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Restructuring a Micro-Cap Company

Many sharp investors have learned the benefits of reading through a company's annual and quarterly reports, as well as other public filings.

It is not uncommon to come across a company with what seams to be very promising products or technology that is trading at a deep discount to what its perceived valuation should be. For sharp investors, selecting the right company to invest in can be very rewarding. However it is very important to know what type of company you are looking at. Is this a growth company, where new products and services could lead to a significant increase in sales and profitability? Or is it a turnaround/restructuring situation? It is important to know the difference between the two types as they require a different form of analysis. In this article we will take a look at evaluating a micro-cap company as a turnaround or restructuring situation as a potential investment. Our focus is going to be on those micro-cap companies that are generating revenue.

Micro-cap companies are generally defined as those with market capitalizations less than $300 million in value. Most micro-cap companies have either a limited amount of revenue or no revenue at all, and many are essentially start ups where the value of the company really lies in the products and services being developed. Many of these companies have very small management teams that usually own a significant portion of the company's common stock; and as a result wholesale management changes as typically seen in large companies are not an option for micro-cap companies going

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through turnarounds or restructurings. The majority of companies that are in need of a turnaround or restructuring find themselves in a distressed situation; primarily due to either cash flow issues or the market for its products and services has evolved and the company has not managed to keep up with the changes in the market. Therefore when evaluating a potential turnaround or restructuring situation, it is important to ask three (3) primary questions regarding a company's ability to restructure and turn itself around: Can the company reduce its expenses and deploy capital where it is needed? Can the company increase its sales and cash flow? Can the company obtain additional financing on terms favorable to existing shareholders? If yes can be answered to these three (3) questions, then a company has the potential for a successful turnaround or restructuring. If of the answer is no to any of these questions, then it is best to move on and look at something else.

For those companies that have revenue and are in need of a corporate turnaround, the most important thing is to reduce the company's expenses and get the company cash flow positive as quickly as possible in order to stop the drain on the company's financial reserves. This is very important as it will buy the management of the company time to deal with the other problems facing the company. The quest to get a company cash flow positive can involve several different tasks from restructuring debt, cutting expenses, and increasing sales; with the solution usually involving some combination of all three.

For many companies involved in a turnaround or restructuring situation, restructuring the company's debt is a key part of the part of the process. I have worked on several debt restructuring projects, and they have all involved having serious discussions with the holders of the debt about the future of the company. The success or failure of these discussions will depend a lot on the relationship the company has with its debt holders and if they see greater value in the company

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continuing in operation. If the debt holders can be convinced there is value to the company as an ongoing entity and they have a good relationship with the management of the company, then there is a good chance that they will agree to some form a debt restructuring. Usually these debt restructurings involve converting the debt to equity, or some portion of the debt to equity and a reduction in the interest rate, resulting in a reduction in the interest payments on the remaining debt. However, if the debt holders believe they have a better chance of recovering their investment by either seizing collateral or by liquidating the company, it may be nearly impossible to get a deal done to restructure the debt.

Reducing the overall expenses of the company and eliminating unnecessary expense items is a key component of any turnaround and restructuring. Sometimes this will involve a reduction in the staff or number of employees, other times it will involve eliminating unnecessary items that the company can really do without. The key component of the process is to successfully determine what is an essential item and what a company can live without.

Often overlooked or ignored in a turnaround is how can a company increase the sales of its existing products or develop new revenue streams. This is a three pronged approach. It is very obvious that the high profit margin products and services need to be expanded or given additional resources so sales can be increased. The lower margin or unprofitable products and services need to have a full review with the goal of determining how sales and profit margins can be increased. If these goals cannot be accomplished then a company needs to seriously look at either selling these product lines or discontinuing them. The next thing a company needs to do is to determine how and where it can add new products and services to create new revenue streams. This can be one of the hardest parts of the entire restructuring, determining where new opportunities are and how to take advantage of them, but it is ultimately key to the long term survival of the business. For most of these companies they got into trouble because their product mix was not where it needed to be, and reconfiguring their product mix is key to their future.

It is also important to understand if the company will need to obtain additional financing in order to complete its turnaround and restructuring. The potential financial sources for a company going through a restructuring is primarily limited to strategic investors, shareholders, and investment companies that specialize in investing in turnarounds and restructurings. A strategic investor is usually thought of as a business partner to the company who sees significant value in the company's product and services and decides to make an investment in order to secure access to those products and services. Since strategic investors usually seek to maintain good relations with the company and its management, which typically owns a significant portion of the common stock in a company, the strategic investors will usually invest in a manner that avoids massive potential dilution to existing common stock shareholders. A good example of this is many years ago when Apple, Inc. 'AAPL' was in not doing well financially, and Microsoft Corp. 'MSFT' invested in Apple through a special class of preferred stock.

Investment firms that specialize in investing in distressed companies often do so with an eye towards potentially taking over the companies they invest in. They are generally going to structure their investments in a manner that places a lot of restrictions on the management of the company, and its common stock holders. They will almost always structure their investments in a manner that allows them to take over the company if things do not work out as planned; and when this happens the common stock holders are usually wiped out. Obviously, if a company you are looking at is in the process of obtaining financing from one of these types of investment firms you will want to remove them from consideration as a potential investment.

It is usually a good sign when a company has deep pocketed shareholders who are willing to step up to the plate and increase their investment in the company. When done properly, these shareholders will work to assist the company's management in gaining the resources needed to complete the turnaround, as well as structure their investment so that existing common stock shareholders will be able to participate in the upside potential of the company as well.

As a potential investor in a micro-cap company that is in need of a turnaround or restructuring there is an opportunity for very outsized gains to be realized. However it requires a substantial amount of work in determining if a company has the ability to effectively execute a turnaround or restructuring. When doing your homework on these companies, do not be afraid to pick up the telephone and call the management at the company to see what they have to say. Be a little skeptical when talking to them and do not take everything they say at face value. However with some hard work you should quickly be able to figure out who is being straight forward and honest with you and who is not. Only invest in those companies where you believe what the management is saying, and you believe the company can answer yes to the three questions at the beginning of this article.

ABOUT CORAL CAPITAL PARTNERS AND ERIK NELSON

Erik Nelson is the President of Coral Capital Partners, an independent consulting and advisory firm focused on companies and participants in the lower and middle markets. Coral Capital Partners provides cost effective solutions to real world issues and situations. Coral Capital Partners, Inc. provides services to Investment Banks, Private Equity Funds, investors, and both privately held and publicly traded companies, as well as various stakeholders in those organizations. This has included international public companies with operations on three (3) continents to smaller privately held domestic companies. Our experience in the areas of corporate advisory, due diligence reviews, and regulatory compliance allows for a cost effective and efficient solution to the issues at hand. Please feel free to visit our web site at: www.coralcapital.com or call our offices via. telephone # (404)-816-9220 to see how we may be of assistance. ■