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Buying distressed businesses

BY MUAZZIN MEHRBAN

Despite the financial crisis creating difficult conditions for most, it has also provided opportunities for shrewd, cash-rich investors to acquire distressed companies. With Fitch reporting that a possible 1500 firms could default by 2010, there will be plenty of chances for investors to make strong purchasing returns, provided that they have the right plan to turn targets around. On the other hand, buyers should be aware that there are a number of initial factors needing to be considered when making a distressed purchase. A troubled company may seem an attractive buy, but there is no guarantee of long-term success. Furthermore, there are numerous other challenges that a company can face when pursuing a troubled business.

Approaching the target

Initially, buyers should weigh up the effectiveness of their turnaround strategy for their target against the cost effectiveness of that strategy, in order to decide whether the approach is financially viable. "Factors which will influence this decision include the cash reserves of the target, the amount and structure of the target's debt, market share, industry conditions, demographic trends and opportunities for growth. In every distressed company investment, it is important to have a realistic, detailed business plan and exit strategy," explains Lynn Hiestand, a partner at Skadden, Arps, Slate, Meagher & Flom (UK) LLP. The key is to understand the difficulties a distressed company faces, both now and in the future. This is crucial, given that in some cases business fundamentals may have shifted irreversibly.

Also, the time taken to close a transaction and make the target profitable again must be a consideration. Furthermore, Deborah Hicks Midanek, president of Solon Group, advises that the level of expertise required for a successful turnaround should not be underestimated. She lists several steps that should be taken. "Build a team of trusted advisors: attorneys and financial advisors, accounting team and operating knowledge, that can analyse and structure effectively. Consider the degree of knowledge the buyer has or needs properly to assess the operating realities of the company. If additional expertise is required, engage an industry expert to assist, and learn as much as possible from that resource without handing over responsibility," she says, insisting any distressed target should be thoroughly vetted before a deal is proposed.

As such, greater emphasis must be placed on due diligence when considering the purchase of a distressed business. The process allows purchasers to decide on the finer points of the deal, such as whether an acquisition should take the form of an asset or share sale, if any changes are required at senior management level, and which staff should be earmarked for retention. "An extensive review should be undertaken of the target's key relationships including suppliers, customers and lenders. One of the key questions to be determined is whether the company's problems arise from its balance sheet – over leverage – operational/management challenges or both," recommends Ms Hiestand, arguing that due diligence can help to identify exactly what fundamental problems a firm has.

Ms Midanek agrees, adding that the process is a valuable chance to identify key resources or the possible lack of them. With regards to management, she thinks due diligence can help in the evaluation process, if a distressed firm has the right personnel who can accept and effect the changes necessary for a successful turnaround. However, she warns that many due diligence teams overlook a company's value proposition to its customers when assessing potential deals. As such, she insists that asking questions regarding a target's clientele, e.g. what alternatives they have and where the company is vulnerable to losing customers, is vital in uncovering its long term potential for success.

Paying the right price

Of course, no amount of due diligence can change the fact that placing a value on a target is difficult right now, given the number of micro and macroeconomic issues that need to be considered. Issues within a company depend on the level of distress a target is under and the urgency with which it requires a sale. However, some experts say past performance should not be used as an indicator for future performance - if nothing else, forecasting the future results of a distressed firm in this way can be very tricky. On a wider scale, macroeconomic conditions can affect a troubled firm if the market it operates in is also depressed.

Once all the main value drivers have been identified, buyers can focus on how much they are willing to offer. "Assessing comparable transactions, doing the discounted cash flow analysis, looking at acquisition multiples that may apply to various components of the business are important disciplines to apply," asserts Ms Midanek, who suggests that a number of questions should be satisfied before a valuation is reached. "What are the motivations of the seller and any other interested party? What can the buyer afford to pay and for what value? What consideration structure best suits the needs and risk ▸▸

profile of both sides? What is the impact of the legal venue in which the sale may proceed on the consideration that can be offered? And finally, what does it take to win the deal at a cost acceptable buyer?" Assessing the availability and cost of deal financing should also be considered before calculating a fair price for a company.

Ultimately, the appeal of distressed companies is the opportunity to purchase a high-quality asset at a discounted price. But for the purchase to be considered beneficial, restructuring should allow it be sold for a profit at a later date. As such, it should be scrutinised in terms of the time and focus required to achieve it. Some analysts believe the best opportunities for distressed investors come from firms which possess strong and profitable core functions. They also observe that distressed firms with healthy operations can be bought at distressed prices simply because of difficulties faced in the refinancing process. In addition, incumbent owners of such firms do not always understand exactly what they own and lack perspective on how to improve their situation.

It follows that the major risk associated with distressed investments is that a turnaround could be unsuccessful. Strong business fundamentals, a practical business plan and proficient management can help mitigate some of the risk. But Ms Hiestand warns that buyers should be aware of the less obvious legal risks associated with distressed investments. "One risk is that the transaction may be subsequently challenged by an officeholder in the event that the company goes into insolvency. Of course, such risk is generally minimised if the transaction is at arm's length, negotiated by the parties in good faith and for fair value. Further, in order for the directors to avoid accusations of breach of fiduciary duties, appropriate advisers, both legal and financial, should be engaged on an ongoing basis and actively involved in the sale process." In addition, decisions made by the board of directors should be accurately documented and checks should be made to ensure that those close to the deal have no personal transaction benefits.

Also, it is recommended to plan for additional liquidity at the time of purchase, in order to avoid the risk of falling short when trying to secure a deal. The uncertain economic and political environment means it is worth paying to secure standby liquidity should it be required. Furthermore, developing a capital structure which mimics the business model will also help to minimise risk. If possible, buyers should look for ways to leave risky assets and liabilities to one side. Creating term buyouts, whereby a seller earns as the company achieves set benchmarks can lower the risk of buyers losing out on initial investments. However, enforcing such a strategy does require high levels of legal framework and often disagreements arise because benchmarks are not clearly defined.

Timing the move

It is generally cheaper to buy firms during insolvency as it is easier to acquire operations without taking on liabilities. However, insolvency sales require court approval and transaction details. This would leave the deal open to scrutiny, and could result in a competitive bidding procedure like an auction. Furthermore, Ms Hiestand believes insolvency has a negative effect on company image. "One of the important factors which may influence an investor's decision to wait until the company is subject to formal proceedings, before proceeding with a potential acquisition, is whether the company can survive the stigma associated with insolvency in many jurisdictions. In particular, the company's brand and relationships with key stakeholders, for example suppliers and trade creditors, may be severely impacted once the company enters into formal insolvency." This is one of the reasons companies choose to purchase prior to insolvency, lowering the risk of damaging a brand, despite forgoing potential savings.

Also it is argued that the odds of deal success can be reduced if a buyer waits until insolvency to make a bid. The time and cost of a deal, two factors crucial to measuring a deal's worthiness, are no longer certain. "Should a purchase from an insolvency proceeding be contemplated, the right legal advice, always critical, is an imperative, as is an understanding of the insolvency process itself," explains Ms Midanek. "Valuation becomes even trickier as many players are manoeuvring for various advantages for their constituencies that may not relate at all to achieving a sale of the enterprise." The lack of a common goal held by parties involved in insolvency process can often lead to a deal becoming less attractive.

There are clearly many distressed firms which can be purchased at a discount and turned around, making them worthy of investment. Indeed, many are only struggling because of a dearth in liquidity. However, a potentially profitable target does not guarantee a successful turnaround. Firms looking to acquire distressed companies must apply thorough due diligence and ensure that they have identified exactly where targets are failing. Returns on distressed purchases can be very lucrative, but the risks that come with them are often proportionally greater. ■

Deborah Hicks Midanek
President, Solon Group, Inc.
T: +1 (917) 853 3598
E: dhmidanek@solongroup.com
www.solongroup.com

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Merchant Banking for Companies in Transition

Deborah Midanek counsels imperilled companies and their constituents and has led various businesses through strategic, operating and financial challenges. She enjoys a reputation for thinking creatively, and contributing to realising unusually strong results. Ms Midanek holds an MBA from Wharton and an AB from Bryn Mawr College.