




Energy Insights:  
Energy Transactions

# Deal Making\*

Mergers and acquisitions  
in a distressed economy

\*connectedthinking

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# Mergers and acquisitions in a distressed economy

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*A distressed market means there is opportunity available for energy companies that understand the nuances of deal making in a down cycle. The key to success is rethinking your acquisition approach.*

Like the last tile in a long row of falling dominos, the energy industry has finally been hit by the worldwide credit crisis and subsequent global economic slowdown. While the short-term impact is being felt through considerably lower commodity prices, the often overlooked consequence of this “crisis of confidence” is a dramatic reduction in merger and acquisition activity throughout the energy sector.

In recent weeks, the bank-sector liquidity issue has been addressed by government involvement. Yet, there still will be a delay before confidence returns to capital markets and stability returns. Will it be six months? A year? Longer? No one knows for sure.

In the meantime, current market conditions are creating opportunities for buyers with access to capital who are not content to sit on the sidelines watching and waiting.

## Deal making in a distressed market

Dealmakers content to wait for better days may believe they are acting prudently, but there are often tremendous opportunities to be found in a distressed market, especially for those willing to recognize and understand the unique dynamics involved.

Deal making during difficult economic times requires a different approach and mindset on the part of the buyer. In order to understand the target company’s current fiscal position, its prospects for the future and its realistic long-term value, traditional approaches to due diligence are not ideal. Dealmakers must be careful to properly prioritize their pre-contract activities and be extra-vigilant in obtaining and reviewing the latest possible data throughout the process.

For a long period of time, dealmakers have enjoyed an up cycle in the economy. The result is that most corporate and private equity dealmakers possess only experience doing deals during buoyant economic times. The reaction to downturns has traditionally been to “wait it out.” Dealmakers need to gain expertise to complete deals during distressed times, which will likely be beneficial beyond today’s down market. Financial crisis severity and even frequency may increase as the global financial infrastructure becomes increasingly complex and interconnected, giving advantage to those companies that can continue to constructively operate in downturns.

## Innovating earn-outs

One of the most challenging aspects of closing a transaction in difficult times is reaching an agreement on deal value. Buyer and seller may agree on a value multiple (i.e., six times EBITDA), but they may diverge on what EBITDA figure to use. If economic distress has driven EBITDA levels down, the seller will seek to use a forecast-adjusted EBITDA

to arrive at a fair valuation. This forecast-adjusted EBITDA will, from the seller's point of view, be a fairer representation of the earnings power of the business. From the buyer's point of view, there is uncertainty around the forecast adjustment. This is a perfect case for an earn-out, where, for example, the buyer can agree to pay six times historical EBITDA to close the deal and an additional amount once earnings have, in fact, improved.

As simple as this sounds, this often creates a singular focus on acquired-company earnings if target management has some stake in the earn-out (which is often the case). The acquirer can very quickly be at odds with the target in terms of integrating operations and people, or in new strategic directions that make the acquisition a success but could reduce EBITDA in the short term.

This fundamental defect in earn-outs can be addressed through more sophisticated metrics. Companies that are serious about doing deals during distressed times should consider which metrics make the most sense from a strategic and post-deal operational point of view, and write these metrics into the acquisition agreement. This is not something that is often done in practice, but should be. Candidates for such metrics would include capital efficiency, new customer development (or existing customer retention), labor productivity, new product/service development, and so forth. Best practices in incentive compensation should be consulted as part of a deal maker's tool kit.

### Familiarity with bankruptcy process now a “must have” among deal makers

Severely distressed companies often have valuable assets that can be utilized more effectively by stronger, well capitalized companies. Dealmakers who understand the bankruptcy process (including the motivations of and options available to key stakeholders) will be well positioned to pursue a value-creating transaction.

Understanding the differences (in terms of cost, certainty of outcome, timing, and deal structure) between a “363 sale” and through a “plan of reorganization” could be immensely important in developing an effective pursuit strategy. Rarely is bankruptcy expertise a core competency of a buy-side deal team, however, it should be.

For example, a “363 sale” involves working with the company's ownership to put a rescue plan in place; detailing which assets the buyer wants and which, if any, liabilities it will assume; and having a judge approve those arrangements. This approach can be relatively fast (if it is seen as fair to creditors). It may even obviate the need for an auction under the oversight of a bankruptcy court, and, if done properly, can minimize transaction costs for the buyer.

An acquisition through a plan of reorganization (POR) is generally the preferred method if the acquirer seeks substantially all the assets of the debtor. The acquirer is intimately involved in preparing the POR, including negotiating the details with the various interested parties. Some of the strategic advantages of consummating a transaction through a POR include the avoidance of a 363 bankruptcy court auction, and flexibility of financing terms since the acquirer may be able to negotiate favorable terms with existing lenders and creditors. While this approach may result in lowest-possible deal value, it can be time consuming, expensive, and the outcome less certain.

The overarching issue for today's dealmakers is that a working knowledge of bankruptcy, presumably gained through distressed deals in today's environment, will be a capability that is always available when the time is right. Bridging the gap in this arena will be critical to making transactions involving bankruptcy scenarios successful.

### Shifting priorities around pre-deal activities will be vital to a successful transaction

The time leading up to inking a deal is chaotic and rushed. Often sellers create this dynamic to keep buyers off balance. As for due diligence, the art is often more about picking your battles and managing your knowledge risk rather than performing an orderly, comprehensive assessment of the target. Most deal makers accept the reality that due diligence is all about prioritizing activities and focusing on key areas of risk/opportunity.

During times of distress, these priorities are different, and they are particularly important because the stakes are much higher. Being a skilled buyer in a distressed environment means embracing this challenge and focusing on certain key aspects of the task such as:

Avoid the temptation to be relaxed about the most recent month's P&L / balance sheet. Insist on detailed access to records and a robust period of due diligence right up to signing the purchase and sale agreement. Do not do the "heavy" due diligence based on balance sheets that are two or three months old. A lot can change in two or three months, and a sudden decline in performance can be concealed from a buyer who is not alert.

- Evaluate credit risk of key members in the supply chain, in both directions, to the extent possible. Failure of a key customer can create tremendous cash flow pressure. Failure of certain key suppliers can mean a long term adjustment to the cost of supply (if market participants are reduced as a result of the failure). Note that an analysis of supply chain financial health can lead many companies to identifying potential acquisition candidates if vertical integration is desirable.
- Focus on the amount of working capital and cash that should be on hand at the close of the deal, given a reasonable assumption about the future state of the business. In a down market, working capital tends to fall. A routine adjustment mechanism pegged

to a temporarily diminished balance sheet may result in a large unintended increase in the effective transaction value.

- Develop a clear understanding of the maintenance spend of the target company in the months leading up to the proposed acquisition. Under-spending on maintenance during hard times will represent an effective increase in the true transaction value of the deal. Ensure that the purchase and sale agreement has a provision to protect the buyer from seller's starving the company of needed maintenance spend pre-close.
- Negotiate representations and warranties around working capital and other key accounts that are precisely defined, and seek "escape clauses" if the representations and warranties are materially breached before funds flow on the deal. Given that Material Adverse Change clauses tend not to protect companies from sector declines, deal makers should find innovative ways to use balance sheet (or earnings) representations and warranties to provide a deal "escape hatch" if the sector experiences a severe decline.
- Be alert to incidents of fraud which often accompany sharp downturns. Where possible, insist on waiting until the year-end audit is complete to ensure there are substantive tests of details. If the timing of the transaction is off the audit cycle, include substantive tests as part of the due diligence work. Also, be alert to red flags related to foreign corrupt practices (particularly FCPA violations).
- Develop a good understanding of the impact of changing currency exchange rates on historical and forecast P&L statements. Unusual exchange rate changes, a common feature of global financial distress, can influence perceived trends in the underlying business.
- Look carefully at changes in backlog, such as relationship between contracted versus "open order" backlog. Conduct a careful analysis of margin in backlog to look for evidence of profit erosion.
- Place more emphasis on understanding the value of net operating losses (NOLs), which may be building on a target company's books. Understanding the "deal value" of an NOL as a potential buyer and, in some cases, from competitive bidders' perspective may be necessary in developing a winning bid.
- Apply greater rigor in preparing a detailed integration plan. There is a much lower margin for error in terms of costs and benefits--and realizing expected deal value--during a financial crisis. A rigorous integration program should be prepared and executed.
- Be certain to understand the hidden costs of obtaining credit and change of control implications of current credit facilities. During a credit crisis, banks may refuse to negotiate replacement credit facilities when a change of control occurs. Such credit support mechanisms as bonding, LOC's, guarantees may come through in a much different shape during a credit crisis than when credit markets are functioning normally.

## Keys to dealmaking in a down cycle

There is no question there are value-creating opportunities awaiting dealmakers who are keen to manage their way through the deal risks presented by the current market conditions.

Dealmakers should start thinking now about how deal processes will differ in this environment, so they are prepared to maximize acquisition opportunities.

- In some instances, it may make sense to bring bankruptcy specialists onto deal teams to develop bidding strategies that will exploit the limited range of options available to sellers.
- For all buyers, due diligence should focus on key risks presented by the stress in the economic environment. Diligence priorities will look much different in a crisis than they would look during periods of normal economic and credit activity.
- Utilizing structuring techniques such as earn-outs to resolve gaps between buyer and seller will become more prevalent. Effectively managing earn-out deals will require a firm commitment to developing structures that support smart management and strategic investment post transaction.
- Recognize that deal making requires some new areas of expertise that may not be readily available on the deal team. Third-party assistance can be invaluable in a number of key acquisition areas, such as bankruptcy options, deal structuring, in-depth due diligence and determining tax implications. A third party can bridge knowledge and expertise gaps that deal teams may face during this unique period.

By developing distressed-deal-making skills now, buyers will not only create value in today's distressed environment, but they will also build a critical business skill that can benefit their shareholders many times over in the years ahead.

## About the Authors



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