# Integratin
# distressed

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# Creating value from a mix of opportunity and risk

# assets

As the economy improves and M&A growth recovers, the move to purchase distressed assets (assets that are in default, under bankruptcy protection or heading toward such a condition) has become a significant vehicle for growth by acquirers. Transactions involving distressed assets tend to be significantly discounted and can represent the deal of a lifetime.

The number of US corporate bankruptcies spiked to 207 in 2009, the third-largest annual total on record. The assets of these firms combined to an astonishing $594 billion.[1] The distressed asset deals announced in 2009 were valued at $84.4 billion, quadrupling the value of such deals in 2008.[2] Even more remarkable is that this transaction value reflects the "distressed" value of assets.

While distressed asset transactions can be advantageous for both the acquirer and the target, the role of creditors, bankruptcy courts and competitive bidders can constrain time and information, leading to less complete financial and operational due diligence. In addition, energy and attention must be expended to negotiate terms with multiple stakeholders and fix "broken" operations. These complications create a unique set of hazards and constraints that differentiates distressed M&A from traditional M&A activities.

We believe the challenges of successfully executing a distressed M&A transaction can be overcome by effectively focusing on:

- Determining how to create value.
- Containing the melting ice cube.
- Rebuilding confidence.

In this article, we will discuss how these three activities can improve the value of a distressed transaction.

### Determine how to create value

Conventional M&A thinking exemplifies the view that a successful integration requires a well-defined vision of how the target will exist within the combined entity. A cohesive integration strategy addresses many questions, including: How will this transaction create value? How much value will be created? What risks can impact how much value is realized?

With a cohesive integration strategy, value levers can be defined and due diligence can be focused. However, before buyers can determine how to create value, there must be clarity of purpose.

#### Clarity of purpose

When faced with a plethora of targets at below book values potential bidders can become overwhelmed and rushed by an ensuing bidding war. The limited time to react to these opportunities can lead to an "I know I can do something with this business" approach to deal making which can ultimately result in poor strategy or integration – and destruction of value.

Without a clear purpose, companies may also be lured by a fire sale price tag, which can increase a company's appetite for risk by creating an illusion of "cushion room" during due diligence. Similarly, companies may pursue a transaction solely to block a competitor from acquiring the bargain priced target. For example, a purchase made to block a competitor from acquiring an asset is more likely to remain as a standalone operation until a full integration plan can be devised, while a thoughtful strategic acquisition is more likely to be integrated as quickly as possible.

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On a recent engagement, our client didn't have the luxury of time to develop an elegant integration strategy or create a detailed integration plan. Rather, the sole focus was on establishing transition service agreements to maintain operations. This led to minimal effort on retaining talent and resulted in higher than expected employee attrition. Once there is clarity on why the transaction is being pursued, attention should turn to identifying the value drivers.

#### Focus on value

In distressed M&A transactions, there is typically not enough time to devise the complex value creation methods and business models that are designed for traditional mergers. In distressed transactions there needs to be a quick but relentless focus on the few activities that can create the most value (or at least stop value destruction).

In a recent distressed asset transaction, two success factors were identified early on: retain top talent and shed toxic assets. This simple identification of value drivers drove all negotiations, served as a guiding principle for integration planning, and ultimately led to a successful outcome. It is also important to note that distressed asset transactions allow for the avoidance of less-than-desirable assets. To a large extent, this allows buyers to pick and choose what they will acquire and which toxic assets they will leave on the chopping block. While this cherry-picking of assets can be time consuming, it can prove to be a tremendous source of value for the buyer.

With some distressed asset transactions, incomplete due diligence or a compressed transaction timeline may preclude getting the input required to clearly identify the drivers of value. To address this hazard, acquirers can use an interim stabilization period post-close to buy time to develop an appropriate integration strategy and understand the acquired asset. This allows the acquirer to determine what elements usually back office operations can be integrated regardless of the integration strategy, while avoiding the pain of mobilizing towards a vague end state only to change direction later. This often happens in situations where acquirers are presented with "opportunistic" buys, such as many of the deals that occurred in financial services in the second half of 2008.

In practical terms, a stabilization period represents a decision to maintain current leadership, strategy and organization for a predetermined period of time. The goal of the stabilization period must be clearly communicated to all stakeholders to avoid the potentially erroneous perception that no change will occur. To successfully adopt this "close now, integrate later" approach, internal stakeholders must also be prepared for deferred benefits, since the synergy benefits and strategic changes can obviously not yield benefits until they are implemented.

### Prepare for the unexpected

In spite of the simplicity of focusing on value, distressed asset transactions tend to throw curve balls that transaction teams must be prepared to respond to – flexibility and contingency planning are par for the course when acquiring and integrating distressed assets.

Even if transaction teams are able to develop detailed integration plans, the most elegant of plans can be easily disrupted as the decisions of stakeholders and bankruptcy courts can dramatically impact the activities and pace of integration. This is especially true in the area of any support required by the acquired operations.

Conflicting stakeholder demands can be problematic for any transition service agreements (TSAs) established with the parent company and/or third parties to provide support for the acquired operations. Uncertainty around transition services makes an otherwise stable transition more challenging. As assets are disposed of, the core operations of the distressed company will continue to lose employees as the best employees typically leave quickly. Even the employees that do remain could have their attention split among several acquirers. The competition for resources to support the transition can be intense. Necessary staff to support TSAs should be closely examined and provided appropriate retention bonuses. For example, when Enron was dismembered

**Creditor Committees**
Comprised of different classes of creditors, committees are typically one of the primary stakeholder groups that must approve a sale and plan of reorganization.

**Section 363**
Under the Bankruptcy Code, Section 363 allows an asset sale free and clear of claims and liens. Purchasers should pay particular attention to the applicability of Section 363 of the Bankruptcy Code, which allows the debtor to sell assets without encumbrances and liabilities.

In order to mitigate this risk, high priorities should be to operate independently as soon as possible and to develop contingency plans for transitional support.

and sold, the bankruptcy judge approved a $29 million Key Employee Retention Plan (KERP) to compensate as many as 900 essential employees. The KERP was entrusted to Enron, its creditors' committee, and the plan's objectors in an effort to preserve an estimated $20 billion in value.[3]

In order to mitigate this risk, high priorities should be to operate independently as soon as possible and to develop contingency plans for transitional support. 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 assessed by the acquirer. Contingency plans should be developed to address supplier access agreements, the transfer of intellectual property and, of course, transition services.

The Good…

In the preliminary phases of a distressed acquisition and integration, the acquirer provided money specifically for employee retention.

The target's top talent and key leaders were told, "You've got a job here." This message stabilized the population and stopped key employee flight. We recommend taking this activity beyond the executive level to key personnel critical to the acquisition.

## Contain the melting Ice cube

Unlike a "typical" acquisition, the timing of a distressed transaction moves at the speed of the courts; this can be a double-edged sword. A compressed transaction timeline can create internal confusion and chaos, while an extended timeline can exacerbate a sense of uncertainty – both can precipitate the loss of customers, suppliers and employees.

### Compressed transaction timelines

A potential buyer does not know if an asset has been won until the auction closes – and once the asset is won, quick (or immediate) closure is usually necessary. This creates the possibility of overlooking key planning elements such as supplier, employee and regulatory communications which are required to set the stage for transition. Often a competitive bid situation unfolds so quickly that necessary communications happen on an ad hoc basis. History is replete with examples of press releases that go out too early – or too late. During one specific acquisition we were supporting, our client's plans were impaired by the introduction of a trustee who severely limited pre-close communications.

With this lack of clarity, companies can underestimate the complexity of a distressed integration and miss the mark on selecting the appropriate closing timeframe. Pushing back 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 with experienced teams.t The teams should utilize traditional integration tools, but 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 plan the post-close transition. Distressed asset transactions typically feature poor communication to external stakeholders, customers, employees and suppliers. However, since these groups are critical to preserving value, every effort should be made by the acquirer to implement an effective communication strategy.

### Extended timeline

The legal formalities that accompany a distressed purchase can greatly extend the transaction timeline and delay deal closure. 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/stop commands and alienates employees. The slower pace and confidential nature of discussions also often means that employees remain unaware of progress longer than in typical acquisitions. This often occurs when an acquirer is awaiting antitrust approval or when negotiations with stakeholders drag on.

With this lack of transparency, employees end up typically relying on external information, blogs and rumors. Any negative press encourages employees to leave the company for one that is more financially stable. The mass exodus can impact business relationships, damage key intellectual property, and erode the expected deal value. While, at the same time, competitors will likely make every effort to use the distraction of a distressed environment to recruit the best people.

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

1. Will I have a job?
2. What will be my role in the new organization?
3. Will my compensation or benefits change?
4. Will I be relocated?

Acquirers of distressed companies need to be proactive in responding to these queries to improve their chances of successfully retaining talent. Key employees should be provided with retention incentives and should be communicated with as soon as possible.

**And the Bad…**

Early in a distressed acquisition, it became apparent that the target's employees were demoralized. From top executives to staff, they had all lost a sizable investment. Everyone's deferred compensation plans, stock options, company focused 401ks, etc. were worth zero.

The employees needed to deal with the shock and anger of being part of a bankruptcy. New leadership was needed to inspire them and give them hope.

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To maintain morale and performance an acquirer should first focus on company stabilization instead of immediately reorganizing, changing reporting relationships, or shedding employees. 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.

Most importantly, communicate with target employees early and frequently so that they are kept abreast of current developments. You may not always be able to provide an answer, but just the fact that you are talking with them will help engender trust and a sense of stability.

### Rebuild reputation

The cornerstone of most distressed asset transactions is keeping the customers, external stakeholders, employees, etc. from defecting. While purchasing a distressed asset may remove the liabilities bogging down the target, the damaged reputation of bankruptcy is harder to repair. To exacerbate the situation, interactions with stakeholders are usually restricted by the bankruptcy process. As such, acquirers must quickly understand the process timeline and engage with stakeholders as soon as possible. Once engaged, stakeholders need the opportunity to voice frustrations and concerns before beginning to discuss the terms of continued support.

#### Communicating with external stakeholders

With a bankruptcy, customers and vendors can often be unaware of transition plans and the impact on their interests. If not carefully managed, potential confusion will amplify this impact, and competitors will likely fan the flames, spreading fear, uncertainty and doubt. Effective customer retention, brand protection and strategic communication programs are critical to keeping customers retained and involved post-close.

While vendors have priority for payment of new goods and services after a bankruptcy filing, they are also exposed for claims before the filing. Before or around a bankruptcy filing some vendors may decide to cut their losses and halt deliveries. A downward spiral of vendor fear and abandonment can ensue. The acquirer must be upfront with vendors and let them know that it intends to pay for goods and services going forward, and how - if at all - it will treat liability for goods and services before close (obviously in a manner consistent with bankruptcy law). Where beneficial, suppliers should be transitioned to, or from, the acquirer's trusted or preferred suppliers.

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

Timely and aggressive communication with all external stakeholders is imperative, as distressed asset deals are surrounded with substantial negative publicity and uncertainty. This encompasses not only communication with the target's stakeholders, but also those of the acquirer. The loss of one or two critical stakeholders can irreparably harm value. Special attention should be placed on strengthening essential relationships and minimizing extraneous ones.

Managing stakeholder expectations and communications is based on trust and honesty. Transparency, reliability of financial data, and predictability of outcomes can help create trust to earn supportive behavior among stakeholders.[4]

**The Key of culture**

Messaging is extremely important in distressed deals. Specifically, the CEO of the acquirer needs to sell the vision to target employees in a very credible way. Odds are the employees heard from a CEO who was saying "everything is fine" right up to the bankruptcy filing. This generates a large amount of distrust towards authority.

With distressed acquisitions, CEO messages to acquired employees should focus on items such as:

- We want you and your business.
- Here is our vision and what we can become together.
- Here is how we'll take care of you.

### Integrating cultures

Integration of cultures poses its own set of issues, with target employees typically fearing the unknown that exists around the operations and plans of the acquiring company. In order to combat this uncertainty, target employees tend to cling to what they are accustomed to. They may even try to replicate their former business environment and practices within the new company, potentially negating the actions the acquiring company has taken to improve the target's performance.

In distressed M&A deals, cultural integration becomes an even more significant factor. The acquired operation is often seen as a "failure" due to its financial situation. As such, the target's employees can be treated as second class by leadership, employees and customers. Not only can this dilute the value of the acquired firm, but also understandably demoralize the employees who were brought over. Many distressed M&A deals that don't work well flounder on the shoals of culture and the attitude that "we won, you lost."

While distressed situations typically result from a wide variety of internal and external factors, employees from both the acquiring and target companies often see the target's position as an outcome of poor performance or decisions. As the most talented employees leave, the remaining employee population will have a higher proportion of lower performing employees who are more dispirited and demoralized.

Before corporate cultures can be combined, it is important to first decide the amount of integration that is appropriate. From this decision, organizational structure and leadership decisions can then be used to facilitate integration. Management must decide what to keep, discard and adopt from the target company in order to achieve the desired combination of company cultures. With distressed situations there is great emphasis placed on words and deeds.

Communication is key to a successful cultural integration because it 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.

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**Close to home: techniques to integrate distressed assets**

In March 2009, Deloitte* announced a deal to acquire the majority of the assets of BearingPoint's Public Services practice, including contracts and practitioners. BearingPoint was in Chapter 11 and selling business units to facilitate debt repayment. The deal closed a mere six weeks after its announcement and within days of Bankruptcy Court approval.

Deloitte recognized multiple challenges in the integration but focused pre-close on resolving three key obstacles to facilitate a successful transaction:

- Language in the acquired contracts typically identified specific individuals for delivery of services and leadership. Failing to retain these individuals could devalue or negate some purchased assets (contracts).

- Potential conflict of interest risk existed with certain clients and sub-contractors, creating a risk of Deloitte purchasing assets it could not hold.

- Many of BearingPoint's clients were concerned about potential service decline in the confusion of a bankruptcy, with numerous competitors circling.

Deloitte moved quickly to interview, hire and onboard over 150 equity partners, principals and directors in fewer than 30 days.

A combined leadership team from Deloitte and BearingPoint structured the initial activities with a deliberate focus on resolving these key obstacles in order to preserve deal value and lay the groundwork for a smooth post-close transition. The team recognized that it would need to have a bias for speed – with clarity in decision-making being key. Accessibility of decision-makers at Deloitte made possible prompt actions on key activities including:

1. **Enroll leadership and create a vision**
   Deloitte focused on creating a team environment, enrolling BearingPoint leadership, and quickly creating a joint vision of the combined business that was both compelling and exciting. Understanding that key leadership was aligned and communicating a shared vision provided significant comfort to employees.

2. **Retain employees**
   Deloitte moved quickly to interview, hire and onboard over 150 equity partners, principals and directors in fewer than 30 days. This communicated to the entire organization that Deloitte was not making wholesale changes, but was instead leveraging the unique skills and relationships of BearingPoint leadership to develop trust in the combined leadership team. A unique "Two in the Box" approach placed BearingPoint and Deloitte leaders together to identify issues and improve cooperation in all aspects of the transition. Over 4,000 employees were successfully onboarded in live sessions around the country within two business days after the closing of the transaction. Clients and services under existing contracts continued unimpeded.

3. **Define the purchase**
   Deloitte recognized that prior to close it would need to undergo an extensive process utilizing focused teams to perform diligence on all contracts. Deloitte utilized legal, risk and business teams to review each contract and identify issues and concerns. The process separated contracts and other assets that could not transfer to Deloitte to help ensure the purchase only included those contracts Deloitte wanted.

4. **Connect with the client**
   The joint leadership team worked side by side with account management and business development to meet with clients early in the process and bring them along for the journey. Client concerns over delivery and service quality were addressed by constant communication on deal plans and status, continuation of engagement staff and leaders, and continued proposal work showcasing an expansion in future capabilities. Client meetings were pivotal to maintaining contract value through focused leadership communication and stewardship.

Transactions involving distressed assets are expected to increase. For companies with access to capital, the purchase of a distressed asset may provide unique opportunities to grow or diversify the business relatively inexpensively. However there are some costs and risks that extend beyond the price tag. Even experienced serial acquirers may struggle with the pace and ambiguity created by the acquisition and integration of a distressed asset.

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* As used in this article, "Deloitte" means Deloitte Consulting LLP, a subsidiary of Deloitte LLP. Please see hyperlink http://www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries.

**Endnotes**

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