Identifying and managing special situations at VC-backed companies

Yoav Kfir, CEO at special situations advisory VAR Management, answers frequently asked questions about distressed situations – one of the most common special situation investments – and proffers ideas on how they could best be managed.

Economic data show a double digit percentage of *distressed* companies in the local Israeli economy. The problem embraces from 10 percent to 50 percent of companies depending on macro economic circumstances as well as industry sector characteristics, timing and other factors. While the start-up/VC environment is built on a few, very strong successes or home runs, weaker portfolio companies are more common and essential for stronger ones to be built upon.

What is a special situation?

Special situation is a term widely used to describe unconventional occurrences in an enterprise life cycle. It may include restructuring, reorganization, transition or change scenarios, as well as winding down and liquidation.

What are the common symptoms of a distressed special situation?

One of the major obstacles we face is that we are often called into a situation and asked to advise, manage and execute too late. As in any personal health problem, the sooner you are aware of a problem and act accordingly, the better the chances to get it cured.

We can often quickly spot the most common symptoms of corporate illness or a developing special situation. The leading causes are:

- Cash problems. Less than 9-12 months of cash calls for an inspection. The longer one waits, the fewer one's options.
- Internal personal problems impacting the board of directors, shareholders and/or management.
- Non-compliance in submission of corporate documents, tax filings, formal/governmental reports.
- Repeatedly unmet business plan milestones – financial and operational.

What are the interests and exposures in a special situation?

Special situations usually cause conflicts of interests among participants.

Different groups (i.e. shareholders, board members, management, employees, creditors, suppliers) may have diverse interests. One of our most important missions is to make sure that all participants have a clear view of their exposures and interests. With that perspective, several viable options can be evaluated, and a proper *game plan* can be structured.

The most common interests that are usually identified for shareholders and board members include:

- Maximization of proceeds in an M&A transaction
- Maximization of chances for recovery/restructuring
- Minimization of additional cash infusion
- Minimization of personal liability of directors and officers
- Minimization of bad public relations
- Retaining industry and employee trust in investor
- Minimization of management attention

Creditors and employees have other sets of interests.

What can be done in a special situation?

While we all remember the famous tale of the Baron Munchausen who pulled himself by the hair out of a swamp, I think most of us would find such a task very difficult to accomplish. Just like you need a doctor to perform surgery, you need an outside professional expert to fix *special* corporate problems.

The early stage treatment

If a professional expert is on the scene early enough, no immediate *stress* treatment may be required. The outcome of his/her work may be just a risk and exposure analysis followed by more frequent parameter reviews and company monitoring on a bi-weekly, monthly or quarterly basis.

The mature stage treatment

At other times, risk analysis outcome can lead a professional expert to prepare and assist in implementing short and long term recovery plans which might also include a potential M&A transaction.

The last minute treatment

In cases where a company does not have time or funds to do much, the options may include:

- Revealing exposures toward relevant groups – creditors, shareholders and board of directors
- Immediate downsizing to reduce cash drain
- Creditor arrangements
- Proper corporate resolutions
- Distressed M&A

It is important to remember that D&O insurance policies won't always cover company directors and officers in such cases.

To add a bit of optimistic flavor, I would note

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that in certain *insolvent* cases we have handled, and where liabilities were even two to three times larger than assets, a rapid M&A process resulted in proceeds of millions of dollars that were distributed later to shareholders with no legal action taken against the company and/or board of directors.

The 'late arrivals'

We sometime get one to three year-old cases that have not been properly treated and terminated. In such cases, we try to solve and minimize personal and company claims, clean-up formal, governmental reporting and liability issues and see that entities are properly and officially dissolved, whether in Israel, the US, the EU or another place.

Who are the players?

Most of our successful M&A transactions in distressed situations (over 15 in the last two-three years, generating proceeds of over $75 million) were within the *close circle* of the distressed company – entities relating to shareholders, commercial parties (clients, distributors, suppliers), competitors and key employees. Approaching a wider circle requires more resources of time and money, but may result in greater rewards. In certain larger transactions, we usually approach foreign private equity firms, hedge funds and/or individual investors that may be interested in such investment opportunities.

An optimistic conclusion

As the name implies, special situations require special attention. While special situations cases may shed risk and exposure, they can also present an opportunity for growth and change, leading to a better corporate and personal future.

Looking at the glass as being half full rather than half empty can only benefit you as a shareholder. In the worst case, you will reduce management attention and free funds to focus on better opportunities. In other cases, M&A transactions can generate returns on equity of millions of dollars, or alternatively companies can be restructured and turned into successful enterprises. ■