Wake Up Call

Business Strategies in a Struggling Economy

I am representing one of the largest financial institutions in Malaysia. As we all have been aware, many companies have been impacted by economic downturn, which resulted in selling off their businesses or assets at prices below their intrinsic value. I see this as a business opportunity. What kind of assessment should be undertaken in acquiring distressed company and what are the challenges?

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A crushing debt load and weak operating performance are often associated with distressed companies.

There are several ways for investors to grab opportunities on distressed company which includes provide financing to companies, utilizing debt to equity strategy and buying business or assets.

Investing in distressed businesses may become an attractive investment option for keen investors. As Stuart C. Gilson says in the book published by CFA Institute, "The practice of investing in distressed companies is popularly known as 'vulture' investing. The risks of investing in this market are highly firm-specific and idiosyncratic. Investors who are adept at managing these risks, who understand the legal rules that must be followed in corporate bankruptcy and who are skilled at identifying or creating value in a distressed situation consistently earn the highest returns in this market."

The priority is to conduct a thorough evaluation of the risks involved in the transaction.

The scope of the commitments, contingencies, and remaining and/or unrecorded liabilities must be assessed, as well as the lasting effects insolvency may have on the target company. Liabilities for taxes, suppliers, customers and employees are the most common liabilities. Once assessed, these effects can be mitigated and/or factored into the purchase price.

It is usually preferable to conduct due diligence to avoid surprise or hidden liabilities by discovering them in advance rather than discovering them after closing deals. It is common in the course of due diligence, the liabilities will turn out to be greater than initially assumed, accounts receivables will be more difficult to collect than represented in the financial statements and issues regarding employees will be more troublesome than anticipated. Distressed M&A typically involves indemnification to provide some protections against unwanted liabilities.

Investors should consider assigning third party to evaluate the businesses or assets being acquired and manage how the transaction should be structured.

Distressed businesses need to be stabilized by creating a short-term plan to address cash flow needs. It requires funding to cover working capital for trade creditors, loans and interest payment and restructuring costs such as professional fees. Distressed businesses need to be fixed in terms of their operation and organization.

KEY POINTS

- Investing in a distressed businesses or assets can offer high rewards for companies who have proper turnaround talent and able to manage such investment.
- Thorough due diligence is required to uncover hidden risks or liabilities.
- Distressed businesses need to be stabilized, funded and fixed to make a turnaround.

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