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Alternatives to Bankruptcy: A Buyer's Perspective

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Investors historically have been attracted to distressed assets for one simple reason—the potential to acquire quality assets cheaply. While this investment thesis is far from foolproof, the attraction remains strong.

The current recession, along with the upheaval in the credit markets, has created a unique situation for distressed and turnaround investors. A number of companies currently are experiencing either operational or financial distress (or a combination of the two), and the manner in which to acquire these firms is a critically important decision for the buyer. Commonly used processes for buying distressed assets range from traditional court-supervised Chapter 11 processes to negotiated out-of-court settlements.

The process chosen affects valuation, investment risk, and eventually, investment return. While many of these issues can be quantified or modeled, it is impossible to completely determine the damage incurred by a target company while enduring a period of distress and surviving a distressed sale process.

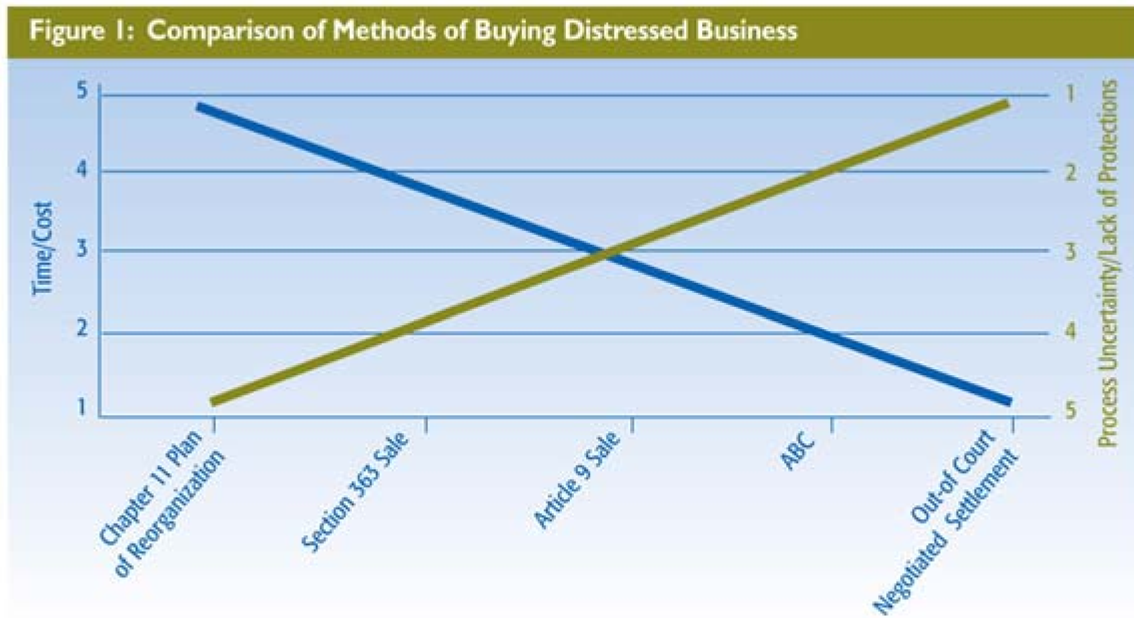
This article explores many of the considerations that a buyer of a distressed company must contemplate. The legal and technical aspects of the different processes available to facilitate a transaction are beyond its scope. The focus here is on the buyer's perspective, with particular emphasis on the series of trade-offs that are made by the selection of one process over another. Specific attention is paid to the concept of damage done to the acquisition target as a result of a lengthy process.

The sales process used generally is chosen by the major economic stakeholder. The buyer of the distressed firm doesn't always get to make that decision but often strongly influences the outcome. The process chosen is determined by the needs of the company, but the decision ultimately is the result of who has the stronger negotiating position—the buyer or seller.

In a perfect world, a buyer of a distressed company wants to acquire the firm under these ideal circumstances:

- A relatively low, but fair, purchase price that puts an investor in a position to make a healthy risk-adjusted return
- An acquisition that is "free and clear" of all liens, claims, and encumbrances
- A sale that is endorsed or certified by a judge
- Severely limited successor company liabilities
- A quick and low-cost transaction process
- Limited competition for the desired assets
- Limited negative publicity or disruptions that potentially could affect customers, vendors, and employees of the target acquisition

Unfortunately, it is practically impossible to accomplish every item on this list. In fact, many of the desired outcomes listed are direct trade-offs with each other. **Figure 1** graphically depicts in simple terms the major tradeoffs related to the different ways to buy a distressed business.



While Chapter 11 plans of reorganization and Section 363 sales are the more time-consuming processes, they also afford the most certainty, bidder protections, and clear title. At the other end of the spectrum are out-of-court negotiated direct sales. These types of sales generally take less time and cost less, but they do not provide the protections inherent in a court-supervised process.

The key to handicapping the decision on what process to use is based partly on determining how long the distressed asset can survive the process—and what permanent damage, if any, has been created.

Staying Power

Of course, the most important aspect of buying a distressed company is finding a good company that will enable the investor to make a good return. That return must be adequate enough to cover the inherent risks of a period of distress and some form of distressed sale process. While it is not within the purview of this article to discuss choosing and valuing investment targets, it is critically important to judge the strength or "staying power" of the intended acquisition.

A key consideration for choosing or judging the appropriate form of transaction process is time. Therefore, it is critical for a buyer to ascertain the ability of the target firm to survive a lengthy restructuring and sales process. This is analogous to a doctor recognizing that while a patient may have several treatment options, the patient's relative health may rule out some of those choices.

Considerations that should be reviewed include cash position (and potential cash burn rate), relative market position within the firm's industry, and the options available to all stakeholders in the process—customers, suppliers, management, employees, lenders, and regulators.

A buyer must judge the relative staying power of the acquisition target on two different and critical levels. First, can the target survive a lengthy Chapter 11 reorganization or Section 363 sale process? Practical experience suggests that the process always takes longer—and is more costly—than original estimates. If the protections and certainties afforded by a court-supervised process are required, can the company survive the longer process period? Does it have enough cash? Will its customers and suppliers support the business during a longer period of uncertainty? Second, the buyer must determine if permanent damage will be done to the acquisition target through a longer, and more public, process. This second point is critical and much more difficult to ascertain.

A company going through a period of distress and subsequent sale is much like an automobile that has been in an accident. If it is not totaled, the car can be repaired. Visual and functional repairs can be completed, but as is often the case, the automobile may never be quite the same again. In addition, the car will have its repair and rebuild history permanently attached to its record—forever negatively affecting that vehicle's resale value.

Much like the rebuilt car, some restructured companies carry a stain or stigma well into the future. The amount of time that a firm carries such a stigma post-transaction is directly proportional to its ability to satisfy or exceed customer expectations for

performance and the company's ability to rebuild mutually profitable relationships with its vendors.

Damage Assessment

Thoughtful and comprehensive due diligence is necessary in any acquisition, but it can be very challenging to conduct on a firm under distress. An important difference in buying a distressed asset versus a healthy company is the amount of time given to complete many distressed due diligence processes. A prospective buyer must accomplish comprehensive due diligence in much shorter and compressed timeframes and gather enough factual evidence to determine the firm's "staying power" and to ascertain the level of permanent damage, if any.

Determining the ability of the distressed firm to survive the sales process is easier than gauging the level of permanent damage. The shorter term staying power is largely a function of cash position and the length of the runway that it creates.

Additionally, determining the relationship between the company and its vendors and suppliers is critical. Unfortunately, traditional customer contact and customer surveys are often limited in distressed due diligence. When appropriate customer surveys are allowed, they are often granted at the very end of due diligence, which creates a risk of its own—a buyer might find the customer relationships are weak only after spending meaningful time and money on due diligence. Understanding customer fealty (or lack of it) is critical early in due diligence.

Management may not always be helpful in determining the relative support of customers and suppliers. Aside from the normal task of determining the quality of a target's management team, a buyer must quickly ascertain the "intellectual honesty" of the incumbent management team. While gathering the incumbent team's opinions on these supplier and customer relationships, a buyer also must determine the ability of those executives to give dispassionate, realistic, and thoughtful opinions on the entire

business. A healthy amount of skepticism is required of the buyer. While there can be myriad reasons a firm became distressed, a good management team accepts responsibility for the situation and focuses on solutions rather than blaming external factors.

One area in which buyers of distressed businesses are often misled by management is supplier criticality. Few management teams relish the prospect of negotiating a settlement with the trade. Often, their personal relationships with suppliers affect management's judgment. Too often, buyers of distressed businesses excessively compensate trade suppliers because they relied too heavily on incumbent management's opinion of supplier criticality.

Buyers should use their own judgment—after seeking input from a number of sources—and rely on common sense in determining supplier criticality. Most customers and suppliers react predictably in their own economic self-interest. The key to handling these relationships in the interim is to always act fairly, even if the move is unpopular, and to communicate as openly as is practical.

Far more difficult to diagnose is the level of permanent damage done to a business in distress. In the short term, it is relatively easy for a buyer to determine the options available to suppliers, customers, and employees. Obviously, the shorter the process timeline is, the fewer are the options available to these stakeholders. The consideration that a prospective buyer must focus on is the longer term options available to these key stakeholders. Uncertainty within a particular supply chain will cause well-run, thoughtful companies to review their strategic options.

Recently, a key OEM supplier to a distributor of electrical products went through a lengthy, well-publicized Chapter 11 reorganization process. During that time, the OEM consistently failed to meet minimum fill rates. In an act of self-preservation, the distributor looked overseas to source the OEM's main product and eventually found the exact factory that was making the OEM product. Surprisingly, the factory had no

confidentiality arrangements with the OEM. The distributor is now in the process of introducing this competitive product—at much more favorable prices and margins. Potential disintermediation is something that must be understood by all buyers of distressed assets.

The common sense rule of thumb in determining the short-term and long-term viability of a distressed asset is to question its reason for existence. What would happen if the firm went away? How would its customers and suppliers react? If the only prediction is that the demise of the target would cause a brief period of disruption, then the target may not be a wise investment. On the other hand, if the demise of the firm would lead to the formation of a new, similar player in the supply chain because the role being played was critical, then the company has good prospects for surviving, even through a tougher sales process.

In reviewing distressed buying opportunities over the last year or two, many firms failed the "reason to exist" test. Many automotive component suppliers fell into this category. Did the world really need seven seat bracket suppliers? If one went away and only six remained, would anyone really miss the seventh company? The answer is clearly no.

While nothing is ever assured, a distressed firm has improved its chances for a long-term survival immeasurably if its suppliers and customers are sincerely interested in its survival. If the firm's survival is clearly within the economic self-interest of the suppliers and customer community, the basis for a restructuring, rebirth, and future economic vitality is likely.

Value Creating Potential

Buyers of distressed companies will continue to be faced with decisions on what process to use to acquire these firms. The merits of the respective processes will be measured against the obvious tradeoffs. High process certainty and protections will be judged

against process time and cost.

While it may be possible to estimate the financial costs, the buyer must understand two important factors: 1) Can the firm survive the process; that is, how much short-term staying power does the company have?, and 2) How much long-term impairment has taken place?

The answers are not only key to helping decide which alternative process should be used, but are also the essence of understanding the potential for value creation at the particular company. The key to understanding all of this is judging the importance of the firm to its suppliers and customers. This "reason to exist" can only be determined through thoughtful and objective due diligence, balanced with a healthy dose of common sense.

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