

Distressed M&A opportunities

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In the current environment, the number of companies facing huge financial difficulties or collapsing is constantly increasing. But this distress is creating opportunities for both buyers and sellers. Purchasers can acquire valuable assets at bargain prices, while sellers may be motivated by a need to reduce debt, meet short-term cash requirements, deal with possible covenant defaults or refocus on core business opportunities, among other things. Furthermore, since insolvency numbers tend to peak 12 to 18 months after the start of a recession, analysts expect the trend to continue in 2009. As such, there will be, in some regions, more opportunities for cash-rich investors going forward. In other countries, however, the lack of appropriate regulation is hindering the ability to take advantage of some attractive valuations. But in general, acquiring distressed assets often presents risks that buyers should be aware of to avoid running into difficulties.

Opportunities in Central Europe

Since the beginning of the year, some countries have noticed an increased interest among investors in distressed investments. This has been particularly the case for countries in Central and Eastern Europe (CEE). Cash-strapped companies in this region, because of the current downturn, have become attractive opportunities for investors with sufficient liquid-

ity. "Until now, distressed M&A transactions were considered highly risky," recalls Ireneusz Stolarski, a partner at Baker & McKenzie Gruszczynski & Partners Attorneys at Law LP. "Today, the situation is different as potential targets are companies with strong and long-established market positions and significant assets, which have run into financial problems due to lack of liquidity. These new circumstances offer an opportunity for companies which have retained financial liquidity to take over their competitors, which in turn is conducive to market consolidation." He cites Poland as an example, where the dramatic depreciation of the zloty has driven many companies into difficulties because of so-called currency options. Some of them have subsequently been forced to sell in order to limit further damage.

But in other countries, most distressed investors are taking a 'wait and see' approach, given the current economic instability and concerns regarding the extent of the downturn. In the US, for example, recent figures show that total deal volume fell over 20 percent in 2008, compared to 2007. Potential US buyers are being cautious, so investment has been sporadic, with the main transactions being conducted in particularly troubled sectors such as financial services, explains Evan Blum, a principal at GlassRatner Advisory & Capital Group. "Much of the activity has been government-

generated and/or guaranteed. Strategic buyers were generally not in a hurry as they watched valuation metrics fall quickly. Those that looked to execute transactions watched the target company's earnings deteriorate and capital market alternatives dry up for such companies. As a result, the strategic players were often able to buy with little cash down combined with an earn-out payment. Most of those deals were done because the seller had no other alternative but to liquidate in bankruptcy." Concerning financial players, their investments have been limited by the crisis in credit markets and uncertainty over valuations.

On the other hand, it is clear that buyers in the US are at least preparing to move into the market. "Fundraising for investing in distressed opportunities has seen an increase in the last year," points out George B. South, a partner at King & Spalding LLP, "with private equity funds amassing large blocks of capital in anticipation of going on a buying spree for discounted assets, debt and equity securities, while at the same time remaining cautious in light of continuing uncertainty in the financial markets." When they will put the capital to work is unclear, but is likely to hinge in part on access to debt financing and overall stability in the financial markets, which is likely to have improved markedly by the end of 2009 or first quarter of 2010.

In some European countries, such as Spain, the situation regarding distressed M&A transactions is somewhat bleaker. Activity has been lower than most expected, mainly because of differences between buyer and seller price expectations. Similarly to the US, investors are being cautious and are therefore waiting for prices to decline further. In addition, the accounting regulations of Spanish banks have been a major hurdle to investment, as have the comparatively risky loan-to-own strategies available in the country.

Similarly, Gulf countries have seen no increase in distressed M&A deals. The few deals over the past year were mostly government-mandated transactions, such as the merger between Emirates Bank International and the National Bank of Dubai. "With no adequate takeover regulation in most jurisdictions, it ►►

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has been impossible for willing investors, if any, to take advantage of some attractive valuations of publicly listed companies," explains Karl Tabbakh, a partner at DLA Piper. "In the private sector, the M&A activity has been very slow because those who have liquidity are preserving it in the hope that prices will come further down and those who need funds cannot find financing because of the credit crunch." As such, activity may pick up when finance is easier to come by, although whether the effect on distressed M&A levels will be instantaneous is unclear.

Sector-by-sector activity

There has also been disparity on a sector-by-sector basis, with some industries seeing much more activity than others. This is likely to continue in the months to come. "Specific industries that should see considerable distressed investment generally are both over-levered and have experienced significant diminution in asset value due to secular changes in the industry," says Mr Blum. "In these industries, existing investors are less likely to re-up or

restructure their portfolio investments. Given their legacy positions, they are less likely to put new dollars into new opportunities in the sector. This opens up opportunities for distressed investors," he explains, citing broadcasting as an example of a sector where values have been noticeably impaired.

Financial services, as well the banking and automotive sectors have also presented a number of attractive distressed opportunities over the last few months, as they have felt the effects of the financial crisis more acutely than most. "Further decline in the number of cars sold will force spare part suppliers to consolidate and restructure in order to cut costs and start receiving more varied orders," confirms Mr Stolarski. "A similar scenario is likely to unfold in the banking sector where the market is expected to be consolidated by the banks, which have not been significantly affected by the financial crisis. This is particularly true on specific local markets where opportunities for taking over banks unable to maintain interbank financing are likely to present themselves." Indeed, recent weeks have seen private equity firms snap up two distressed lenders in the US, and it is thought that this trend will continue.

Consolidation is also underway in the Russian banking industry, "where up to five banks have already changed hands due to problems with financial stability, according to Anton Klyachin, a senior partner at Salomon Partners. "In this sector, the state, through its designated agencies, actively participates in financial assistance to distressed organisations," he notes. But there are also opportunities elsewhere for Russia-focused investors. "Real estate is a close second with regards to distressed M&A activity. It was heavily financed through short-term debt, which was acceptable on growing real estate market, but becomes immediately problematic when prices started to melt." He adds that the Russian consumer goods sector has also been very active for distressed investors.

In the US, the most attractive industries have been the healthcare and energy sectors, along with financial services, while in some European countries, most distressed deals have taken place among real estate and construction companies. José María Gil-Robles, a partner at Garrigues explains that in Spain, there is a stock of unsold residential units totalling about one million. In addition, he adds that general opportunities for distressed investment exist among private equity-owned companies. "As

happened in the early 90s in the US, there are a number of companies among the portfolios of private equity sponsors believed to have weak balance sheets but strong businesses," he explains, insisting however that "in a crisis as severe as this, all sectors will be affected and there should be opportunities in all industries." So for many investors, waiting for the right opportunity in the right sector to arise may just be a matter of patience.

Benefits and risks

It is often suggested that investing in a downturn creates the biggest returns, and there is some credence to this view. A number of companies have seen their market value diminish without this being strictly reflected in their financial performance – a very attractive quality in a target. "Certainly, the main benefit is the low valuation of a distressed asset," agrees Mr Klyachin. "A number of distressed M&A transactions which took place in Russia in 2008-2009 were for a nominal price like 5000 Roubles or \$200 – so the companies are effectively being sold for debt. In addition, some purchasers and investors are seeking to spin off part of a distressed asset or business in which they are mostly interested, which becomes possible in the reorganisation process," he says.

Low prices are always good news for well-capitalised buyers, and those already familiar with the target's sector or the target itself will find themselves in an excellent position to snap up a bargain. Furthermore, strategic purchases of a company with key customers or technology should enable the buyer to enhance its competitive position when things improve, says Mr Blum. "Additionally, acquisitions of distressed companies in more troubled sectors such as broadcasting or retailing may enable the buyer to fortify its future position as a survivor. In such sectors, only the top players in that industry may ultimately remain, so a distressed acquisition may be an offensive move that can serve defensive purposes as well," he explains. As such, the price is just one of many benefits of making distressed acquisitions at this time.

Of course, there are always catches and complexities associated with such acquisitions, particularly when multiple creditors are involved, but these can be managed with a little care. "Moreover, if the transaction itself and the related restructuring processes are managed well, it is possible to strike a good

deal with creditors,” asserts Mr Stolarski. “Arrival of an investor on the scene usually sends a positive signal to creditors and encourages them to sign a debt settlement agreement. As such, distressed companies may also be easier targets for a hostile takeover where cooperation with the largest creditors often becomes needed,” he notes. Getting the creditors onside is an important part of a successful distressed deal, as doing so will generally reduce the burden of debt on the target post-acquisition.

In cases where the target is in particularly acute distress though, it is important that buyers know exactly what they are getting into. It is true that in certain cases, a distressed acquisition can be a completely fresh start for the target – for example, the increased ease of acquiring the business, but not the capital, from an owner, means that most of the company’s problems can be left with the seller. “Furthermore, if the business is acquired in insolvency proceedings normally it will be with no liabilities and with the chance to renegotiate employment conditions or agreements with certain suppliers,” notes Mr Gil-Robles. But some companies may already be on their last chance. “Filing for insolvency can be the death knell for some companies, so waiting for court proceedings is not always the smart choice,” he warns. The legal and financial situation of a distressed company can change rapidly, so buyers will have to act quickly if they wish to purchase a business as a going concern.

But simply missing out on an opportunity could be the least of their problems. The extent of a company’s problems is not always immediately clear, and discovering the truth of the matter post-deal is often an unpleasant matter for both sides. Therefore, due diligence is a key consideration, asserts Mr Tabbakh. “A successful buyer will be ready to conduct due diligence swiftly and be prepared to negotiate transaction documents in a condensed timeframe. As the buyer will be left with limited legal recourse once the sale completes, it could try to negotiate other protection mechanisms such as holdback amounts, earn-outs or escrow arrangement,” he suggests. As such, it is recommended that buyers perform a thorough audit of the target’s legal and financial standings before restructuring the transaction and planning the reorganisation process.

The legal position of a distressed company (including vis-à-vis its creditors, suppliers and employees) is worthy of particular focus by a prospective buyer, as to ignore or overlook

such issues will, in many cases, cause materially adverse consequences for the buyer. But it is also important that the buyer establish, prior to consummating the purchase, an accurate picture of how the company makes, spends and manages its money. The investment plan needs to consider the current cash needs of the target, the extent to which financing for operations and capital expenditures is readily available, whether insolvency is imminent, any current management deficiencies and any tax or other liability issues. “All of these issues need to be viewed against the backdrop of the current economic climate and, from the buyer’s perspective, the purchase agreement should be drafted to provide some downside protection. In this regard, buyers have begun to include financial market material adverse effect clauses as a condition to closing,” observes Mr South. Nonetheless, determining the importance of, and negotiating closing conditions can be very complex, so hiring a forensic accountant and an advisory firm to assist with the process may be critical. As such, due diligence and related financial audits should be undertaken as early as possible. Only then can the reorganisation process be laid out.

Admittedly, achieving such comprehensive results from the due diligence process is easier said than done. There is generally a lot of pressure for acquirers to move quickly when conducting distressed deals, and such pressure can scupper the plans of even the best-intentioned acquirer. “The distressed companies cannot wait and therefore the purchasers and investors often do not have enough time to perform standard due diligence investigations or even agree upon all the issues. In many cases the purchasers or investors will still pursue the transaction and take these risks,” observes Mr Klyachin. But this may not be a sensible idea. In some cases, information pertaining to the target may be missing or erroneous, making it impossible for the buyer to develop an accurate picture of their purchase. In such cases, the price should reflect the uncertainty, and investors must be prepared to walk away if this cannot be achieved. This will be a much cheaper option than going through with an over-priced, poorly-planned deal, as it can also involve the added costs of bitter and protracted litigation.

Litigation is also a very real issue when trying to achieve intercreditor consensus further down the line. For investors, getting all of the creditors onside is not always easy, even when their options are few. In particular, se-

cured creditors will be actively involved in the negotiations, thereby increasing the number of parties that need to be in agreement before the deal can proceed. As such, there is always a danger of intercreditor disagreement, and some may try to initiate court or even bankruptcy proceedings in protest. As such, investors should never take their assent for granted, and should make contact with all important creditors, particularly banks, in the initial stages of the acquisition.

These risks will need to be taken into account if the deal is to be successful. But completing the deal is only half the battle when company needs to be restructured. The severity of this process will very much depend on the type of company, according to Mr Gil-Robles. “When the company has a sound business but a leverage problem, there is probably no need to replace management, but the team will probably have to be reinforced with experienced turnaround specialists. In other cases, the management is part of the problem and needs to be replaced immediately, so the investors need to move fast in finding the appropriate replacement team. In this case, they should have also factored recruitment fees into the investment plan,” he says. This can be a stressful process for a company, so the acquirer may wish to hire a transition consultant to mitigate the upheavals felt by the remaining management, employees, vendors and customers.

Going forward

There are a lot of issues to take into consideration when conducting distressed M&A. Some investors do this with ease, others struggle and many fail. This is already clear in certain markets, where distressed deals among publicly-listed companies are showing less of an increase. “It will be difficult to see an increase in M&A activity in the absence of an appropriate takeover regulation in Abu Dhabi,” says Mr Tabbakh. “Currently this is a major impediment to well funded investors taking advantage of some opportunities in the market. Foreign ownership restrictions also limit the pool of available buyers and therefore have an impact on the level of M&A activity,” he explains.

But it is clear that the number of distressed deals is, in general, on the rise. Access to finance is still restricted, and distressed companies are increasingly finding that a quick sale may be their only remaining option for survival. “Due to the fact that traditional debt-

or-in-possession lenders have demonstrated that they do not currently have the liquidity or willingness to fund companies in Chapter 11 and existing lenders (more often than not) have been looking to extricate themselves from distressed situations, more distressed companies will be forced into an expedited sale of their businesses or assets," confirms Mr South. "This shortage of credit may favour strategic buyers with stronger balance sheets or cash positions than their competitors. In addition, these circumstances should give rise

to significant opportunities for private equity firms, which are increasingly showing interest in buying distressed assets after, in large part, sitting on the sidelines since the current recession began." Furthermore, other private equity firms are also starting to sell their distressed portfolio companies, which will also contribute to deal flow.

Anecdotally, property and construction, financial services, auto manufacturers and suppliers, consumer products and retail will offer the most opportunities for distressed investors,

but it may be some time before these and other trends become apparent. Restricted access to finance across the global market has meant that the rise of distressed M&A has been slow but steady, with cash-rich buyers taking advantage of cheap opportunities. However, they will soon be facing more competition when finance becomes more freely available, something that is likely to happen later this year. As such, it is thought that distressed transactions will drive M&A activity the world over throughout 2009 and into 2010. ■



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