

Distressed asset investing

Finding opportunities
and addressing the risk



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Let's Talk



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Finding opportunities and addressing the risk

In a global environment where credit is scarce and cash is invaluable, how organisations manage their capital agenda today will define their competitive position tomorrow. This requires business leaders and executives from across the enterprise to examine new strategic options relative to financing, resources and revenue growth. It is in this context that distressed asset investing represents a powerful opportunity. Distressed asset acquisition can be a shrewd deployment of corporate or private equity and hedge fund capital. But a strong understanding of distressed assets is imperative to avoid the inherent risks, and to find and leverage the available opportunities. Knowing how your organisation's distressed asset strategy fits into your wider, overall capital agenda is essential to success.

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Introduction

The global recession may be easing but recovery is fragile. While certain well-publicised deleveraging events have occurred in the financial sector, many economists believe asset prices have yet to fall to levels commensurate with post-recessionary demand. Government stimulus and other intervention programs enacted the world over have softened the extent of the downturn that would have otherwise occurred.

The gradual withdrawal and termination of these programs will lead to new rounds of financial anxiety across a range of industries and companies. Further, there is a “wall of debt” that will be maturing over the next two to three years. Many lenders will be unwilling to renew arrangements without substantial improvement in pricing and other issues, and few new lenders are likely to materialise. So, as global government stimulus recedes and refinancing pressures increase, we expect the number of distressed assets to rise.

Valuing, negotiating and acquiring distressed assets is a complicated, high-pressure, high-stakes initiative filled with layers of potential risk. Once acquired, distressed asset turnaround is itself a complex endeavour. Companies most likely to prosper in the coming distressed asset environment will be well-informed and prepared. A prospective buyer must understand the complicated acquisition process, as well as the agenda of each stakeholder involved. A successful acquirer will also need clearly-defined investment objectives, confidence in its own valuation processes and insight into potential acquisition strategies. Add to this the need to move fast and maintain sufficient management resources to make it all work. So, although opportunities abound, distressed asset acquisition is neither for the uninformed nor the risk averse.

The efficient and effective use of capital has always been a high priority. Distressed asset transactions can be a remarkably effective use of capital. Moreover, in a marketplace with increasing acquisition opportunities, stakeholders expect that a company will have the means to fully capitalise on an array of opportunities. In short, opportunities are unfolding – and organisations will be expected to understand how to participate and succeed.



No guarantees of success

Executed competently, distressed asset acquisitions can be an effective deployment of capital for corporations, private equity houses and other investors. Acquisitions of this nature might provide buyers with large assets – such as equipment or technology, revenue streams, or even a new geographic customer base – for a fraction of what they might otherwise cost. Mid-sized businesses might be able to buy smaller companies whose distress stems from a lack of scale, enabling the acquirer to expand its volume and geographic footprint. Often, companies acquire distressed assets as a means of securing access to technologies or other elements within a supply chain. Alternatively, a company might acquire a distressed asset simply as a defensive measure to prevent capabilities, capacity, technology or other advantages from falling into the hands of a competitor.

In an ideal transaction, assets would be acquired with minimal capital expenditure, blend perfectly with the acquirer's business model, integrate seamlessly with operations, and extend scale and efficiency, generating above-average returns for decades.

But almost by definition, distressed asset acquisitions are rarely ideal. The potential challenges associated with a purchase are many, each potentially threatening the buyer's return on investment. Moreover, these transactions tend to take place in compressed timeframes, adding greatly to the risks of overlooking hidden liabilities, overpaying or underestimating the effort needed to turn around operations, meld new and existing businesses, and increase potential capacity online and generate new revenue streams.

Potential opportunities of buying distressed assets

- ▶ Deeply discounted assets can deliver above-average returns.
- ▶ Opportunities include growing market share, expanding geographic or product footprint and generating new revenue streams.
- ▶ Distressed assets often feature significant levels of embedded debt financing – even more valuable in a tight credit market.
- ▶ Distressed asset acquisition can be a defensive measure, preventing sales, market share or proprietary technology or processes from falling into competitors' hands.
- ▶ “Rescued” employees at underperforming companies can become highly motivated.

Potential challenges of buying distressed assets

- ▶ Lack of familiarity with distressed assets could cause the acquirer to overpay.
- ▶ Lack of experience in integrating distressed assets can lead to costly delays or chronic underperformance.
- ▶ Inexperienced buyers could unwittingly take on an array of off-balance sheet liabilities ranging from product warranty issues to unfunded pension obligations.
- ▶ Valuation, due diligence and closely related processes must be adjusted to reflect the nuance of distressed asset market conditions.
- ▶ Underestimation of cost and effort of turnaround can reduce return on investment.



Hidden risk and dangers

Due diligence in a distressed asset context requires careful evaluation of risks, but in particular, an intensive focus on identifying hidden – often off-balance sheet – liabilities. For example, when buying assets from insolvency practitioners, the assets are often transferred with no warranties or indemnities of any kind. Potentially damaging legacy issues include underfunded pension liabilities, employment contracts, termination agreements, warranties, off-balance sheet product liabilities, regulatory issues, commercial contracts and breach of contract claims.

These issues increase the need for thorough due diligence. Due diligence needs to be completed rapidly and needs to focus on key operational, commercial and financial areas. Discerning the potential value of an asset requires a forensic approach to understanding hidden liabilities as well as their origins. You must also be able to assess whether you have the ability to re-configure and re-deploy the target's assets to generate target returns. The likelihood of success will depend on a handful of factors, including the negotiated acquisition price, the speed with which the assets can be integrated and the expected performance of the assets. The information gained will help you negotiate more effectively and possibly avoid some of the previously-mentioned challenges.

Potential distressed asset buyers need both financial and management resources. Distressed assets carry higher risk than traditional assets, so the expected return on capital should be greater than it would be for less-risky investments. Because decisions usually have to be made over compressed timeframes, having focused support from an experienced distressed asset advisor is essential.

You should also be ready to commit cash, paper and/or equity. Cash, welcome in any transaction climate, is even more valuable in a credit-starved marketplace. Less credit availability will tend to mean fewer competing bidders. So those with cash, paper and/or equity, or a workable combination will likely occupy a strong negotiating position.

This is not to say that the use of credit is completely out of reach. Distressed assets do in fact frequently produce unexpected embedded credit financing from sellers looking to help facilitate a deal. In most cases, distressed assets are controlled by creditors, often banks or other lenders. Working with these creditors, you can assume existing liabilities in the form of new loans. Embedded financing commonly enables a leverage ratio in excess of 50%. In other words, in spite of tight credit markets, distressed assets present an opportunity to leverage investment capital, by allowing the rollover of all or part of existing corporate debt.

Learn the past, but look to the future

Valuing distressed assets can be especially challenging. Often, there are few comparables. Historical performance data based on the current owner or owner's use of the assets can be helpful.

However, in performing valuation and due diligence, companies should be keenly aware of the importance of not limiting their analysis to only backward-looking historical data supplied by the seller, trying to plot trends in sales, costs or earnings before interest, taxes, depreciation and amortisation (EBITDA). You need to plot future returns for any distressed asset based on a brand new set of forward-looking circumstances that build on previously underutilised opportunities and strengths. These distressed assets are presumably heading to the right management with a business plan that can derive greater value. The fact that the assets may be acquired at a relative discount would presumably add to their future value.

So, valuation and associated due diligence should tend to focus on the new owner's operating metrics as applied to the expected future deployment of the acquired asset. Valuation should also include any tax liabilities inherent in the acquisition, and take into account the expected tax structure going forward.

Some common potential liabilities

Potentially damaging distressed asset legacy issues to watch out for:

- ▶ **Underfunded pension liabilities** - Companies under duress for some time have likely been skimping in some areas – such as providing for future liabilities.
- ▶ **Extended employment contracts and termination agreements** - Substantial employee payments may be triggered by acquisition, termination or similar events.
- ▶ **Enforceable warranty risks** - In the run-up to distress, has the company compromised quality? Or perhaps poor quality led to distress in the first place. A purchaser should explore possible buyer or client warranty issues faced by the target.
- ▶ **Product liability and regulatory issues** - Due diligence should include a close look at facilities, supply chains and products in the marketplace, with special attention to regulated substances, hazardous materials, recalls of related products or even violations of trade or operational regulations.
- ▶ **Breach of contract claims** - A distressed organisation may have slighted the terms of contract with suppliers or customers. Due diligence here means sorting out how faithfully the firm has been performing its contractual duties – and what penalties or damages could be imminent.
- ▶ **Tax exposures** - The sale or any pre-sale re-organisation could trigger tax liabilities which may become a responsibility of the purchaser.

Structuring the acquisition

There are many ways to acquire distressed assets. For a typical corporation, the most common approach is to buy the asset outright or to acquire the asset or discrete assets within an insolvency process.

For example, the analysis could show that a corporate entity has numerous legacy liabilities such as those mentioned previously (see "Some common potential liabilities"). In this situation you might determine that rather than buy the entire legal entity, it makes more sense to purchase through an insolvency process. In this way, you may structure the sale and purchase in order to separate the asset from certain liabilities and leave the latter with the insolvent entity.

Other structuring techniques involve purchasing operating companies and leaving behind entities that hold the financing arrangements. Even if you have the option to leave certain operating liabilities behind, it may choose to honor these liabilities (for example, an equipment lease). In some cases, the failure to make things right with suppliers, customers or others will result in the loss of goodwill. In these instances, you may wish to retain liabilities, factoring the accompanying cure cost in negotiations and bidding.

Potential legacy issues are by no means the only factor to consider when contemplating a purchase of just discrete assets or an entire corporate entity. Other factors may also come into play. For example, the tax implications of an asset purchase versus share deal may differ significantly and, therefore, impact the total purchase price. So companies need to weigh the positives and negatives of the broader transaction before deciding which approach makes the most sense. Should you prefer to acquire unencumbered assets as opposed to entire companies, various jurisdictions have enabling processes.

You may like to think about moving a company into jurisdictions where restructurings can be implemented more efficiently.

The distressed investing equation

There are risk/reward factors that can impact market attractiveness, that are strategic in nature, and which can help determine whether a distressed asset investment will be successful.

- ▶ **Price** - Just because an asset is inexpensive does not mean it is a bargain.
- ▶ **Complexity** - Most distressed asset acquisitions are complex. Complexity helps those that are well-prepared and experienced, and deters less-prepared competitors. Complexity also helps pave the way for lower acquisition price.
- ▶ **Imperfect information** - Working with experienced advisors, acquirers can turn risk into opportunity. Imperfect and even incomplete information can aid lower price justification in the negotiation process and can also deter other bidders.
- ▶ **Speed** - Companies whose governance enables fast action will have a competitive advantage over others whose decision-making process is more protracted.
- ▶ **Leverage** - Existing leverage may often be rolled as senior lenders recognise it may be the only way to attract new equity capital and deliver the transaction.
- ▶ **Operational fix** - Acquirers need to understand the challenges to be addressed before the assets can become productive and generate returns. Commercial and operational due diligence is arguably more important than financial due diligence.
- ▶ **Exit /Integration** - Any buyer – commercial or private equity (PE) – needs to have clearly-defined objectives including an end-game for the investment.

Moving forward with caution and confidence

Other means of participation

There are many additional means of participating in the upside potential of distressed assets. Not all are applicable in every circumstance, nor will all be appropriate for all organisations. Nonetheless, these strategies should be understood by all participants if only to have a better appreciation of potential competitors. Additional approaches include:

- ▶ **Buying the option** - This means gaining control of an asset by purchasing shares at a relative discount. Using this method, the buyer can either support the company (believing a turnaround is possible) or restructure it through a formal insolvency.
- ▶ **Loan-to-own** - Gaining control of the asset through buying into the debt structure where the value breaks, and forcing a financial restructuring via a debt for equity swap.
- ▶ **Par recovery/Flow trading** - In these two trading strategies, an investor buys into the debt of the distressed organisation with the hopes of profiting from an improvement in the underlying credit conditions.

These strategies are often used by professional distressed investors and hedge funds who want to take a portfolio approach to investing in distressed assets. By purchasing the debt and/or equity shares of a range of attractive distressed assets, these investors will have the benefit of optionality and blended returns in order to meet their required hurdle rates. Corporations may find it beneficial to partner with such specialist organisations or investors, and use their financial expertise and even capital to acquire other target businesses and assets through the purchase of debt.

The role of tax

The tax aspects of a distressed asset transaction should be evaluated rigorously. Potential synergies can be a source of significant value. But at the same time, the failure to fully understand the tax issues can be a source of added operating cost, investment risk and lower return.

Adjustments in the structuring of a transaction can profoundly alter tax characteristics. Subtle – and sometimes not so subtle – adjustments in deal structure can impact everything from all-in cost of financing to the realisation of gains or losses. Similarly, there may be opportunities to alter deal structure as a means of optimising operational cash flows, perhaps in the minimisation of GST, customs duties or other ongoing expenses.

Underperforming assets may represent an opportunity to negotiate tax debt and terms with relevant tax authorities. A State or national tax body will in many cases be willing to adjust policies if it means the difference between an ongoing versus a failed operating entity within its borders.

In general, the tax issues associated with distressed asset deals are both complex and highly material. As such, companies need to leverage tax expertise early on in order to evaluate such intricacies and inform and enrich related decision-making processes.



Harnessing human capital

For acquirers with the right skills and mindset, distressed assets often hold another potential source of value – the workforce. While it may take weeks or months of difficultly for companies to admit distress to stakeholders and reach out for solutions, those inside the organisation may have been operating under a cloud of uncertainty for some time. Management is often given incentives through equity, which can be problematic for those working at a distressed asset. Reviving their hopes and channelling their energy productively represents added value waiting to be unlocked for a buyer who recognises and is able to leverage that potential.

Chronically weak organisational performance robs workers of their vitality. Uninspired and unmotivated, these individuals tend to focus on their own job security and future careers rather than the objectives of the company. For many, it can be a low point psychologically. Moreover, deteriorating morale can accelerate distress.

If you have vision and solid leadership skills, you can extract value from an underperforming workforce. A compelling business plan can lead to a tremendous bounce in energy, focus and performance. Skilled acquirers in the distressed arena understand this dynamic and use it to accelerate and enhance the integration of the new assets. In essence, value can be created by deploying the human capital more effectively than the previous management team.

Be fast or be gone

Perhaps the greatest challenge in the complicated, high-pressure effort to secure distressed assets is the need for speed. Businesses tend to fail very quickly, even if they have been suffering for some time. That is because management teams are often in denial and fail to take critical steps that might soften the distress. When the failure becomes evident, key stakeholders such as lenders and bondholders move with great haste to protect their capital.

Distressed asset resolution – always a fast-paced process – has accelerated in the new economic landscape. Small- to mid-size deals are often announced and concluded in three to five weeks. Even large, sometimes massive transactions that previously might have been completed over a six- to nine-month period, are now being resolved in one to two months, if not sooner.

Also, the speed of these transactions poses additional challenges for those thinking of straying beyond their core competence. The allure of low acquisition prices may tempt you to deploy capital in an entirely new field. While there is nothing inherently wrong with such an expansion, the fast pace of distressed asset divestiture places bidders from outside a given industry at a disadvantage. Unfamiliarity with the business or industry complicates and therefore slows the due diligence process, conferring advantage to industry insiders. Perhaps worse, a bidder from outside a given industry may feel pressured to cut corners. Moving too fast in unfamiliar territory may yield costly mistakes.

You should not even consider the distressed asset arena unless your organisation is capable of moving swiftly and confidently. Organisations uncomfortable or inexperienced with making quick decisions will likely find their efforts wasted as prized assets fall to swifter rivals.



Organising for distressed acquisitions

Once a company understands the potential challenges and risks of distressed asset investing, it can more readily assess how to move ahead to prepare for an acquisition. An immediate realisation is that any company or PE house serious about playing in the distressed assets space will need to develop supporting processes and governance.

Vital to this will be a board-level and senior management team that understands the goals and objectives of the acquisition. Moreover, the organisation must be confident that it can capably manage both the risks and the opportunities. The compressed time frames needed exacerbate the wide range of risks associated with distressed assets. Heightened opportunities, of course, go hand-in-hand with greater risk.

To take advantage of those opportunities means preparing in advance to be able to pinpoint appropriate targets, understand the components of value and move forward with a due diligence process that highlights the most relevant variables, both those considered to be historic, as well as those that are forward-looking. The organisation must be willing to move forward based on solid, but rarely perfect intelligence. If the culture is one that insists on reviewing and re-reviewing data to determine soundness, the distressed marketplace might be the wrong place to focus.

Once an organisation is committed to the pursuit of distressed assets, there are a range of steps that can enhance the associated processes. Consider the speed required to execute deals. Although companies tend to fail rapidly and in spectacular fashion, there are often telltale signs of coming failure prior to collapse. To the extent you can improve tracking and early warning systems, you can begin due diligence prior to formal announcements and be well ahead of the competition when an opportunity arises. One of the most effective means of gaining insight is by soliciting input from a broader cross-section of your organisation in the process.

For example, companies should ask their externally-facing employees to listen for potential situations. A logistics worker might ask suppliers if they've been facing any trouble getting paid. A sales or service-oriented employee could query customers and clients as to any problems with deliveries or order fulfilment. Credit, collections and other finance staff can be asked to stay on top of credit alerts, downgrades or similar events that can be precursors to severe distress. Expanding awareness throughout the organisation can lead to better intelligence and create a competitive head start.

Conclusion

In every industry, distressed assets have the potential to generate above-average return on capital. But success is far from guaranteed. Companies must acknowledge in the beginning that such assets carry higher risks than more conventional investments. In addition, companies will need keen insight into credit assessment, liquidation, restructuring and related insolvency rules and practices. This should include knowledge of the various acquisition and integration strategies and legal structures that can facilitate or enhance distressed investing, as well as all associated tax implications.

Companies should also expect to operate outside their traditional comfort zones. Valuations will tend to be based more on expected deployment, not historical data. Companies must also be willing to streamline decision-making. Insistence on endless review processes featuring multiple signoffs will likely confer success to a swifter competitor.

If you have confidence in its processes for addressing the challenges, there can be great opportunity in distressed assets. These are assets that can be acquired at steep discounts relative to traditional assets. Moreover, these assets may come with stapled financing, enabling significant leverage and therefore reducing the amount of deployed capital. Given capable leadership, the human resources in a given acquisition can be inspired to greater performance.

Today, there are increased opportunities for distressed asset acquisition. If you are adequately prepared you will likely find enormous opportunity. Those who fail to prepare and capitalise will likely face the ire of shareholders and other stakeholders. Owing to greater complexity and heightened risk, distressed asset investing requires a company to commit greater management capital. But with preparation, information and nerve, this type of investment can yield rich rewards.

Contacts

Questions you should ask before moving to acquire a distressed asset

1. How did the company become distressed? A collapse in market demand? Difficultly refinancing debt? A thin and fragile supplier base? Poor product development?
2. What are the reasons for and against the distressed asset acquisition? To what extent is our judgment about moving on this acquisition swayed primarily by low price?
3. Is the target over leveraged? How much is too much? How will we know?
4. Should we buy the entire company or just its assets? How will we determine which is the best option?
5. Where does the value break and should our strategy be to acquire through the debt?
6. How confident are we in our company's due diligence process and capabilities to execute thorough research quickly and effectively? What can or should be done from both a cultural and resources perspectives to raise this confidence?
7. If it is a cross-border acquisition, are we aware of all of the host country's governmental regulations and restrictions regarding distressed targets, restructuring, liquidation and other insolvencies?
8. How should the acquisition be structured to maximise tax efficiency?
9. Do we have the ability to re-deploy these assets to generate above-average returns?
10. Does our company's culture support the potential benefits and challenges associated with the acquisition of distressed assets? What is our company's risk tolerance? What is our board of directors' perspective on what it takes to make distressed asset acquisition a successful strategy?
11. Does my company fully understand the complicated tax implications of a distressed asset acquisition?
12. How do we expect to utilise the newly-acquired asset compared to how it was used previously? What new perspective on asset and capital deployment will we bring to this otherwise distressed asset?
13. Have we considered in our bid, not only the price, but other conditions, such as the assumption of liabilities, supply contracts or leases?
14. Does the distressed asset represent businesses outside our company's direct experience? Would the acquisition constitute an expansion of a core competence, or a foray into an entirely new business line?
15. What would our exit strategy be if the acquisition does not generate the necessary return on investment?

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