Orderly LIQUIDATIONS Can MAXIMIZE Return

by Edward Castagna

The American economy is witnessing a record number of corporate failures and turnarounds. For the typical lender caught in the middle, a standard strategy for squeezing cash out of liquidated assets is to schedule a forced liquidation, also known as a "fire sale" or auction. Many lenders do not realize that there is another option available — orderly liquidation — which can recoup a higher return on liquidated assets.

There are key differences between the orderly liquidation and auction processes that lenders should consider. Orderly liquidations allow a longer time frame than auctions for gathering competitive bids. This can eliminate the variables that sometimes sink an auction sale, (i.e., inclement weather, remote locations and top bids that fall far short of an equipment's worth).

Orderly liquidations, however, frequently prove a better option than auctions for maximizing the value of distressed assets. Armed with this knowledge, lenders can manage liquidations more effectively through economic downturns and recoveries.

Liquidations on rise

Asset managers and workout specialists at financial institutions are dealing with the fallout from an unprecedented level of corporate failures in 2002. Unfortunately, experts are predicting similar tidings in 2003.

PricewaterhouseCoopers (PwC) estimates that public bankruptcy filings this year will decline slightly, to approximately $240 billion worth of assets. "With economic growth not expected to accelerate until the second half of 2003, there will be little immediate relief for the most 'at-risk' companies in industries that have faced significant overcapacity (or low capacity utilization), severe price competition, and declining growth prospects….The bankruptcy picture for 2003 will represent only a slight improvement from 2002 rather than the beginning of a return to historical levels," according to "The Phoenix Forecast: Bankruptcy Barometer 2003," published by PwC.

It's clear that lenders should brace themselves. On a positive note, lenders are refining their liquidation strate-

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gies during these difficult economic times and will emerge better equipped to manage loan defaults and bankruptcies that are inevitable even in the most robust economies.

Liquidation options

In an orderly liquidation, equipment is marketed and sold over a flexible period of time at a flexible price that is specified by the creditors. Equipment may be sold individually, as groups of assets, or as an entire portfolio. Creditors and/or courts can hire an outside remarketing company that handles orderly liquidations to manage the process from start to finish. The remarketing company can recover the equipment if necessary, store it, and orderly liquidate it, or can liquidate the equipment from its home location. Today, many orderly liquidations are conducted via Web sites that enable remarketers to post details about the equipment and gather bids.

Orderly liquidations help creditors. For example, creditors can adjust the time frame, if necessary, to attract a larger base of bidders, including international buyers who may want to inspect the equipment before making a purchasing decision. They can also cut the time frame short if needed for a faster sale. Orderly liquidations are particularly useful when selling specialized equipment that cannot be marketed to the general public and/or when the equipment is housed in a remote location that would hamper the chances of attracting large numbers of buyers to a public auction. Remarketers with global experience can even tap into international markets to command a higher selling price. This method also allows creditors to begin selling off items individually, as they become available; for example, railcars arriving from various locations.

In an auction**,** equipment is marketed and then sold on a specific date. Creditors and/or courts can hire an outside company to manage the process. The equipment may be delivered to the auction house, or it may remain at its home location until the sale. Today, some auctions are Internet-based, but the majority are public auctions held at a specific location. Most auctions also are structured as absolute auctions, which means equipment is sold for the highest bid made during the sale, regardless of its worth. Other auctions that operate with reserves will sell equipment only if bids reach a predetermined threshold. Unfortunately, reserve auctions may deter bidders looking for bargains.

Auctions are usually the best strategy for selling assets with wide public appeal, such as automobiles and computers. Auctions also tend to attract a large number of bidders quickly. Creditors also should consider this method whenever a fast, all-encompassing sale might be in their best financial interests; for example, to allow a troubled business to close swiftly and avoid incurring additional expenses. However, creditors must remember that orderly liquidations also can be structured to sell off assets quickly. Before determining an optimum selling strategy, creditors should consider the types of assets being sold, location, overall financial situation and other relevant variables.

Both orderly liquidations and auctions require targeted advertising in order to reach potential buyers. To be effective, on-site auctions also must be held in an easily accessible location on a convenient date. One element that cannot be controlled when scheduling an on-site auction is the chance of severe weather, which may chase away bidders.

When comparing the up-front costs of an orderly liquidation versus auction, lenders should keep in mind that most remarketing companies usually handle orderly liquidations via a single sales-commission fee that covers all related services. Most auction houses, on the other hand, prefer to quote a relatively smaller sales-commission fee, then charge additional for such required services as transportation, cleaning and refurbishing the equipment. A majority of auction houses also charge a buyer’s premium, which is a fee buyers must pay in addition to their winning bid. The standard buyer’s premium is ten percent. Bidders sometimes factor in this buyer’s premium when determining their top bid for a specific piece of equipment. In such cases, an auctioneer’s commission of 10 percent is really 20 percent if the standard buyer’s premium is in effect.

A lender’s perspective

Joe Santora has an interesting perspective on orderly liquidations. He once worked for a well-known equipment auction company. Today, he works on the other side of the auction block, serving as an asset manager for FirstMerit in Akron, Ohio.

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"Now, being on this side of the fence, I prefer orderly liquidation or private sale," says Mr. Santora. Based on his colleagues' comments and his own experiences, he estimates that orderly liquidation yields higher returns than auction "probably nine times out of ten." He believes orderly liquidations also provide lenders a greater sense of control over the outcome. "There's no question about it, when you place a piece of equipment in an auction you are at the mercy of the bidders."

Mr. Santora's strategy for liquidating distressed equipment is to opt for orderly liquidations whenever possible, and to consider auctions when the assets in question and financial situation warrant this approach. Before making a decision, he consults the auction history of a particular type of asset, trade publications and specialists who can help determine a possible selling price if the asset is sold via orderly liquidation.

Jeff Wright, first vice president at Crestmark Bank in Troy, Michigan, also prefers using orderly liquidations whenever possible. Mr. Wright says his sentiments are shared by most workout professionals he meets.

"If handled properly, orderly liquidations usually maximize more dollars to the bank," explains Mr. Wright, who has 15 years experience managing workouts for various asset-based lenders. "I would say in most cases, I'd try to pursue that route first. Company management understands the industry and has the contacts and knowledge to orderly liquidate the assets for the most value. If you have a guarantor on the hook, with something at risk, they tend to be more cooperative and work with you."

"If there is a glut of equipment, the market is depressed, as it is today, or the equipment is specialized, and you have the time, orderly liquidation is the better route," Mr. Wright adds. "For inventory, if it is a proprietary product and the market is limited, it may make sense to work through the work-in-process and finished goods and convert it to a receivable which will likely maximize more dollars to the bank. Receivables tend to be more collectable in an orderly liquidation scenario. Debtors are more likely not to pay or will offset if they know a company is shutting down."

Mr. Wright also considers the borrower's corporate budget and trustworthiness of its management. "There are some cases where, if you review the budget of the company and the cost benefit does not justify doing an orderly liquidation, you may then want to go through a forced sale type of liquidation. If you are going to be expending more costs than you are generating value, then you are better off just liquidating now and taking your hits," he says. "Or if you don't trust management, if management is deceptive and doesn't want to work with you, then you may want to consider a forced sale. If a company has a history of diverting funds on you, then you may want to just shut it down or put it in the hands of trustee or somebody you can trust."

Charles S. Kelley of Houston, Texas, has another perspective on liquidations. He is a partner at Mayer, Brown, Rowe & Maw, one of the world's largest law practices. Mr. Kelley has represented parties on all sides of liquidation proceedings but, like his firm, is best known for work on behalf of leading lenders.

Are lenders better served by orderly liquidations than by auctions? "It really depends a lot on what the asset is, and the business," Mr. Kelley says. "Orderly liquidation, generally speaking, is the best way to maximize value."

Orderly liquidations tend to net higher prices because potential bidders have more time to perform due diligence on the equipment being sold. "If they have time to do due diligence, they tend to offer prices that more closely approximate what the seller perceives is the value," Mr. Kelley says.

Due diligence can include the following activities: inspecting the quality and integrity of the equipment; reviewing historical financial information related to revenues generated by that equipment to determine value on an income-based methodology; reviewing the maintenance and operational records of the equipment; and having qualified personnel test the equipment's reliability and performance. These steps may vary substantially depending on the asset being acquired, whether it's a business, equipment, intangible asset, or some other asset.

Mr. Kelley also feels auctions fail to attract the highest possible bids when sellers are allowed to enter into asset-purchase agreements with potential buyers beforehand. The company that has expressed interest in purchasing the assets — known as the "stalking horse" — signs an asset purchase agreement that is submitted to the banks and/or courts. Then the stalking horse has access to information necessary for performing due diligence prior to the auction, but other potential bidders don't have access.

"The problem is, if the first purchaser (the stalking horse) low-balls. There is a special fee, a breakout fee, that must be paid to the stalking horse if another company outbids its price. This creates disparity and inequality. I represented an entity that was interested in buying telecom assets, and the final selling price in that auction was actually lower than we were willing to pay," Mr. Kelley says. He has also witnessed the effects of stalking horses in auctions involving other industries, such as truck manufacturing.

Other types of auctions, however, are recommended by Mr. Kelley. "When you are not talking just equipment — oil and gas leases, for example, that are publicly recorded — you can learn a lot about the property beforehand. In an auction on property that is well advertised, and given the fact that these kinds of purchasers are, by nature, more likely to gamble, then auctions get closer to fair market value."

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Certain types of assets, such as cars and computers, also do well at auction because the equipment appeals to a broad section of the general public, and the purchase itself is considered fairly low risk. “If you list heavy cranes, you may get only two to three prospective purchasers at an auction. With cars, the sky’s the limit on bidders,” Mr. Kelley says.

When in doubt

Orderly liquidations tend to net higher selling prices than auctions. Yet there are a number of factors to examine before choosing an optimum liquidation strategy. When in doubt, lenders can seek the advice of an asset-management professional who specializes in the equipment leasing and finance industry. ▲

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Defining Values

At the time of a loan or pending liquidation, lenders will often obtain an estimate of the possible value of the equipment in question. Appraisers calculate value based on the type of liquidation method that will be used.

Most appraisers believe that an asset’s orderly liquidation value versus forced liquidation value depends on the type of asset in question and financial circumstances surrounding its sale, among other variables. While this is accurate, according to many appraisers’ Web sites, it is also true that orderly liquidation values tend to exceed forced liquidation values.

A search of the Internet reveals that numerous appraisal firms describe orderly liquidation value as the value at which assets are sold over a reasonable period of time in order to maximize proceeds received. Forced liquidation value is the value at which the assets are sold as quickly as possible for any price possible, such as at an auction.

However, the American Society of Appraisers (ASA) textbook on “Valuing Machinery and Equipment: The Fundamentals of Appraising Machinery and Technical Assets” takes a more neutral approach to defining these values:

“Orderly liquidation value is the estimated gross amount, expressed in terms of money, that could be typically realized from a liquidation sale, given a reasonable period of time to find a purchaser (or purchasers), with the seller being compelled to sell on an as-is, where-is basis, as of a specific date.”

“Forced liquidation value is the estimated gross amount, expressed in terms of money, that could typically be realized from a properly advertised and conducted public auction, with the seller being compelled to sell with a sense of immediacy on an as-is, where-is basis, as of a specific date.”

In other words, orderly liquidation provides a more flexible time for attracting potential buyers. This is one of the most important reasons why orderly liquidation values tend to exceed forced liquidation values at auction.