Sustaining Value in a Changing Economy—Audio Podcast Series Part 4: Managing Acquisition Opportunities in a Distressed Market

KPMG LLP

This transcript is based on a KPMG and *Canadian Business* audio podcast which can be heard at www.sustaingvalue.com.

Jared Mitchel: Welcome to the 4th in a series of podcasts on sustaining value in a changing economy presented by Canadian Business magazine and KPMG Canada. I'm Jared Mitchel. This series looks at the consequences of current global economic upheaval, the effects on business of tightening capital markets, foreign currency fluctuations, volatile energy prices and rising global competition. In this podcast we'll be speaking with Michael Creber, partner in KPMG's advisory services on the subject of making effective acquisitions. Michael, welcome.

Michael Creber: Thank you for having me.

Jared Mitchel: These are difficult times for business. Are they necessarily bad though?

Michael Creber: Jared we see opportunities arising. The economic slow down and what the press has termed the credit crunch has resulted in two effects on the market place. The first one we've seen is that there's an increased number of stressed an distressed entities and the second thing we've seen is that business evaluations have been decreasing. While that appears to be rather negative on the surface it does create opportunities. It creates opportunities for stronger companies to grow by acquisition and it creates opportunities for investors to participate in consolidation. Industry consolidation, along the lines of the North American Steel industry over the last few years. Investing in distressed companies can produce oversized returns if risk can be managed.

Jared Mitchel: Well how is that possible that you're having oversized returns in what was clearly a distressed market?

Michael Creber: There are a number of reasons, let me give you just one. First of all when you deal with distressed companies there are unique opportunities to enhance value or release hidden value that are more difficult to reach when you're dealing with healthy companies. For example, it's quite usual for companies in distress to have significant tax losses or tax shelter pools that are unavailable for their use because they are losing money. A buyer, if structured properly, can preserve and utilize those losses post acquisition.

Jared Mitchel: Are you at KPMG seeing any difficulty for buyers in raising funds to making acquisitions at this time?

Michael Creber: There's no question that credit conditions have tightened and liquidity is less ample then it was historically, however we are seeing two trends in the marketplace. One, we're seeing the distressed funds of which there are a number in Canada and numerous in the US who have been sitting idle on the sidelines for the last few years re-enter the market and become much more active. Second of all we've seen increased activity by strategic buyers who have the ability to bring industry experience to acquisition opportunities. We are finding that there is funding available in Canada for properly thought out and well structured deals.

Jared Mitchel: Now, distressed companies, are you talking about the sort of companies you would find that are have gone into formal insolvency?

Michael Creber: Well Jared there are obviously various levels of stress and distress in the market place.

And it's like a continuum from early stage losses and cash restrictions to actual formal insolvency proceedings. It's important for a buyer to understand where in that continuum his target is. It will effect a number of things, primarily the timeline. Clearly if you got the targets going to run out of funding in a few weeks the timeline's very short. It's going to affect the parties at the table if it's become evident that the companies insolvent there can be more stakeholders interested in preserving their rights and maximizing their recoveries. They'll be at the table more often and finally they affect the process, whether it's a private negotiation or it's a formal auction through bankruptcy process.

Jared Mitchel: Do you find that there are different characteristics between uh healthy companies and ones facing distress when it comes to buying them?

Michael Creber: There are different priorities of the stakeholders. Clearly if

somebody's having a liquidity problem and they're apt to run out of cash in the near term, then the timeline and certainty of closing is important.

Jared Mitchel: So you really need to know what the condition of the company you're, you're thinking of acquiring is what the condition is before you act on it. How should you approach any company that's in distress?

Michael Creber: There are a number of steps obviously, in trying to culminate a transaction with a company or particularly a distressed company. Let me highlight a couple of areas which are should be focused on if it happens to be a distressed situation. One is understand the players and their motivations. The motivations will change and more players will be at the table. Some examples obviously are the union which will have a bigger seat at the table, we can use Stelco as an example of that. If you happen to be a retailer whose ended up in financial distress you'll see landlords have a bigger say in a transaction etc. It's very important to understand people's motivations so you can try and craft your offer to satisfy as many of those concerns as you can. A second area is, understanding the problem and developing a solution. By nature if a company is distressed it has a fundamental problem. Understanding what that is whether it be an industry issue, whether it be a structural issue, whether it be undesirable contracts that were entered into, it's very important to come up with a solution. If the transactions culminated, it's important to execute that solution immediately to stop the cash bleed.

Jared Mithel: Just to go back to something you said a few minutes ago, what are the differences in motivation between key players in a distressed company?

Michael Creber: When dealing with a healthy company, generally you're dealing mostly with the shareholders board directors and management. The other stakeholders are comfortable with their position and while they'll be watching it they're not loud or at the table as frequently. When you get into a distressed company those players become very concerned about their contracts, about their future, about their recoveries and they will want if a more active participation. They'll want a more certainty of close, price, always important, but it moves down a little bit. It's important to get the company back on its feet.

Get the liquidity in the company and get a turn around plan in place as quickly as possible.

Jared Mitchel: What are the risks in purchasing these, these kind of distressed enterprises?

Michael Creber: There's obviously the risk of being of not being the successful bidder. Significant time and energy can be spent ah money can be spent in attempting to be the successful purchaser of a distressed company. And obviously you'll want to mitigate the likely of it being unsuccessful and getting no value for your efforts. The second risk is risk of failure to create the value that you anticipated. So you're the successful bidder but you didn't create the value. That is obviously a non-satisfactory result.

Jared Mitchel: Is there a way that those risks can be mitigated?

Michael Creber: There are a number of ways to mitigate the risks. The keys as we see them, are as follows.

To try and mitigate the risk of having an unsuccessful closing as I said before, it's very important to understand the key players, their motivation, and craft your deal to address them. The second method of mitigating is to select your entry point. There are a number of ways to enter into the process.

It can be through purchasing existing securities, it can be through private negotiations, it can be through equity investments, or it can be actually waiting and going through a formal auction type process and insolvency. Selecting the appropriate entry point will mitigate your risk of failure by allowing you to increase your ability to control the process yourself as the buyer.

Jared Mitchel: We've been talking with Michael Creber, a partner of KPMG's advisory services on managing acquisitions in a time of economic distress. Listeners are invited to read more about this subject in the January 26th 2009 issue of Canadian Business magazine. You can hear all the podcasts in this series by going to canadianbusiness.com/kpmg. I'm Jared Mitchel, for Canadian Business and KPMG.