TRENDWATCH

Forecast on Distressed M&A: The Shape of the Economic Recovery

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The obvious distinguishing feature of the current recession is speed—speed of the fall and the apparent speed of the recovery. But it remains to be seen whether the recovery takes the "V" shape some economists predict or the bumpier, up-and-down "W" model hypothesized by others.

Four key economic factors characterize distressed M&A in the current recession:

> **1 - No Liquidity**: A scarcity of acquisition financing for even thriving businesses means no leverage to support distressed deals;
>
> **2 - No Bottom**: Nobody likes to buy when the market has not yet bottomed out;
>
> **3 - No Buyers**: To maximize ROI, financial buyers (hedge funds and private equity firms) generally include debt financing in their acquisitions. Poor liquidity distorts the debt to equity mix and uncertainty about the bottom of the recession reduces a financial buyer's appetite for distressed M&A. Conserving resources in case their own businesses are jeopardized, even strategic buyers with cash will avoid the distressed asset market;
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> **4 - No Rush by Creditors**: Where a business' troubles are bad but not critical, secured creditors may decide not to trigger enforcement level defaults. Instead they might choose to exercise patience, putting the business on "life support" under forbearance terms, discouraging discretionary capital expenditures and enhancing monitoring.

Observing a variety of recent troubled situations, we have identified at least two "stages" in the evolution of the distressed M&A market and one anticipated stage yet to come. While not cleanly separated or clearly identifiable, the first two stages suggest a general trend and provide insight into the third.

Stage I: No Deals

Once the 2008 financial crisis had hit the U.S. and then Canada, and for many months following, virtually no distressed businesses were sold as "going concerns." Liquidation scenarios were equally grim, with liquidators passing on entire asset classes.

A decline in regular M&A in both countries was expected, but the absence of a robust distressed M&A market was not. With no market bottom in sight into the first quarter of 2009, even liquidators and buyers with coffers of cash were reluctant to move on distressed targets, as were

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financial buyers (hedge funds and private equity firms) who look for debt financing as part of their optimal mix. Also, many creditors and lenders assumed a wait-and-see position, rather than triggering enforcement on troubled businesses. Private M&A processes run by debtors failed due to a scarcity of buyers and financing. Distressed acquisition funds were forming, but not fast enough to address early troubled situations. The result: buyers were holding out for a fire sale, but nobody was selling.

Stage II: Bottom in Sight, Limited Liquidity, a Few Buyers and Secured Creditors Starting to Lose Patience

In this stage, current as of this writing, distressed acquisition funds and strategic buyers might consider distressed businesses that are market leaders or niche players. Strategic buyers with war chests are well-positioned to turn struggling businesses around, having rationalized their own. Troubled entities are selling, but in relatively small numbers. With buyers focused on businesses that complement their own, deals remain hard to close and prices low.

It remains to be seen whether the recovery takes the "V" shape some economists predict or the bumpier, up-and-down "W" model hypothesized by others

The rise of the equity markets ahead of the grassroots economic recovery has created a price expectation gap. Where the price exceeds available financing, the buyer must increase the equity component of the deal, negotiate a lower price, find another source of financing, or abandon the process. In some cases, existing lenders to a distressed target will roll their debt to avoid driving an even lower price, and then provide new management and fresh working capital to help the business weather the storm.

With trouble continuing to plague creditors, insufficient liquidation values to drive "going concern" sales and few buyers, Stage II is not conducive to a high volume of distressed M&A activity.

Stage III: The Future: Exiting the Recession, Increased Liquidity, More Buyers and Impatient Secured Creditors

As mentioned, distressed M&A activity in the coming months will depend on whether the recovery tracks the "V" shape or the slower and bumpier "W" model.

With a quick recovery, fewer businesses will be sold as increased cash flow sustains them through the recovery. Traditional M&A activity might resume, but at a slow pace, given that without creditor pressure, owners of targets will be hesitant to sell in a depressed but climbing market.

Alternatively, a slow climb out or a bumpy "W" recovery might instil confidence in price values, causing creditors and buyers to pressure debtors into distressed sales. Their patience wearing thin, secured creditors will be eager to exit from stagnant business interests and protracted recovery cycles. Liquidity's return will fuel deals. These factors and the uncertainty inherent to an attenuated recovery could yield increased distressed M&A activity in 2010.

Certainly, Canada's productivity gap, the result of a manufacturing slump combined with a climbing dollar, is trending toward a slower recovery. Canadian industry sectors relying on U.S. demand likely face a long climb ahead. Any bump in interest rates will put the pressure on to sell distressed assets. The risk of slipping back into recession is, by all accounts, real and pressing. The market for distressed M&A over the coming months will depend on the shape of the recovery.

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