



Middle Market Turnaround Strategies: *Balanced Approach for Long-term Success*

by James Tyson, Director

Risk Factors

Some estimates place the number of distressed middle market companies (MMCs) at over 250,000. These estimates suggest that the number of underperforming MMCs is much higher. MMCs face different challenges than those faced by large cap, publicly-traded firms. The core products and services offered by MMCs are usually non-proprietary and provide little pricing leverage. In the absence of pricing leverage, MMCs are themselves vulnerable to increasing costs and expenses. These factors come together to limit opportunities for MMCs to build the cash reserves enjoyed by large cap companies. And, as we know, limited cash reserves place the MMC at a much greater risk to disruption or change—either in the MMC's specific market or in the economy as a whole.

Balanced Approach

Turnaround consultants are called upon for one very obvious reason—a company is facing a financial crisis. The first step is always triage: identify the problem, set priorities for action, and try to stop the bleeding. The next steps, whether accomplished with or without bankruptcy protection, involve longer-term solutions including debt restructuring, shedding (presumably) non-core assets, or an outright sale of the business.

These financial solutions, while absolutely necessary, seldom address the fundamental weaknesses in the company. Managers and professionals can become too focused on financial issues and forget the big picture, even though financial solutions are just one piece of the puzzle. A true solution

requires a clearly-defined strategy; an operational plan that is aligned with the strategy; a financial plan designed to support the strategy; and legal advice that is coordinated with the strategy.

Whether a company is in crisis, distressed, underperforming, or stretched by an aggressive growth curve, the integration of finance and operations pursuant to a well-defined and well-structured strategic plan, supported by sound legal advice, is the foundation of long-term success. The challenge is to find the proper balance.

Strategic Planning and Alignment

There are many different approaches to strategic planning and each approach offers unique advantages and disadvantages. Although the details will differ, the process is much the same—define the strategy, measure performance, manage the results. The most important aspect of strategic planning, more important than the particular planning tools or techniques used, is simply devoting the time to begin the process and developing the discipline to follow through.

In the beginning, the company must identify the value that it provides to its customers. This includes recognizing the company's core competency, understanding the value that it has to current customers, and understanding how that competency might be developed to anticipate the needs and wants of customers in the future. How many MMCs—distressed, underperforming, or otherwise—have actually taken the time to formally consider these issues, document their conclusions, and implement the results?

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ANNOUNCEMENTS

BBK is proud to announce the following team additions:

Steven Abbott, Senior Director
Detroit

Mark Bateman, Manager
Detroit

Alexander Craig, Managing Director
Detroit

Corina Dobre, Associate
Detroit

Monica Farhat-Apotheker, Executive Assistant
Detroit

Robert Fesmire, Manager
Detroit

Roland Heuke, Director
Frankfurt

Ulrich Koch, Director of BBK Ratings GmbH
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Richard Leal, Senior Director
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Manfred Schönleber, Managing Director
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For more information on any of the articles shown here, please contact marketing@e-bbk.com.

CASE STUDY

Laying Down the Price

BBK was recently engaged to create an expert witness report for a key player in the gaming industry. In this instance, the client was to operate as both management and financier of a contemplated Native casino. The client had incurred damages due to a partner's improper execution of the original business plan. As both the reasons for improper execution and the quantum of associated damages disagreed upon by the client and its former partner, BBK was brought in to provide an analysis.

BBK analyzed the original business plan to determine that, if it would have been executed, what profits would have been generated and subsequently made available to the client through its management services contract.

Although the plan was generated in 2002 and there is a lack of public financial data on Native casinos in this particular state, BBK took these steps to triangulate available data and generate a robust analysis:

- Reviewed agreements between the client and the tribe
- Compared two independent original market studies for gaming demand (in order to vet the revenue forecast) and then checked for subsequent and unforeseen changes in demographic, legislative and competitive environments



- Examined EBITDA margins of public gaming comps and provided a walk to the business plan forecast based on dynamics of gaming entities in closed markets
- Examined EBITDA margins of a limited population of Native casinos (in the same state) private via 144A bonds filings and established business plan margins were comparable

BBK concluded that the profits projected under the business plan were a reasonable proxy for what would have happened if the plan had been executed, and that the business plan's contemplated payments from the Native casino to the client were consistent with the executed agreements. ■

FINANCIAL

BBK's Client Support Services Group



BBK strives to provide clients with a full service organization that meets and exceeds needs and expectations, in both a professional manner and on a cost effective basis. BBK's Client Support Services Group (CSS) is a good example of this commitment.

The BBK CSS Group is made up of highly proficient analysts skilled in document research, data tracking, and fact-finding management and organization. Clients that employ the group find that they can improve performance through accelerated information gathering, improved data accuracy and implementation of more timely solutions. After all, time is not only money—it also enables you to increase your options significantly.

In the automotive sector, BBK's CSS Group currently provides clients with critical support relating to distressed supplier case-related:

- Payables
- Receivables
- Tooling
- Expense and recovery accounting
- Bridge parts bank management
- Escrow and disbursing agent services

Proper and successful management of the valuable accounts receivable (A/R) asset requires skill, diligence, persistence and hands-on professional experience. The BBK CSS Group offers A/R collections and portfolio valuation, review and oversight of best practices in credit management policy and procedures, and reserve and loss minimization advisory—they can deliver the immediate involvement, performance improvement and optimal results required in these areas.

The BBK CSS Group works seamlessly with clients' in-house teams. For example, a mid-sized community bank experiencing a construction-materials contractor loan required immediate assistance reviewing and collecting a seriously past due accounts receivable held as collateral. The BBK CSS Group quickly set up meetings with the supplier, contacted the general contractors and labor unions, preserved lien and bond rights, collected draws via joint checks, and provided detailed and timely updates to the bank's executive management. Maximum available funds were collected and the bank attributed the significant reduction in their distressed loan portfolio to BBK's CSS Group's actions, expertise, attention to detail and level of experience. ■

To learn more about the BBK CSS Group or for more case examples, please contact CSS Group Lead, Alin Stewart, at 248.603.6319 or astewart@e-bbk.com.

VIEW FROM CHINA

Private Equity in China

by James Feldkamp, Director, Excerpted from *Financier Worldwide*

Western private equity firms searching for the next source of home run deals have put China at the top of their list. The private equity industry is growing at an astounding pace in China. In the second quarter private equity firms invested \$2.4 billion in 45 Chinese companies, according to Zero2IPO. During the same period, venture capital firms—tracked separately from private equity—invested \$694 million in 113 Chinese companies, an increase of 66% over the first quarter. Over 55% of private equity funds were invested in traditional industries, while 58% of venture capital money was directed to the IT sector.

An estimated 300 private equity and venture capital houses are currently operating in China. Firms are flocking to the country on the heels of huge returns—such as the 100-fold gains of Draper Fisher Jurvetson on Baidu and the 1000 percent return of Carlyle on Ctrip. But although the China private equity market is garnering plenty of attention, the opportunity for sizeable rewards is not without pitfalls.

Perhaps the biggest challenge centres on regulations. For example, the regulation that prohibits foreign private equity firms from transferring their shares to Chinese citizens closes domestic listings as an exit mechanism. In response, buyout and VC firms pursue external exit routes, such as listings in the US or London.

Rumours abound that new policies will be forthcoming in the weeks or months ahead. But that is small comfort in the meantime. Barings Private Equity Asia has noted that investors apply a discount of up to 30 percent on China investments due to the regulatory risk.

There will be considerable political posturing in the run up to the fall Party's Congress, as the government sets the stage for the next term. The current government has been notably friendly to foreign investors and aware of the benefits they provide. However, an agitated population and concerns that the market has become a bit frothy is urging leaders to consider countermeasures, to keep the economy from spiraling out of control and to increase the prominence position of local firms. For now, the Chinese government remains progressive. It continues to grow more sophisticated and the majority of its regulations are market oriented.

With funds oversubscribed and investor pressure to pursue above market returns in Asia, private equity managers frequently underestimate the challenges and risks involved. The two primary challenges for private equity investment in China are ownership control and capital control.

Due to the relatively recent privatisation of businesses in China, companies are largely run by first generation entrepreneurs or government-installed managers with a strong reluctance to relinquish control of their companies. They develop a deep emotional bond with their organisation that contrasts with the more detached professional management culture of



established entities in developed markets. Consequently, foreign private equity firms can fight tooth and nail for ownership rights on paper, but actual control may not manifest itself in practice. Frequently a local manager, even if he only retains a minority interest post-deal, will stubbornly continue to oversee the company's direction and its flow of funds. As a result, many foreign private equity firms are increasingly considering minority interests with defined influence over operations instead. This can be better for all parties and prevents the private equity firm from harbouring a false sense of security that it is definitely in control.

Easing this process is the growing trend of Western private equity firms partnering with local firms led by Asian nationals. While 80 percent of private equity investments in 2006 were made by foreign firms, local leadership teams were deployed to develop front end relationships with potential targets. The days of Western representatives of foreign firms entering negotiation rooms to face Chinese owners are fading. Today, deals are being managed by domestic teams, and discussions are carried out in Mandarin or the local dialect.

Proven Chinese entrepreneurs are joining private equity firms in rising numbers. Among them are Hurst Lin, former founder and chief executive of Sina who joined Doll Capital Management, and Neil Shen, founder and president of Ctrip who joined Sequoia. When successful entrepreneurs form part of the investment team, it helps to build team spirit and close the deal, as the seller may be negotiating with a respected role model who has already made it in the domestic market. Hiring local entrepreneurs has also boosted the dispersion of leadership and operational skills throughout the Chinese market in recent years.

In addition to the ownership control issue, the other major hurdle is capital control, which requires prospective acquirers to do their homework. Buyers must be prepared to analyse the target at length to determine what capital controls are in place, who has the relevant authority and whether avenues for capital flight can be closed. The Chinese government is trying to control the incidence of management teams or owners siphoning capital offshore. In 2005 they introduced regulations to eliminate many offshore vehicles and make them illegal for domestic companies to establish. This law was subsequently repealed, however, as it immediately created a huge backlog of pending private equity deals requiring review and special approval under the introduced regulations.

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Balanced Approach

Once the company has a clear understanding of its customers' needs, it can develop the internal processes that are necessary to satisfy those needs. All companies have processes in place that are used to deliver the company's products or services, but the key is to make the connection between internal process design and customer needs. In this context, developing the internal process means going through the formal exercise of considering how the internal process satisfies the customer and continually improving the process to meet the needs of customers as they evolve.

Well-designed internal processes alone won't guarantee customer satisfaction. The next step is to align the company's intangible assets—knowledge, people, organization, culture, and systems—to support the critical internal processes and make them operate effectively and efficiently. This alignment is the most important aspect of the strategic plan; it connects your most important resource, your people, to your customers in the best way.

This isn't as esoteric as it sounds.

If a shirt laundry learns that its customers value quick turnaround of perfectly-cleaned shirts (with all of the buttons intact), it means that it needs to a) identify those employees that are best at cleaning shirts; b) assign them to shirt cleaning; c) offer training to improve their shirt cleaning skills; d) schedule sufficient labor and machine time to meet customers' turnaround needs; e) implement a button-inspection process to count broken buttons; f) determine what is breaking the buttons and fix it; g) replace the broken buttons; and h) let the rest of the world know how well it's doing.

It seems like common sense. But, as the saying goes, common sense is often not-so-common. Effective strategic planning requires someone to organize and manage the process. The strategic planning manager or consultant must create action plans to implement the strategy and develop measurements for key criteria to monitor the effectiveness of critical processes.

While strategic planning is an important part of the cure for distressed companies, it is best used as a prevention tool. In that sense, implementation of a strategic planning cycle is essential for all MMCs. Managers need this process to constantly stay on top of the business, its challenges and

its opportunities. MMCs should take advantage of their smaller size to move quickly, build effective teams of both employees and professionals, and make quick decisions—all in the context of a well-defined strategic plan.



"It's important for everyone involved to understand that as a company becomes more distressed its options become more restricted"

Early Intervention

When managers at MMCs fail to develop a clear strategic plan and fail to align their resources to fully support the plan, the failures can lead to a financial crisis. If they then fail to recognize (or refuse to make) the tough decisions that are necessary to right the ship, the situation can deteriorate. As this happens, some managers may see the reality but won't understand how they arrived in that position, or other managers won't see (or will choose to ignore) the reality. Either case will hinder the possibility of early intervention and reduce the chances for success.

It's important for everyone involved to understand that as a company becomes more distressed its options become more restricted. Underperforming companies still have the luxury of deciding what is best for everyone in the long term. The key, of course, is to face the situation as early as possible, when liability risk is lower and the chance for success is greater. Early intervention can be the difference between negotiating the turnaround of an underperforming company or the restructuring of a company in bankruptcy.

Conclusion

The ultimate success of a turnaround engagement often lies with the willingness of management to face the reality of their situation quickly and honestly—and then to have the courage to seek the help that they need to resolve the problem. When a distressed company seeks help, it should understand that financial, operational and legal advice are necessary to provide a balanced solution. Like a three-legged stool, each discipline must work together to support the whole. Financial triage will always be the first step, but long-term success in turnaround engagements requires an emphasis on strategic and operational issues. Once the strategic plan is developed, financial solutions will buy the time necessary to make operational changes and implement the strategy, while legal solutions should provide the environment in which things can get done.

In the end, good strategic planning asks and answers the most important questions faced by every business: Do we have the right products in the right markets? Are our assets properly and efficiently deployed? Can we respond quickly to change? Are we building for a solid future or just trying to survive the day? If the company doesn't ask and answer these questions early and often, the questions will be answered by creditors, lawyers and the courts—and that's not a good strategy. ■



LETTER FROM BBK

Ready to Make the Deal

Private Equity in Automotive Restructuring

I recently had the opportunity to attend and speak at the Automotive Industry Restructuring Finance Summit in Dearborn this past September. The Summit enabled automotive suppliers and private equity funds to share their perspectives on the automotive industry and exchange ideas for success in the future. The number of private equity firms in attendance was a tremendous statement. By my calculations, there were over \$300 billion of funds represented! The next time somebody tells you they can't get refinancing, it's not because there aren't willing partners out there.

Those of us at BBK have been well aware of the number of interested investors in the automotive space. The challenge to obtain financing for many automotive suppliers is two fold: 1) who are the funds and how do I get to meet them, and 2) what are the expectations of these funds, from the company, in order to attain a deal?

Included in the Summit was a workshop I conducted with Guy Morgan, Managing Director, to answer these questions. The workshop was well attended and showed the thirst of information that many middle market automotive suppliers have for private equity firms. In our workshop, we emphasized the need for three important factors—advanced planning, honesty in future financial performance projections, and a clear plan to achieve change. Too often we see failed deals because the company starts the process too late and value has eroded despite management's best efforts to keep things together.

As one of our panelists said about advanced planning, "when you're so far behind that you have to work six months to get to the starting line, you limit your options." How true.

We also talked about the need for honesty in financial projections—private equity firms have seen the unrealistic projections too many times. We asked, "why is today always the low point in the projections?" Consider the "hee-haw test"—will a reader of your projections truly believe them and your plans, or will they dismiss them as just a joke? We encouraged our attendees to take a good honest look at their plans and projections.

Finally, we focused on change. What are you doing today that will yield different results tomorrow? The focus on change should not only be present strategically in the business, but also in operations on the plant floor.

These three factors are critical for a successful financial turnaround. Restructuring in the automotive industry can face many challenges and the Summit was a great chance for suppliers and private equity funds to discuss financial solutions to support a stronger automotive industry in the future.

Companies that face restructuring on their own can make the process more difficult by taking on too much (from implementing the restructuring, learning the process, working with creditors and running the business—all at the same time). Planning ahead and lining up resources you can trust early in the process is the best decision to maximize your results.

Jim Connor
Managing Director

For more information or a copy of the Automotive Summit Workshop materials, contact Jim at jconnor@e-bbk.com

EXPANDING LEADERSHIP

BBK is pleased to announce the addition of two Managing Directors:

Alexander Craig joins BBK in Detroit as a Managing Director in the Corporate Advisory Group. He has over 25 years of business management/executive management experience in the aerospace, information technology, insurance and manufacturing industries.

Manfred Schönleber joins BBK in Frankfurt as Managing Director European Operations Group Lead. He has over 30 years of experience in Germany, the United States and Austria and brings his expertise in purchasing, supplier development, quality, cost benchmarking and launch management.

INDUSTRY EVENTS

BBK voiced its thought leadership at the following industry events:

August 22, 2007 OESA Council Meeting, Mike Wagner, Director of Proactive Services, spoke on "Proactive Process".

September 20, 2007 Automotive Industry Restructuring Finance Summit, Jim Connor, Managing Director, moderated a panel on "Early Experiences with Financial Restructuring: Successes and Lessons Learned".

October 9, 2007 at the OESA Merger Mania: Value Investing in the Automotive Sector, William G. Diehl, President and CEO, presented "Polarized Supplier Performance: Characteristics of 'A' Players".

October 12, 2007 at the Mid-America Plastics Partners Annual Conference, Guy Morgan, Managing Director, presented "Small Processors Can Win Big".

October 29, 2007 for the Institute of Management Accountants and Financial Executives International, William G. Diehl presented "Navigating Trouble on the Horizon" with James Plemmons, Dickinson Wright PLLC.

BBK also participated in the Center for Automotive Research's Management Briefing Seminars in Traverse City, MI, the Automotive Industry Restructuring Finance Summit in Dearborn, MI, the APICS International Conference and Expo in Denver, CO, and the AME Annual Conference in Chicago, IL.



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Private Equity in China

Ultimately, although deadlines can be short in China as competing firms chase different deals promising exceptional

exit multiples, there is no excuse for neglecting due diligence. Buyers need to track assets and cash flow thoroughly. They must be prepared to get their hands dirty and delve into the target's financial records, which in China typically consists of multiple sets of books. This takes on even greater importance if the target company is the subsidiary of a larger conglomerate, as it can be unclear exactly how much capital will be attributed to the unit once it is spun out. At the same time, buyers must be careful to avoid being mired down in paperwork. Failure to set research objectives and to know precisely what to look for can make the entire exercise fruitless.

Once the relevant financial information has been uncovered, the next step is to return to the negotiation table and outlay the exact changes required. If the planned exit is through international financial markets, this is a positive motivator for ensuring the target company adopts certain reforms and heads

toward compliance. But such changes do not occur overnight, and when the deal is signed, it will doubtless be based to a certain extent on intangible promises regarding the future direction of the entity.

Investments are taking place chiefly in the IT and financial sectors. IT tends to be busier as it is not dominated by state-owned enterprises, which trigger government controls, and the leadership demographic is more progressive and entrepreneurial. In addition, financial sector investments are longer term due to industry-specific regulatory constraints, which also make exits more difficult to realise.

Activity has reached a point where several signs hint that an IT bubble may be forming in China, just as it did in the US. It may be a self-fulfilling prophecy as the same players from the US and Europe repeat old strategies in a new market. These players need to know their history, do their homework, and partner with effective advisors that have profound understanding and extensive experience to account for the unique challenges that China presents in this global environment. After all, successful private equity investments in China, for all their promise, are by no means guaranteed. ■



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