

# Unlocking value in difficult situations.

DISTRESSED M&A



## Distressed M&A toolkit

**COVID-19 and the resulting economic instability will have an adverse effect on some businesses for months, and potentially years, to come. For private equity investors and other financial sponsors, this will create opportunities to acquire good assets (which may be in need of short/medium term financial support) at attractive valuations. Distressed transactions have their own rule book. Bidders should be ready to leverage the opportunities this presents and prepared for the challenges thrown up by what are often fast-paced, complex deals.**

### Structuring the deal

#### Who holds the keys?

Understanding the interests and motivations of the broad range of stakeholders is essential. Senior and junior lenders, equity investors, management, pension scheme trustees, landlords, trade creditors, unions and regulators can all play important roles in facilitating (or frustrating) a transaction.

It is important to get a handle on valuation, where the value breaks in the target's structure and, as a result, which stakeholders have a seat at the table early.

#### Bridging the gap

Whilst the likely medium/long term impact of COVID-19 and the resulting economic uncertainty remain unclear, negotiations around valuation will often reveal a mis-match between exiting stakeholders' expectations and what prospective bidders are willing to pay.

Sellers and administrators will tend to favour maximum value upfront, but, by way of example, the circumstances of senior lenders can give rise to a departure from that general rule. It may be possible for incoming equity investors to desire a structure where lenders can help bridge the value gap by 'rolling over' value into the new structure (at a better notional rate of recovery than would be the case on an upfront cash deal).



#### Making use of the tools at your disposal

Deal structure is likely to require careful thought early in the process. A share acquisition will often offer the seller the best chance to preserve value (e.g. by avoiding the need to move key contracts), whereas a business and assets sale may allow the buyer to cherry pick the assets it wants and leave certain liabilities behind.

The ability to leave liabilities behind can help to minimise the risk of the unknown and can narrow the scope of the buyer's due diligence exercise. It is important to remember that some liabilities (e.g. employment liabilities) cannot be left behind and will need to be priced in. Formal insolvency procedures can also be used to facilitate a transaction by allowing the target's liabilities to be right-sized whilst limiting some negative impacts of insolvency on a viable business. Key examples in the UK include:

|   |   |
|---|---|
| <b>Pre-pack administration sale</b>               | Allow business and assets sales of an insolvent business to be executed on an accelerated timetable and completed simultaneously with the appointment of the administrators. This minimises value destruction through a low profile, seamless transfer to a buyer.  |
| <b>Holdco administrations</b>                     | Can provide a route to clear-out the existing equity/debt structure by placing the holding company structure into administration (e.g. where existing investors/lenders are unable (or unwilling) to recapitalise the business) to facilitate a solvent sale of the operating business (which continues to trade normally). |
| <b>Company Voluntary Arrangements (CVAs)</b>      | Can be used alongside a solvent sale to right-size the business' liabilities as a condition to a solvent transfer.  |
| <b>Schemes of arrangement/restructuring plans</b> | Allow secured and other dissenting creditors to be crammed down to facilitate restructuring of the target's balance sheet and/or equity.  |
| <b>New free-standing moratorium</b>               | Allows the target to buy time and breathing space to execute a solvent sale or restructuring.   |

It is worth remembering that 'solvent' sale processes or exercises designed to attract new investment which are embarked upon in good faith at the outset can quickly erode and give way to accelerated M&A exercises and ultimately to pre-pack administration sales.



**The clock is ticking**

Distressed deals normally necessitate a severely truncated timetable. Bidders need to be prepared move quickly (and to commit costs early to address difficult due diligence and structuring issues). Prior knowledge of the target business and/or the wider sector will allow bidders to take a risk weighted approach to key issues.



**Diligence – often difficult, but remains key**

Compared to a solvent sale process, the information available to bidders on a distressed deal will often be limited in scope and quality, particularly due to the accelerated timetable and an often underprepared and resource constrained target.

Despite these challenges, targeted DD which focuses on key risk items is crucial (particularly because contractual protections are likely to be limited – see below).

Issues like change of control provisions/consents to transfer (in key leases or contracts), TUPE, material liabilities (e.g. litigation or pension obligations) and regulatory approvals can all drive transaction structure – so identifying problem areas early is key.



**Minimal protections**

Insolvent sales are conducted on a buyer beware basis with limited or no contractual protections for the buyer. On administration sales the buyer will also be required to provide indemnities in favour of the administrator in respect of potential liabilities to the administrator arising from the transfer. Even where a solvent sale is possible, limited equity proceeds are likely to mean that in practice the buyer is left with little recourse against the sellers under the transaction documents.

Bidders, therefore, need to be prepared to price in material risks (or potential risks). Good due diligence, a detailed plan on transaction structure and background knowledge of the target and the wider sector will put bidders in the best position to do this.



**W&I**

Given limited contractual protection is likely to be available, buyers are increasingly looking to W&I to help bridge the gap on distressed deals. A conventional W&I policy should still be the preference where possible (i.e. where there is a management team who are willing and able to give warranties, even on the basis of a £1 cap, and undertake a disclosure exercise) because it is likely to offer the broadest cover.

In more challenging situations a synthetic W&I policy (where the insurer itself gives the warranties under the policy) may be available. A synthetic policy is likely to be more expensive and will offer less cover because of the limited nature of the disclosure available and the absence of anyone to stand behind the warranties (even in the case of fraud).



**Hidden costs**

Bidders should beware of hidden costs, such as ransom payments demanded by essential suppliers and post-transfer tidy up costs. They should look to identify historic liabilities owed to critical suppliers to the business who cannot be replaced post-completion and be prepared that payment of those liabilities may be the cost of ensuring ongoing supply.



**The equity deal**

Striking the right deal on equity terms with the management team will be key to creating new alignment and incentivising growth. With distressed businesses, buyers are likely to favour mechanisms which will incentivise a strong post-COVID-19 recovery (e.g. ratchets (as opposed to large up-front sweet equity allocations)). Consideration should also be given to investment cost noting that the incumbent team are likely to receive limited/no proceeds and, as a result, may have limited amounts to invest.

Given the increased risk profile of a distressed transaction, downside protection is likely to be a big point for incoming financial sponsors. Sponsors (particularly on minority or portfolio deals) are likely to seek to put in a significant proportion of their investment on a prior-ranking basis. Having the right under-performance triggers and step-in rights will also be key in the event of further distress.

Depending on where the value breaks outgoing sponsors are sometimes asked to roll-over some of their value. Where this is the case, it is important to make sure that the rights attached to this are appropriate and don't frustrate the incoming sponsors ability to drive the bus going forward. On other occasions they may receive an anti-embarrassment slice of equity in return for a cooperative approach when their interests are otherwise fully out of the money.



**Regulatory clearance**

The fact that the target is distressed will not remove any requirements for regulatory approval. Given that it will often take weeks or months to obtain clearances (depending on the regulatory regime and jurisdiction), this can be make or break for a target which is in urgent need of financial support. Bidders and their advisers should establish as early as possible whether clearances are required and, if they are, whether or not it is possible to obtain derogations from mandatory pre-closing filings or otherwise access expedited processes for clearance. Where merger control clearance may be required, an absence of substantive overlap is likely give financial sponsors a clear advantage over trade acquirers in a distressed process.

Relevant experience

AZZURRIGROUP

Azzurri Group and its joint administrators on its sale through administration to US investment firm TowerBrook Capital Partners

GIRAFFE

The operating company of the Giraffe Restaurants and Ed's Easy Diner brands, on its company voluntary arrangement

carpetright.

Carpetright on its CVA and rescue fund raising, followed by their delisting and takeover by a major shareholder via a scheme of arrangement

LAURA ASHLEY

PwC as the administrators of noted homeware and fashion retailer Laura Ashley on the sale of its brand to US restructuring and investment firm Gordon Brothers



Powerleague Fives Limited, a leading sponsor-backed provider of 5-a-side football facilities, on its company voluntary arrangement

AUSTIN REED

Alteri Investors on the acquisition of the outstanding shareholder loan notes and the entire share capital of the ultimate holding company of clothing retailer Austin Reed



Looping Group on its acquisition of iconic British theme park Drayton Manor in a pre-pack administration process



YGM Group in relation to its acquisition of the clothing retailer Aquascutum out of administration



Itsu, the grab and go sushi chain, on its company voluntary arrangement

Key contacts



**Paul Dolman**  
Co-Head of Corporate,  
Head of Private Equity & Financial Sponsors  
paul.dolman  
@traverssmith.com  
+44 (0)20 7295 3274



**Lucie Cawood**  
Partner, Private Equity & Financial Sponsors  
lucie.cawood  
@traverssmith.com  
+44 (0)20 7295 3468



**Kirsty Emery**  
Senior Associate, Restructuring & Insolvency  
kirsty.emery  
@traverssmith.com  
T: +44 (0)20 7295 3371



**Emma Havas**  
Partner, Private Equity & Financial Sponsors  
emma.havas  
@traverssmith.com  
+44 (0)20 7295 3294



**Peter Hughes**  
Partner, Restructuring & Insolvency  
peter.hughes  
@traverssmith.com  
T: +44 (0)20 7295 3377



**Ian Keefe**  
Partner, Private Equity & Financial Sponsors  
ian.keefe  
@traverssmith.com  
+44 (0)20 7295 3303



**Genevieve Marten**  
Partner, Private Equity & Financial Sponsors  
genevieve.marten  
@traverssmith.com  
+44 (0)20 7295 3387



**Adam Orr**  
Partner, Private Equity & Financial Sponsors  
adam.orr  
@traverssmith.com  
+44 (0)20 7295 3267



**Edmund Reed**  
Partner, Private Equity & Financial Sponsors  
edmund.reed  
@traverssmith.com  
+44 (0)20 7295 3286



**James Renahan**  
Partner, Private Equity & Financial Sponsors  
james.renahan  
@traverssmith.com  
+44 (0)20 7295 3466



**Natalie Scoones**  
Senior Associate, Restructuring & Insolvency  
natalie.scoones  
@traverssmith.com  
T: +44 (0)20 7295 3466



**Edward Smith**  
Partner, Restructuring & Insolvency  
edward.smith  
@traverssmith.com  
T: +44 (0)20 7295 3482



**Ian Shawyer**  
Partner, Private Equity & Financial Sponsors  
ian.shawyer  
@traverssmith.com  
+44 (0)20 7295 3269



**Will Yates**  
Partner, Private Equity & Financial Sponsors  
will.yates  
@traverssmith.com  
+44 (0)20 7295 3460



**George Weavil**  
Partner, Private Equity & Financial Sponsors  
george.weavil  
@traverssmith.com  
+44 (0)20 7295 3392

Travers Smith LLP is a limited liability partnership registered in England and Wales under number OC 336962 and is regulated by the Solicitors Regulation Authority. The word "partner" is used to refer to a member of Travers Smith LLP. A list of the members of Travers Smith LLP is open to inspection at our registered office and principal place of business: 10 Snow Hill, London EC1A 2AL.