GUEST ARTICLE

Distressed U.S. M&A Market Draws Foreign Interest

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The weak U.S. dollar has made American companies much more attractive to foreign buyers in the last couple of years, as evidenced by the recent acquisitions of high-profile assets like the Chrysler Building and Anheuser Busch. Increasingly, foreign buyers are also becoming more active in the market for distressed assets, a market they have traditionally avoided. With continued expectations for a weak dollar and an increasing supply of distressed companies in the near future, foreign companies may have an unprecedented opportunity to purchase U.S. assets at bargain prices over the next few years. And for distressed companies, a larger number of foreign buyers in the market may be the key to realizing recoveries for their creditor and shareholder constituencies.

In this article we identify the advantages, issues and obstacles related to the acquisition of distressed businesses by foreign acquirers, as well as the means by which they can overcome and/or mitigate any potential obstacles from both buyer and seller perspectives. For simplicity, it is assumed that sales of distressed companies will be conducted pursuant to Chapter 11, however, the topics discussed would generally be relevant in an out of court sale as well.

Purchasing Distressed Assets

There are a number of important advantages to purchasing distressed assets, including the following:

• Buying assets "free and clear of any interest" under §363 of the Bankruptcy Code: Because a sale of assets in bankruptcy is subject to a judicial process, a buyer can readily purchase assets free and clear of all prior liens and claims, including claims that may remain unpaid after the sale is completed.

• Low cost entry into the North American market: Globalization has provided companies with a powerful incentive to expand into new markets, particularly when their customers enter the market. While globalization has clearly impacted suppliers and sourcing across many industries, top-line expansion into new markets has proven challenging for many. With a targeted distressed opportunity, foreign buyers can acquire plant capacity, augment their brands, and expand their distribution infrastructure, all at a value proposition that should be far less than either "greenfield" expansion or acquisition of a healthy company.


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• Availability of capital: Financing is increasingly coming from alternative sources of capital, such as hedge funds, private equity funds and commercial finance companies, which in turn are becoming more and more global due to expansion into European and Asian markets. The number of sources of exit financing for distressed investments has increased in recent years as well, both from traditional and alternative sources. In addition, many companies have built up large cash balances over the past few years and therefore have a greater ability to finance their own acquisitions.

• More favorable exchange rates: The weak dollar has made U.S. assets, whether healthy or distressed, attractive investments.

• Ability to leverage sourcing and supply chain strengths into new channels: For those companies that have adept and cost effective supply chains, a distressed acquisition provides a quick and cost effective means of entry into new markets.

• Ability to consolidate foreign markets: Foreign entities with U.S. based operations are perhaps best positioned to purchase distressed assets, enabling the consolidation of select markets, plant infrastructure and purchasing power.

• Ability to cherry-pick assets: Buying assets in the United States, particularly in bankruptcy, gives buyers the opportunity to select the assets they really need from a distressed business without having to purchase the entire company

Why Avoid The Distressed Market?

Despite the potential advantages to purchasing distressed assets, foreign buyers have long avoided the U.S. distressed market. While globalization and exchange rates are rapidly having an impact, the reasons for foreign restraint are real and need to be understood. Such reasons include the following:

• Inability to move quickly: Many foreign cultures do not conduct business at the same speed as in the United States. With most distressed opportunities, liquidity constraints and stakeholder issues mandate a fast moving process with certainty and closure, often in timeframes of 30 to 120 days. Faced with such daunting requirements, many would-be potential buyers simply opt to stay on the sidelines.

• Fear of the unknown: Many foreign buyers are not familiar with the U.S. market. Confronted with an underperforming entity and an unknown market, a buyer may choose to play it safe, opting instead to grow organically or through an acquisition of a healthy business.

• Legal issues: The U.S. bankruptcy system is fundamentally different from those in most other countries. Confronted with the need to navigate a complex, potentially costly and sometimes confrontational process, a buyer may simply stand down.

• Concern about legacy issues. Buyers are concerned that the issues that caused or were related to a company's distress (e.g., management control, excess capacity, environmental issues, pension obligations, bloated workforce, burdensome debt, market issues, etc.) will continue to have an effect on a business after it is acquired. Many buyers don't have the ability or willingness to effectuate a turnaround if needed.

• Integration issues: A buyer's perceived ability to successfully integrate an acquired business post closing can be an impediment to doing a deal, whether the target is healthy or distressed. Furthermore, given a distressed business and its inherent issues, coupled with potential cultural and logistical issues that foreign buyers can face in acquiring any U.S.-based business, integration takes on paramount importance.

Addressing Obstacles

Sellers of distressed assets can entice foreign companies to participate in the sale/auction process of U.S. entities by proactively addressing those issues relevant to foreign buyers and the specific deal. While any sale is ultimately "arms length," the mindset of the seller must be that of a "collaborator." The seller and its advisors must work with and educate potential buyers on the opportunity and the process; therefore, knowing the obstacles and how to confront and overcome them is of paramount importance.

• Inability to Move Quickly: In order to overcome this obstacle sellers must make it easy for buyers to get access to information and get answers to questions in a timely manner. Therefore, when going to market, the seller must be armed with the following:

■ Clear, concise and detailed offering memorandum. The memorandum should address all relevant aspects of the business; assuming that strategic buyers have a

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thorough understanding of all aspects of the business often results in omission of important information and delays the process.

■ Detailed, well organized data room which addresses all portions of the business (i.e., financial, operations, human resources, legal, environmental, and appraisals). Presenting this information in sufficient depth will go a long way towards mitigating buyer concerns of investing significant effort and resources into a vast unknown. In strategic sales certain information must remain confidential until the seller has reason to believe that a buyer is going to bid; therefore, buyers must be properly educated as to why select information is withheld. Most strategic buyers will understand, though one should expect extensive pushback and negotiation.

■ Third-party due diligence firms. Both the seller and the buyer should consider use of third parties to prepare/analyze detailed due diligence materials. This facilitates due diligence in a timely manner without disclosure of competitively sensitive information.

■ Detailed responses to preliminary due diligence questions. The seller's advisors (financial, turnaround, legal) must work with management (including operational, sales, financial and administration) in preparing for anticipated questions/areas of concern. Prepared responses can significantly improve the seller's response time and provide a positive impression to buyers—a first impression is a lasting one and may directly affect a buyer's level of interest.

• Fear of the unknown: Many buyers, concerned that the acquisition of a distressed company has significant market risk due to possible damage inflicted to customer and supplier relationships during the company's decline, are determined to address these concerns from the outset. Yet, it is often the goodwill and solid relationships with customers and suppliers, built up from years of doing business, which enable a distressed business to continue as a going concern and provides the opportunity in the first place. Therefore, the seller and its advisors must identify the gatekeeper(s) of those relationships within the company and enlist their support in the sale process. Clear and realistic information about the nature of stakeholder relations must be conveyed to prospective buyers from the beginning of the process. To the extent these relationships are strong and sustainable, the concerns of the foreign buyer can be addressed early on and verified during the due diligence process.

• Legal Concerns: The perception of some buyers that the legal process is unwieldy, expensive and time consuming must be confronted early on. A potential buyer's legal and financial advisors must explain the nature of the process, the speed of the process, and the advantage of retaining local bankruptcy counsel at the beginning of the process to improve the buyer's competitive position and understanding of the nuances of the case and the local court. Communication between buyer and seller bankruptcy attorneys at the outset often leads to a faster, smoother and less expensive sale process.

• Legacy Issues: One of the most significant advantages of purchasing a distressed company, particularly in a bankruptcy context, is that a buyer can negotiate an asset purchase agreement that leaves behind onerous liabilities, ineffective and superfluous employees or managers, redundant facilities, and unfavorable contracts so that the acquired business can provide financial returns rapidly. In this regard, the buyer's due diligence is crucial. However, legacy operational issues, such as inefficient processes, high defect rates, late deliveries, proliferation of products/services, and low customer satisfaction, as well as dysfunctional corporate cultures, are not as easy to pinpoint in "standard" due diligence as other issues. Furthermore, once these issues have been identified, it can be difficult to determine whether the operations can be turned around and/or the culture changed cost- and time-effectively. Buyers can address these concerns by retaining a turnaround consulting firm during the due diligence process to uncover these key issues, verify whether they can be overcome and assist the buyer in stabilizing and/or turning around the business post-closing, thereby reducing the risk of a mistake.

• Integration Issues: As many M&A veterans know, reaching and closing a deal is often the easy part. The real challenge comes in integrating the acquired company into the buyer's organization. The risk of a failed acquisition is high, epitomized by the commonly cited statistic that 70 percent of acquisitions fail to achieve their goals. In addition, the short timeframes often encountered in distressed situations (as described earlier), most notably for due diligence and closing, increase the risk of failure and further complicate an acquirer's ability to understand the opportunities and pitfalls, build the integration team, and develop an effective integration plan with timeline and metrics. A foreign buyer must recognize the potential asset leverage (e.g., sales growth, value-chain integration, accelerated R&D, etc.), cost efficiencies (e.g., scale economies, productivity gains, headcount reductions) and new opportunities (e.g. new customers, new products, new markets) in order to set up the appropriate post-merger structure that will reap anticipated synergies. Similarly, foreign buyers must be aware of and be able to address potential hazards, such as cultural differences, management concerns, operational issues, and stakeholder (customer, supplier) concerns. Buyers and their M&A advisors are typically adept at recognizing the opportunities, but less comfortable identifying the potential hazards. However, greater use of turnaround consulting firms in the due diligence, integration planning and execution phases in the last few years has resulted in increasing sophistication among foreign buyers.

Conclusion

The current market conditions are ripe for foreign buyers to acquire distressed U.S. assets at bargain prices. In order to further encourage foreign buyers who have traditionally avoided the distressed market to participate, sellers and their advisors should work with and educate potential buyers on the opportunity and process, and have detailed information available to facilitate due diligence in a short time frame. Buyers should retain experienced and knowledgeable advisors (M&A, legal and turnaround) to help them understand the bankruptcy rules and auction process, identify the core assets and liabilities that lead to value, develop an M&A integration process to maximize the synergies from the assets, and assist with operational restructuring during transition. By following these guidelines, both buyers and sellers will significantly increase the likelihood of successful transactions, and show the rest of the world the U.S. distressed market should no longer be avoided. ❖

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