Mergers & acquisitions — a snapshot

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What's inside

Companies in distress: A successful turnaround requires decisive action

Economic uncertainty, heightened global competition, evolving government regulation, and rapid technological changes can prove challenging for many companies. In many cases, decisive actions in implementing financial and operational restructurings may successfully turn around a company in distress. In other cases, the challenges may prove too daunting and a bankruptcy filing may be necessary. While bankruptcy filings have slowed from their highs right after the financial crisis, they continue to exceed one million filings per year in the U.S.

For companies in this type of financial or operational distress, it is often difficult to know when to take action and where to turn for assistance. This edition of *Mergers & acquisitions — a snapshot*, is the first in a series focused on the relevant considerations prior to, during, and after a bankruptcy. This edition provides leading indicators of companies in distress, an overview of the turnaround process, actions management can take to turn the business around, and how a turnaround advisor may help.

[1] Accounting Standards Codification (ASC) 805 is the U.S. standard on business combinations. ASC 810 is the U.S. standard on consolidation (collectively, the "M&A Standards"). ASC 852 is the U.S. standard on reorganizations (the "Reorganization Standard").

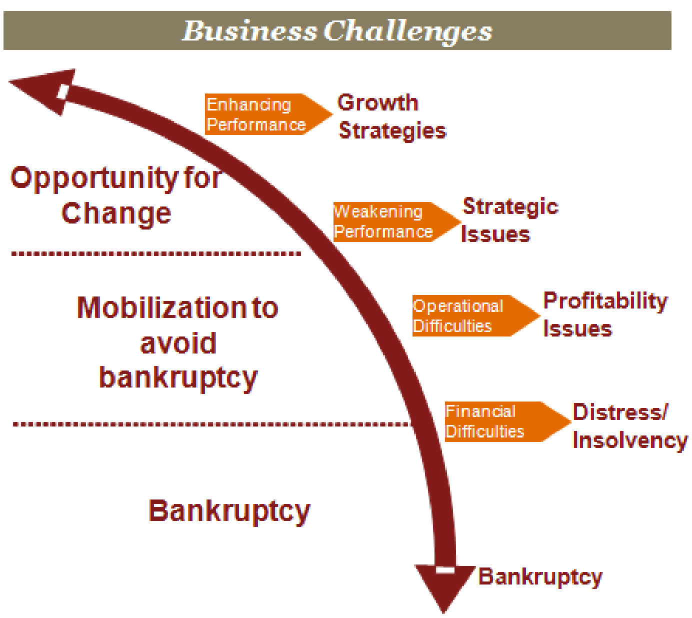
Knowing when to take action

When faced with severe financial and operational troubles, companies tend to wait too long to initiate turnaround activities. The more financially distressed a company is, the fewer the options that may be available to fix the problems and rapidly put the company on the right path.

The first signs of distress usually manifest as a significant decline in profitability, which negatively impacts cash flow. Over time, the liquidity drain from underperformance can eat away at the financial well being of the company and ultimately result in:

- Constraints that limit the company's ability to operate efficiently and meet obligations on a timely basis
- Debt covenant violations that accelerate liquidity issues
- Limited access to traditional debt and equity capital sources
- Overleverage that causes key stakeholders, including vendors, customers, and employees, concern and potentially motivates them to reassess their relationships with the company

Business challenges can present opportunities to change and grow the business, but companies need to mobilize quickly to prevent a further decline into bankruptcy.



Key accounting considerations – These business challenges can lead to a number of challenging accounting and financial reporting issues. Continued operating losses and negative cash flows will likely result in the need to consider the potential for goodwill and long-lived asset impairments, as well as the recoverability of working capital accounts, such as accounts receivable and inventories.

Deteriorating financial conditions may also lead to debt covenant violations. Covenant violations often result in the debt being due on demand by the creditor, which requires current classification of such balances on the balance sheet, further challenging the company's ability to continue as a going concern.

The turnaround process

There are typically three phases in a successful turnaround: (1) Stabilize the situation, (2) Assess the operational and financial alternatives, and (3) Implement the turnaround. Some key considerations for each phase are discussed below.

Stabilize the situation

The first step of any turnaround is to stabilize the finances and operations of the distressed company and provide confidence to all stakeholders that proactive steps are being taken to preserve value. The initial focus should be on developing liquidity forecasts and improving cash flow management to provide the time needed to properly assess potential alternatives.

Assess the operational and financial alternatives

Next, the company should assess its operational and financial alternatives to maximize the value of the turnaround plan. While industry-specific operational expertise is critical, a multi-disciplinary team with expertise in financing, tax, valuation, operations, legal, and country or territory specific matters is often essential.

Business planning, financial forecasts, and related valuation – The development of a business plan and related financial forecast serves as the backbone to any strategic alternatives analysis. A business plan is developed by defining business objectives, reviewing industry and competitive landscapes, analyzing business lines, and assessing risk factors.

Integrated financial forecasts should be developed to reflect the economic impact of the various business plan alternatives. Based on those forecasts, the enterprise value of the various alternatives can be determined, striving for a balance between value maximization and risk mitigation.

Analyze financial alternatives – Once the business plan options are narrowed down, the liquidity needs should be analyzed, as well as the debt capacity and optimal capital structure of the business, taking into consideration the dynamics of the marketplace. This analysis will be compared to the company's existing capital structure to determine whether it is workable given the new realities of the business or if a restructuring or recapitalization would be more beneficial. This review should include evaluating the cost of debt, lender covenants, equity components and future capital requirements. If the company requires additional liquidity, the ability to place new capital within the existing capital structure will also be analyzed. This may be the most effective solution if a company simply needs additional liquidity to bridge the turnaround of the business. For larger liquidity needs, a more robust restructuring or recapitalization may be required.

Key accounting considerations – A company may consider restructuring its debt as part of the turnaround process. A debt restructuring may be achieved by repaying or exchanging existing debt with new debt with the same lender or otherwise amending the terms or cash flows of the arrangement. In some cases, the existing debt will be partially or fully settled. In other cases, interest expense will be affected prospectively. In either event, the accounting treatment for new and existing debt issue costs and costs paid to the lender will need to be considered.

Implement the turnaround

Implemention can take various forms. There are generally three potential operational alternatives when assessing the path forward:

- Keep and restructure
- Sale as a going concern
- Wind-down and exit

Gathering complete data is essential to the process. Each of these strategies are discussed below.

Keep and restructure – Solutions should be developed with the goal of delivering sustainable change and continuous process improvement. These solutions will focus on lowering operating costs, improving cash flow, and developing efficiencies that can lead to increased market share and higher margins.

Operations can be optimized by addressing the following opportunities:

- Sustainable cost reduction: driven by transparent management of information and accountability
- Supply chain management: improving supply chain processes and eliminating risks so that the company can anticipate, create and manage changes necessary to remain competitive
- Customer impact: understanding what customers want, need and value most to gain a competitive advantage
- Revenue growth: moving from strategy development and opportunity assessment to implementation and consistent execution
- Corporate performance management: translating the company's strategy into financial and operational plans and then measuring how well the company is meeting those plans

Key accounting considerations – The strategies outlined above will often result in a fundamental change in the scale, location and operational direction of the business. A restructuring may involve the closing or consolidation of operating locations, terminating employees, or cancelling or exiting operating leases and other long-term contracts. Many of these actions will result in current period accounting charges, which will impact the company's financial performance as management begins the turnaround. Disclosure of the company's performance in executing its plans will likely be key in its communications with stakeholders.

Sale as a going concern – The sale of a distressed business is a distinct process that requires specialized expertise. A bankruptcy filing is often utilized as a corporate finance tool. Following are some of the key considerations that are unique to the distressed M&A process:

- Valuation: distressed company valuation requires modifications to the conventional M&A valuation methods, including comparing going concern values to liquidation values, determining which assets and liabilities are part of the sale, and assessing which sales process will optimize value
- Process: uncertainty created by distress within a company's customer or supplier base often requries an accelerated sale process. Trade-offs may be required between the increased value generated by a robust marketing process versus the diminishing value created by the consumption of cash or the loss of key customers or vendors. Having the ability to quickly articulate the value of the enterprise and avenues for buyers to stabilize and turn around the target are key to maximizing the proceeds to the seller.

- Multiple stakeholders: distressed situations frequently include negotiating with multiple stakeholders with conflicting agendas. Knowing how to organize, communicate and align various stakeholders is critical when dealing with distressed situations

Wind-down and exit – While management may be proficient at running operations on a day to day basis, winding down a business brings unique challenges and requires different skillsets. Specialists can be helpful in assisting companies develop plans to efficiently wind down the business and avoid potential pitfalls. Challenges that may need to be addressed include:

- Developing a strategy for ceasing operations (e.g., close quickly, selling off inventory, phased closure)
- Evaluating the impact on relations with customers and suppliers
- Understanding the implications on contractual obligations
- Developing a cost/benefit analysis for the funding of on-going losses
- Analyzing funding requirements and funding sources
- Assembling a wind-down project team, structure, and lines of communication
- Developing a key-employee retention program
- Ascertaining tax implications
- Determining how to manage communications to stakeholders and any public relations requirements

Turnaround advisors have extensive experience in helping clients shape and then develop detailed plans for winding down businesses. By virtue of their experience, they can identify the potential pitfalls and strategize how to work around them. Their experience and credibility can assist with securing wider stakeholder buy-in with, among others, financing sources, unions, employees, and pension trustees.

Conclusion

Financial and operational underperformance does not always signal the beginning of the end for distressed companies. Decisive and timely actions, with the benefit of advice from experienced professionals, can begin a successful turnaround of the business that refocuses strategy and ultimately creates value for all stakeholders.

Stay tuned for future editions in our series on companies in distress, which will highlight considerations during and emerging from a bankruptcy filing.

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