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DISTRESSED M&A

Unpredictability has been the trending theme of the distressed M&A market over the past 12 months. High interest rates, persistent inflation and the prospect of recession has continued to drive debt defaults and bankruptcy filings, creating opportunistic and distressed acquisition opportunities. And with such economic conditions creating greater levels of distress for some sectors than others, a sustained restructuring cycle is likely to persist for at least the next year if not for the foreseeable future. ■

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FW: What do you consider to be the main trends and developments to have dominated the distressed M&A market over the past 12 months or so?

Robinson: Uncertainty is a trending theme in 2023. In Q4 2022, investors and advisers were optimistic that market sentiments would provide clear views on growth, volatility and inflation. The prospect of recession in the US and globally put a dampener on healthy M&A at the end of 2022 and into Q1 2023. Rising inflation and slowing growth have continued to put pressure on the bottom line, and throughout the year, key events such as the failure of Silicon Valley Bank in Q1 2023 have sent shockwaves of volatility across the globe. The US Federal Reserve and the European Central Bank (ECB) continue to raise interest rates to combat inflation, putting even more stress on companies with high leverage and maturing debt. As a result, there are opportunistic and distressed acquisition opportunities with accelerating distressed deal volumes in the market.

Fogarty: One of the most notable aspects of the UK distressed M&A market over the past 12 months has been its unpredictability. It is probably fair to say that activity has been slower than many in the market had predicted given the adverse economic conditions. And where companies have become distressed, they have predominantly been at the micro-end of the market. But some sectors have seen greater levels of distress than others, with companies in construction, retail and hospitality being hit particularly hard. And this has provided potential opportunities for the distressed investor. High-profile retail sector insolvencies, such as Made.com, Joules and Wilko, have led to those businesses, or parts of those businesses and sites, being acquired by larger retail groups.

Klein: In US Chapter 11 proceedings, there has been a recent trend of prepetition creditors participating in section 363 sales on a defensive basis. The classic example of a secured creditor credit bidding or setting a reserve level with a credit bid is the easy example, but there are situations where there is a need to construct synthetic credit bids on behalf of unsecured noteholder groups. In a nutshell, the unsecured noteholder group bids an amount of cash that it would otherwise receive as proceeds from the asset sale or under a Chapter 11 plan. This only works, of course, if the unsecured noteholders are far enough in the money, but in those circumstances, it is an important tool to maximise value in the sale process.

Mazza: High interest rates have dominated the markets over these past 12 months, with the cost of borrowing at its highest for more than 20 years. Despite this, large, financially stable institutions are issuing bond debt at record-high levels. According to the Wall Street Journal, in a single day in September 2023, 19 companies sold 47 bond tranches in the US investment-grade market, a record since PitchBook began tracking deals in 2012. A number of borrowers are coming to terms with the high interest rate status quo. While borrowers should be able to navigate, if not take advantage of, this environment, companies with less sound balance sheets may face challenges as they absorb these higher capital costs. And the rising financing costs have contributed to sustained, relatively low levels of M&A activity. Companies with business plans dependent on inexpensive capital that persisted since the Great Recession may have to overhaul their projections to ensure they can compete and determine refinancing and recapitalisation options.

Winters: A very slow year in 2021, followed by a spate of crypto and mass tort filings in 2022, has finally given way to a more conventional US restructuring cycle in 2023. Large Chapter 11 filings are up across the board. In particular, the long-awaited healthcare restructuring wave finally arrived in 2023 with a significant slate of bankruptcies and other restructurings in the healthcare space. The healthcare cycle was coupled with a significant number of retail and commercial real estate restructurings, as many predicted. High interest rates and persistent inflation have continued to drive debt defaults and bankruptcy filings. Although 2023 saw an uptick in mega cases, middle market filings dominated the landscape.

FW: How would you characterise the current appetite of distressed investors? Are certain types of assets proving attractive?

Fogarty: The impression that we have in the UK is that there is still strong appetite to do deals provided the price is right. With the market having been relatively depressed for a number of years, there is a considerable amount of capital stored up that is ready to be invested. But there is also perhaps some understandable uncertainty, given the ongoing and potentially worsening difficult economic and geopolitical conditions, as to the nature of the businesses which are coming to market and their future viability. It is notable, in this regard, that the administrators of Wilko concluded that no significant part of the group's operations were capable of being rescued as a going concern. The assets that did sell were only certain of the key sites and the brand itself. This is a trend we are seeing repeatedly in retail where the 'retailer' as such is disappearing from the high street and moving to an increased online presence. We are also seeing that certain types of real estate assets are proving to be an attractive proposition for foreign investor clients.

Klein: Distressed investors continue to express an interest in distressed assets where they believe the return on investment is there. They are ultimately economic actors. By their nature, distressed investment opportunities are idiosyncratic, and each opportunity is unique – the particular circumstance will largely inform whether a distressed investor will prioritise debt deals over equity investments, and a generally negative macroeconomic outlook will guide distressed investors to structure investments with upside and downside protection. In contrast, strategic investors' appetite remains strong, and they continue to participate in distressed asset purchases where perceived synergies are present.

Mazza: Distressed asset sales are likely to rise as companies that took advantage of ultra-low interest rates and covenant-lite debt during the coronavirus (COVID-19) pandemic start reaching maturity. As a wave of borrower-friendly debt comes due, borrowers will be forced to refinance at current rates, or, if they are unable to do so, become targets of distressed M&A opportunities. The commercial real estate industry, which has been further impacted by lingering knock-on effects of the pandemic, including high office vacancies that have not recovered from the pandemic and high interest rates, will be among the sectors most likely to feel the pain, with hundreds of billions in commercial property loans maturing in 2023 and 2024. This has been a particularly acute trend for regional banks that invested heavily in the commercial real estate market in the 2015-22 timeframe, when that market was booming. As more commercial real estate developers default on loans, banks with high exposure to the commercial real estate market will be forced to absorb losses. Some borrowers are simply going into default, and lenders are allowing for extensions, including maturity extensions, to avoid the write-down, and potentially wait out the turbulence. If the volume of this activity continues to pick up, distressed real estate investors should see purchasing opportunities in the near term.

Winters: While Chapter 11 filings are up, the regular-way M&A market has been soft over the past 12 months, which has impacted the distressed M&A sector as well. Section 363 sale volume has been up relative to last year but remains low relative to prior years. We have seen a number of section 363 sales close with the lenders' credit bid serving as the winning bid after lacklustre interest. Section 363 sales that have closed have generally been at lower dollar values – $100m or less – and have been spread across the relevant distressed sectors. Industry watchers expect, however, M&A activity to pick up across the market in the coming quarters, which should have a corresponding follow-on effect in the distressed sector

Robinson: There are two major categories of distressed investors to take advantage of current market conditions. The first is defensive, strategic companies making investments to either bailout struggling supply chain partners out of necessity to shore up their own production, or to take advantage of lower valuations to vertically integrate. These parties are focused on fortifying their core, profitable business lines to weather continued uncertainty. The other category includes opportunistic financial investors ranging from hedge funds to vulture funds to traditional private equity funds. For these investors, risk-adjusted returns are priced more attractively, and they have more bargaining power than distressed sellers. There are significant arbitrage opportunities in the market, and we caution differentiating smart money from less disciplined gambles on cheap assets.

FW: What particular challenges does the distressed M&A process generally involve, compared to 'traditional' M&A? For example, what considerations need to be made when structuring and financing this type of deal?

Klein: For purchasers, due diligence is key. In US section 363 sales, timelines are often tight, but purchasers need to understand that assets are purchased 'as is', representations and warranties (R&W) fall away at closing, and there will not be an indemnity provided by the selling debtor. Investment decisions need to be made on the strength of the due diligence that the purchaser is able to perform in the allotted time. Interested parties should get involved early in the process, and there are often benefits to negotiating to be the stalking-horse bidder to allow time to adequately diligence the assets and negotiate the purchase agreement.

Mazza: The risk and uncertainty that investors or acquirers face in the distressed M&A process can be distinct from a 'traditional' M&A process. There is generally some tension between the target company and investor in this respect, with the investor or acquirer wanting more flexibility, while the target wants more certainty that the investor will consummate the transaction. For example, targets will try to commit the investor to the transaction and provide fewer off ramps. On the other hand, investors will typically try to inject conditionality into transaction documents which will allow them to walk away, with minimum penalty, if the target fails to meet certain conditions, particularly because diligence is typically limited in the distressed M&A context in light of the need for speed. These uncertainties are balanced against the buyer seeking to make a deal at a bargain price. Price is also important, as

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the acquirer wants to avoid being sued for a potentially fraudulent conveyance after the fact for allegedly not having provided reasonably equivalent value for assets acquired from a distressed seller, while also getting a bargain. If the target is in a Chapter 11 proceeding, auction process dynamics may add to the complexity of such deals.

Robinson: Asymmetry of information is a fundamental concern in M&A. The trusted ecosystem of advisers, auditors, consultants, lawyers and underwriters works diligently to close the information gap between sellers and buyers. By default, healthy M&A has built-in insurance for missteps in diligence and assessing risk. Miscalculations with a healthy, growing, highly profitable business are smoothed over with cash flow. In distressed transactions, asymmetry of information can be more costly. Distressed assets tend to come with ongoing carrying costs, in addition to upfront consideration paid. To that end, distressed transactions utilise delayed consideration, seller notes, earnouts and other structures to mitigate risks. They also employ more flexible financing to support ongoing costs and potential unforeseen delays in turnaround to profitability.

Winters: Timeline, stakeholders and publicity are all challenges of the distressed M&A environment. Because of the high costs of a restructuring, distressed processes typically proceed on an expedited timeline – often 60 to 90 days from commencement to closing for a section 363 sale. Stakeholders can be diverse, outspoken and possessed of divergent viewpoints. There is often, at a minimum, a fulcrum creditor, often a secured lender, making a credit bid. That lender may or may not have a recovery-driven view of valuation that can be both unrealistic and difficult to ascertain. And in all circumstances any in-court process is going to have a much higher degree of transparency and publicly-available information than would a comparable out-of-court process.

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> Reynolds Porter Chamberlain

Fogarty: The condensed timetable can be particularly challenging. A distressed M&A process will often take place over just a few weeks or, in some cases, although more unusually, even a few days. The purchase therefore needs to be agile, particularly if third-party consents will be required such as from a regulator or an evaluator's report. And, in many cases, the purchaser is unlikely to have any meaningful recourse against the vendor if things go wrong. Where the company is being sold out of an insolvency process, insolvency practitioners typically resist giving any warranties and indemnities to the purchaser in connection with the sale. Any claim that the purchaser may have against the vendor may be of limited value if the vendor is insolvent or sells without liability While there can be considerable upside potential in acquiring a distressed business, these risks need to be carefully considered by the purchaser and factored into the price it is willing to pay or the way in which the transaction is structured. A sale made by way of a pre-packaged administration, under which the business or assets of a company are sold immediately after the administrators are appointed, is a procedure that has often been used in the UK market, which can help minimise the impact of the company's insolvency on the sale value and the operations of the business. We are seeing an increased use of this process in recent months.

FW: What strategies and methodologies should be employed to value distressed companies, identify and manage potential risks, and lay the groundwork for maximising return on investment down the line?

Winters: Fundamental principles of risk-return and valuation are comparable across traditional and distressed M&A. The risk of overpaying is just as present, if not more present, in a distressed context given the likelihood of a public auction. Having some competitive edge remains critical, whether it be unique insight in the industry or the ability to move quickly and get into the stalking-horse position. The opportunity to realise a unique value proposition due to distress exists but can be overstated and overemphasised as compared to business fundamentals. Likewise, the risk of spending time and money on a situation where the incumbent lender does not in fact want to let go of the asset at a realistic threshold needs to be carefully managed.

Fogarty: The purchaser should seek to undertake as much due diligence on the target company and assets as possible in the time available. This is likely to be limited and the information-gathering exercise therefore incomplete. Due to timing, financial advisers may often have only limited knowledge of the company's affairs. Access to, and cooperation from, existing management may also be limited. All of this should again be factored into the price that the purchaser is willing to offer for the business. It is also important, when any sale is to be combined with a restructuring process, to ascertain where the value is likely to break in the distressed company to get a better understanding of where any potential challenge to the sale or restructuring may arise. Specialist advice should always be taken at an early stage, whether acting buy or sell side.

Robinson: Traditional valuation methodologies, such as leveraged buyout models or comparable companies' assessments, fall short in distressed situations. Instead, concentration should be aimed at developing conservative, grounded cash flow models to purchase assets at the right value. The surest way to fail in acquiring distressed companies is to overpay. There are recurring cash needs in stressed and distressed companies, so debt sources and equity need to be flexible and patient enough to see through to the other side of profitability and return of capital investment. There is a sliding scale to evaluate success based on the relative investment and efficiency. The optimal outcome is paying minimal cash consideration upfront, and securing low-cost, patient debt capital.

Mazza: When evaluating distressed companies, investors and advisers should focus on targets with strong business plan fundamentals, as temporary influences are not necessarily going to reflect long-term performance. Traditional methods for valuing healthy companies are a starting point but may need to be tweaked to fit the distressed M&A context. Thus, advisers will need to tweak existing methods to know exactly what they are getting; this typically involves making certain risk deductions that would not be necessary in the more traditional M&A context, which will ultimately be reflected in the pricing of deals and expectations regarding return on investment down the line.

Klein: Due to the lack of R&W protection and other avenues of recourse generally available in non-distressed M&A transactions, investors in distressed assets should be thoughtful to avoid successor liability and, when possible, obtain court orders that provide that the purchased assets are 'free and clear' of all liabilities. With respect to go-forward legal risk, investors should be especially mindful of liabilities that run through a sale and are not otherwise dischargeable through investment documents and court orders, such as certain environmental liabilities that run with the land. Ultimately, investors should have a clear and concise vision for how they intend to improve the distressed asset's performance or, when applicable, quickly and efficiently implement integration synergies.

FW: How should parties manage the competing interests of the various groups associated with a distressed transaction? To ensure a smooth process, is it important to preserve relationships with key stakeholders?

Fogarty: Given the speed and pressures under which such transactions are often made, it is essential that there is a good line of communication put in place at the outset between the vendor and the purchaser and that this is maintained throughout the process. Positions may need to be agreed on a wide range of issues, such as employees, intellectual property (IP), stock, contracts and debts, among others, within a very short timescale and the interests of each stakeholder are not always aligned. Early communication with those stakeholders is important and consultation, if possible, is key to ensure a smooth transaction. Having a clear strategic pathway at the outset is crucial to getting this right and ultimately a successful transaction.

Robinson: There were good times before distress, days past with revenue growth, profitability and high aspirations for continued success. Financial distress makes it easy to forget those better days and disparate parties are out to preserve their own interests, their own jobs, their own investments and their own reputations. Advisers can play a key role in guiding groups through this process and move from emotional, inefficient bickering to finding universal solutions. In distressed situations, time is the limiting factor whether it is a debt maturity, a customer deadline, or payment due to a key vendor. The stress and pressure of self-preservation can obscure the greater good, alternative solutions and creative collaboration. Trusted advisers can assess these critical

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issues in the process and get parties aligned for mutually beneficial returns.

Mazza: It is vital in any distressed transaction that the distressed party consider its various constituencies' objectives, rights and potential points of leverage. The distressed party should methodically go down the capital structure and evaluate the interests of secured lenders, bondholders, unsecured creditors and shareholders. It is crucial to determine which constituencies are likely to be allies in a potential transaction, and who might not be, as well as what leverage those constituencies might have to impact the outcome of a distressed transaction. In the bankruptcy context, certain of these constituencies may band together to create formal or informal committees which carry substantial weight in the bankruptcy process. It is important to understand potential motives to respond appropriately.

Klein: While each situation is different, if a bidder of distressed assets is buying a going-concern operation, then understanding dynamics with the trade creditors can be critical. In the Chapter 11 context, the purchaser may be well served to negotiate cure costs and assume contracts of the debtor, pay or partially pay certain trade creditors to maintain relationships, and purchase avoidance actions against any trade creditors to ensure that the estate does not bring those claims later against important suppliers to the purchased business. Likewise, during the bidding process, understanding the dynamics between the unsecured creditors committee, the debtor and any secured creditors is key. Are the secured creditors buyers or sellers of the assets? Are there material issues with the liens of the secured creditors that the unsecured creditors committee is challenging? Can the purchaser be part of a global deal to resolve Chapter 11 case issues through its bid in a way that would garner support from a critical mass of stakeholders? Ultimately, purchase price is king, but understanding the dynamics and being nimble and creative can help bidders win an auction.

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Winters: Stakeholder dynamics are fundamental to distressed M&A. At a minimum, there is usually at least a secured lender group, an official committee of unsecured creditors and a management constituency to contend with. Even within these constituencies – and especially within the ranks of what is often a diverse group of financial institutions in a syndicated loan facility – viewpoints and interests can be highly divergent. It is critical to get an early sense of who has true decision-making authority and what their viewpoints are. In particular, a threshold issue in many distressed M&A transactions is understanding whether the fulcrum secured lender wants to sell to a third party at a reasonable valuation below the principal amount of their debt or instead wants to take ownership and wait out the market for a better sale opportunity on the other side.

FW: For its part, how should a distressed company go about preparing information to maximise the chances of a successful sale? What initial preparations might prove useful?

Winters: Potential bidders in a distressed M&A process will want to see much of the same information that bidders would want to see in a regular M&A process and likely more. Both a 13-week cash forecast and a well-developed long-term business plan should be at the ready. Management and advisers should have a clear view of exit financing and other cash needs. Otherwise, expect buyers to proceed as they do in traditional M&A, including by submitting extensive diligence lists, requesting multiple management and adviser calls, and requesting site visits and other more cumbersome diligence. All of this is on top of the already extensive diligence exercise inherent to the restructuring process, putting significant strain on the management team.

Mazza: The distressed company should come up with a business plan that has been thoroughly vetted, providing a real barometer of go-forward value for the business. Distressed investors will focus on distressed companies with sound business fundamentals whose distress can truly be attributed to transitory factors. When companies are putting together business plans, while transitory factors should not be overly-emphasised, adjustments to forecasting that take into account higher capital costs, given that those costs appear here to stay, are going to be fundamental. Inflation may prove transitory following aggressive interest rate increases by the Federal Reserve, but the days of cheap capital are in the rearview. Distressed companies should highlight for potential investors assets or collateral that will minimise downside risk for the investor in the event the distressed target is unsuccessful in achieving a turnaround. Advisers who not only know the rules of the road, but also have broad experience navigating distressed situations from the various seats at the table, can be an invaluable resource for distressed companies to run a well-organised process. Put another way, distressed situations benefit from a wartime consigliere.

Klein: The distressed M&A process is generally on a very tight timeline, so from a technical perspective it is critical that a distressed company populate a well-organised data room as early in the process as possible. The company should also have materials in place to respond to diligence questions, which are often duplicative from interested investors. And a well-prepared and responsive management team is important to build bidder trust and confidence in the diligence process. From a strategic perspective, in preparation of the robust marketing or auction sale process, a company should strongly consider pre-sale marketing to lock in a stalking-horse bidder, which can result in a more efficient auction and sale process and a floor price for the assets.

Robinson: Time has the biggest impact on distressed companies. With more time the main manufacturing line will be repaired and running at full capacity, the customer receivable will be paid, and a record customer order will be signed. Distress does not usually happen overnight, so management and board members should remain diligent, and maintain self-awareness to ask for help sooner rather than later. Bring on advisers to work through concerns and to assess proactive tactics. Lenders, vendors and other partners are more amenable when there is time to understand key issues and to find mutually beneficial solutions. While quantitative analytics and process expertise are key tools, advisers provide the most leverage with more time to assess, understand and communicate with key stakeholders to find solutions together.

Fogarty: An important first step for any distressed company contemplating a sale of its business is to appoint specialist financial and legal advisers at an early stage. Their role will include looking at the best way in which the transaction should be structured, the presentation of the key financial information, whether any transaction can take place on a solvent or insolvent basis and the extent of any marketing that is to be undertaken. While distressed M&A transactions often move quickly given the risk of value destruction in the target business, any sale requires careful planning. Early engagement with the financial advisers is therefore key to present the business in the best possible way. Preparing a comprehensive data room and ensuring that senior members of the management team are available to answer questions throughout the process is also important. It is critical that management have a good understanding of exactly what assets the company legally owns and up to date knowledge of and access to financial information.

FW: What are your predictions for the distressed M&A market over the coming months? To what extent do you expect to see an increase in activity?

Mazza: In 2022, there was a strong expectation that distressed M&A would pick up due to high interest rates and inflation. Yet, the impact of interest rates and inflation have yet to work their way through the system, due in part to a big push by large companies to lock in record-low interest rates during the pandemic. But those low interest rates will eventually roll off, and as they start to do so, there will be greater opportunity for distressed investors and more 'loan to own' activity. There is a lot of dry powder to put to work and investors would rather put capital to use than have it sit on the sidelines and watch inflation devalue their money.

Klein: Given that interest rates appear to be staying higher for longer, we expect continued increased activity in distressed investing, including M&A. There is also an increased trend for creditors of distressed companies to push for a sale process to be run as part of a toggle Chapter 11 plan of reorganisation as a way to maximise option value and potentially avoid a litigious valuation fight at confirmation hearings. So more economic distress plus more appetite for section 363 sale processes before committing to a standalone reorganisation should drive additional distressed M&A activity. Purchasers with dry powder should

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> Birch Lake Associates, LLC

have plenty of opportunities to put money to work.

Robinson: Distressed M&A should continue to accelerate over the next two to three quarters. We are only seeing the beginning of the impacts of rising interest rates and volatility, and the prospect of recession remains uncertain. Large, healthy companies will focus on core, profitable operations, leaving room to carve out less profitable, non-core assets. Opportunistic investors will take advantage of arbitrage where risk-adjusted returns are attractive. Many companies simply will not be able to withstand the pressure of low growth and high inflation on costs and operations. We are in for an extended cycle of distressed M&A.

Fogarty: Given the ongoing difficult UK economic climate with high interest rates and concerns over the cost of living and the increasingly turbulent geopolitical backdrop, it seems unlikely that the level of corporate insolvencies will decrease significantly in the coming months. And with that is likely to come opportunities for the distressed investor and a significant increase in activity. While many participants were making similar predictions 12 months ago and the wave of insolvencies and distressed deals did not materialise to the extent that some predicted, our impression is that the market is now getting steadily busier. In particular, we expect there to be a focus of interest on underperforming brands in the retail market, with purchasers potentially more interested in acquiring the brands and IP of the company, as was the case in Debenhams and Wilko, rather than the business and its stores as a whole. Real estate is another sector in which we are already seeing and expect to see heightened levels of activity over the next 12 months.

Winters: With most observers predicting a continuation of high interest rates and inflation for the foreseeable future, it appears that we are entering a sustained restructuring cycle that should persist for at least the next year if not for the foreseeable future. Indicators of defaults and distress remain high nearly across the board. Healthcare, real estate and retail – and the consumer sector more broadly – will likely continue to be drivers. Some observers predict that in the coming quarters a return to heightened M&A activity will coincide with the ongoing restructuring cycle. This could lead to a headier distressed M&A market than we have seen in recent quarters. ■

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