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An M&A BOOM IN BUSTED COMPANIES

A Nasty Postcript To the Broken Deal

Legal Aftershocks In Key Divestitures

When Bad Things Happen to Good Companies, Find a Buyer

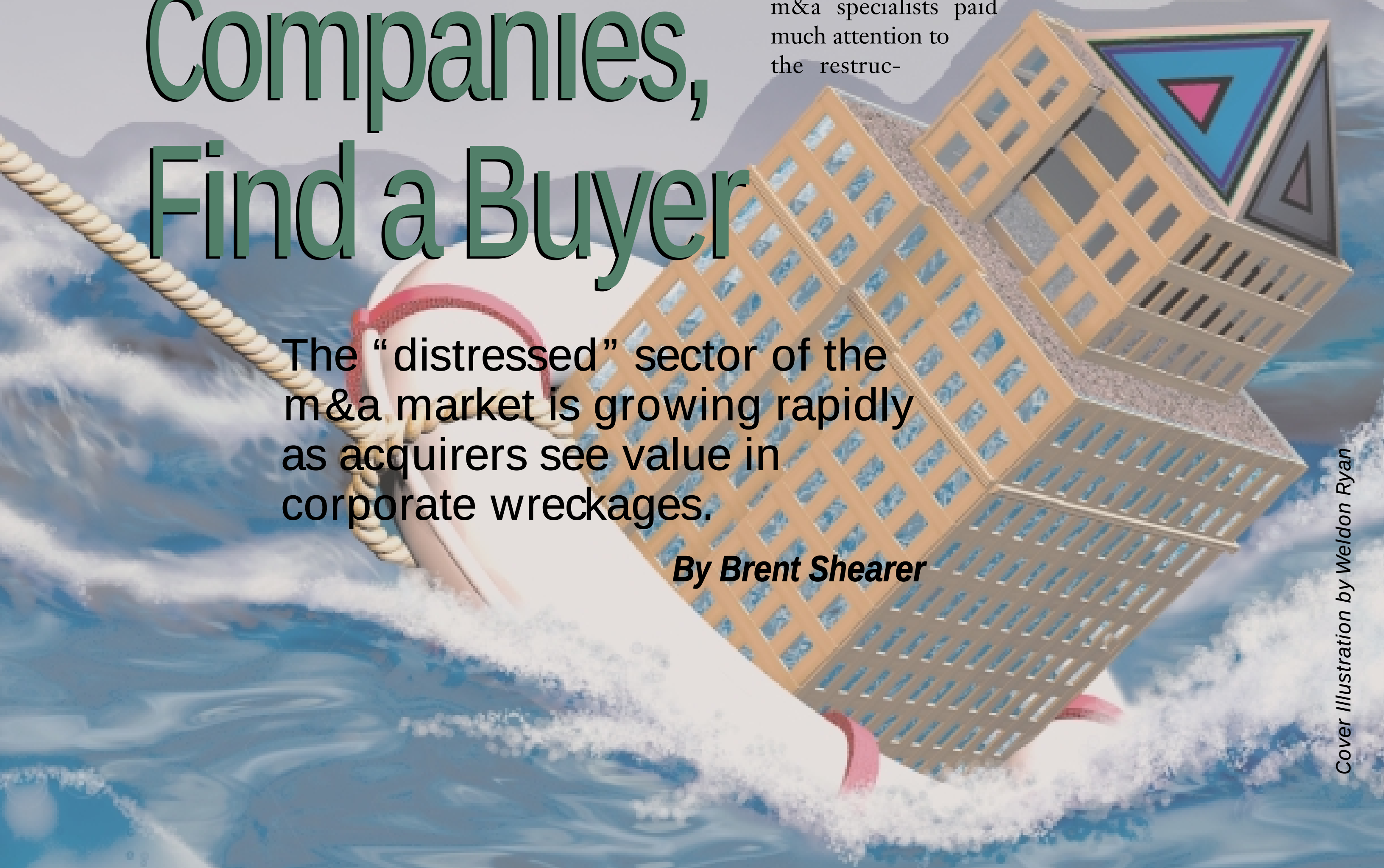
The "distressed" sector of the m&a market is growing rapidly as acquirers see value in corporate wreckages.

By Brent Shearer

"Doing a distressed m&a deal is like tying to sell an ice cube before it melts," says Henry F. Owsley, a principal at boutique investment bank the Gordian Group in New York. That being the case, there are a lot of ice cubes on the block in today's sagging economy and a lot of dealmakers struggling to unload them before intermediaries, investors, management, and debtors are left with little but a puddle to divvy up.

During the economic boom of the mid- and late 1990s, distressed m&a was a sideshow populated by such firms as Dresdner Kleinwort Wasserstein (the former Wasserstein Perella & Co.), Lazard Freres & Co., Houlihan Lokey Howard & Zukin, Blackstone Group, Rothschild Inc., and a few others. Most of Wall Street's powerhouse financial institutions don't take on distressed m&a work for a number of reasons ranging from the potential clients' financial constraints to conflicts of interest with creditors.

Few people outside of the fraternity of distressed m&a specialists paid much attention to the restruc-



Cover Illustration by Weldon Ryan

turing activities of firms that specialize in distressed situations — which often include m&a — when the Nasdaq was booming and the chase for IPOs and technology investments was the preferred path to riches. But this former wallflower of a sector now is enjoying its most robust level of activity since the economic slump of the early '90s.

"The increase in distressed m&a is a continuation of a trend we've been seeing for some time now," says Barry W. Ridings, co-head of restructuring at Lazard. "The trend is linked to the slowing of the economy, the tightening of credit, and a confluence of other events that make it close to a perfect storm."

In the film Ridings is referring to just about everything went wrong for a ship's crew. If you translate that kind of stormy weather into the adverse business conditions faced by many companies today, you have a picture of what is driving distressed companies to consider restructuring options. And m&a is an increasingly attractive option for restructuring distressed companies. While it may be hard to appreciate this perfect storm if your company is the one being battered and forced into Chapter 11, it has meant an up-tick in activity at firms that specialize in restructuring. But one difference this time around is that there is a larger group of potential acquirers.

"We're seeing a lot of more-traditional companies taking a look at buying troubled businesses," says David L. Resnick, who heads up Rothschild North America Inc.'s restructuring practice. In addition to this new class of potential acquirers kicking the tires of ailing companies, you also have the traditional bottom-fishers, or distressed investors, who see new opportunities as the number of distressed companies increases.

Can you say credit crunch?

The foundation for the distressed m&a revival is the tightening of the purse strings by lenders in the face of the highest rate of defaults on corporate debt since the last economic dip — the slump of the early 1990s. According to Moody's Investor Services, default rates on corporate debt have risen to levels not seen for nearly a decade, and they are projected to rise even further this year. The global default rate on high-yield bonds rose to 6% in 2000 from 5.1% in the preceding year. The rating agency forecasts a 9.1% default rate for 2001.

One result of this heightened default rate is an increase in pressure on lenders to get their money out of the weaker companies in their portfolios as quickly as possible. In addition to a sale, options for a sputtering company include refinancing the debt load, reorganization, and a workout plan.

"Because of the pressure that lenders are under, we're seeing that companies in trouble are often choosing to opt for a sale because lenders increasingly don't have the patience for any other restructuring option such as a reorganization, which can take as much as a year or longer," Resnick says.

One choice that distressed dealmakers say is out of favor now is the option to issue new equity in a stumbling company. "Reorganized equity is not as attractive as it once was as an exit strategy," says Andrew Rahl, a bankruptcy attorney at the law firm of Anderson Kill & Olick in New York.

However, an interesting wrinkle in today's distressed m&a market is that the tightness of credit cuts both ways. Not only are lenders short on patience but potential acquirers can also have trouble rounding up cash. "Financial buyers are at a disadvantage in today's distressed m&a market," says Andrew Miller, head of restructuring at Houlihan Lokey. "Many of them are being forced to equitize their deals more than they have in the past."

Tight credit has also led to an increased level of anxiety among bondholders in many cases. "In the last 12 to 24 months, we've seen an increase in the debt-holding community's willingness to get organized earlier in the process," notes H. Roy Stroube, III, a bankruptcy lawyer at Akin, Gump, Strauss, Hauer & Feld in Houston. He says he's seeing the formation of ad hoc debtors' groups even before the company goes into Chapter 11.

See you in Chapter 11

As more companies report earnings disappointments and other operational snafus, Chapter 11 becomes either a reality or at least a possibility for many companies that may be targets for a distressed deal. Indeed, Miller notes that most distressed deals get done in Chapter 11.

In conversations with a number of distressed m&a experts, *Mergers & Acquisitions* has heard many opinions about the advantages and disadvantages of selling a company while it is under the umbrella of court protection. Without belaboring readers with Bankruptcy Sales 101, a number of practitioners were willing to add their tips to the body of knowledge that exists on negotiating the rapids and shoals of Chapter 11 and ending up with a sale.

Stroube says that due diligence is vital in evaluating companies that are candidates for a distressed m&a deal, but added that the process differs from normal due diligence. "You have to be able to drill down deeper to determine the true going concern value of the enterprise," he says. Stroube cautions that since failing companies have far more "gremlins and goblins" on their books than healthy companies, getting a clear picture of a distressed company is harder.

Stroube also states that the due diligence process should include a going-forward component so that potential acquirers form a reasonable expectation of the reliability and the value of the company after it is sold.

In distressed m&a, time isn't on your side

It's all well and good to recommend thorough due diligence, but as a number of distressed specialists point out, you don't have much time in most distressed transactions. After all, the ice cube is melting.

Ridings says that "these companies all have chronic liquidity problems so everyone is in a rush to get a deal done." The afflicted company, usually one in Chapter 11, already is probably having trouble meeting its credit obligations. It may have impaired relationships with customers and may be faced with a rash of employee departures. As these negatives snowball, only quick and decisive action can get a deal done.

"In about one-third to one-half of our assignments, we get called in to rescue a deal after things have gone wrong," Miller says. "A lot of these companies are bleeding cash and we have to sell them quickly. We try to get the deals done in 60 to 90 days," he says.

The necessity of a short-term focus in most distressed situations means that the highest bid isn't necessarily the best one. "You fit your strategy to the circumstances you're dealing with," says Peter S. Kaufman, a principal at the Gordian Group. "Sometimes the certainty of getting the deal done is more important than holding out for the most money."

Miller noted that common failings of dealmakers who are new to the distressed arena include a lack of experience with bankruptcy law and creditor rights. As the parties try to structure the deal, management will be unlikely to have experience in selling assets from a distressed situation, so the need for experienced dealmakers to handle the process is vital.

But having said that, there is some overlap between what bankruptcy expert Rahl calls regular m&a guys and distressed specialists. "The best distressed m&a people are getting busy and we expect to see another wave of these deals coming to the fore this year," he says. "Some dealmakers can swing in and out of this area as it heats up."

But Rahl cautions that working in a bankruptcy environment, where most distressed deals occur, requires knowledge of a number of special rules that overlay the rest of the m&a world. "Unless the people on the deal know these rules and the people involved in enforcing them, they will have trouble working in this environment," he says.

Top 10 Ways to Screw Up A Distressed Transaction

10. Lousy, rushed due diligence
9. Inaccurate valuation
8. Paying too much for the asset
7. Lack of understanding of bankruptcy law
6. Lack of understanding of m&a basics
5. Inability to craft a pact that creditors can support
4. Selling common stock in a deal where the company is worth less than the underlying claims
3. Failure to account for liability overhang from previous operations
2. Putting in new capital and allowing it to be used for past sins
1. Selling healthy assets to try to save underperforming ones

A more crowded table for distressed deals

Whether a dealmaker is a distressed specialist or a generalist, he can expect one complicating factor when doing a distressed deal: more interested parties around the table. In most regular m&a deals you have the buyer and the seller only. In a distressed deal, you have those two parties plus representatives of different creditor groups. In some deals, there may be additional constituents. And if it is a Chapter 11 sale, the court will have to okay the results.

"The biggest difference between distressed m&a and regular m&a is that you have multi-party negotiations," Resnick says. Resnick adds that valuation is a key issue in these talks and determining it is not easy given the different viewpoints and interests of the multiple parties that are involved in the talks.

While valuation may be relatively cut-and-dried for a successful business, Miller says that it is much more subjective a measure for companies that are on the skids. "Because there is not enough value to go around, you have inherent conflicts of interest. Equity holders will have a different perspective than bondholders, management will have its own interests. That's why you need bankers who understand these competing claims," he states.

In the final analysis, distressed dealmakers cut the best deal they can, but practitioners don't expect to end up celebrating with the other deal participants. "In a conventional environment, an m&a sale is a good result for everybody and people go home happy. In distressed situations, there isn't enough money to go around and people usually have had to settle for less than they hoped to get," Owsley says.

So, not only does the distressed dealmaker have to make his pitch to an audience that isn't necessarily on the same page, he has to show why the enterprise is salvageable in the first place. "It's a lot harder to put a good face on a company that doesn't have profits," Ridings says. "You have to create a story to sell the company."

Another notable difference between distressed m&a and other types is that once the decision is made to sell, the seller has to go through with the transaction. "Usually in a distressed deal, the seller doesn't have the option of pulling out at the last minute," Kaufman says.

Where the action is in distressed m&a

Distressed m&a dealmakers say that they are getting assignments from a variety of sectors, but they note that industries that are highly leveraged and that run on low margins are particularly well represented on their client lists.

Rahl offered supermarket companies as an example of a difficult sale for distressed dealmakers because their assets are perishable. On the other hand, he says, gas and oil assets are easy to sell because the assets are easy to value.

Ridings says he is seeing more of what he calls "venture high-yield deals," which he characterizes as companies that raised capital via junk bonds based on a business plan that wasn't sound as opposed to companies that had an operating business. He says that telecommunication and media companies took on a lot of high-yield debt in 1997 and 1998, but have run into trouble as the economy has soured.

Another distressed m&a executive, John M. Collard, chairman of Strategic Management Partners in Annapolis, Md., describes the telecom industry as littered with companies that have half-built networks, no customers, and little choice but to try to sell their remaining assets.

Ridings notes that for many of today's failing companies the recipe for going into Chapter 11 includes compounding business risk with financial risk. "Once you do that, you greatly increase your chances of not making it."

Other conditions that can drive companies into the hands of distressed m&a advisers include an overhang of industry-wide liability, such as that which hit **Johns-Manville Corp.** and other asbestos manufacturers. A Chapter 11 sale is often the only choice for companies that have heavy liability exposure.

Bad management is another characteristic mentioned by restructuring specialists as a frequent creator of distressed opportunities. "Have you ever seen a company in financial difficulty that had good management?" Rahl asks. He says that in many distressed situations, management is part of the problem because they don't understand how they ran the company into the ground. Lacking that knowledge, they aren't likely to understand how to fix it.

One industry sector that isn't expected to play a big role in distressed m&a is the dot-com community. Distressed specialists say that there aren't enough assets at most failed dot-coms to worry about. But leaving the failed dot-coms aside, distressed m&a dealmakers are finding that their deal flow includes not only the many tech and telecom companies that have come crashing down but also a variety of old economy companies. In all, a broad spectrum of traditional industries that got into trouble for various reasons, including overbuilding (movie theater chains) and cheap foreign competition (apparel companies), are now a source of distressed deals.

Miller says that his firm is getting new clients from a number of sectors, including steel, textile, and paper companies in part because these industries are among those hurt by cheap imports. He also includes busted rollups, synergy plays that never developed synergies, service businesses, and distribution companies as areas that are contributing to deal flow at Houlihan. "We're seeing a steady flow of distressed transactions as creditors seek to monetize their positions through sales."

Among recent well-publicized distressed deals, Ridings mentions the **Trans World Airlines Inc.** sale as an example of a highly leveraged company that had problems but that still retained an attractive set of assets. In January TWA filed for bankruptcy; it was sold to American Airlines' parent company, **AMR Corp.**, in April for $742 million.

Vlasic Foods International Inc., the stumbling pickle maker, originally sold its condiments and barbecue sauce businesses to **H.J. Heinz Co.** for $195 million in late January. It then superseded that agreement with a pact to sell all of its North American businesses, including pickles, condiments, and barbecue sauce, to buyout firm **Hicks**, **Muse, Tate & Furst** for $370 million in April.

Why not pull the plug?

The payoff for acquirers in distressed m&a situations is that they can pick up assets cheaply. For debtors, a good sale is one that gets them out of the company with as much of their investment as possible intact. For the company, if the sale allows it to reorganize and start life over under new management, it will be deemed a success.

Rothschild's Resnick pointed to two transactions he was involved in as good examples of the value that can be created by distressed m&a. The acquisition by **Schlumberger Inc.** of **Cell Net Data Systems** was done at a significant discount to what Cell Net's assets had been worth. Cell Net produces electronic metering systems for the reading of utility service. In the deregulating utility industry environment, the concept had seemed promising, but the company failed to execute its business plan. Now Schlumberger has been able to broaden its offerings in its utility services sector by offering Cell Net products.

Resnick cites a distressed deal by a financial buyer as another example of a transaction that added value for both parties. **Key Plastics LLC** was able to continue operations and emerge from Chapter 11 after **Carlyle Management Group** bought it. Key Plastics, a maker of plastic components and subsystems for the auto industry, will be run by Carlyle.

An interesting aspect of the Key Plastics deal was that the acquirer's status as a financial buyer was an advantage. Resnick and other distressed specialists say that a strategic buyer usually is in a better position to do a distressed deal. But in the Key acquisition, this general rule was reversed. "Sometimes a financial buyer can be more flexible," Resnick says. Strategic buyers are more likely to want a clean balance sheet, while in the Carlyle Management/Key Plastics transaction, it was the private equity investors who put together the most compelling purchase plan.

But for both strategic and financial buyers, distressed transactions will continue to offer significant opportunities as long as credit remains tight and companies fail to execute their business plans. "Given the pressures on lenders and companies, we see distressed m&a taking place on a more accelerated timetable for the foreseeable future," Resnick says. ❐

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