

Distressed Mergers & Acquisitions: Beauty is in the eye of the beholder

Successfully managing in a downturn requires being a step ahead of the situation at all times. Arm yourself with a deep understanding of your organization-wide risks, and plan for various downside scenarios. Know your pain points intimately, and build flexibility into your capital structure to weather the storm and to quickly take advantage of opportunities.

Be prepared, be proactive, and be decisive.

As capital markets continue to be volatile and sentiment toward global economic fundamentals becomes distinctly bearish, now is an ideal time for companies to assess the appropriateness of distressed M&A as a strategic tool to better position their business. This strategy applies not only to companies under duress due to poor earnings or liquidity outlooks, but also to companies flush with cash—these companies can utilize opportunistic acquisitions to better position themselves to exploit the eventual return to positive economic fundamentals. Whether you're a buyer or a seller, distressed M&A requires a well thought out approach and discipline.

This article focuses on the buyer's perspective, but as any seller knows, understanding the buyer's rationale and approach is valuable when driving towards a successful sale.

What is distressed M&A?

Distressed M&A comes in many shapes and sizes, and is not just about companies being sold through a court-governed creditor protection process. Although this is a common scenario, some of the most successful distressed M&A transactions have taken place well in advance of a solvency crisis. While some may argue that the purchase price may be higher in this situation, a company can often avoid the potential damage to an on-going business that an extreme liquidity crisis or creditor protection can cause. The key is to identify distressed M&A opportunities early, as they are often completed on a proprietary basis, quickly and quietly.

Key trigger points for potential buyers to look for include:

- Companies that have been refinanced or acquired over the past 24 to 36 months and have high levels of debt (a “good company, bad balance sheet” scenario).
- Companies that have made multiple acquisitions and where operating results may be deteriorating.
- Canadian operations of multinationals, where the parent may be looking to generate liquidity and the Canadian operations are not seen as strategic priorities.
- Companies looking to refinance, where alternate capital structures such as preferred shares or convertible debentures are more tenable than they may have otherwise been in the past.
- Companies with a strong portfolio of intellectual property, such as proprietary technology or brands that may be interested in monetizing some of their investment.
- Companies operating in industries that are highly cyclical or very capital intense.

Keys to a successful distressed M&A transaction

Who to call



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1. Identify why the target company is distressed.

Once a buyer understands the causes of a company's distress, they are better positioned to assess the likelihood of returning it to profitability. But don't underestimate the severity of these problems—financial and operational diligence is critical, and it is wise to seek input from outside resources that are unbiased and less vested in a particular transaction. Be sure to build a plan to address and resolve the root cause of the distress, or you run the risk of inheriting a losing proposition. Common causes of a company's distress include:

- Credit availability/overleveraged
- Operational difficulties
- Weak or absentee management
- Foreign exchange losses
- Fraud and accounting irregularities
- Lawsuits
- Obsolete business model

2. Determine who the influencers are on the sellers' side of the table, who will be making the decisions, and to whom do they owe a duty of care.

The stakeholders can be varied in a distressed M&A situation. Depending on the stage of distress, shareholders may have less influence than in a normal course transaction; management may be accustomed to their way of doing business, or have concerns about their role going forward—particularly if the buyer plans to collapse the target company into their existing operations. The buyer should be mindful of the fiduciary duties of the board, as well as the influence of lenders, key customers, suppliers, and trade unions. Each may have a say in the final decision, and often times will be motivated by different objectives. A strategy should be developed for dealing with each of these constituents, including a communications plan that clearly establishes what each influencer should expect. Many distressed M&A transactions have fallen apart in the late stages when competing influencers believe that they have been misled or have misunderstood what they were gaining from the proposed transaction.

3. Use multiple approaches to valuation and deal structure.

Valuation of distressed companies is often less defined than in normal course transactions. Market and income based valuation methods such as comparable transactions and capitalized earnings are often less relevant, particularly where value creation will largely be determined by the execution of the turnaround plan. Many potential buyers of distressed companies fall back on the liquidated value of the assets of the business; however, this approach is more likely to

leave the buyer coming up short if the asset truly holds future opportunity. Most successful buyers of distressed companies use multiple approaches to valuation. A combination of post-closing earnings or free cash flow, valuation of realistic potential synergies, and tangible asset backing is the approach that most often succeeds. Although most buyers do not like to pay for what they bring to the table, limiting your valuation to the worst case liquidation scenario likely leaves you short of the finish line for valuable assets.

Deal structures will vary depending on the opportunity at hand, but buyers typically prefer asset purchases for distressed M&A. This strategy has the benefit of protecting them from contingent liabilities, and perhaps leaving behind some of the assets and liabilities that they do not want. However, asset transactions can impair your bid in the eyes of the seller, particularly where the seller is left with liabilities such as severance and redundant leases. Asset transactions also often overlook hidden value in such areas as utilization of tax losses, and the continuation of favourable contracts that may require third-party consent to assign or transfer.

4. Commit sufficient resources to getting the deal done, and hire legal and financial advisors with strong backgrounds in distressed M&A.

Distressed M&A typically moves at an accelerated pace, and often the situation can be murky and emotional, particularly when you are outside of your comfort zone dealing with insolvency related issues, or with the special situation arms of the lenders to the target company. Successful distressed M&A is a specialized skill, requiring an approach tailored to the specific set of circumstances at hand, where industry knowledge must be combined with a wealth of financial and distressed expertise as well as an understanding of the global marketplace. Most business operators have not been afforded the breadth of experience necessary to develop these skills, so be sure to arm yourself with seasoned legal and financial advisors that can guide you through the complicated world of distressed M&A.

We are in uncertain times, and whether your company possesses an abundance of available financial resources, or its liquidity is challenged, it is best to approach the applicability of distressed M&A on a proactive basis. Sellers who act early will avoid the prospects of a “fire sale” scenario and position themselves to better manage their resources to protect and enhance the value of their core business. Proactive buyers will gain early stage involvement in potentially rewarding transactions, and allow for the negotiation of better deal terms and structures. The alternative is allowing a strategic opportunity to reach a court-governed sale process, where wide scale auctions often see terms and timelines dictated, and where much of the value of the business may be lost as scavengers pick over its carcass.

