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Turnaround Topics

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Maintaining Private-Equity Involvement and Funding When Their Initial Investment Is Underwater

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Private-equity (PE) involvement in distressed companies has grown more complex than ever. As market headwinds persist, performance deteriorates, valuations shrink or a company faces a wall of debt maturities, turnaround professionals increasingly encounter situations where a PE sponsor's original investment is "underwater" — unlikely to ever return capital, let alone deliver any return. In many of these cases, keeping the PE sponsor engaged, and ideally contributing follow-on capital, is key to maximizing enterprise value, preserving jobs and salvaging lender recoveries.

PE funds must make tough decisions about whether to throw good money after bad or walk away. At the same time, lenders, management teams and other stakeholders must evaluate whether the PE sponsor is adding value as a constructive partner in the turnaround or just part of the problem.

This article explores strategies and structural tools that can keep PE sponsors at the table, even when their original investment has little or no value. It also offers guidance for professionals navigating these complex negotiations and underscores the need for skilled turnaround advisors to align diverse constituencies on a shared path forward.

Why PE Pullback Is Common

Volatility has increased across many sectors during the past five years, and the short-term outlook is choppy at best.[1] A combination of macroeconomic, industry and company-specific factors frequently plague PE portfolio companies:

- Inflation and interest rate hikes have distorted business models;
- Tariff policies and global trade tensions have impacted cost structures and supply chains;
- Failed operational initiatives, such as enterprise-resource-planning implementations, unprofitable expansions or flawed acquisitions, have eroded value; or
- Talent turnover and misaligned incentives have damaged execution.

PE firms that invested under rosier assumptions are now reckoning with the need to pivot their strategy to protect and/or recoup value. The combination of depressed earnings before interest, taxes, depreciation and amortization (EBITDA), combined with smaller multiples, has led to reduced valuations that might not be sufficient to repay debt.

Understanding the Situation: A Stakeholder Assessment

Before pursuing new capital, stakeholders must realistically assess the future of the business. Is the turnaround complete, or is the business still in a downward spiral? How long will it take for the business to begin to generate positive cash flow, and how much cash burn is expected during this time? What is the execution risk associated with the turnaround plan? Does it require a new product or distribution channel, millions in capital expenditures and/or other aggressive assumptions, or is it based on reasonable initiatives that are a relatively light lift to implement?

Completion of the turnaround plan typically identifies the cash need, which should then be sen-

1 Nan R. Zhang, "Private Market Trends Amid Economic Volatility," *Informa Connect: Wealth & Investment Mgmt.* (May 21, 2025), informaconnect.com/private-market-trends-amid-economic-volatility (last visited on July 9, 2025).

sitized to include potential delays, shortfalls and a cushion. Who will participate in funding the cash need, to what extent, and at what cost and potential recovery? If the lenders are overcollateralized (in that the assets used as collateral on a loan are greater than the value of the loan), they will likely be prepared to provide some accommodation — provided that other stakeholders contribute to the cause. Management can participate via salary deferrals, which might not contribute a significant portion of the required funding but can certainly send the right message and provide comfort. PE sponsors might be asked to provide a portion of the required funding or a limited guarantee, which may be released upon achieving certain financial thresholds.

When lenders are undercollateralized, or when the estimated enterprise value is less than the debt load, the situation gets quite interesting. If lenders believe in the turnaround plan and have faith that the company can turn around, they might be more apt to figure out a way to support the company. They also might simply move toward liquidation, foreclosure or a quick sale — without the PE sponsor's support. The calculus for the PE sponsor is often a bit more difficult, however.

Key Questions for PE Sponsors

For PE firms, decisions regarding follow-on investments in a struggling portfolio company are multi-faceted:

- What is the timing and trajectory of the expected recovery? Is it two quarters or five years? The shorter the time frame, the more likely they will be to consider injecting more capital.
- What is the execution risk associated with the turnaround plan? Will it be trying to hit the most ambitious (but risky) goal, or is there a very good chance of success?
- Are they prepared to walk away from their investment in the portfolio company, and what are the potential ramifications?
- Will these actions potentially harm relationships with limited partners, co-investors, lenders, management teams and future targets that they may be pursuing? Walking away also means ceding control of the board, which may create other issues and potential exposure in a meltdown scenario.
- Does the fund have sufficient and/or available capital for investment?
- Is the PE sponsor in fundraising mode? Are they prepared to show a complete loss on its investment?
- Is the return on investment of this particular portfolio company meaningful to the overall return of the fund? If so, the PE sponsor will likely be more motivated to invest capital to ensure the survival of the company.

It is important that all stakeholders share an understanding of these decision-making dynamics. There are many reasons why a PE sponsor might be inclined to inject capital into a struggling portfolio company, but if their existing investment is underwater, the new money will likely need to be structured differently. The new investment must first be structured to protect downside risk, and ideally to capture some upside on the new money and the prior investment.

Lender Perspectives

In distressed situations, lenders often serve as the ultimate arbiters of possible financing solutions. Their willingness to work constructively — or to enforce their rights — can determine whether a company stabilizes or spirals further. One of the first things that lenders should consider is whether the key stakeholders, including the PE sponsor and management team, are showing tangible commitment. If PE sponsors are not willing to contribute new capital or if management appears unprepared to lead a turnaround, lenders could be reluctant to extend additional accommodations or time.

The type of lender also influences the options available. Regulated banks, due to capital adequacy rules and regulatory oversight, are often less flexible in distressed situations. They might prefer to quickly exit troubled credits to avoid further provisioning. On the other hand, private-credit funds or business-development companies might have more latitude to support creative solutions, although they, too, must consider public mark-to-market implications.

Most lenders do not want to own the companies they lend to, and foreclosing is typically a last resort. When no credible turnaround plan exists, the PE sponsor disengages or there is no path to raise the required capital, they might still have little choice. In these situations, lenders might enforce stock pledges, reconstitute boards or install a chief restructuring officer (CRO) — all without taking formal equity ownership. These moves can buy time and position the business for a sale or internal reorganization.

To break impasses and take control, lenders increasingly favor the introduction of independent directors. These individuals bring objectivity to governance and can play a vital role in overseeing a turnaround.

Creative Structural Tools for Follow-On Investment

When a PE sponsor is considering a follow-on investment into a distressed company, the structure of that capital becomes critical. Traditional equity injections, when the original investment is already underwater, are rare. Instead, PE sponsors typically seek investment structures that provide downside protection to the new money while preserving a sliver of upside in the event of recovery. These structures can be tailored to the company's situation, the degree of lender cooperation and the level of PE sponsor confidence in the turnaround.

Senior secured debt is the safest investment option for a PE sponsor in a distressed scenario. By positioning the new money at the top of the capital stack, PE sponsors ensure that their follow-on capital receives priority repayment in the event of a liquidation or asset sale. This structure is also frequently used when new money is provided by both the PE sponsor and the lender.

In more collaborative restructuring environments, PE sponsors and lenders may agree to a *pari passu* investment. In these cases, new money provided by the PE sponsor is *pari passu* with existing debt — sharing the same rights and protections — reflecting a higher degree of alignment and shared belief in the company's future. While less protective than senior secured positions, this structure is frequently used to attract new capital.

Some situations call for more bespoke solutions, such as splitting the capital stack into distinct waterfalls. These arrangements allow some, most or all of the new money to be repaid before any repayment flows to existing debt-holders (or equityholders). It might also rearrange the priority payments based on negotiations.

To bridge the gap between near-term risk and long-term potential, some PE sponsors negotiate contingent value rights. These instruments entitle the PE sponsor to a future payout if the company meets specific performance benchmarks, such as achieving a certain EBITDA level or completing a sale above a defined valuation.

Other creative structures include earn-outs tied to lender recoveries or exit values. These may serve as mechanisms to provide potential recoveries to PE sponsors to recapture some of their new and/or prior investment if certain thresholds are met. These structures can be particularly effective in bridging gaps among stakeholders when there is disagreement over valuation or recovery timelines. Follow-on investments in distressed situations often are paired with revised management-incentive plans. In distressed situations, realigning executive compensation with the new capital structure is critical, as the original option pool or incentive plan is likely worthless.

Ultimately, the best structure is one that balances PE sponsor risk with enterprise stability and stakeholder alignment. In distressed scenarios, no tool is perfect, but with the right mix of flexibility and control, these instruments can provide a viable path forward.

Steps to Forge a Sustainable Turnaround

Designing an attainable turnaround plan requires more than just capital. It calls for coordination, realism and trust among all parties. There are essential steps to forge a turnaround strategy that stakeholders can support.

Assess Execution Risk

The first step is to determine whether the company's core issues have been resolved. Persistent operational inefficiencies, weak supply chains and work backlogs, or unresolved technology problems are red flags. If the company remains structurally unsound, no capital structure can deliver a recovery. Stakeholders must confront these realities early and with transparency.

Establish Trust and Neutral Governance

In strained situations, rebuilding trust is critical. Appointing independent directors or a CRO can depersonalize conflict and restore credibility. These neutral actors provide objective oversight, facilitate decision-making and help bridge gaps in communication among PE sponsors, lenders and management.

Understand Sponsor Fund Dynamics

Each PE fund operates within specific constraints. PE sponsors near the end of a fund's lifecycle could lack capital for follow-on investments, while others in fundraising mode might be motivated to avoid high-profile losses. Understanding these dynamics enables more productive negotiations and ensures that the turnaround plan is grounded in what the PE sponsor can realistically deliver.

Right-Size the Capital-Raise

Turnaround plans often fail because the capital need has been misjudged. Underestimating the requirement can leave the business short of the runway, while overcapitalizing wastes limited resources. A thoughtful assessment of working-capital needs, recovery timeline and contingency reserves is critical. Phased capital deployment tied to milestones can reduce risk for all parties.

Align on Industry and Market Outlook

Stakeholders must share a realistic view of the company's operating environment. In such cyclical industries as construction or automotive, macroeconomic recovery might be slow or uneven. Misalignment on market expectations can create friction around valuation, risk appetite and timing, often derailing otherwise-workable plans.

Preserve Optionality and Flexibility

Even the best-laid turnaround strategies must adapt to changing conditions. The capital structure, governance framework and strategic plan should allow for pivoting, whether that means a sale, refinancing or operational reset. Preserving optionality ensures that the company can adjust course if performance falters or market dynamics shift.

Orchestrate, Don't Just Finance

Ultimately, sustainable turnarounds succeed through orchestration, not just funding. A well-executed plan requires alignment among stakeholders, governance that builds accountability, and the flexibility to evolve. With the right structure and leadership, even distressed companies can regain stability and value.

Real-World Case Studies

The decision to maintain or relinquish PE involvement in distressed companies is rarely straightforward. Outcomes often hinge on the dynamics between PE sponsors, lenders and capital-structure strategies.

In one example involving a food manufacturer backed by a PE sponsor, delays in a major manufacturing line expansion jeopardized a critical national client relationship. The expansion had exceeded budget and fallen behind schedule, triggering a cash shortfall at a time when lender support was limited. A liquidation analysis indicated that a forced wind-down would have resulted in a $10 million loss for the senior lender, which is an unacceptable outcome. Ultimately, the lender agreed to provide $1.5 million in additional financing to complete the rollout, preserving enterprise value and averting near-term losses.

In another case, a packaging company operating in a distressed industry faced imminent disruption from vendors demanding payment of overdue balances. With $5 million in new funding required to stabilize operations, the PE sponsor structured a capital infusion using a tiered approach: $2 million in senior secured debt, $2 million *pari passu* with existing senior lenders, and $1 million as subordinated capital. This structure distributed risk in a way that encouraged stakeholder alignment and support.

These examples reflect the diverse outcomes possible when sponsors, lenders and advisors respond to distress with creativity, flexibility and shared strategic goals.

Conclusion: In Distress, Every Move Counts

Maintaining PE involvement when the original investment is underwater is delicate, but not impossible. When structured carefully and with full transparency, follow-on capital from PE sponsors can be the catalyst for a meaningful turnaround.

Ultimately, every distressed situation is unique. While there is no perfect blueprint, the most successful outcomes stem from proactive collaboration, flexible structures and experienced leadership. The PE sponsor's reputation, the lender's patience and management's capability all hang in the balance.

As more companies confront maturity walls, compressed valuations and operational headwinds, the need for practical, creative turnaround solutions will grow. Turnaround professionals must remain vigilant and proactive, ensuring that stakeholder incentives align before it is too late. In every case, the presence of an experienced turnaround advisor can help separate emotional decisions from strategic ones, preserving options, maximizing value, and keeping hope alive when others have given up. abi

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