

Turnaround Topics

BY ALPESH AMIN AND JESSICA MAREK

Moving to Strategic M&A When Debt Isn't the Strongest Path



Alpesh Amin
Riveron; Chicago



Jessica Marek
Riveron; Chicago

Alpesh Amin is a senior managing director with Riveron in Chicago. He has more than 20 years of experience in corporate finance, restructuring and management consulting. Jessica Marek is a director in the same office, where she focuses on developing financial, operational, and strategic solutions for companies facing challenging circumstances or distress.

To sustain or grow an enterprise, every company's lifecycle will require either financing sources or the involvement of other strategic partners; these realities ring true whether a company is healthy or distressed. Market-leading companies — and their boards and management teams — often wish to capitalize on opportunities and go on the offensive by self-funding, seeking third-party financing or driving synergies through mergers and acquisitions (M&A). These proactive approaches allow a company to strengthen financial and operational performance and gain competitive advantages.

By contrast, underperforming and distressed companies seek financing or M&A strategies as defensive initiatives out of necessity. These defensive approaches aim to turn around and restructure an underperforming organization's financial and operational performance. Whether a company finds itself in the offensive or defensive state, it is critical to examine the available financing and M&A strategies, and how each avenue can impact an organization.

Strategies for Strength: What the Trends Say

After the Great Recession of 2008, the equity and debt capital markets grew rapidly. For companies in need of capital, this presented endless options for financing — at historically low interest rates. During the capital markets expansion, unprecedented access to capital allowed healthy businesses to finance growth and provided underperforming businesses a second (and sometimes a third or fourth) chance to finance turnarounds. While the readily available capital preserved businesses and jobs, it also extended the runway for underperforming companies that may otherwise have been acquired by healthy competitors or strategic acquirers — had the access to affordable, flexible capital not been available. Although M&A activity remained a strong, attractive option, many distressed companies instead sought the refinance path as a way to resurrect underperformance.

Fast-forward to early 2020, and the world changed. The COVID-19 pandemic headwinds that businesses were to face and are still facing meant that all companies, regardless of their positions in the marketplaces they served, had to re-evaluate their operating models, financing options

and M&A strategies in order to stay competitive. Debt-financings slowed during the pandemic, while M&A activity rose to historical highs. As businesses assess their outlooks for 2023, several factors have influenced and will continue to impact the global economy, including Russia's ongoing war with Ukraine, domestic and global inflation, high energy costs, and domestic and global equity markets and gross domestic product slowdowns. Accordingly, businesses must carefully evaluate both financing and M&A strategies given the current and expected state of the economy.

Debt No Longer as Dazzling

Companies in need of flexible capital today are finding that the debt-capital markets are less attractive and debt products are more expensive than in pre-pandemic and pandemic periods. Today, coexisting with COVID-19, we are facing widespread business challenges including inflation, supply-chain disruptions and labor shortages. As a result of the Federal Reserve's 2022 interest rate hikes, debt-capital costs have increased more than 3 percent, with additional hikes likely in order to combat inflation. In addition, debt-capital providers, including bank lenders, nonbank lenders, private investors, hedge funds and private-equity debt-capital funds, all have seen an increased amount of underperforming loans that will require restructuring. This trend has tempered lending appetites. Many capital providers have indicated that they anticipate increased loan portfolio stress in the coming quarters, and as a result, new loans will face increased scrutiny and stricter documentation along with increased pricing, lower leverage ratios or availability formulas.

Stemming from these changes in debt capital market conditions, companies will increasingly consider the M&A market as an alternative to debt capital in order to restructure their businesses. The pressures to do so will likely increase, given the historically easy access to debt financing that delayed the inevitable industry consolidation that turnaround professionals would expect to see, as healthy businesses gain market share and weaker competitors partially or fully fold into stronger, healthier platforms. This phenomenon has impacted most industries and has been prevalent since the Great Recession, where underperforming businesses were given access to debt capital at favorable terms and

pricing, enabling them to refinance their debt several times over just to stay afloat. The market now appears to be at the end of that cycle, as debt providers place increased scrutiny over borrowers and extend credit with higher pricing.

Most Roads Now Lead to M&As

With debt-financing options becoming tougher to obtain and, when available, on less attractive terms, the M&A alternative must be considered. Distressed-business advisors with expertise in corporate finance, restructuring and turnarounds recommend that companies considering an M&A path as part of a restructuring take the following important steps.

Know Your Business and Its Industry Position

Leaders need to assess the key attributes and relative strengths and weaknesses of their companies. Will the best M&A path involve a partial sale or a transaction encompassing the entire business? Are there parts of the business that have to be sold or divested, while other parts are viable as standalones? Where does the company stand compared to its competitors? How do customers and suppliers view the business — and will an M&A process preserve, strengthen or weaken these critical stakeholder relationships? For leaders, understanding the answers to these questions will allow them to evaluate whether or not an M&A path will benefit the enterprise.

Partner with Advisors Early in the Process

Unless company leaders are experts in the M&A process, businesses are best served by working with advisors offering a depth and breadth of experience in both capital-raising and M&A processes. Companies must also consider the business areas and functions that might be impacted during these processes, including business operations, financing needs, M&A strategy, valuation, deal documentation and execution, and tax implications. Accordingly, an effective deal team will likely need to be composed of a distressed business consultant, an investment banker, legal counsel and accountants.

Advisors' industry expertise can vary widely, whether a strategic M&A occurs within consumer products vs. energy vs. health care sectors, for example. Any trusted team of advisors must therefore be familiar with the unique needs of each industry in order to best vet options for their clients in a strategic transaction. Here, the focus of advisory teams might include structuring the deal, identifying potential acquirers, and evaluating and ensuring the strategic and tactical success of a transaction. Further, adept advisors can also help navigate the realm of potential buyers, which will typically consist of financial and strategic partners. Financial buyers include private-equity and similar private-capital-type investors, while strategic partners would include companies in the same or similar space, whether these are competitors, customers, suppliers, or financial firms with strategic investments in the seller's industry.

Understand Your Company's Value

It is important for companies to gauge the market value range for a business, and having advisors perform this ser-

vice is well worth the cost. Companies, their boards and their management teams must understand the valuation of their enterprise and how stakeholders will be handled or repaid. After all, consequences are high in these situations. Important questions that must be answered early on include the following: Will the company be able to pay all of its creditors? Will shareholders receive some return for their investment in the enterprise? As may be the case in a distressed transaction, a company could be attractive to the market but at valuations lower than its debt obligations. In such situations, companies and their advisors must carefully explore options with the debt-holder in order to build consensus and work toward the best path forward to maximize value.

Determine the Best Path Forward to Execute an M&A Transaction

An M&A path is sometimes deemed the best option for a company by the board, management and its advisors — but stakeholders can be resistant. In such cases, a transaction may have to be consummated inside a judiciary proceeding such as chapter 11 bankruptcy. While pursuing an out-of-court path is often more efficient and less costly than an in-court process, there are times when the courts are necessary. Having a skilled advisory team that can help assess and pick the best path forward is an invaluable service for companies in this position.

Set and Manage Buyer/Seller Expectations

Companies, their boards and their management teams must also have realistic expectations around what the business may look like under new ownership, post-transaction. A strong acquirer clearly has competitive advantages that enable them to set the terms of the deal, which might not be favorable to the seller. The seller's management team might want continued employment with the buyer, but this might not be feasible. Buyers could agree to take all of a seller's employees, or they might only want a subset. Sellers might want the business to be run a certain way after a sale, but buyers might not agree. These are just some of the many examples of deal-term issues that will arise during a contemplated deal. It is critical that sellers understand what terms may and may not be amenable from a prospective buyer's perspective. If expectations are not set early on in an M&A process and managed throughout the process, a deal critical to both the buyer's and seller's business could fall apart and fail to close.

Conclusion

While no one can fully predict the economy's direction, many restructuring and turnaround professionals believe that economic volatility will abound for the next several quarters. The headwinds will mandate that underperforming companies seek both debt-capital and M&A strategies as part of any restructuring and turnaround effort. Concurrently, investors and healthy companies will be evaluating distressed businesses in order to unlock value, generate returns and strengthen market positions.

As debt-financing costs continue to rise and terms continue to tighten, debt capital is simply a less-effective restruc-

continued on page 53

Turnaround Topics: Moving to Strategic M&A When Debt Isn't the Strongest Path

from page 17

turing tool than it was just a few quarters ago. As a result, borrowers in distress must evaluate the M&A path, and do so with trusted advisors skilled in navigating this complex path in order to maximize enterprise value.

In a market economy, change is inevitable and industry consolidation is necessary. At some point, every organization will face some type of M&A opportunity, whether it is an

appealing acquisition or the disposition of some or all of the underperforming aspects of its business. Indefinite organic growth is rarely possible, so realistic growth will inevitably involve some form of business combination transaction. This process is not always easy or comfortable, but with the right planning and support, it can be the best path toward a stronger and healthier business. **abi**

Copyright 2023
American Bankruptcy Institute.
Please contact ABI at (703) 739-0800 for reprint permission.