of whether a business actually fails, losses have to be quantified, at the very least to determine whether there is anything worth saving.

Truthfully, once you've identified that your business is in trouble, it's difficult to prevent the downward slide, says Scot Campbell, director of valuation for BIK & Co., LLP, a CPA firm with offices in Libertyville and Palatine, Ill. "People generally want to stay away; they don't want to extend credit and it has a spiraling effect, making it harder to succeed," he explains.

"We're seeing an increased amount of valuations," says Paul Melville, a certified insolvency and restructuring advisor and principal in Grant Thornton's Corporate Advisory and Restructuring services practice. Melville is an automotive corporate recovery and restructuring expert.

The reasons a company flounders are many. While the vast majority of entities are experiencing some kind of decline in business these days, some "are in distress because of a combination of the economic decline and an inability to absorb the downside risk because of limited resources, especially financing and financial resources," says Dr. Mark L. Frigo, director of The Center for Strategy, Execution and Valuation at DePaul University's Kellstadt Graduate School of Business. Frigo is also coauthor (with Joel Litman) of *Driven: Business Strategy, Human Actions and the Creation of Wealth*, and regularly contributes to the Center for Corporate Financial Leadership (CCFL) Executive Education Series.

Frigo's Return-Driven Strategy describes what he and Litman learned from studying successful companies. "Every high-performance company we studied in our research…faces a risk of fading, and in every case the reasons for the fade can be charted to how the tenets (of the Return-Driven Strategy)…began to be neglected or couldn't be executed," he explains.

For Avi Deitcher, principal of operations consulting firm Atomic, Inc., the prime objective in scrutinizing a failing company is to find a way to fix it. He places a value on it as it stands, and then determines what it could be worth if its failings were remedied. He also very objectively considers what it would take to save it.

Emotions run high when you're talking about value, problems and improvements, however. "The biggest challenge for owners or management is to recognize that they have a problem and that they need to get help," says Deitcher. "It's often difficult for an entrepreneur or even top management to come to terms with the fact that business revenues have dropped below the point at which the company is generating a reasonable profit. You have to get past the emotional and go back to the rational."

Reno Lovison, of Reno Lovison Marketing, provides auction values for failed or folding concerns. "These appraisals are usually used to negotiate debt, set a purchase price or occasionally are used by stakeholders who want to understand their downside exposure," he says.

Lovison first compares the assets in question to similar ones recently sold at auction or under quick or forced conditions. This comparison is part objective, part subjective, since Lovison

considers information such as the state of the economy and industry, where assets are stored and what's likely to affect potential value.

"This portion can be construed as subjective, but it is important for interested parties to consider for themselves whether the assets being evaluated might be selling at a time when the market for the property is strong or perhaps not as strong," he explains. "We are in a weak market right now, so businesses forced to liquidate will not find as many willing buyers. Since the ability to borrow also is tight, those who might want to buy may not have access to the financing they need. This all has an impact on the value."

Jim Schultz, director of business valuation services for FR&R Business Valuation Consulting LLC in Deerfield, Ill., recently worked on a case involving a construction company that did grading and roadwork. He looked at what might be on the horizon for this type of business, and in doing so considered the impact of potential federal and state government-funded infrastructure projects, as well as the types of operational controls and management changes that would be necessary to turn the business around.

In many cases, he says, the business might be in distress because of the loss of a key person, whether through retirement, death or departure for greener pastures. Without that key person, the business is worth less and, in extreme cases, nothing at all. You evaluate a distressed business using the same factors you would for a viable business—assets, market multiples and earnings. Depending on the specific situation, one or more of these may be deteriorating—and fast.

Ultimately, though, valuing a distressed business comes down to answering one question: How much cash flow will it generate in the future? "I look at the company's strengths, weaknesses, opportunities and threats, and I ask: 'Is the industry going up or down?' and 'Does the company have a weakness that it can turnaround?'" says Schultz. "You have to become an expert in the industry, which entails reading trade publications and talking to experts and business brokers. You also may need to establish whether or not there is a chance of renegotiating any loans or finding new lenders." After all the analysis, you may determine that there is indeed the possibility for future business opportunities.

When there is hope, ask, "At what rate is the business going to return to profitability?" "Somewhere you have to forecast what is doable," says Campbell. "Of course, any valuation requires some educated guesses," he cautions. That may include goodwill, intellectual property, patents, customer relations or a strong brand name—assets that may have been damaged as the company floundered.

"Activity in goodwill impairment can be a test," says Massimo Messina, a partner in Grant Thornton's Economic Advisory Services practice and leader of the Midwest Advisory Services Group, based in the Chicago metropolitan area. The business may take significant goodwill write-offs and, in fact, revalue all its assets. And while Messina reports that M&A is still down, the activity he's seen is amongst healthy businesses. "I haven't seen any bargain purchases," he comments.

Nevertheless, if the Allianz prediction is correct, there may be many more opportunities to put a price on distress in the coming months.

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