Distressed M&A: You do not have to sell cheaply, but you must move quickly - Part 1

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While it is too early to know the full impact of Covid-19 on the economy, we are seeing that lockdown restrictions in South Africa are starting to have a significant impact on the bottom line of a number of companies.

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In the coming months, we expect to see more distressed mergers and acquisitions (M&A) resulting from companies being pressured by creditors to divest assets to pay down debt and avoid going into business rescue (or liquidation), or to fund ongoing operations.

How is distressed M&A different?

Except for the abbreviated timetable, distressed M&A is not too different from traditional M&A. However, distressed M&A comes with certain legal and commercial challenges for both the buyer and the seller. Some of these challenges include preparing the asset for sale in a short period of time, giving the buyer a reasonable opportunity to do a due diligence, bridging the inevitable valuation gap and quickly obtaining regulatory approvals.

In a distressed M&A, the seller must balance the need for speed against an inherently complex divestment process that usually takes longer than expected to complete. The buyer must mobilise resources to be able to execute quickly because the best returns are often made by acquiring good assets in an existing portfolio forced into a sale.

To overcome some of the challenges, the seller and the buyer should:

Have a strategy

The seller should take a disciplined approach to the divestment process. This involves developing a divestment strategy and mobilising a dedicated deal team to execute the divestment.

A divestment strategy should include:

- Preparing a **business valuation**. The business valuation should take into account Covid-19 related impacts to revenue (e.g. due to business interruption), expenses (e.g. reduced compensation, additional costs to support remote working, increased sanitation and safety costs) and liquidity (e.g. government incentives, customer and supply payment arrangements).
- Analysing **optimal deal structures** and, to the extent required, a **managed separation**. Tax structuring will play a key role. There may a need to enter into a transitional services agreement with the buyer for a fixed period post-implementation.
- Assessing the pros and cons of a compressed **auction sale process** versus a **single buyer process**. An auction sale process will take more time but is likely to result in a higher deal value due to its competitive nature.
- **Understanding key legal issues** that underpin the asset being disposed of (e.g. change of control provisions, B-BBEE requirements etc.) and **key regulatory approvals** required to implement the divestment. Understanding these issues will enable the seller to be forthright about any problems associated with the asset. This will help accelerate the due diligence and enable the buyer to price these problems instead of trying to regulate for these problems in the acquisition agreement.
- **Identifying the buyer.** A trade buyer (a buyer that operates in the same or similar market) may be willing to pay more for the synergies that can be realised from the deal but may give rise to greater deal complexity/uncertainty arising from the competition approval process. Financial buyers (such as private equity [PE] firms) may pay less but there is a higher degree of deal certainty. Some PE firms are keen acquirers of distressed assets.
- **Using technology** to undertake or complete parts of the divestment process in a post Covid-19 world. Face-to-face management Q&A sessions, all-night boardroom negotiations and travelling to conduct due diligences may no longer be possible. A large part of the due diligence process will need to be conducted remotely through virtual data rooms.

Be an early mover

Buying a distressed asset out of business rescue as part of a “pre-packaged buy-out” does not necessarily mean that the buyer is getting the best deal or buying at the best price. It may be more beneficial to acquire an asset from a company that is on the brink of financial distress rather than from one that has already entered the business rescue process.

The business rescue process takes time and the three-month statutory period within which to “wrap-up” the business rescue proceedings is often extended. Even though business rescue practitioners are using the business rescue process to put together these “pre-packaged buy-outs”, the courts have expressed reservation as to whether, as the primary objective, it is competent to use the process to divest of distressed assets as part of a managed wind-down. Any legal challenge to the basis for pursuing the “pre-packaged buy-out” will delay the divestment process further.

Other risks include limited contractual protections. For example, the business rescue practitioner will not give any warranties and indemnities to the buyer. The buyer will not be able to insure itself (in the form of W&I insurance) against the risks associated with the asset. Because the protection offered by warranties and indemnities is curtailed, the buyer will need to undertake a comprehensive due diligence which is both time consuming and costly.

Therefore, while a buyer may be able to acquire a good asset at a significantly discounted price through the business rescue process, a buyer would need to consider whether it is better to acquire the asset inside or outside of the business rescue process.

A buyer and a seller should both make use of an experienced legal M&A restructuring team to help them navigate this complex aspect of the distressed M&A process.

In part 2, we'll discuss fair and flexible pricing mechanisms, MAC conditions, due diligence, and regulatory approval.

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