STORM™

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KEY MANAGEMENT NEWSLETTER & UPDATES

Opportunities for Investors

With the slowdown in sectors of the economy and the tightening of credit we are seeing the EBITDA multiples return to more reasonable levels. At the same time we are seeing marginal companies experience cash flow problems and loan covenant violations. This is creating opportunities for the investor willing to assume risk or who has the industry and operational knowledge to identify the potential upside and mitigate risk.

At STORM we have been through many of these cycles. We have also seen and helped correct mistakes made by investors who have made good financial decisions but, lacked the experience to understand the industry and operational risks involved.

Understanding the business and the operational details of the business are critical in determining the capital risk and the potential opportunities in investments. This is especially true when considering investments in cyclical businesses, marginal operations or in crisis situations. This is where STORM's expertise in the due diligence phase can assist you in avoiding the many pitfalls of high-risk investing.

Due Diligence – What You See is Not Necessarily What You Get!

At STORM we often are called into a crisis situation after the "turnaround experts" did not deliver. Unfortunately, many of the problems we have addressed in the past could have been avoided or handled much easier during the due diligence process or before the company was purchased or emerged from bankruptcy. Too often we have found issues and exposures that were never uncovered in the due diligence phase or disclosed by the sellers. While the paperwork may have been sufficient to avoid a legal claim, the reality was that problems and exposures existed and were not discovered during the normal due diligence investigation.

While we must be careful not to disclose the specifics of our engagements here are a few examples of problems which were overlooked in the normal due diligence phase:

• UNKNOWN ENVIRONMENTAL PROBLEMS – A half billion dollar manufacturing company in bankruptcy who had Phase I and II environmental studies completed. No underground storage tanks (UST's) were reported on a major manufacturing site. Fortunately, we were called in during the final phase of due diligence. By working with key employees we found that indeed no UST's were on the property, but *two railroad tanker cars with disposed oils and other chemicals* were buried under the parking lot. Nobody had asked about railroad cars!

In another situation, environmental consultants reported in a Phase II study that one of the manufacturing sites was free of environmental problems. We discovered that buried under a picnic site was a 100-year old dump site with toxic chemicals which the consultants had missed.

• UNKNOWN RISKS – In another situation, we were not engaged in the due diligence phase but were appointed to operate the company just after emerging from bankruptcy. Unfortunately, we later found that one of the manufacturing sites we planned to close had been and was still supplying the local town (some 90 homes & businesses) with water from our wells – at no charge and with no liability protection. Worse yet, a dump existed adjacent to the property, and the company had a waste treatment facility on site near the well. This risk alone could have put the company out of business if there were any claims made concerning the health of the town's population!

• OFF BALANCE SHEET EXPOSURE – During a recent engagement, STORM was called into a late-stage due diligence for a paperwork review of the transaction. In a single day's review we noticed that the company had a union retirement plan. Familiar with the union involved (it was likely multi-employer plan) we insisted the prospective buyer further investigate details of the plan. The buyer found that the off balance sheet potential exposure was over $900 million dollars <u>more</u> than the entire purchase price for the company.

• FINANCIAL REPORTING & PROJECTIONS – Our team consulted on a transaction for a $600M+ company after the LOI was executed. We found the companies projections were unrealistic and that several key customers where at risk. We also discovered that contrary to the companies reports and projections, two of the three operating subsidiaries were in fact unprofitable and were rapidly going downhill. This, in addition to other detailed operational exposures not previously revealed, using our findings, the buyer decreased the purchase price by more than a third!

There is never a right way to do the wrong thing.

- Author unknown, but he was right!

• OFFSHORE RISKS – We were engaged to look at "the newest and most modern process manufacturing plant in the industry" located in a foreign country. We were told that with a 383 purchase out of bankruptcy the buyer could simply leave the union behind and the plant could be profitable overnight. What we found was to the contrary - by law we would have to settle with the union and it wanted more than $20M USD just to disband. Another problem was there would be no guarantees that the next day they would be back organizing the work force. A likely outcome given the huge termination bonus for its members! The result was that prior to the purchase we were able to work with management and pull all the critical tools and dies out of the facility over a weekend and walked away from a disaster which would have devastated the company.

• HUMAN RESOUCES FINANCIAL EXPOSURES – After the purchase agreement was in place for a large asset purchase transaction, we found that the buyer had unknowingly agreed to assume the responsibility for some 12,000 employees worldwide. (About ¾ of whom the purchaser intended to leave behind.) Fortunately the sellers had a detached financial "turnaround consultant" who was handling the details of the transaction. Just prior to the transaction date we were able to have the employees (who were ultimately left behind) terminated at the seller's expense; thus, avoiding tens of millions of dollars in termination costs for more than 9,000 employees worldwide.

These are but a few examples of the value STORM brings to operational due diligence. The key is to get the right advice early in the review and uncover pertinent issues quickly while the buyers can still take action. In many situations our team has been able to execute strategies to resolve such issues prior to the sale by working with management and convincing them to shift their loyalty to the buyers prior to the sale.

In situations where the <u>operations must be improved</u> to realize the opportunity you need *expert advice on the **operational issues** and business prospects*. In these situations a small investment upfront may save you millions of dollars down the road!

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