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Making the best out of distressed M&A

With a potential economic slowdown on the horizon, as well as broad structural changes in several industries, distressed M&A deals are expected to rise in 2020. Under higher pressure and an accelerated timeframe, how can dealmakers make the best out of a challenging situation?

After several buoyant years of growth, the global economy is slowing down, and with it comes the rising likelihood of distressed M&A transactions

A recent survey of European dealmakers conducted by law firm CMS, found that 95% of respondents expect distressed M&A to increase in the coming year.

Why is this the case? First, the growth is sluggish and demand is slowing. In tandem with this, geopolitical factors from US protectionism to Brexit continue to pile on the uncertainty.

Second, the way the world does business is changing. From digital disruption to decarbonisation, businesses are under pressure to be on the right side of global megatrends.

Where some see gloom, others see opportunity. Savvy strategists have the opportunity to acquire new capabilities and market

share from slower-moving competitors. And, with ample reserves of dry powder, PEs are already eyeing up opportunities in the distressed arena.

That is, provided they can navigate the challenges specific to distressed situations. As Gary McKeown, CEO of Imprima, puts it: "In a distressed situation, everything has to be done immediately; the typical M&A process of several months may need to be condensed to weeks if not days."

To find out more about what the next 12 months might have in store, we brought together six experts from the fields of law, consultancy and academia to share their insights into the drivers, opportunities and pitfalls of distressed dealmaking.

Deal drivers: turbulence ahead?

Expert speakers



Gary McKeown
CEO,
Imprima



Rüdiger Wolf
Managing Director,
Boston Consulting Group



Meziane Lasfer
Professor of Finance,
Cass Business School



Ben Hughes
Director,
Deloitte



Rhys Evans
Senior Associate,
Freshfields Bruckhaus Deringer



Vance Chapman
Partner,
Akin Gump

Distressed M&A is expected to increase in 2020. So where do the opportunities lie? In this section, we shine a light on the geographies likely to prove vulnerable to economic headwinds – and find out why there's no such thing as a 'typical' distressed asset deal.

Mergermarket: How do you see the global macroeconomic environment developing in 2020?

Rhys Evans, Freshfields: We're at a slightly strange juncture from a macroeconomic standpoint. On the one hand, we're at the end of a long bull run, there's a lot of dry powder in the market and global M&A activity is still extremely strong. On the other, you've got tension around US-China trade, concerns about populism and fears of a slowdown, although well short of recession. So there is a sense that we are coming to the point where a correction is expected.

Vance Chapman, Akin Gump: There are several factors in the pipeline that people are concerned about. There are the obvious ones like the Asian slowdown, the possibility of trade wars, the Trump presidency, the Brexit saga and technological change. So there are a lot of known-unknowns. But it's always the unknown-unknowns that catch everybody out.

Mergermarket: What regions do you think are most vulnerable to economic headwinds?

Ben Hughes, Deloitte: Whilst the mood may appear more positive in the UK following the recent election, Brexit still needs to be delivered and various economic indicators point to growing pressures. On a global level, the current geopolitical environment combined with growing concerns over the growth prospects of various economies points to a more uncertain environment. Given the inter-connectivity of the global economy, any fundamental shock to the system could be felt far and wide.



Distressed M&A is going to be a trend for the coming years.

Rhys Evans, Freshfields

Vance Chapman, Akin Gump: In Europe, the manufacturing sector looks vulnerable. On the trade war side, I think Trump's looking to get something in place in time for the November 2020 election. Something will be sorted out. I'm more worried about the ability of China to cope with its domestic debt, though this is a recurring annual theme. Looking at the UK, the new Brexit cliff edge is set for the end of 2020. Both sides are supposed to make a decision by the middle of the year about concluding a trade deal within that timeframe. It will be interesting to see this play out.

Mergermarket: Do you expect opportunities in distressed M&A to increase in 2020?

Rüdiger Wolf, BCG: The trend towards distressed asset M&A has picked up in the last year in Europe and especially in Germany. We expect this to continue. We don't see a major recession at the moment, but there are headwinds for certain sectors such as retail, automotive and machinery.

Vance Chapman, Akin Gump: The UK retail sector is particularly exposed. That's going to continue. And UK industries that are exposed to a hard Brexit and forex movements also look vulnerable. That's really going to play itself out in the second half of the year. Turning to Europe, we've already seen a heap of opportunities in retail. Looking ahead, European manufacturing will continue to offer opportunities for distressed transactions.

Rhys Evans, Freshfields: Distressed M&A is going to be a trend for the coming years. Tech companies will continue to have a disruptive influence in different sectors. Retail is the clear outlier for that. Another behaviour we're seeing is companies pivoting

towards their core activities and disposing of non-core business. That's particularly acute where they are underperforming.

Mergermarket: Is there any such thing as a 'typical' distressed situation?

Rhys Evans, Freshfields: Distressed M&A covers a range of situations with different drivers. At one end of the spectrum, you have insolvent companies that have ceased to trade and are in administration. At the other, you have functioning companies in sectors and markets which have become more challenging. If you are facing those headwinds, one response is to sell off parts of the business. Then you've got companies which are in the middle and showing signs of distress. An example is where covenants about ratios between profitability and debt have been breached. This can be an early warning of problems.

Meziane Lasfer, Cass Business School: Distress takes a number of forms. Some of these can be managed, others cannot. Business risk is the first factor: the target is distressed because its product is obsolete, the competition too great or management too weak. It is difficult to adopt a recovery strategy in those situations and the likelihood of success is low, unless if a stronger new management is brought in and is able to revive it. Financial risk – debt – is the second factor. If a target is debt-laden, but otherwise sound, the likelihood of success is high, provided the buyer injects cash. Agency conflict is the third factor. In such cases, the managers are using the company's cash for their own high compensation or luxury benefits, like private jets, rewarding themselves instead of the shareholders. In those cases, the likelihood of a successful restructuring is high. Fraud is the fourth distress factor. There are clear dangers in buying a company tainted by fraud. However, acquisition of individual assets is likely to be successful. The fifth and final factor is financial distress driven by macroeconomic risk. This typically applies where a company's fortunes hinge on commodity prices – mining companies are an example. The likelihood of success is low because there are some macroeconomic risks that no bidder can manage.

Critically, though, the success of a takeover depends not only on the health of the target, but also the health of the bidder. Even when you control for business risk, financial risk and macroeconomic risk, the likelihood of generating a good return is non-existent if a distressed company is taken over by a distressed bidder.



Opportunities in distressed M&A

Distress can afflict businesses of any type – but some sectors are more vulnerable than others. Here, we examine which industries are likely to be targets for distressed M&A in 2020. We also look at what sort of buyers are expected to be most active – and what sellers can do to make sure they maximise value in a distressed situation.

Mergermarket: What sectors do you expect will be most active for distressed M&A over the coming 12 months?

Rüdiger Wolf, BCG: We see a lot of distressed situations in retail. People are still consuming, but retailers haven't adapted to the rise of digital channels. The automotive industry also needs to adapt. This is less about technology and more about lower demand from China and mainland Europe. This applies to OEMs in Germany and Europe. It applies even more to automotive suppliers. The machinery industry is also being affected: growth has slowed, the impact of Brexit in Europe is unclear and trade conflicts are on the rise. On top of this, lenders are becoming more hesitant about supporting turnarounds. This can act as a trigger for M&A.

Ben Hughes, Deloitte: Various macro and micro dynamics are putting pressure on a range of sectors including automotive, travel, energy and retail. However, it is not simply a case of saying one sector or another is doomed. Take retail as an example, yes it is going through structural changes and there have been some high-profile restructurings, but retailers such as Boohoo and JD Sports continue to deliver very strong trading results.

Rhys Evans, Freshfields: The retail sector will see continuing challenges. Oil and gas might be another: asset prices are relatively depressed. Oil prices have been low for a few years, and if this continues, business models will become unsustainable. Automotive faces questions about where manufacturing is going to take place in the future – the UK is acutely aware of this and is potentially susceptible.

Mergermarket: Do you expect a growth in specialist funds focused in distressed situations? Or do you expect generalist funds and trade buyers to be opportunistic when approaching these situations?

Rüdiger Wolf, BCG: I would expect to see more strategic buyers. Businesses are preparing themselves for the future, buying is less expensive in distressed situations and there are opportunities to change the competitive situation. Private equity will take its share, but it will be different for certain sectors. We don't see much private equity in the automotive industry, in machinery or the industrial goods sectors. I think we will see an increase in the number of funds specialising in distressed situations. They are better prepared and usually better understand post-acquisition turnarounds.

Vance Chapman, Akin Gump: Funds are typically more successful than corporates in distressed situations because they can move more quickly. Specialist funds follow distressed situations and are usually ready to transact at the drop of a hat. The same can be said of the more general funds where you've got individual portfolio managers tracking specific opportunities. Strategics are generally slower – although you now see more strategic teams ready to transact at the required pace than historically. I don't know whether we'll see a huge growth in specialist distressed fund formation this year. There's been a fair amount of that over the last 18 to 24 months. The ones I've been seeing most recently have tended to be on the generalist side.

Ben Hughes, Deloitte: It's a great time for strategics with an appetite for risk and an eye on acquiring a struggling competitor, although some corporates are more willing to operate in this space than others. I think we will continue to see the turnaround private equity houses and special situations investors being the primary financial investors in this space, as distressed M&A requires specialist skills and experience.

Rhys Evans, Freshfields: I don't think you should discount the role of corporates. We are certainly having more questions brought to us



as legal advisors from corporates looking at these sorts of situations – particularly corporates that have an opportunistic perspective on taking advantage where someone else is having difficulties.


Mergermarket: How can sellers maximise value in a distressed situation?

Ben Hughes, Deloitte: Make sure your housekeeping is in order as it can take a long time to extract the information from systems and present it the right way, which makes life difficult in an accelerated M&A process. Management accounts, board reports, key contracts and operational data should be clear and easy to pull together.

Vance Chapman, Akin Gump: M&A is always a high-pressured situation. In a distressed situation, the timetable is typically contracted to preserve the business and get the sale underway. It helps if the sell side can get ahead of the game, start to organise information and get a real process in place. There is usually a dearth of diligence data available due to problems in the business. And the ability to bundle the data is limited because of timing constraints. Organisation and knowing your assets is key.

Gary McKeown, Imprima: As Ben already mentioned, we also encourage companies and advisors to maintain information in a structured and up-to-date format. In a distressed situation, there are usually two things in play. First, everything has to be done immediately; the typical M&A process of several months may need to be condensed to weeks if not days. Secondly, time constraints mean that information is often unstructured. All of this needs to be streamlined into a transaction-ready state.

Imprima's latest technologies (powered by AI) greatly accelerate the process of sifting through large quantities of unstructured data to find the pertinent information that could be of most interest to the bidder. Our latest product, Smart Review, is specifically designed to find red flags in the information in 10% of the time compared to conventional methods. This makes it even more valuable in a distressed situation as the use of technology allows for asset value to be maximised before it may become too late. All our technologies can be utilised through our market leading M&A Virtual Data Room platform – again saving time in not having to use multiple systems.



Challenges in distressed situations

Participating in a distressed M&A process can be a daunting prospect, particularly for first-time bidders and sellers. For one thing, there is usually an accelerated timetable. That can make it difficult to value the asset and conduct adequate due diligence. In this section, we examine the challenges and what can be done about them.

Mergermarket: What challenges should dealmakers consider with distressed M&A?

Rhys Evans, Freshfields: Speed is the first thing. You might need to condense a diligence exercise into 48 hours and produce draft documents in just a few hours. That has implications for your ability to negotiate deal terms. The second thing is adversity: you can face a situation where you have creditors, equity holders and managers all pulling in different directions.

Ben Hughes, Deloitte: The truncated timetable is the obvious point. Parties who haven't previously participated in an accelerated M&A process expect more in terms of the volume, consistency and quality of information provided. In cross-border deals, you need to be prepared for the quirks of different insolvency regimes. Be prepared for things coming out of the woodwork: for example, an unexpected press leak can lead to the company's suppliers pulling credit, creating even more time pressure.

Gary McKeown, Imprima: Be on the lookout for red flags. Are there breaches of covenants on lending facilities? Has the company breached agreements with suppliers or with banks? Due diligence needs to be much more focused, but also timely. The main thing is to get the transaction completed quickly – that's really what people's jobs are going to rely on.

Mergermarket: How can you arrive at a fair valuation under the pressure of insolvency?

Vance Chapman, Akin Gump: Distressed valuation can be an art as much as a science. If your target is asset-heavy, it's straightforward. Otherwise, you'll need certainty that existing value is transferable. Sellers need a strong story. Is there an accretion in value because an existing portfolio holding is combined with those assets? Is there a clear path to an exit? Are the revenue streams underpinning cash flow forecasts rock solid? Without certainty, you can expect severe pricing discounts.

Ben Hughes, Deloitte: From the perspective of the sell-side, the longer the process runway the better. If we are brought in early enough, the preparation phase is more thorough and there is time for two rounds of bidding which helps to drive competitive tension.

Rüdiger Wolf, BCG: There are at least two things to have in mind to maximise value. The first is undisclosed preparation – it doesn't help if the market thinks you need to sell. The second is a well-prepared process. You need everything ready upfront, including the data room documentation. If it's a carve-out, you need a proper legal and operational concept.

Meziane Lasfer, Cass Business School: On the buy side, you need to be careful if undervaluation of the target is the main reason for a takeover. Is the target undervalued because of economic risk? An economically distressed target – for example, one whose products are no longer selling well – will be difficult to turn around. On the other hand, if the target is undervalued because of financial risk – debt – the problem can be overcome. It boils down to analysing why the target is underperforming.

Mergermarket: Is due diligence more difficult in distressed situations?

Rhys Evans, Freshfields: The diligence process might not look like you would ideally have it. You have to decide what is possible. What targeted diligence are you able to do in the time available? Are you able to get contractual protection for the statements that you've been given? One difficulty is not being able to get contractual protections from the sellers. That's hard to square – unless you're able to get a very good price for the asset.

Meziane Lasfer, Cass Business School: It depends if you are acquiring the whole company or just one asset. Due diligence is easier with a single asset. Problems arise when you have a big company with a large and scattered asset base. Bidders need to discount the value of those assets to reflect the risk. That means applying the highest discount rate. In other words, bidders need to take a due diligence risk premium.

Rüdiger Wolf, BCG: Start by getting an impression of the seller. They should be preparing a proper vendor due diligence and a proper carve-out concept by themselves. Without this, the bidder will be forced to look for discounts. Bidders need to be sure that the due diligence team has the competencies required, including market knowledge, understanding the target's competitive position and identifying the operational levers to improve profitability – especially if growth is not going to be the main driver of profitability. Then the financial situation: how can that be structured? What are the levers to optimise performance?

Mergermarket: Can new technology such as AI help with due diligence?

Vance Chapman, Akin Gump: I have seen it used and I think it's really helpful with respect to processing information. A lot of the things that we look at, though, are complex because they deal with cross-border situations and the rules, regulations and laws applicable in multiple jurisdictions need to be balanced out. But technology is helpful as a process aid. There's not really a downside to it.

Rhys Evans, Freshfields: We've seen a rise in the use of technology to try and bridge the timing gap over the last couple of years. The products on offer are able to look at a large number of contracts for a limited number of key provisions,

such as change of control. There's still obviously advisory work as to what we do with the results of that, but some of the backbreaking work has been alleviated.

Gary McKeown, Imprima: The biggest problem for a company in an insolvency situation is it's usually very cost conscious. It's the worst of all worlds: they've got unstructured data and they don't have the money or the time to sort it out. They can't wait for weeks while advisors go through it all because the company might be dead by then. That's where AI has a twofold benefit: it makes the process more efficient and shortens the timeframe, so the most relevant information can be quickly retrieved from the documentation.



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Rhys Evans, Freshfields



Life beyond the deal: How to avoid post-merger blues

M&A strategies often fail to deliver their promised benefits because post-merger integration is poorly executed. In a distressed situation, the pitfalls have even greater consequences. Here, we examine some of the ways that buyers of distressed assets can make sure they get the most out of their investment.

Mergermarket: What steps should acquirers take to stabilise the business post acquisition?

Ben Hughes, Deloitte: Rebuilding trust with suppliers is a key action post acquisition. This takes time because suppliers will probably have lost money if the deal's been affected by an insolvency mechanism.

It takes a lot of hard work to deliver a successful turnaround post acquisition and the process of stabilising the business post acquisition can take longer than expected, so be prepared and sufficiently resourced.

Meziane Lasfer, Cass Business School: If the target is only financially distressed – indebted – the target will need some cash input to pay back debt and eventually to recover. In this situation, there is a strong case for retaining the existing management. Incumbent managers know the market, and with less debt constraints, they can adopt new growth strategies.

If a company is economically distressed, you should not take it over. But if you do, it's probably better to change the management because they were responsible for the operational problems. The same goes if it is an agency conflict, because in those cases, the managers are running the business for their own benefit, rather than the shareholders'.

Mergermarket: Talent retention is a big challenge in any post-merger integration process. How can this be managed?

Rüdiger Wolf, BCG: I think that the critical point for talent retention is actually during the transaction rather than after it. After the transaction, the employees know the future. During the transaction, they don't. The danger is that employees will leave and that the asset itself loses value. So the seller needs to keep the speed as high as possible.

There are no general rules in terms of changing the management or not. It depends on the business and on the quality of the management. But I haven't seen situations where the buyer actually does the integration and turnaround with additional management capacity.

Rhys Evans, Freshfields: Post-merger integration is always difficult. You need to consider the economic factors as to the ongoing performance of the business. But there are very human factors involved in terms of the workforce. Is it going to be the same workforce it was traditionally? What changes need to happen?

A big part of it is building stability. So it's making sure that there is a clear plan as to the future of the workforce, making sure there's a clear plan as to the future of the products and making sure there's a clear plan as to the provision of those products to customers. The key is having certainty as to what is going to happen next.

Mergermarket: Warranty and indemnity insurance (W&I) is a subject that crops up more and more in discussions of distressed M&A. Is this something you are seeing?

Rhys Evans, Freshfields: Warranty and indemnity insurance is often discussed in these situations. But it faces some of the same difficulties as the process more generally. A short timetable is not your friend. The things that insurers are looking for can be pulled down into the quality of the diligence and the quality



of the disclosure exercise. If you take those away, then it leaves insurers in a much more nervous position.

What we see is that insurers and brokers are willing to move extremely quickly. But where they're not able to get comfortable is where there has been insufficient diligence or insufficient disclosure. It's definitely something that the insurers and brokers are aware of as a market, and they are certainly trying to make their products work in that environment.

The conversation is about who should backstop the risk. If you have a seller who doesn't have the means for recourse to be meaningful, then is there a situation where the insurer itself is the only recourse? That can make insurers uncomfortable because they are the only people who are on the hook here.

But we have seen synthetic warranties offered by the insurer. So instead of warranties being given by the seller or by management, they are backstopped by the W&I policy and there is no liability to the seller or to management. This market is still developing in the UK, in the US and elsewhere.

Vance Chapman, Akin Gump: It is possible that W&I insurance will become more common in distressed M&A. Brokers and the insurance market generally are keen to expand their business but it will generally come at a significant premium in a distressed scenario where the risk most requiring insurance is usually bespoke. Such

premiums and the time taken to get insurers comfortable has historically played against W&I in this space. However, advances in technology may assist with the assimilation of whatever information is available and therefore the modelling underpinning decisions on premium and whether or not to offer insurance in the first place.

Mergermarket: Can new technology, such as AI, help with the post-merger integration process?

Gary McKeown, Imprima: Yes, most definitely. Our recommendation is that acquirers maintain the whole structure of the data room as a post-merger integration data room – pretty much on day one after the acquisition. That's a critical time in the post-merger integration. Having all the information in one place helps with whatever the integration process is. This is particularly relevant in the distressed M&A situation where the depth of DD would not have been as comprehensive as normal given the previously mentioned time constraints. Getting a quick understanding (post-transaction) of where the key focus areas should be is greatly facilitated through AI powered tools. And that's exactly what our customers are able to do with Imprima's suite of due diligence technologies.

About Imprima

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Our clients include high-profile corporations, financial institutions, and advisors.

Whether it's a complex M&A transaction, managing portfolios of assets or completing a time-sensitive restructure, our innovative products enable secure and fast deal execution.

- **Imprima Virtual Data Room (VDR)** is a highly secure, fast and intuitive virtual data room that preserves the confidentiality of mission-critical documents and communications during any transaction.
- **Imprima Asset Lifecycle Management (ALM)** empowers you to organise, manage and track your assets in an efficient and cost-effective way, ensuring they are sale-ready at any given time.
- **Imprima AI** is our new Artificial Intelligence (Machine Learning) tool that increases the accuracy of contract review, whilst reducing both the time it takes to complete and human error.

For more information

Sam Compton

Senior Marketing Manager

Imprima

T +44 7591 387 054 | E sam.compton@imprima.com



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Please contact:

Chris Coe

Sponsorship Sales Manager, Acuris Studios

T +44 20 3741 1075 | E chris.coe@acuris.com

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