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MERGERS & ACQUISITIONS

Cheap at half the price...?

The challenge of acquiring & integrating a distressed business

Contrary to common beliefs going into the deal, distressed businesses have usually already picked every piece of low-hanging fruit available in their previous attempts to improve cashflow, leaving the hard work to the acquirer.

If your acquisition is to improve combined EBITDA or deliver other strategic goals, a counter-intuitive rule is often a safer guide: The lower the deal price on offer, the worse the acquisition may ultimately be for your business.

For those with access to the funding, the current market provides a golden opportunity to acquire distressed or bankrupt businesses at knock-down prices, and consolidation of such firms is already well-underway in many sectors. Some basics haven't changed, however: A great price does not necessarily guarantee a good acquisition, and many have found out the hard way that using a distressed acquisition to improve their business performance still depends on business fundamentals, and your ability to improve them once the deal has closed.

Let's look on the bright side: If there's one thing the current economic climate has improved, it is the availability of distressed and bankrupt businesses for sale. Given the selective nature of this downturn (many businesses continuing to thrive while others suffer), the relative financial stability following last year's turmoil, and the continuing appetite of emerging market businesses in M&A, distressed acquisition activity is now accelerating; if predictions of an extended recession come true, we're likely to see more of the same in future.

Some of those smart (or fortunate) enough to have both the funding and intent may equate today's reduced prices with good deals: The lower the price, the better the deal. While this is clearly true to a point, it pays to keep in mind the fundamental difference between an asset and an ongoing business: The former brings realisable value immediately, while the latter offers only a promise of value in future. This distinction has little to do with the structure of your deal and everything to do with your acquisition rationale: Unless you wind down the acquired business immediately, your distressed purchase may initially give you little more than ongoing costs, liabilities, and other commitments that will be extremely difficult to untangle, and will take time, and money, to improve. Even in a 'normal' acquisition, post-deal cost savings are often far more elusive than is initially hoped, and – contrary to common opinion – distressed businesses have usually already picked every piece of low-hanging fruit available in their previous attempts to improve cashflow, leaving the hard work to you.

So if your acquisition is to improve combined EBITDA or deliver other strategic goals, the converse rule is therefore a safer guide: The lower the deal price on offer, the worse the acquisition may ultimately be for you, and despite what some may tell you, there is no deal price, no matter how low, that guarantees a return on your investment!

Exacerbating the situation is the breakneck pace of distressed deal-making: To take advantage of the opportunity, you usually have to move quickly; however here more than ever you want to ensure that your due diligence, integration strategy & planning is robust, comprehensive, and stress-tested against market and target uncertainties. The markets are already littered with recent stories of poor deals into which businesses jumped, to their ultimate regret. (Lloyds post-crash takeover of Halifax Bank of Scotland has just claimed the scalp of their Board Chairman; will Fiat's leadership soon risk a similar situation?)

So, the questions is: *How do potential acquirers need to change their standard M&A and integration practices to ensure that, regardless of the final price you pay, you will be able to transform the distressed business into the strategic asset or profit-generating engine you're looking for?*

Before answering this question, is it important to reconsider the fundamentals of why businesses fail. Typically, when owners or managers of such firms are asked this question, you often hear of a 'perfect storm' of recent external conditions: increased supplier costs, entry of larger competitors, or reduced access to short-term credit or loan guarantees. While this all may be factually correct, these symptoms do not highlight the underlying inability of management to predict or respond to them, which in our experience is usually due to things such as:

- Incomplete or unclear business strategy to differentiate themselves in a changing market;
- Deteriorating relationships with customers, loss of confidence/credibility in the market;
- Management attention spread too thinly across diverse functions & activities ;
- Lack of clarity around management authority and responsibilities;
- Conflict or infighting within the executive team;
- Poor executive focus or inability to 'say no' to new initiatives;
- Poor practices and capabilities around cost control.

With these in mind, the question actually becomes: *If we buy this business, is our own management team going to be able to address or eliminate these problems smoothly and quickly, and if so, how?*[1] Such fundamental management issues are not addressed simply by acquiring at a good price, or at any price for that matter. Instead, they are resolved only as part of effective post-deal integration that prioritises management structure, capability, culture, incentives, and more. In many cases, the best response is simply to walk away, and many successful businesses pride themselves on regularly doing just that, leaving the competition to deal with an indigestible acquisition.

Transforming distressed acquisitions

If you do want to take advantage of the sales while they last, you should keep the following in mind:

- **Look beyond the immediate temptation to 'cover yourself' by conducting more exhaustive legal, financial and commercial due diligence:** While increased due diligence is

[1] This perspective does not exclude the classical acquisition rationale in which economies of scale improve combined profitability, however our experience suggests that distressed businesses typically failed to spot the need or opportunity to do this for themselves (e.g. by acquiring another group themselves or selling the business earlier) – which brings us right back to the management issues listed.

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warranted, it can cause business leaders to miss that previous point about distressed organisations: *The ultimate failure of the business is almost invariably down to poor management.* This is not merely the same as poor *managers*, as it also needs to consider how the management team is structured and operates to govern and steer the business. If your intention is to keep on some or all of the existing management team post-close (a choice in itself fraught with problems), make sure your integration due diligence takes a very hard objective look at management culture, capability, division of responsibility & authority, team dynamics, motivations and incentives – all of these will probably need to change significantly as part of post-close integration and recovery.

- **Get to the root cause, and symptoms, of the internal issues that led to the distressed sale, and design them out of the combined business**: A holistic view of your post-close business Operating Model will help ensure that problems in areas such as measures & incentives, internal capabilities & processes, market relationships, and team behaviour & dynamics are considered properly. While these softer dimensions will perhaps deal with root cause, other symptomatic issues may also require even more time, attention and funding to get right – manufacturing practices, product quality, customer service, staff morale, brand and market perception. Bring a hard-nosed, objective mindset to this exercise, testing every assumption you are making: If the target wasn't able to solve their own problems, are you sure that you can? If customers have lost confidence in the proposition, can you rebuild it, and how long will it take? If your answers are not robust, tested, and clearly executable with a high likelihood of success, the best thing you can do for your business might just be to walk away.

- **Get visibility and control of costs from Day 1:** Establish new processes and responsibilities for payment authorisation, and set targets and clear responsibilities to reduce cash haemorrhaging from the business. Often the first problem is lack of visibility, so put in place simple reports to understand and monitor key areas of expenditure.

- **Understand and prepare for legal, regulatory and operational compliance issues from Day 1:** Distressed and bankrupt firms have typically underinvested in their business for some time, and this may have led to unintentional non-compliance in working conditions, production safety, etc. As the new owner, you will become liable for any such breaches from 'Minute 1', so this must take the highest priority in due diligence and planning. Furthermore, local legislation will dictate the validity of novated or transferred customer and supplier contracts, operating permits, and insurance coverage so ensure sufficient resources to investigate and action any gaps within the first few days post-close.

> ***As the new acquirer, you may be seen by some as wealthy enough to pay up without complaint, while others may genuinely not realise that you, as the new owner, are not bound by all the commitments made by the previous management.***
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> ***While these issues often are no more than minor financial irritants, such misunderstandings (real or invented) can sour new relationships just at the point when you need them to be at their best.***

- **Embed recovery into integration:** Develop a single recovery and integration plan using trigger points to link, e.g. brand transition with a demonstrable improvement in product quality; new strategies to be announced and launched by leadership teams; new objectives and incentive schemes to follow any necessary headcount reductions. This will help ensure that integration helps to raise the acquired business up rather than dragging your own business down.

- **Prepare for attempts to exploit the situation at your expense:** Some suppliers, customers, and even employees may take this opportunity to try to reset their commercial relationship with you, especially if they feel it will enable them to redress any real or perceived wrongs committed by the previous owner. We have seen suppliers quietly substitute pre-deal discounted terms or prices with 'new customer' rates; customers spot price differences between you and your newly-acquired ex-competitor, and automatically move to the lower price; and employees or unions resurrect grievances or negotiating points that the previous owner 'had promised to address next month'. In one case we even saw employees collectively sue their new employer within the first week for claims they had been unable to obtain from the previous owner.

  As the new acquirer, you may be seen by some as wealthy (or naïve) enough to pay up without complaint, while others may genuinely not realise that you, as the new owner, are not bound by all the commitments made by the previous management. While these issues often are no more than minor financial irritants, such misunderstandings (real or invented) can sour new relationships just at the point when you need them to be at their best. Which leads us nicely on to...

- **Plan your communications and engagement processes in detail before Day 1:** The unusual benefit of acquiring a distressed or bankrupt business is that, unlike a traditional acquisition, you typically start with a high degree of employee and customer goodwill: You have after all saved the firm from potential collapse and widespread job losses. However, this remains a sensitive, stressful and uncertain period for everyone, especially so for those within an organisation that may have been through, or on the brink of, insolvency for some time. Expectations of you as the 'white knight' will be very high, and will need firm but careful managing.

The decisions you take during your first few days as a new owner – what stays in place, what changes immediately, what will be considered later – will set the tone for everything that follows. Avoid the risk of being bounced into premature decisions by having an overarching integration/turnaround strategy and targets that can be communicated on Day 1 in a way that builds trust and credibility. People will understand and expect radical change, including any 'bad news' about restructuring and possible job losses, so deal with these issues as openly as possible. Provided you present this within the context of the wider vision for the business and the compelling need to do things differently in future, you can keep everyone on board with your plans, even those who will ultimately be leaving the business.

A hard but true rule: The greater the degree of previous management in the same roles post-close, the clearer the message that the new business is really not going to be all that different to the old one, albeit perhaps with a new name on the building.

- **Confirm the previous management team's individual roles in the new business as early and quickly as possible:** While these individuals usually have a significant amount of institutional knowledge about the business, and may hold some key relationships with customers and suppliers, some of them are also likely to be part of the problem.

  As tempting as it is to retain much of the existing management in place for as long as possible, most CEOs with whom we've spoken tell us that in hindsight it was the wrong long-term strategy. Rather than treat them as a group, work to understand each individual's capabilities, motivations, working style, relationships with their peers, and career aspirations. If they complement those of the new business and you feel they could play an effective long-term role in the wider organisation (ie outside the previous boundaries of the acquired firm), then consider them either in their previous position, or perhaps in a new one somewhere in your own organisation that still allows them time 'on call' to advise or support the transition. Others should be removed from the business either immediately or following a **short** transition period during which they can support integration and knowledge transfer, doing so in a clearly-advisory role, and if at all possible from a distance to avoid employee confusion around how to work with the 'new' boss when the 'old' boss is just down the hall.

  Avoid the transitional 'co-role' model for integration in which two individuals (typically one from each 'side' of the deal) temporarily share the same position within the business. Despite its use in some deals we've observed, and the good intentions underlying the practice, nothing confuses people more than having two individuals presented as, or even just perceived to be, in the same role. It slows down decision-making, encourages politics and in-fighting as supporters line up behind each trying to predict the ultimate 'winner', and in our view is no substitute for clear, definitive decisions made on if not before Day 1 to ensure crystal-clarity about responsibility and authority in the new business.

A hard but true rule: The greater the degree of previous management in the same roles post-close, the clearer the message that the new business is really not going to be all that different to the old one, albeit perhaps with a new name on the building – not a good start to recovery.

TRANSFORMING DISTRESSED ACQUISITIONS: EIGHT BETTER PRACTICES FOR ACQUISITION & INTEGRATION

1. Look beyond the immediate temptation to 'cover yourself' by conducting more exhaustive legal, financial and commercial due diligence
2. Get to the root cause, and symptoms, of the internal issues that led to the distressed sale, and design them out of the combined business
3. Get visibility and control of costs from Day 1
4. Understand and prepare for legal, regulatory and operational compliance issues from Day 1
5. Embed recovery into integration
6. Prepare for attempts to exploit the situation at your expense
7. Plan your communications and engagement processes in detail before Day 1
8. Confirm the previous management team's individual roles in the new business as early and quickly as possible

ABOUT THE AUTHOR

Carlos Keener is a specialist in M&A Integration, and the founder of Beyond the Deal, a business that provides acquisition and integration strategy, planning and execution support to clients worldwide. In addition to leading M&A and integration programmes, Carlos advises businesses on corporate and acquisition strategy; enterprise operating model design; integration strategy, planning and execution; and turnaround of poorly performing acquisitions.

Before establishing Beyond the Deal in 2001, Carlos was a senior consultant at PricewaterhouseCoopers, and a senior manager within Accenture's Corporate Strategy and M&A practice. Based in the UK, Carlos' work has taken him across Europe, the US, Africa, Latin America, the Middle-East, and the Far-East.

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