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Crisis Management Experts:

Maximizing Shareholder Value in Distressed Situations

Whether one calls them crisis managers, workout or turnaround professionals, such specialists are in demand by beleaguered equipment leasing companies helping them to maximize shareholder value and work out problem situations whenever possible.

By Susan Carol

Call them crisis managers, workout or turnaround professionals, but regardless of your label, when a leasing company gets into trouble, the company's board or its senior managers may well wish to consider calling in such specialists. These are trained professionals who can (1) provide an independent review and appraisal of the company's plight, (2) provide additional, experienced resources to assist senior management in its turnaround efforts or, if necessary, (3) replace existing management with professionals experienced in the "fire drill" known in the industry as crisis management.

Amid the news of high-profile scandals and business failures, such specialists are in demand in the equipment leasing and finance industry, helping beleaguered companies maximize shareholder value by stopping the hemorrhaging, working out the company's problems or, if this proves impossible, moving the company into a bankruptcy and reorganization or liquidation.

"Banks aren't the only financial institutions suffering from the downturn of the economy," says Larry Smircich, managing director of Malvern Hill Associates, a crisis management and turnaround boutique headquartered in Stamford, CT. "It seems as if almost every day there is an article on monitordaily.com about a leasing company in trouble, with the attendant accounting irregularities, write-offs, divestitures and liquidations." While existing management, frequently assisted or replaced by professional crisis managers, is often able to salvage these situations, unfortunately some cannot be saved, with the result that Chapter 11 reorganizations and Chapter 7 liquidations are on the rise. According to the 2002 Industry Future Council Report published by the Equipment Leasing Association (ELA), 100 rollups and bankruptcies have occurred within the past two years.

Ed Castagna, senior executive vice president of Nassau Asset Management, of Roslyn Heights, NY, has seen a change in his company's business mix. In 2002, he noted a dramatic increase in the number of companies in trouble. "It's up a good 40 percent," he says. Nassau has been providing recovery, collections, remarketing and appraisals for more than 25 years and, in a troubled economy, is often called upon to squeeze cash out of equipment values and shore up a lessor's asset management department. When the economy began to soften, Nassau added additional personnel and an integrated information system to provide clients with very detailed reports on every asset—including its value and the stage of the sale.

"We can try to collect from and rehabilitate troubled lessees. We stay with the assignment from beginning to end, from collection to liquidation—and everything in between," Castagna says.

Why the demise of so many lessors?

Peter Otto, a fellow managing director with Smircich at Malvern Hill, asserts that recent leasing company failures support the findings of The Alta Group's report, Perfect Storms, which was published a year ago in conjunction with the ELA's Equipment Leasing and Finance Foundation. "Lessors often fail when the board or senior managers force the company to grow out of its niche. This kind of change is usually driven by someone with a very dominant personality that overwhelms the existing culture. On several occasions, Smircich and Otto have witnessed board members and managers who, in their drive to achieve their own goals, implement deeply flawed business plans, cut off two-way communication with their subordinates, and figuratively kill the messengers bearing bad tidings when the business deteriorates. Too often, with "incentives" like these, subordinates become "yes men," and the damage of these strategies grows undiscovered until it may be too late to fix.

"From what I've observed," says Castagna, "the problem is in the origination of the deals. In their head-over-heals drive for growth, a lot of companies are buying portfolios that they didn't have a role in making—maybe they were broker packages. They got a lot of bad deals by focusing on volume and not quality." Like Otto, Castagna agrees that prompt action can make or break a business. When a lessor is in trouble, it makes sense to get out of the deal and cut the losses—before it's too late.

Charles Kelley is a partner in the worldwide legal firm of Mayer, Brown, Rowe & Maw, based in Houston, and has 11 years of experience in representing Fortune 500 companies through business reorganizations. Kelley says many problems he sees stem from poor management. "Managers need to be asking themselves: 'What am I doing wrong?'" He says too often managers get away from their core business or buy new businesses too fast and fail to write off the "goodwill" that artificially inflates portfolio values.

Unbridled Optimism

Overextending a business can result from unbridled optimism—either a belief that good times are just around the corner or that future returns will be exceptionally high. "Sometimes, when things go bad, people double the bet," Otto notes. "In the USA Capital case (see case example below), its loans went bad, so they got more loans to cover the bad loans." Otto says it appeared to be a variation of a Ponzi scheme: "They were just trying to keep the company afloat until good times—which never came."

Unbridled optimism can also lead to inflated asset values, something Castagna has seen in his business. Appraisal is a tricky business, and if it's done wrong, it can undermine a lessor's portfolio. Castagna says Nassau's many years in the business and day-to-day experience in equipment remarketing grounds its appraisals.

"We're always conservative and realistic. We've very in tune with the market. If we say something's worth X, more often than not, it's worth X," he says. Castagna's company recently integrated its IT systems to better evaluate its data and provide more valuable reporting on assets. The result is an equipment remarketing index that tracks, among other things, the sale price of equipment as a percentage of its original cost. Information like this has led many of Castagna's long-term clients to rely not just on Nassau's equipment remarketing services, but on its expertise in dealing with equipment values. Those clients use that information to set residuals and manage their portfolios.

Smircich noted that Castagna's conservative approach toward appraisals might have helped avoid the turnaround/liquidation case Malvern Hill worked on in Texas—Houston Convenience, d/b/a MS Express, a chain of 70 convenience stores. A bank conservatively lent Houston Convenience slightly more than 50% of the stores' value, as appraised by a national accounting firm. The only problem is that, when liquidated, the company's assets realized only a small fraction of the loan —much less than the appraised value.

Turnarounds and the Bankruptcy Process

Timely turnaround services can provide the intensive care needed to avert a fatal crisis if there are only moderate cash flow problems or sales below expectations. As long as the business model makes sense and there is a revenue source, there's hope for recovery, Malvern Hill's managing directors maintain. Prompt treatment is the key, but "often, we are called in too late," Otto says.

If there is not enough time or liquidity to effect a turnaround, a bankruptcy filing may be a company's best alternative. Smircich says, "There are basically two possible Chapter 11 outcomes: restructuring or liquidation." Most Chapter 11 filings in the U.S. lead to a restructuring. With creditors held at bay by the first- day orders from the court, the company has time to develop and submit to the bankruptcy court a reorganization plan that is subject to the review and approval of the creditors. During this process, crisis management specialists can help preserve core businesses within a lessor's organization, protecting the corporation's reputation and allowing its essential business units to operate as usual under the protection of Chapter 11.

Kelley observed the efforts of Malvern Hill to save MS Express, the Houston convenience store chain. "Malvern Hill is comfortable making decisions in a speedy manner," Kelley notes. "Their associates are cost effective and smart about managing resources to bring maximum value. In other words, they don't spend $100 to save a penny," adds Kelley, who specializes in both business reorganization and civil litigation for major corporations, engineering firms, real estate investment companies, banks and accounting firms.

Case Example: USA Capital

As a result of an introduction and recommendation by the workout department of a major New York bank, Malvern Hill was retained by the board of USA Capital, Inc., a Denver-based leasing company that had experienced significant accounting irregularities and had removed its senior managers. According to Malvern Hill's principals, the loss of its credibility with its lenders as a result of these irregularities had killed any hope of saving this company.

"We concentrated instead on first identifying which lenders had security interests in which assets, then on transferring the servicing of these leases to third-party servicers with compatible accounting systems. Finally, having moved the lender's collateral out of the immediate control of USA Capital, we focused on filing for Chapter 11 protection," Otto said. This was accomplished within the first three weeks of the assignment. "After this fire drill, we spent the next five months collecting the unencumbered receivables, converting the case to a Chapter 7 liquidation, winding up the company, and finally, turning the keys for the remnant assets over to Harvey Sender, of Sender & Wasserman, P.C., the company's Denver-based Chapter 7 trustee."

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At Sender's request, the U.S. Bankruptcy Court for the District of Colorado designated Nassau as the third-party asset liquidator for USA Capital in 2001. "Our role was to liquidate equipment according to the requirements of the court order—meeting the needs for issuing legal notices, acquiring competitive bids and assuring commercially reasonable sales," Castagna says. The work is ongoing.

While Nassau can conduct auctions and liquidate assets in a single day, it specializes in orderly liquidations, which keep control of the sale, including prices, timing and conditions, with the client. The asset and the amount of time available for liquidation determine which method of sale is best.

Case Example: Xerox Credit Corporation

A classic case of a business model getting overextended was Xerox Credit Corporation (XCC), based in Stamford, CT. XCC initially leased only Xerox equipment to Xerox customers. It acquired several niche leasing companies in the 1980s and rapidly expanded its customer base to include all manner of non-Xerox equipment—e.g. vehicles, aircraft, ships, medical equipment, etc.—to borrowers in the U.S., U.K. and France. During that era, Xerox labeled itself as a "document and financial services company" in its annual reports.

It introduced a reward system that pushed the heads of its new subsidiaries to grow out of their niche and achieve 20 percent annual growth in loan volume. Senior management of these subsidiaries was given credit authority and, at the same time, compensated on an incentive program based on achieving volume. Even years later, Smircich has to shake his head when recounting this formula for disaster, one that he has seen repeated over and over in the industry. "Anyone can achieve volume. This problem is getting the first monthly payment back from your lessee/borrower!"

In 1990, Xerox elected to withdraw from the third-party finance business and revert to financing Xerox transactions only. Unable to sell this business for the price it wanted, Xerox initiated a liquidation plan in 1991, which was completed in 1997.

The initial strategy pursued by Smircich for XCC was to use secu-

ritization as an exit strategy for three of the companies, thereby getting more than a billion dollars of lease receivables off the balance sheet. To reduce headcount, Otto was able to outsource almost all of the collection process, cutting XCC's headcount to a very small handful of managers working for Otto who "watched the ranch" while the labor-intensive tasks, and their inherent costs, were transferred to companies with vastly lower cost structures. In the end, the liquidation came out much better than XCC's liquidation plan. At the end of the day and in the spirit of all good crisis managers, Otto shut off the lights, locked the front door, and mailed his keys back to his ultimate boss at Xerox, Stuart Ross.

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Ross, a former vice president and CFO of Xerox Corporation, had assumed the role of chairman and CEO of Xerox's financial services business to head up the liquidation process. He reports that while this liquidation was not easy and careers were unfortunately affected, they considered the overall outcome a success. Smircich and Otto were successful, he says, because they were able to communicate the value of the company's assets to potential buyers.

"None of the companies that Xerox acquired went bankrupt. We found good CEOs to run them, and creditors were satisfied," he reports. Today, Ross, who was with Xerox for 33 years, is retired and in demand to serve on corporate boards. Xerox may have become overextended, but he says the company had excess capital to invest and had a vision of becoming a holding company like GE. Then, the market took a downturn in the late '80s to early '90s, and Xerox reconsidered its strategy.

Successful turnaround secrets

"Sound business judgment is the key in a turnaround," says Smircich. "We have a reputation for being straight shooters." In fact, Smircich says he is not afraid to suggest to a reluctant board of directors or company chief that it would be far better to bring in outsiders to stand behind them rather than being alone up front, holding the bag when the litigation process begins.

"They know we will make sound business judgments that try to preserve and protect shareholder values rather than the flummery of the prior situation," says Otto.

Castagna and Kelley say senior managers and board members invested in a company are likely to spot problems faster than they have in the past. Referring to an "Enron Effect," Kelley says investors are now going to scrutinize numbers to ensure that assets are valued correctly and that all of the numbers make sense.

"Businesses are aware that the media, the public and government are watching, so they are working hard to do the right thing. They should be calling in outside assistance sooner," Kelley adds.

For more information on Malvern Hill Associates, log onto their web site, www.malvernhill.com. For Nassau Assert Management, see www.nasset.com. Lastly, for Mayer, Brown, Rowe & Maw, see www.mayerbrown.com *m*

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