

## Distressed M&A: leveraging opportunity in a downturn.



With upheaval in the economy, a surge of bankruptcies and a general fear of “what’s next”, there has been a marked decline in traditional Merger & Acquisition (M&A) activity. However, could this economic shakeout present a powerful opportunity for some companies, especially those with an eye toward growth and an appetite for acquisitions? Using the economic downturn to position a company for growth may seem like an obvious strategic play. However, companies looking to engage in distressed M&A transactions must operate based on the unique characteristics and challenges that are typically present in a distressed market.

The number of companies filing for bankruptcy has begun to spike again because of the recent travails of the financial services industry and its ripple effects into other sectors. With today’s more creditor-friendly bankruptcy code limiting the time a company can operate under Chapter 11 and limited access to financing for bankrupt companies in the current environment, a greater percentage of companies will likely be forced to sell assets versus reorganize. These factors should enable nimble buyers to mine opportunities in distressed or bankrupt businesses – and be well positioned to thrive in the next economic upturn.

In this point of view, we discuss the types of buyers likely to be active in today’s market; characteristics of and timeframes for mergers and acquisitions involving healthy, distressed, and bankrupt assets; and opportunities and pitfalls to consider when acquiring distressed companies. Having the tools and knowledge to navigate and capitalize on distressed M&A opportunities is a distinct competitive advantage in the

current deal environment. It is equally important to understand that the distressed M&A market is quite different from a healthy market, and transactions need to be looked at with very different perspectives in these environments.

### Every deal is different, especially for distressed companies

Even under normal circumstances, the dynamics of M&A transactions vary widely from one deal to the next, particularly in terms of available buyers, the timeframe for closing the deal, and the processes involved. When distressed or bankrupt companies are involved, these dynamics may grow even more complex — much more so in a distressed market than in a healthy market. What you don’t know can hurt you.

### Healthy versus distressed/bankrupt acquisition targets

**Potential buyers.** Healthy markets and healthy business tend to favor the seller. These conditions can drive demand from a larger pool of strategic and financial buyers with ready access to capital. A seller’s advantage deteriorates, however, as the company shifts from healthy to distressed or bankrupt, and the upper hand becomes the buyer’s. But not every buyer has the ability or desire to deal with a troubled target, and many strategic and financial buyers will only consider transactions with healthy companies. As a result, competition thins and can leave the buyers with more of an edge in negotiations when considering a distressed/bankrupt target.

**Deal timeframe.** This same construct holds true with respect to timing. In a healthy situation, the seller can accelerate or extend timing to meet its transaction objec-

tives. For example, the seller may speed the process to limit the amount of time potential buyers can take to consider due diligence findings. Conversely, deal timelines may be stretched if management anticipates reporting solid interim results that would reflect favorably on the deal's value. In distressed or bankrupt deals, value erodes as time passes and flexibility is hindered in part due to changes in the bankruptcy code, lack of financing and the ongoing adverse impact of the current credit crisis.

Deals for healthy acquisition targets typically have the potential to proceed swiftly and efficiently, but with today's decreased access to capital and lower valuations due to the availability and cost of capital, as well as concerns around business prospects stemming from the state of the economy, timing a transaction is no longer a sure-bet. However, although the timing of transactions involving healthy companies is not as predictable as it once was, distressed transactions may involve more rigorous due

diligence or other oversight activity beyond what is seen when dealing with healthy companies.

In a challenging marketplace, deal-savvy buyers decide early on whether or not they are going to make a play for a bankrupt business. Chances are, by the time a distressed business falls into bankruptcy, the buyer has already participated in the diligence process and negotiations with the acquisition target's Debtor-in-Possession (DIP) lender — the bank that usually holds the senior security interest in the company's assets both in advance of bankruptcy and then as DIP lender through the Chapter 11 process. The DIP lender typically drives the timing to force a sale or reorganization.

Considering the steps required to close a deal for a bankrupt business — a public announcement, bankruptcy court oversight, and auction — the process itself is reasonably efficient, but not necessarily fast. Obstacles that buyers face that may slow the process down include creditor objections to the sale and stakeholder's rights. Once a 363 sale is announced, the process is generally quick, but getting to the 363 can sometimes be difficult.

#### Attributes of the deal

Beyond the dynamics introduced by the health of the target company, three other core attributes of M&A transactions can impact a deal. As a buyer in a distressed market, paying careful attention to your access to information, value creation, and the balance between risk and return to maintain your competitive advantage becomes even more important.

**Access to information.** M&A transactions are a process of discovery, of uncovering risks, discovering opportunities, and validating hypotheses about potential value. To that end, a healthy seller is inclined to provide only the minimum amount of information necessary to convince potential buyers to bid the highest price. Enough information is shared that a buyer can develop an understanding of the deal's upside and weigh strategies for mitigating the downside — but not too much information that a buyer may begin to reconsider. That being said, through a buyer's due diligence and negotiation of the purchase agreement, especially in regards to representations and warranties, any "issues" will come out in the wash. The seller of a healthy business is not incented to hide issues as this could lead to post-closing litigation (potentially for fraud).

In distressed situations, the seller has fewer options and may have to be more open in terms of the type of information it provides — and may provide more access to that information. Similarly, in bankrupt organizations, greater depth of information, more access to management, and greater insight may occur early on in the due diligence process. If the bankrupt

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## Section 363 Sale: Protecting an Asset's Value

In distressed times, troubled companies tend to lose value quickly. There are, however, provisions of the U.S. Bankruptcy Code that can protect a company's value during a bankruptcy. Under Section 363 of the Bankruptcy Code, a debtor is permitted to conduct a sale of assets for the purpose of preserving value for the benefit of creditors and constituents in the Chapter 11 bankruptcy process. The benefits of Section 363 include permitting the buyer to acquire only the assets it wants, and where appropriate, to assume liabilities of the debtor subject to the acquirer's determination — that is, free and clear of the previous liens and claims.

company decides to negotiate a purchase agreement with an initial bidder, also known as a “stalking horse” bidder, this timing can be of benefit to that bidder, but can be a detriment to others involved in the auction process. The presence of the stalking horse bidder, who has increased access into the bankrupt company for due diligence purposes while negotiating the deal, can force others to make a decision very quickly once the stalking horse makes a bid and essentially can set the bar for the terms of the deal.

**Value creation.** Armed with information from the seller, a potential buyer can begin to pinpoint opportunities for creating value from the deal. If the seller is a healthy business, the buyer will be looking for ways to maintain and build upon the current growth platform. For distressed targets, value can only be created by changing historical practices, such as the cost base, the business model, the management team, or a combination of these factors. Bankrupt companies, however, can be attractive to buyers because of the myriad ways available to bring a troubled company back from the brink. In addition to using the value creation strategies that could be applied to healthy or distressed companies, they also have the ability to adopt other strategies. Some fixes are balance sheet-driven: too much debt and not enough equity. Others, such as Chapter 11 remedies, permit the debtor to use bankruptcy to reject onerous contracts and benefit from the elimination of the obligations.

**Risk versus return.** In terms of a deal’s risk versus return, there is a stark contrast between healthy and distressed situations. In healthy acquisitions, the presumption generally is full valuation with moderate returns. With distressed companies, value prices can yield higher potential returns. Given the different risk profiles, execution risk becomes much more prominent in distressed M&A because of the operational changes required. Deals involving bankrupt companies can present even bigger risks, including the potential failure to turn around the subject company, resulting in yet another Chapter 11 bankruptcy down the road — a situation sometimes referred to as “Chapter 22.”

### The critical role of due diligence

The art of the M&A deal rests largely on the acquiring company’s ability to peel back the layers of the target company to see what the real essence of the business is beneath the surface. This holds true in healthy deals, but it is especially important with deals involving distressed and bankrupt companies. Because the risk/return paradox is so different in healthy versus distressed markets, thorough due diligence is even more important when contemplating a distressed transaction. Issues that may not be of great concern in a healthy company may be “make-or-break” factors when considering a distressed company.

The due diligence layers can be categorized into three broad areas: industry/external factors, business operations, and financial and tax issues:

**Industry/external factors.** Understanding the industry outlook and stability are essential to any M&A deal. Does the market exist for the company’s products or services? How has the industry consolidated? Is it oversaturated with competition? Can consolidation help alleviate the competitive pressure? Also, look closely at who the potential winners and losers are. In the industry value chain, who has the advantage? Gaining an understanding of these dynamics helps provide a lens for analyzing forecasts of the M&A target and understanding the true essence of the business or assets.

**Business operations.** The key focus of business operations include finding the source or sources of distress. Take a close look at comparable transactions or comparable trading companies. Consider why the target company trades, for example, at a fraction of peer multiples. Why did a certain transaction close below average trading values for the industry? Answers to these questions can help to accurately frame the state of the business’s operations and offer a clear view of long- and short-term viability.

**Financial and tax issues.** Among the many financial factors to examine in any M&A transaction, perhaps one of the most critical is the quality of earnings and the company’s cash flow. Having an understanding of a company’s cost run rate before bankruptcy, and the run rate with the changes in cost structure that will likely

### Transaction structures

The traditional approach to acquiring an M&A target through an asset or stock transaction certainly can be employed when a distressed or bankrupt company is involved; however, a distressed situation or bankruptcy opens the door to many other options, as well, including:

- Uniform Commercial Code (UCC) Article 9
- Assignment for the benefit of creditors
- Claims acquisition
- Chapter 11 (reorganization) bankruptcy
- Chapter 7 (liquidation) bankruptcy
- Section 363 sale (see sidebar “Section 363 Sale: Protecting an Asset’s Value”)
- Plan of reorganization
- Receivership
- Claims trading

The choice of one of these approaches over the others may be influenced by the courts, creditors, and prospective buyers. It may also vary based on circumstances such as the overall health of the target company and the value of its assets. The bottom line is that there may be many options available for structuring an M&A transaction when a troubled company is involved.

happen in the distressed environment is an important consideration for buyers. Next, look for overvalued assets or under-investment in plant, property, and equipment. Also, will the entity use fresh-start accounting? What are the implications of any cancellation of debt income? A review of tax issues should include, among other things, an assessment of the overall effective tax rate, FIN 48 issues involving uncertain tax positions, existing controversies with tax authorities, and availability of foreign tax credits.

### Potential opportunities and pitfalls in distressed M&A

Whether your M&A goals include turning around the current situation or creating an entirely new strategic direction for the acquired business, a detailed business plan is critical to your deal execution risk. Certainly, due diligence plays a pivotal role in formulating such a plan. Other factors that can contribute to an effective deal include:

- Retaining or installing a skilled and incentivized management team

- Providing active oversight through all stages of the deal
- Devising effective responses to operational or cost-structure issues
- Having ongoing access to equity capital

One intangible you should always rely on in M&A transactions is a healthy dose of realism. Being able to identify problems, capitalize on opportunities, and have a clear view of the big picture may be the most valuable attribute of all, especially in deals with distressed or bankrupt companies.

Conversely, one of the biggest pitfalls in distressed or bankrupt M&A transactions is a lack of realism. This can scuttle the long-term potential of any company — healthy or distressed. There is a reason why a troubled company is in distress. Effective buyers can work to overcome this pitfall by knowing the industries it wants to be in, identifying companies within the industry that may be appropriate targets, and crafting a strategy for the acquisition that considers best-case, worst-case, and moderate results.

When buyers “bet on the wrong horse”, they can be faced with a myriad of challenges from the acquired company including:

- An industry or business in long-term decline
- No vision or strategy for success
- Long periods of under-investment
- Damaged culture, values, or core competencies

Also, the availability of acquisition financing can be a significant stumbling block, especially in today’s volatile credit environment. In fact, we believe financing may be the difference between closing the deal yourself and watching another acquirer capture the prize.

### Looking for the silver lining

Headlines about the current economic situation have been the focus of late and with good reason. Still, possibilities exist to create value and build wealth — on Main Street and on Wall Street. While your company may be feeling the effects of the economic downturn, those that are prepared to make moves and acquire distressed businesses may realize significant benefits in the future. However, engaging in a transaction with a distressed company requires even more preparation and diligence than a typical transaction.

We believe the conditions are right for forward-thinking buyers with an eye for distressed companies to acquire undervalued businesses — or even mere assets — in today’s economy and to be prepared for the next period of economic growth. Considering the issues outlined in this point of view, your business may craft a sound and effective strategy in the distressed M&A market.

#### M&A Pulse Check

In a recent Deloitte Dbriefs webcast on mergers, acquisitions, and distressed businesses in an economic downturn, we asked the more than 1,500 participants a series of questions on the topic. Their responses appear throughout this point of view.

Which factor would you consider to be the most important in determining the success of distressed acquisitions?

- Detailed due diligence – 37.5%
- Detailed business plan – 18.1%
- Skilled and adequately incentivized management – 13.2%
- Active oversight – 9.9%
- Appropriate capital structure – 7.7%
- NA/Don’t know – 13.5%

Total responses: 1,116

#### M&A Pulse Check

Which would you consider to be the most important potential pitfall to avoid in a distressed acquisition?

- Betting on the wrong horse – 36.2%
- Deal structuring – 20.7%
- Acquisition financing – 8.3%
- Adequate buyer protection from liabilities – 19.7%
- Getting out-bid – 2.1%
- NA/Don’t know – 13%

Total responses: 1,023

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