Distressed M&A: Finding opportunity and value amid the risks
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Distressed deals always come with special risks and complexities, and the ongoing pandemic and economic turmoil will likely accentuate these in many industries. Smart businesses want to be well-prepared with an approach that can make success more likely in a transaction. That means knowing clearly where the value in a deal lies, focusing on how to stop any meltdown of a target business as the transaction proceeds, and moving fast to address reputational damage.

Introduction

Distressed asset M&A has been a significant growth path for acquirers in previous economic downturns. Acquisitions can be possible at significant discounts. Buyers, in some instances, find deals that were too expensive in the past and will be unavailable in the future—now-or-never opportunities.

We are in the early stages of a new cycle of distressed asset M&A. Amid the economic turmoil caused by the global pandemic, many industries are under extraordinary strain, even as there are also countervailing forces that create significant uncertainty about how events will unfold.

The lockdowns and the virtual halt in global travel to slow the spread of COVID-19 have been devastating in the travel and hospitality industries. Some brick-and-mortar retailers have already sought bankruptcy protection, though this is an industry in which viable businesses emerge less frequently from distressed situations. Oil and gas producers are experiencing low crude prices that will be unsustainable for some. Real estate owners face empty malls and offices, not to mention tenants unable to make rent or mortgage payments. There are strains all across the global economy.

At the same time, asset values are not taking the hit they have in past recessions. Extraordinary interventions by the US Federal Reserve and central bankers around the world, along with unprecedented fiscal support, have helped volatile markets to rebound after initial steep losses in reaction to the pandemic. Lending has not dried up. Many potential buyers, both strategic and financial, are flush with cash, offering alternatives that may help some troubled companies avoid bankruptcy.

Affected businesses trying to ride out this economic shock are being forced to make some tough decisions. By the end of the third quarter of 2020, it should be easier to see the course of the health crisis and estimate its impacts on employment, consumer spending, and production.

Even if the scope or breadth of the distressed opportunities can’t yet be fully known, smart M&A leaders are preparing. For companies that are coming through the disruptions of the pandemic positioned to thrive in a world changed by COVID-19, this is a time when they will want to be ready to do deals.
Ready for distress

In that light, it’s important to keep a clear focus on the complications and risks presented by distressed transactions (involving assets that are in default or under bankruptcy protection or headed there). While deals can be advantageous for both the acquirer and the target, the role of creditors, courts, and competitive bidders can impose time constraints, restrict information flows, and otherwise interfere with due diligence and disrupt integration planning. In addition, energy and attention must be expended to negotiate terms with multiple stakeholders and to fix broken operations.

How to negotiate these challenges successfully? We believe M&A leaders can minimize risks in executing a distressed transaction if they:

- Know where the value lies
- Are mindful of the melting ice cube
- Work fast to rebuild reputational damage

This article will discuss each of these three principles, with the overall goal of determining if a distressed asset transaction, with its special complexities and risks, will create value and help a company to thrive in the new normal that will emerge from this pandemic.
Know where the value lies

Successful integration requires a well-defined vision of how an acquisition target will exist within the combined entity. How will this deal create value? How much value will be possible? What risks can affect value realization? With a cohesive integration strategy, due diligence can be focused and value levers well-defined.

The unique circumstances of distressed transactions may muddy the thinking around value creation, however. For buyers to ensure a successful integration of the acquired business, they need to have clarity of purpose, stay focused on value drivers, and prepare for the unexpected.

Clarity of purpose
When weighing multiple distressed targets that may be available at below book value, potential bidders can become overwhelmed. They may be rushed into a bidding war or pushed by the timeline of a bankruptcy proceeding. With limited time, the deal thesis may come down to I know I can do something with this business. Such an approach may result in poor strategy or botched integration. Similarly, the illusion that there’s a natural cushion in a fire-sale price can interfere with proper due diligence. A disciplined approach to due diligence and integration planning, even if it has to be done rapidly, will likely yield better results.

Fortunately, in the decade since the last cycle of significant distressed M&A, the digital and analytical tools that can be brought to bear for due diligence and planning have grown more sophisticated. A digital enabler and various AI products can help accelerate the process of analyzing data and information to develop a fuller picture of the target business and to make plans based on that. This is particularly important in distressed situations, where the timing of a close may be unpredictable.

Pursuing a transaction solely to block a competitor from acquiring a bargain-priced target can also cloud the purpose of a deal. An asset acquired for such a reason may be kept as a stand-alone operation for too long while a full integration plan is devised. A well-thought-out strategic acquisition is more likely to be integrated as quickly as possible. For example, consider a situation in which a buyer doesn’t have the luxury of time to develop an elegant integration strategy and simply focuses on transition service agreements to maintain operations. This can lead to problems. There may be minimal effort to retain talent, for instance, resulting in high employee attrition.

Value drivers
Once there is clarity on why a transaction is being pursued, attention should turn to identifying value drivers.

In distressed M&A, there may not be enough time to devise the complex value creation methods and business models that help traditional mergers succeed. Rather, there needs to be a rapid but relentless focus on the few activities that can create the most value—or at least stop value destruction.
A buyer may decide, for example, that retaining top talent and shedding toxic assets are the two success factors that will matter most. The identification of these value drivers can focus negotiations and guide integration planning, leading to a successful outcome. Distressed deals often allow the buyer to avoid less-than-desirable businesses or assets, cherry-picking what they want. While this can be resource-intensive, it can prove to be a tremendous driver of value for the buyer.

In some transactions, incomplete due diligence or a compressed timeline may preclude getting the input required to clearly identify value levers. To address this issue, buyers may decide to set an interim stabilization period post-close to gain time to understand the acquisition and develop an appropriate strategy. In this period, the acquirer can determine what elements, such as back-office operations, might be combined regardless of the overall integration approach. They can avoid the pain of mobilizing toward a vague end state only to change direction later, which is a real hazard when acquirers are making an opportunistic purchase.

**Prepare for the unexpected**

As simple as a focus on value creation might seem in the abstract, bankruptcy sales and other distressed transactions tend to throw curveballs in real life. Transaction teams must be prepared to respond with speed and flexibility. Contingency planning should be par for the course. Even when transaction teams are able to develop detailed integration plans, these can be easily disrupted by the decisions of stakeholders and bankruptcy courts.

In particular, conflicting stakeholder demands can be problematic for transition service agreements established with the parent company and third parties. Uncertainty around these agreements can make an otherwise stable transition more challenging. Necessary employees to support transition services should be identified and provided retention bonuses. There is ample precedent for bankruptcy courts approving key employee retention plans. Outsourced services have in recent years become a viable alternative channel here. It may be appropriate to use a third-party provider with maturity and scale to stand up services rapidly for key transactional processes to run the business.

In order to mitigate these risks, getting the acquired business to independent operation as quickly as possible should be a high priority. Contingency planning is most effective if employees from the target are included on the planning team, as they can provide a depth of company insight that cannot be quickly developed by the acquirer. Contingency plans should be developed to address areas such as supplier access agreements and the transfer of intellectual property, along with transition services.
Be mindful of the melting ice cube

The timing of a distressed transaction moves at the speed of the courts. This can be doubly problematic: A compressed transaction timeline can create internal confusion and sow chaos, while an extended timeline can exacerbate a sense of uncertainty. Both can precipitate the loss of customers, suppliers, and employees—a meltdown that can threaten even a well-planned value creation strategy.

Compressed timelines
A potential buyer does not know if an asset has been won until the auction closes, but once that happens, a quick or immediate close is usually necessary. This creates the possibility of overlooking key planning elements, such as customer, supplier, employee, and regulatory communications, that are required to set the stage for the transition. Often, a competitive bid situation unfolds so quickly that important communications happen on an ad hoc basis. History is replete with examples of press releases that go out too early—or too late.

Given the complexity of a distressed transaction and integration, acquirers may miss the mark on determining an appropriate closing time frame (where they have that option). Pushing back against an aggressive close date can compromise the integrity of the deal by diminishing momentum. Similarly, last-minute changes to the close date add uncertainty and can lead to false starts. Attempting to delay a distressed close, if even possible, can also have measurable negative financial impact around asset valuation, decreased customer confidence, increased integration costs, and increased personnel attrition due to the overall uncertainty.

Acquirers must appreciate that the timeline to close is not the same as the timeline for integration. For this reason, it is important to mobilize planning teams as soon as an opportunity is identified. Once established, the planning teams can develop an accelerated integration planning program. The teams should approach the integration with a laser-like focus on day-one planning and value preservation.

As part of the preserve-value mandate, planning teams should establish a clear set of objectives for pre-close stability and for the post-close transition. Distressed asset transactions often feature poor communication to external stakeholders, customers, employees, and suppliers. But these groups are critical to preserving value, so every effort should be made by the acquirer to implement an effective communication strategy.

Extended timelines
The legal formalities that accompany bankruptcies and other distressed situations will sometimes drag out the transaction and delay the close. This is arguably the worst possible outcome for an acquirer. The loss of control over the integration process and communications timeline exhausts the integration team with start and stop commands, and it alienates business stakeholders, especially employees.
The slower pace and confidential nature of discussions often means that employees remain unaware of progress for longer than is typical in a nondistressed acquisition. This often occurs when an acquirer is awaiting antitrust approval or negotiations with transaction stakeholders drag on.

Amid a lack of transparency, employees end up relying on external information, social media, and rumors. Any negative press may encourage employees to leave the company for a more stable place. A mass exodus can affect business relationships or diminish key intellectual property, eroding the expected deal value. Competitors will likely make every effort to use the distraction of a distressed environment to recruit away the best people.

In all integrations—but to a much greater extent in distressed transactions—employees are understandably focused on their own welfare. They need some key questions answered sooner rather than later, including:

| 01. Will I have a job? | 02. What will be my role in the new organization? | 03. Will my compensation or benefits change? | 04. Will I be relocated? |

Buyers of distressed companies need to be proactive in responding to these queries. The acquirer should provide key employees with information and retention incentives—and communicate them as quickly as is possible. As the transaction moves forward, it may not be possible to provide all the answers employees want, but the process of listening to concerns and acknowledging them will help engender trust.

To maintain morale and performance, an acquirer should first focus on company stabilization, rather than an immediate reorganization that will change reporting relationships or eliminate jobs. Staffing changes should be minimized before and immediately after the transaction close. However, this needs to be balanced against the potential opportunities to shed employee-related liabilities such as pensions while under bankruptcy.
Work fast to rebuild reputational damage

The cornerstone of distressed asset transactions lies in keeping the right customers, employees, suppliers, and other stakeholders from defecting. New ownership for a distressed entity may remove many issues that have held a business back, but fixing a damaged reputation after bankruptcy is often a big concern.

Success demands that acquirers engage stakeholders as soon as possible, without running afoul of court-imposed restrictions. All involved parties will need the opportunity to voice frustrations and concerns before a real discussion can begin around the terms of continued support.

**Stakeholder communication**

With a bankruptcy, customers and vendors can often be in the dark on transition plans and the impact on their interests. If not carefully managed, potential confusion can amplify their concerns, and competitors may fan the flames. Effective customer retention, brand protection, and strategic communication programs are critical to keeping customers.

While vendors have priority for payment for goods and services delivered after a bankruptcy filing, they are exposed for claims from before the filing. Some vendors may decide to cut their losses and halt deliveries. A downward spiral of vendor abandonment and customer impacts can ensue.

The acquirer must be up-front with vendors and let them know that it intends to pay for goods and services going forward—and let them know how they will treat liabilities for anything delivered before the close (consistent with bankruptcy law and court rulings).

In addition, it is also advantageous to proactively contact regulatory bodies to understand their concerns, communicate your intentions, and ensure necessary compliance. This would be above and beyond standard Hart-Scott-Rodino antitrust activities.

Timely and aggressive communication with all external stakeholders is imperative. Distressed asset deals are often surrounded with substantial negative publicity and uncertainty. This boosts the importance of communication, not just with the target’s stakeholders, but also with the acquirer’s stakeholder community. The loss of support from one or two critical parties can irreparably harm value. Special attention should be placed on strengthening essential relationships and minimizing extraneous ones.

Managing stakeholder expectations and communications is closely linked to trust and honesty. Transparency, the reliability of financial data, and the predictability of outcomes can help to build trust and earn supportive behavior among stakeholders.
Distressed situations can result from a wide variety of internal and external factors. Still, employees of both the acquirer and the target may see the distressed business’s position as an outcome of poor performance or bad decisions. As the most talented employees leave, the remaining employees will have a higher proportion of lower-performing employees, and they may be dispirited and demoralized.

Earlier, we referenced newer AI and digital tools that can be used during diligence. Similar tools can be used to assist acquirers to rapidly take the pulse of media, social media, and recognized websites and blogs to test employee sentiment and determine the key areas driving their concerns. This can be valuable data to inform everything from employee selection to change management planning.

Before corporate cultures can be combined, established, or replaced, it’s important to first decide the amount of integration that is appropriate. From this decision, organizational structure and leadership changes will follow, and these will facilitate integration. Management must decide what to adopt or reject from the target in order to achieve the desired culture.

Communication and actions—words and deeds—are key to a successful cultural integration because they can help alleviate the uncertainty and concern felt by employees during the acquisition. Management can foster open communication by providing consistent messages to all employees and setting balanced expectations.
Conclusion

The distressed M&A cycle that’s beginning presents significant opportunities for healthy companies with the wherewithal to do deals. But it will differ in some ways from the distressed asset activity seen in previous economic downturns. The COVID-19 pandemic creates uncertainties, to be sure, and it presents new considerations that must be layered on top of the considerations that always accompany a decision to acquire a troubled asset.

A buyer may need to ask whether a target business’s supply chain will be subject to disruption if the pandemic worsens. Leaders may need to consider whether customer behavior changes that have created a company’s distress situation are likely to be transitory or lasting. Indeed, the pandemic has created a long list of new questions that are going to apply to any M&A transaction, and these are important even when you’re paying a bargain price for an asset.

The three principles outlined in this report provide a way that—in any set of circumstances—businesses can boost their chances of having a successful distressed M&A transaction. Such guidance will only be more important as this distressed asset M&A cycle unfolds amid the uncertainties of a global pandemic.

Authors

For more context on Distressed M&A in practice, please reach out to our authors.

Tom Williamson
Principal | M&A Consultative Services
Deloitte Consulting LLP
twilliamson@deloitte.com
+1 312 486 2659

Bob Glass
Principal | M&A Consultative Services
Deloitte Consulting LLP
joglass@deloitte.com
+1 719 650 1949
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