

Distressed M&A: Some Strategic and Financial Trends and Considerations

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I. Today's environment and industry structure

Compared with previous difficult economic circumstances, we have entered the current recession with a very different industry structure. In 1991, Richard Coase received the Nobel Prize in Economics for the theory of the firm which was based on the concept of transaction cost, (i.e., the overriding reason for a firm's existence is because there are costs of putting together different market participants that might be lower within a single firm structure than in the broader market). With this, supply chain management and cooperation become much more important. In fact, many industries have developed a model where original equipment manufacturers ('OEMs') have become 'platform companies'. A 'platform company', as a concept, was defined by GaveKal in 2005 as companies that:

'produce nowhere but sell everywhere ... Platform companies know where the clients are and what they want and where the producers are. Platform companies then simply organise the ordering by the clients and the delivery by the producers (and the placing of their logo on the product just before delivery).'¹

In 2007, Bitran referred to a similar concept as 'supply chain disintegration':

'As supply chains disintegrate, OEMs need to find ways to manage the flow of goods, both inbound from outside suppliers and outbound to distributors and customers.'²

So far, platform companies have been very successful in capturing the margin in the value chain. For example, in the computer industry, a typical EBITDA margin for a contract manufacturer ('CM') would be 3-5%, for an OEM (that is a 'platform company' in this industry) it would be around 12%, and for a distributor it would be just above 1% (based on selected company data and the

author's estimates). From an inventory standpoint, a CM would hold inventory for 28 days on average, an OEM for just 18, and a distributor for 39 days.³ On a credit rating scale (Moody's, for example) this translates to an A2 rating for a platform company and Ba1-Ba2 (5-6 notches down) for both the distributor and the CM.

However, with the financial crisis and the resulting changes taking place in the wider economy, there is a strong likelihood of reversal in this trend as transaction costs are going up substantially, the cost of credit has gone up and even more importantly its availability has been reduced, and finally the ability to mitigate credit risk has been impacted by both the withdrawal of credit insurance and the increased difficulty in obtaining 'traditional' financial products like bank guarantees and letters of credit. A company which has a high degree of consolidation in either sourcing or distribution represents a high concentration in terms of both credit and operational risk. While the platform company model in theory (and normally in contractual terms) should provide substantial risk mitigation, the reality is that often most of its business partners would not have enough capital to absorb a material shock. There is, therefore, a clear incentive for vertical integration of the 'middle part' of the chain (i.e. in the above example, the OEM, distributor and contract manufacturer) so the combined company would have no significant concentration problems (on either the supply or sales side) as it will have multiple buyers (instead of, for example, a master distributor) and multiple suppliers (instead of, for example, a single contract manufacturer purchasing all other components and services). This consolidation could be achieved either through 'build or buy' (most parties having some ability to build the core functions of one or the other) or by acquisition.

This change in the model, which I would call 'de-platformisation', provides a good opportunity for

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- 1 A. Kaletsky, C. Gave, L. Gave, *Our Brave New World* (Editions GaveKal, 2005), p. 6.
- 2 G. Bitran, S. Gurumurthi and S. Lin Sam, 'The Need for Third-Party Coordination in Supply Chain Governance', (2007) 48 *MIT Sloan Management Review* 3, pp. 30-37.
- 3 *J.P. Morgan Technology Outlook*, 16 December 2008, p. 9.

nancially strong players (or their private equity investors) to move to a new model (or is it really the previous, old model?) at a relatively low cost. A useful analogy would be the financial services industry, where the recent trend towards the 'originate and distribute' model (the platform equivalent in this industry) is reversing, largely due to credit constraints on the weaker parts of the chain, leading recently to a number of high profile, distressed M&A moves in the financial services sector.

With the emergence of substantially distressed players on both sides of a platform company, there is the possibility of cheaply acquiring both the core manufacturing/sourcing capability and the distribution side. This combination would have a much stronger bargaining power vis-à-vis a platform company (which might still eventually be the acquirer) or 'build or buy' platform company capabilities where design and build may be relatively cheap and where there are brands available for purchase at distressed sale prices. We can see this trend already taking place between electronics manufacturing services ('EMSs') and original design manufacturers ('ODMs').⁴

From a macro perspective, Asian manufacturers were indirectly funding their US channel/consumption through lending by their governments to the US Government. In 2004, Grant described this as 'an unholy partnership with its Asian creditors. They would produce; we would consume ... the United States and its lenders have entered into the biggest vendor-financing scheme in the history of borrowing and lending'.⁵ What is likely to happen in the current crisis is for this scenario to move to a micro-level: suppliers, possibly with help of their governments, sovereign wealth funds or private investors, will use the opportunity to consolidate Western distribution channels as well as platform companies, as soon as these show signs of financial distress. This would allow suppliers to both mitigate the risk (often including any immediate losses from the potential bankruptcies of the other parts of the channel (distribution, retail, sometimes platform companies)), as well as to achieve strategic objectives at a minimal cost. This could happen in virtually any industry adopting a platform structure, for example computers/electronics (Asian contract manufacturers/ODMs consolidating major channels), software ('reverse outsourcing' whereby companies in countries like India acquiring 'high end' Western companies currently outsourcing to them), natural resources (already seen with gas and downstream oil companies consolidating their distribution networks), pharmaceuticals (particularly generic drug manufacturers consolidating distribution

channels), clothing, furniture, textiles, and many other sectors/product areas.

An additional incentive for vertical integration is knowledge transfer. The current distressed economic environment has probably reduced the future scope for 'pure' labour arbitrage (given that there is potential for the cost of labour to fall in the developed world), which therefore places more emphasis on technology, controls and corporate governance, which arguably might be better achieved in a unified entity.

2. Working capital – both a cause of distress and an opportunity for an acquirer

a. Receivables/credit management

As access to credit tightens, working capital management is becoming critical for a company's survival. This pressure on working capital is spread across all three major components: receivables, payables and inventories.

While obviously very important, the receivables side of working capital would often entail the lowest risk of the three components (providing there is a prudent credit policy, low concentration at company or industry level and no major operational issues, such as quality). If payment terms are relatively short (say, 30 days) and the average default rate in the broad economy goes up to 12% per annum (the peak level reached in the risky high yield space in 2002 and a number that represents a fairly pessimistic view of the current crisis), we are still only talking about the cost of bad debt representing some 1% of total sales.

With a reasonable credit policy, including the ability and willingness to withdraw supply before any bankruptcy occurs, any such losses are likely to be substantially lower than 12%. According to Atradius, one of Europe's largest credit insurers, the actual annual corporate insolvency rate in the UK was previously 0.9% per annum (and under 0.5% in the US) in the first half of 2008.⁶ The trend is clearly up and insolvencies are likely to be at very high levels in 2009. However, this risk increases significantly if there is a high company or industry concentration within receivables. For example, if one customer represents 50% of a supplier's sales, the customer's bankruptcy will likely lead to the bankruptcy of the supplier due to an immediate loss of the receivable, probably a similar level of loss on any unsold inventory which may be customer-specific, and 50% drop in annual sales overall unless a suitable

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4 *EMS and ODM Convergence*, Frost & Sullivan #N1A0-28 2007.

5 *Grant's Interest Rate Observer*, 16 January 2004.

6 Atradius, *Economic Outlook: Negative Expectations* <global.atradius.com/images/stories/economic%20research/Atradius%20economic%20outlook%20q4%2008.pdf> (Q4 2008), p. 16.

replacement or replacements can be found quickly. In addition, industry or sometimes regional concentration could well lead to a high correlation between defaults, and an abnormally high default rate compared to the broader economy.

The credit risk of customers is insurable. Having a credit insurance policy will smooth the impact of defaults and even more so where there are any industry or regional concentrations as outlined above. If there are losses, the insurance premiums will go up in the longer term, but the short-term effect is mitigated. This said, there is a noticeable trend by credit insurers to reduce cover. However, this is estimated to affect only about 10% of buyers, but could well be materially higher in a particularly troubled industry or geographic region.

Payment delays from customers, as distinct from outright non-payment, represents a more serious situation. First, there are immediate cash flow implications, which are very significant at a time of reduced credit/financing availability. Secondly, if tolerated, this means substantially higher exposure to particular names (which again might be particularly important in concentrated, uninsured exposures, where such cases most frequently occur).

Long payment terms for customers can normally be mitigated through factoring/invoice discounting/trade receivable conduit securitisation, especially if credit insurance is already in place.

The core issue is where longer payment times are not caused by customers' internal issues (such as a customer trying to improve their own working capital), but by the supplier itself (for example due to quality problems, contractual disputes, or slow or unreliable logistics). This normally means the risk is not insurable (insurance normally just covers the credit risk of the buying customer, such as bankruptcy or inability to pay, not non-payment due to contractual dispute). It also means the risk is not financeable, or financeable with a low advance rate. It may also indicate significant communication and operational breakdown within the selling organisation.

While an acquisition of a target by itself is unlikely to materially change the immediate collectibility and nature of receivables (beyond obvious management and control measures to improve process efficiency), it may still have a material effect on the ability to finance receivables. At a time when financing is more restricted, and with banks and insurers naturally tending to concentrate on their existing clients, if there is a concern about a given supplier's performance risk, then a significantly larger and/or stronger acquirer,

especially one with pre-existing and sizeable financing arrangements in place, can often massively increase the efficiency of the target company financing (i.e., by obtaining a lower price, a better advance rate and even being able to secure a financing arrangement or program in the first place, something that the target would not be able to obtain on its own).

b. Inventory

Excess inventory causes substantial problems, as recently seen in the retail space, and regularly seen in high tech supply. With falling and unpredictable demand, getting the inventory level right is a very difficult task. With the exception of inventory that is covering contractually guaranteed future orders (e.g., purchase order financing, which is effectively receivables under another name) and commodities, excess inventory is substantially more difficult to finance or insure. Sometimes, vendors are taking inventory risks through vendor-managed inventory, various forms of stock protection, etc. Vertical integration cannot fully resolve inventory problems (more predictability for say the retail part of the integrated entity would mean less for the manufacturing part), but it is likely to improve information flow and reduce the so-called bullwhip effect,⁷ caused by information distortions, causing wide swings of demand down the chain.

c. Accounts payable

Accounts payable is an extremely important part of a company's financing, and technically often the easiest to lose (rather like an overdraft). The withdrawal of cover by suppliers could potentially trigger an almost instantaneous bankruptcy, even for a relatively healthy company. In the banking industry, the equivalent would be a run on a bank. In his research on the relationship between bank and trade credit through the economic cycle, Nielsen showed that for both small companies and importantly for large companies without bond credit ratings, their use of trade credit increases during periods of monetary contraction.⁸ Faced with tightening economic conditions, a supplier naturally tries to accelerate collections, but facing sales pressure on the other side, is unlikely to achieve much more than was customarily done before.

However, with 35% of European companies⁹ using credit insurance, the decision to cancel the limit is

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7 H. Lee *et al.*, 'The Bullwhip Effect in Supply Chains', (1997) 38 *MIT Sloan Management Review* 3, pp. 93-102.

8 J. Nilsen, 'Trade Credit and the Bank Lending Channel', (2002) 34 *The Journal of Money, Credit & Banking* 1, pp. 226-253.

9 I. Zax, *What Are The Benefits of Using Supply Chain Financing in Funding/Re-financing of Buy Outs?*, Sloan Fellowship Report, (London Business School, 2007).

often made by the insurer. Technically, a supplier would normally be under no obligation to withdraw credit if there were no overdue payment – new supplies would just go uninsured. But in practice, most suppliers would choose not to extend credit if their insurer withdrew cover. Such an event (the withdrawal of cover) has actually triggered a number of high profile distressed cases. If longer terms were based on available financing (e.g., factoring, invoice discounting and securitisation) and then facilities are subsequently withdrawn, suppliers may well have a strong incentive to reduce terms, but this is less of an issue given that only some 5% of companies use receivables financing.

While it is difficult to generalise about their underwriting process, the withdrawal of a limit could equally be caused by the credit insurer's industry/regional outlook, with particular concerns about a company's financial situation or operations, as well as by reported delays in payments. The best way for a company to reduce this threat is by communication and information sharing, but the event (the withdrawal of cover) is normally catastrophic and its timing is difficult to predict.

From an acquisition perspective, the instant distress caused by a supplier's (or their insurer's) withdrawal/cancellation of a credit limit could well represent ideal timing for acquisition, provided the acquirer sees the company as fundamentally repairable. (Where the issue revolves around payables, this applies to both industrial and financial companies.) By restoring or even improving a supplier's credit terms (and possibly combining it with receivables financing, as above), the acquirer can instantly fix working capital stress and focus on other areas of potential improvement.

In the case of the vertical integration of a distributor by a main supplier, the effect on the supplier's balance sheet is that the inventory is coming back, and the accounts payable by the target to the supplier are substituted by target's own accounts receivable. However, if the target is distressed (i.e. has no capital, among other things) and actually goes into liquidation, the supplier can at best try to exercise retention of title if available and enforceable (neither is certain, in many cases), and recover something from the sale of the remaining inventory. (Receivables are likely to have already been pledged, and 'all money' clause might not work). By acquiring the distributor, a supplier can replace a doubtful asset (an account payable from a distressed company) with a potentially good quality asset which the distributor has (being accounts receivable

from either good quality buyers or from a diversified portfolio of insured receivables). With the latter being financeable, such an acquisition could in fact be both cash-flow positive and risk-reducing for the supplier.

3. Conclusions

The current economic crisis entails new prospects for distressed M&A. The historic situation has involved acquiring a more or less isolated, often mis-managed company, with returns achieved predominantly through generic operational and financial improvements. But now, we are likely to see whole layers within industry verticals becoming distressed, with M&A focusing on vertical integration, and with risk mitigation being a key driver. This will change many industry models, reverting from the 'platform' model to a more traditional structure. It is also likely to lead to distressed M&A originating from different parts of the chain (two likely scenarios could be OEMs consolidating their environment or manufacturers moving up the chain). Given that the wealth distribution within a chain is likely to change, the core consideration will be the overall health of the industry, as opposed to the profitability of a specific individual layer, as the wealth distribution within a chain is likely to change. Working capital financing is likely to be one of the key tools in the financing of such M&As, with the acquiring entity ending up with a manageable receivables book and a lower performance risk. Acquirers should also explore the possibility of pre-building platforms for such financing, that would be able to integrate the targets without undue delay, significantly easing the liquidity risk and pressure arising from acquisitions.

While I believe that industry players will have a key role in this process, this should nonetheless provide potential opportunities for principal players. This would include PE companies (both growth PE and even late-stage venture capital firms) which are well-placed to use the opportunity to very efficiently build the full life-cycle for their investee companies, as well as distressed PE that can consolidate, turn around and present a successful 'turnkey' structure to an acquirer. This is likely to lead to the emergence of 'hybrid' structures, where financial investors work on behalf of a potential acquirer with pre-arranged put/call options, allowing the efficient sharing of risk and reward between the investor and financial acquirer.

