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Case study: How Moto Photo developed its sale

Harry Loyle has always had the strong desire to influence the strategic direction of Moto Photo, which franchises and operates about 400 one-hour photofinishing labs and portrait studios mostly in the United States. He has spent 18 years with the company as an area developer, a franchisee and a board member. In, fact as far back as 1993, Loyle had indicated his interest to be Moto's chief executive officer.

"I believe that most decisions are made emotionally and then you follow up with logic," said Loyle. "The decision (to buy Moto) was an emotional one. I love the concept."

During the last several years, Loyle became convinced that the company's financial stress was restraining Moto from capitalizing on its strong consumer brand and other competitive strengths.

Problems mount

Looking at Moto Photo, it was easy to see the company's financial problems. Moto was highly leveraged. It owed large sums to its secured lenders and suppliers. And losses continued to mount as sales dwindled. In the public market, Moto's stock had drifted into the penny stock category.

The company was having limited success in renegotiating its supply agreement with Fuji Photo Film, U.S.A., Moto's primary supplier. Previously, Fuji had invested $10 million in Moto convertible preferred stock. Among other things, this investment gave Fuji the right to convert its preferred stock into common stock. Because Moto's stock had declined to 4 cents a share, should Fuji want to convert its investment, it would own more than 90 percent of Moto.

Because of stalemated negotiations, Moto had changed to Kodak as its primary supplier. This was an important move because Moto was one of the largest purchasers of film and photographic supplies. But Fuji still owned the preferred stock and was owed additional money from Moto in the form of a secured note.

It appeared as though the company was sliding slowly into insolvency.

Harry Loyle
Moto Photo's president

Despite the problems, Loyle had a different view of Moto's value than the public stock market.

He felt that digital photography, Moto's strong brand and the company's purchasing power offered significant opportunities for the future. In the stores he operated or oversaw as area developer, he noticed that stores that offered new products and services related to digital photography enjoyed strong comparable growth sales and profitability.

Loyle had assembled a group of private investors to purchase a controlling interest in the company. The group's investment was contingent on two conditions: 1) Moto had to resolve its dispute with Fuji; and 2) Moto had to continue to meet all of its debt-service payments. By April 2002, it was obvious that neither of these conditions could be met.

Looking for another answer

In June 2002, Harry resigned from Moto's board to gain a broader perspective on the company. He engaged Jeff Rosenfeld of Kessev Finance to work with him on his evaluation of Moto. Their analysis confirmed that the company had a significant upside. There was a core of assets, which if separated from the other parts of Moto, was extremely profitable, plus there were the opportunities in digital photography.

Loyle and Rosenfeld worked through the different community of interests, who would need to agree to a restructuring plan. They identified a total of 14 groups, many of whom had conflicting interests with one another. The only way any transaction could move forward was to maintain open and regular communication with all the interested parties.

Attorney Lane Fisher of Fisher & Zucker was brought on board to help develop possible restructuring alternatives. The team generated seven strategies for Moto to be recapitalized. Each option met the needs of the different stakeholders in varying degrees.

A plan underway

No matter which alternative the team examined, it was obvious, says Rosenfeld, that the best solution would be the formation of a new company ("NewCo") to acquire Moto's core assets. The purchase would need to be an asset purchase because to buy the stock would force NewCo to inherit all of Moto's liabilities.

To purchase the company, Loyle needed the support of Moto's major stakeholders, including its directors; Moto's senior lender, Provident Bank; suppliers Fuji and Kodak; area developers; senior management; franchisees; and the bankruptcy court.

Without satisfying these stakeholders Loyle could not purchase the company or have a chance of his turnaround strategy succeeding. At the same time, Moto had to be purchased without too much leverage. The strategy required the new company to raise additional investment capital for the Moto system, putting a limit on the justifiable price that could be paid for the company.

More challenges

Each constituent group had to agree that the selected restructuring option was the best outcome for them, even though not all groups would receive 100 percent of what Moto owed them.

Second, clear title to the assets had to be obtained quickly. A bankruptcy filing seemed to be the only way. But there were so many creditors, the team was concerned a normal Chapter 11 bankruptcy proceeding would take too long. Whatever value Moto had would evaporate during the creditors' deliberations.

The team decided the best way to acquire Moto's core business still intact was through a Section 363 filing.

Not your typical bankruptcy

Section 363 of title 11 of the United States Bankruptcy Code provides for a prearranged sale of a company's assets. Moto's sale could be accomplished relatively quickly. Loyle also would be able to purchase just the core business "free and clear" of virtually all liens and claims. Additionally, Harry would be able to leave behind the poorly performing assets and undesirable contracts.

But this strategy carried risk. First, Loyle faced a unique position as the first bidder. For the bankruptcy court to allow a Section 363 sale, the team would need to demonstrate: 1) a sound business justification for using this procedure; 2) that all interested parties were provided with adequate and reasonable notice; 3) that the sale price was fair and reasonable; and 4) that Loyle was acting in good faith. Loyle would be forced to put a lot of time, energy and expense into preparing the necessary documentation.

He would need to file with the court the asset purchase agreement, his business plan and any due diligence he had performed. The bankruptcy court would then encourage other potential buyers to bid.

If another bidder came forward, that bidder would have access to all the of Loyle's information. Obviously, the new bidder could offer a higher price and would have expended significantly less time and money than Loyle. This is why the first bidder is often known as the "stalking horse."

Second, the Section 363 filing required that a number of events occur simultaneously. Moto needed to file for bankruptcy and sign the asset purchase agreement, to raise financing, to notify the SEC, and to talk to the company's franchisees and other constituent groups.

"The real challenge is that we were dealing with a public entity," says Loyle. "No firm agreements could be confirmed or exercised until you made public disclosure."

Moto Photo's board of directors had the fiduciary duty to Moto's shareholders to maximize the value of the company's assets. Procedurally, the board couldn't favor Loyle. It also would need a fairness opinion so the bankruptcy court would have evidence that Loyle was paying an appropriate price.

Because Moto was a public company, the board was forced to maintain a level of secrecy until an agreement was reached. It formed a special committee to manage the negotiations. The board appointed Les Charm as committee chair. Charm was an independent member of Moto's board of directors with experience in liquidating franchise concepts and is also a faculty member at Babson College. Charm attempted to "up the ante" by negotiating deal points to Moto's favor. Even though Moto's position was tenuous, he felt there was value that he had to "extract" from any purchaser, Rosenfeld says.

Loyle was faced with compromising on several points to meet the board's demands. The team had prepared a detailed financial plan which was updated almost daily to measure the financial consequences of each point. Along with assisting in the negotiations, Fisher had to ensure that appropriate legal procedure was followed and that there were no "loose ends."

The negotiations over the asset purchase were difficult, says Rosenfeld.

Loyle had to waive the ordinary buyer protections, such as a financing contingency or a due diligence period. He also had to assume the risk of any deterioration in assets between the date of filing and the bankruptcy sale.

Basically, Loyle was assuming all the transaction risk, based on unaudited financial statements which presented an "ugly" situation, says Rosenfeld. He would not have the opportunity to perform reasonable due diligence. Even if some catastrophic event occurred which would free Loyle from his obligation to purchase Moto, he would have expended tremendous time and money.

To reach a final settlement, both sides agreed to an earn-out where Moto would receive additional compensation if NewCo met certain performance targets.

But, before the board would agree to file for bankruptcy, it needed to be certain that Loyle could finance the transaction and that there would be nothing standing in the way of the transaction closing.

From the team's perspective, it was difficult to seek financing with unaudited financial statements and with internal data that could be wrong. However, the team developed several financing options.

A group gets on board

This is where Moto Photo area developers entered the picture. While negotiations proceeded with the board, Loyle met with his area developers on a regular basis.

He felt the area developers were essential to maintain and grow the Moto Photo system. Many of their stores were the highest volume locations in the system.

"They directly serviced 80 percent of the system," reports Loyle. "They were the people who had direct contact with our franchisees."

The area developers decided to invest in the transaction. Their investment strengthened NewCo's balance sheet and gave the bid even more appeal.

Another important constituent group was Moto's company founders who were respected within the franchise community and within the industry. Their strong relationships with suppliers and local banks were invaluable. It was decided to have them continue with the company as consultants.

Loyle also felt that Moto's operating management was strong and resisted any layoffs or thoughts of relocating the business. He maintained as much communication with this group as allowed by the law.

Provident Bank was also a major constituent in this transaction. All of Moto's cash went to the bank from which it was then disbursed. Although Moto had remained current on its debt service payments to the bank, it was in violation of its bank covenants. If Provident felt that its collateral position was threatened, it could easily foreclose on its loan and take control of the company's cash.

Also, the bank had to agree that Moto could use cash generated to continue to run the business during the bankruptcy period, rather than all of it paying down the bank's debt.

The company founders became important because they had strong connections to the bank. Provident agreed to allow the transaction to be completed, however, it did not want to be NewCo's bank.

With Moto's founders, the team scrambled and found another local bank, Fifth Third Bank, to provide a seven-figure working capital facility and replace Provident.

Fuji and Kodak were another important community of interest. In order for the transaction to succeed, both would have to continue to provide product to Moto. Unfortunately, Loyle inherited a tense situation with Fuji.

Loyle's open and continual dialogue with both Kodak and Fuji proved crucial. says Rosenfeld. While financially the suppliers suffered some loss, the open communication encouraged both companies to continue to supply Moto with product at good prices.

Moto's franchisees represented another important community of interest. While they wouldn't play a direct role in the purchase, their support was necessary for the assets to have any value. Many franchisees were facing difficult financial times because of Moto's poor performance. They stood to lose their investment if the system could not be turned around.

"It was obvious to everybody that Moto had to do something dramatic," says Loyle of his efforts to garner franchisee support.

Because of Loyle's personal involvement and efforts to maintain the existing infrastructure, coupled with his and the other area developers' personal investments, the franchisees were motivated to cooperate with the transaction, says Rosenfeld.

Coming together

In November, there was the simultaneous closing of the asset purchase agreement, the filing of the 363 petition, the filing with the SEC, and the notification of franchisees. Now the petition needed to be moved through bankruptcy court as rapidly as possible. But, the bankruptcy court wanted to keep the bidding open as long as possible because its interest was to get as high a price as possible.

Fisher was able to steer the petition through the court in 70 days, a short time for this type of transaction. Usually, this process takes longer than 120 days and can last for more than six months.

The purchase was finalized in February. The hard work had paid off.

"What sold me on the process," says Loyle, "is it identified each of the constituent groups. I had to think like them—if I were them how would I want this transaction to unfold? It really is the epitome of empathy."

Now the new management team has the opportunity to make Moto Photo the premier brand in the photofinishing industry, he says.

"Digital photography is a 100 percent compounded growth industry," says Loyle. "Nobody knows where it is going to shake out, but that creates opportunity.

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