

# Acquiring a distressed company

A Guest Article by Marcos Theodosiou  
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### **Ten reasons to sharpen due diligence**

Most commentators would agree that the road out of recession is likely to be long and winding. A prolonged downturn is likely to bring about increased sector consolidation and, as such, a fair chunk of acquisitive activity in the next 12-18 months could well involve companies in some form of financial distress.

In this economic climate particularly, some acquirers may decide to forgo or limit full financial due diligence (FDD) on a distressed target. Their reasoning is to minimise their acquisition costs, or to respond to a tight timetable.

However, acquisitions of distressed companies are riddled with complexities and risks that, if not properly assessed, could be very damaging to the acquired business – and, in the worst case, detrimental to the acquirer. In order to identify these risks, due diligence teams need to possess particular skills, including a sharp eye, a keen sense of smell and the determination to stay on the trail wherever it leads, just like a bloodhound!

Drawing on our own first-hand experience of such assignments, we set out below ten reasons why FDD now needs to be sharper and more flexible than ever.

#### **1. The downturn can cloud the impact of other commercial issues**

As most companies have been affected by the recession, it is now more difficult to distinguish between companies whose woes can genuinely be explained by the economic climate and companies dealing with more fundamental issues/factors. The FDD process needs to understand the external forces affecting the business and distinguish these from specific internal factors affecting the business.

In a recent review, the management team attributed the recent demise of their business to falling sales, caused by the recession. However, this failed to acknowledge the unfavourable terms of business agreed with a key customer, which allowed the return of large quantities of unsold stock.

In a similar manner, the recession could be used to explain other failings that in reality stem from poor management, customer service issues, product faults, contractual disputes with key customers and suppliers, raw material/input pricing trends, and strategic aspects of the business. Therefore, any explanation that places the responsibility for poor performance on the recession needs to be scrutinised.

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### **2. Increased likelihood of customers or suppliers failing**

Any acquisition during the recession will need to carefully consider the extent of reliance on key customers and suppliers. The demise of Woolworths had immediate and, in some cases, detrimental effects on the retailer's supply chain. This demonstrates how an otherwise sound business can be dragged down by the downfall of a key trading partner.

The FDD process needs to make specific enquiries as to the company's reliance on any third parties. There are sometimes clear indications of problems, as was the case in a recent review where a key customer was regularly falling behind with its payments.

Further investigation revealed that this customer was part of a larger group facing significant financial pressures. This is clearly a vital issue for an acquirer, as the business could lose a key customer after it is acquired.

The FDD needs to be able to spot indications that a customer or supplier is experiencing financial problems. Some indicators are obvious – for example, reduced external credit ratings.

But in many cases the signals are more subtle. These include aggressive price pressures from customers and suppliers, a lack of communication, press releases and market rumours.

### **3. Pressures on the business could trigger the termination of key contracts**

Cash flow pressures may compel a company to breach key terms in its contracts with customers, suppliers or lenders – for example, payments falling outside agreed terms or a failure to meet agreed service levels.

There are many examples of suppliers and lenders being supportive during difficult trading periods. However, there are also cases where suppliers have taken the decision, or in some cases the opportunity, to terminate their supply agreements altogether on the grounds that the company has breached its contractual terms.

An acquirer would need to ensure that the company is still operating with the support of key customers, creditors and lenders. Otherwise it may be the case that the business is not sustainable.

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### 4. Working capital deficiencies would necessitate additional funding

Recent financial difficulties have created cash flow pressures for companies and many management teams have had to resort to tighter working capital management as follows:

- Trade debtors' collections have been accelerated through tighter credit control. There may be a sustainable working capital improvement if customers are now paying in line with agreed terms. However, there are cases where customers have paid earlier, as a favour to a supplier, and would expect to return to normal credit terms in the future.
- The company has extended its payments terms with creditors, who may have been assured that payments will eventually return to normal credit terms.
- Stock levels have been run down in recent months and as the recession eases, the company will need to build up stock to accommodate increasing sales.

Generally, if working capital is stretched, then the acquirer would need to make allowance for any additional cash needed to supplement working capital levels post acquisition.

Quantifying the extent to which working capital is stretched will most likely require a review of the company's current trading and latest financial projections – an exercise best undertaken by an FDD specialist experienced in reviewing detailed financial projections.

### 5. Built-up creditor arrears could jeopardise the viability of the acquired business

More aggressive cash flow management is often necessary during the recession and can be a very effective way to ease cash flow pressure. However, distressed companies are likely to have delayed payments to creditors without obtaining the creditor's consent to do so.

Given that any creditor with an undisputed debt of over £750 can initiate a winding up petition, the FDD needs to specifically identify any creditor arrears that have been formally demanded from the company.

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In some cases, creditor arrears will need to be settled pre or post acquisition in order to ensure that the business is not wound up. These payments will need to be factored into the cash flow forecasts of the business, so sufficient allowance needs to be made for this cash requirement.

Where creditors are significantly exposed and may also have fixed or floating security over the assets of the company, then the acquisition could not proceed without full consideration of the creditor's position and their intentions.

The acquisition may still be possible with a buy-in from creditors. However, another scenario is an insolvency procedure, which opens up the possibility of a pre-packaged administration or the purchase of the business after it enters into administration.

### **6. Adequacy and continuity of credit insurance cover**

Certain companies (particularly those in manufacturing) rely on credit insurance for continuation of their business. The FDD team would need to consider the impact of the acquisition on the credit insurance cover, i.e. will the acquired company be sufficiently capitalised so that it can maintain its credit rating?

Credit insurers are also likely to be focused on the company-specific financials and may not consider the overall capital structure of the wider group. For example, any new loans from a parent company could have an adverse impact on the business from the credit insurer's point of view, even though it results in the company having access to additional funds. In contrast, an equity injection from a parent company could be more favourable for credit insurance purposes.

### **7. Personal financial pressures on directors**

Personal financial pressures, and the knowledge that the alternative to the acquisition is a potential insolvency, may create incentives for the management team to overdress historical or forecast financial performance or other aspects of the business. Properly drafted warranties will, to some extent, protect the acquirer. In practice, however, they may be costly and very time consuming to pursue in full.

An experienced FDD team will be mindful of such pressures on management and will undertake additional work to confirm information/forecasts that are material to the acquirer's valuation of the business.

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### **8. Undercurrent of opposition may derail the acquisition process**

In certain scenarios, the acquirer may be contending with a hostile management team, particularly where the acquisition is likely to lead to some headcount reductions.

The FDD team may have to deal with an undercurrent of hostility to the acquisition that, though not evident to the acquirer, has the potential to derail even the most commercially sensible transactions, e.g. where management are promoting their own agenda by providing only select information.

The FDD team will need to identify any potential for hostility to the acquisition and then act to mitigate the effects by addressing management's issues, by involving other employees or by invoking assistance or pressure from other stakeholders.

### **9. Skeletons may be exposed ... and buried**

A distressed situation is sometimes the catalyst that exposes internal issues, e.g. weaknesses in financial management and internal bookkeeping, strategic/commercial issues or, in the worst case, fraud.

As some of the recent high profile cases (Madoff, Stanford) have shown, the downturn can expose alleged wrongdoing. The FDD process does not, as a rule, set out to specifically identify fraudulent acts. However, it is possible that the FDD team could, in the course of its review, encounter indications of foul play. It is imperative that the FDD team is mindful of any signs, such as inconsistent answers to questions, and is persistent in obtaining satisfactory explanations.

In a recent review, some gaps in the historical financial information could not be fully explained by management and the review team continued to probe into management's explanations. Eventually the review identified that the directors had an ongoing dispute between them regarding the amounts they had drawn out of the business, with both directors claiming that the other director had defrauded the business.

This was a skeleton with severe implications, as the company was facing future legal costs, additional potential tax liabilities relating to director's remuneration, and also ongoing disruption to its operations.

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Unfortunately for acquirers and lenders, the economic downturn also gives wrongdoers a unique opportunity to bury their skeletons for good under the guise of an insolvency procedure. Although it is possible for an administrator or liquidator to pursue directors where there has been a fraud, in practice directors may take the chance, knowing that most administrators cannot pursue a forensic accounting route unless there are clear grounds that this will be successful and that the cost of this investigation will not be detrimental to the creditors.

A due diligence review on an acquisition out of a pre-packaged administration therefore needs to consider the true reason for the demise of the business and whether this has any implication for the potential acquirer.

For example, if a customer has been over-charged in the past, then they may potentially seek to make recoveries from the new owner of the business, using their continued custom as leverage.

### 10. Tight timescales require more flexibility and faster execution

Acquiring a company from a distressed vendor or acquiring a company that is itself distressed often means that the time available to complete the transaction is extremely short.

There is a need to move quickly to sign a sale and purchase agreement and often limited time to perform FDD on the target – sometimes only a few days. Acquirers are often relying on their own or their management team's sector knowledge to understand the business before putting pen to paper.

Any FDD exercise will need to deal with limited information, a lack of management availability and, in some cases, it will need to be conducted under strict exclusivity/confidentiality arrangements. There is often no time for repeat meetings for the purposes of clarifying information or for elaborate analysis to be performed by an army of junior accountants.

In this environment, the traditional "tick the box" FDD approach is ineffective. The FDD needs to be delivered with flexibility and it needs to be focused on the most critical potential risks for the acquirer.

On a practical level, this means maintaining the emphasis on key risks, asking the right questions, and isolating those specific facts that impact on the acquisition. The acquirer will need to be kept informed of all developments on a daily basis.

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### The attributes of the ideal FDD team

In view of the above, the ideal FDD adviser or team for a distressed transaction will need to have:

- an understanding of the sector and the market dynamics affecting the business
- a top-down or risk-based approach to due diligence, which means the ability to work quickly through information at a high level and then review detail only where deemed necessary to address a key issue or risk
- the ability to work with incomplete information and accounting records, which requires solid technical skills
- excellent interpersonal skills, including questioning skills and the ability to focus management's attention on the information being requested
- the mental stamina to work in a highly pressured environment and to tight deadlines
- appreciation of the stakeholder pressures that a distressed company faces and an understanding of insolvency procedures.

The above mix of skills is not necessarily the mix that most FDD teams have, particularly if they were formed during less testing times characterised by robust growth, happy management teams and very accommodating bankers. Many consultancies have already supplemented their FDD team to address the specific challenges of the recession, which is good news for companies and acquirers of distressed businesses.

The FDD process is now more important than ever and the acquirer is responsible for selecting a suitably equipped FDD team to do the job. Acquirers that do this well will ultimately give themselves the best possible chance of success.

*Marcos Theodosiou*  
*Associate Director – Vantis Corporate Finance*

If you would like more information on any of the points covered in this Guest Article, please contact **TCii** on **020 7099 2621**.