Purchasing distressed businesses

Due diligence tips and financing considerations

What do companies need to consider when they're going to purchase an asset or business, specifically a distressed one?

The two-year global rout in oil markets continues to put pressure on the balance sheets of many service and supply companies. While oil prices have stabilized during the past few months in a band between US$40 and $50 a barrel, with signs of a modest recovery in drilling activity, Canadian service and supply companies continue to look for options to improve cash flow. For many, the sale of assets, divisions, or the entire business may be the viable path forward.

Today, those service and supply companies that are distressed and struggling to survive also provide opportunities for companies in better financial positions. Purchasing assets or businesses now helps those companies to be positioned for more growth when the uptick comes. But what do service companies need to consider when they're going to purchase an asset or business, specifically a distressed one?

What makes a "good" distressed purchase?

For companies with strong balance sheets, solid working capital and excellent relationships with their lenders, a "good" distressed purchase is one in which "the purchase or the purchaser is almost the immediate solution to the problem," says Alex Henderson, a partner in KPMG's Transaction Services group.

"Most often, a distressed company doesn't have access to enough cash to deal with the downturn. It may also have a damaged relationship with one or more of its lenders. Or, the company is overleveraged – but can be deleveraged relatively easily," says Henderson.

Before proceeding with an offer, however, distressed purchases must be thoroughly evaluated. Proper due diligence is paramount.

1. Evaluate the real underlying performance of the asset or business to be purchased

Purchasers need to assess how an asset or division of the business is performing and that it's not benefiting from other parts of the business. "In other words, maybe an asset or division you plan to purchase isn't taking its fair share of costs," Henderson says.

Unfortunately, if the asset or division for sale is part of a struggling company, the typical indemnities and warranties a purchaser might receive from a selling entity aren't going to be worth as much because the selling company may not survive.

"As a purchaser in this situation, you might strike deals that you normally wouldn't strike," Henderson explains. "You may find yourself having to fully quantify possible risks, and positioning for a price adjustment for a potential liability. Rather than on a typical deal with a financially strong seller where you say, 'We'll be fine, it'll be covered by the seller if it ever becomes a problem.' We see purchasers undertaking this extra step in quantifying things."

2. Make sure you have up-to-date information

The recent loss of a major client, for instance, can have profound impact on the value of a business.

"We do many due diligence projects where we'll go back and look at revenues and costs associated with that customer for the last 12-month period. To be accurate, we strip all that out to show how the business will perform in the future," Henderson notes.

3. Look for the upside

In the process of due diligence, reviewing downside risk is important. Purchasers need to uncover any errors in the numbers and bring to light any underlying trends that may not be immediately apparent, but which are negative.

At the same time, purchasers should look for potential upsides, too. Sometimes these are upsides the seller isn't even necessarily aware of.

"Some of the data analytics (DA) tools that KPMG uses may allow a purchaser to understand things about a business that a business itself would never have a chance of understanding," Henderson says. "These tools may uncover exactly where a purchaser can make money and how, which may give a purchaser a competitive edge in a multiple bid situation."

4. Seek out other benefits

With any purchase, the purchaser has to decide what might also come along with the business.

In a distressed situation, purchasers may have a bit more flexibility in determining what those benefits might be. For instance, a purchaser may take a few extra employees that could help in other ways, especially if the purchaser is short-staffed in other areas.

"You may not necessarily need them to run the target business you're purchasing," says Henderson. "You're obviously not a charity doing this. But by taking 10 extra people, you may be able to get a considerably lower purchase price."

Financing options

There are a number of ways to finance the purchase of distressed assets or businesses.

"The easiest method is by using the cash flow from your existing company," says Neil Honess, a partner in KPMG's Restructuring and Turnaround practice.

"In many cases the distressed assets or business being purchased does not meet the criteria for traditional debt financing," Honess says. Often, it's has to be all equity."

Another option is for a purchaser to go to its lender and borrow money by allowing the bank to take security over the purchaser's assets. Alternatively, due diligence can be tailored to assist the lenders in understanding the value of the purchased assets or business.

In some cases, Asset-based Lenders (ABLs) may be the preferred way to finance a deal. Typically these loans are tied to the value of inventory, accounts receivable, machinery and equipment. ABL companies will lend on asset value alone and based on a different set of metrics – typically recovery at auction.

"So in both those cases you've got to be able to present something clear to a lender that there's some real value there," says Honess. "I'm buying a distressed company, but its assets are fairly tangible, liquid assets, that I could sell tomorrow if I have to – whether to a competitor, whether it's to scrap. However, if the distressed assets or businesses themselves really aren't generating cash flow or have adequate value, a purchaser may struggle to get financing that way."

"We see a lot of asset-based lending," says Henderson. "It's not cheap money, but it's generally relatively quick money because the ABL companies have relatively straightforward metrics and they have experience in valuing assets."

A further financing option is for a purchaser – seeking a lending package to purchase distressed assets or businesses – to turn to the bank that is currently owed the money by the seller. That lender may have more of an incentive to complete a deal. Lenders, in general, may be more willing to consider slightly out-of-the-norm scenarios than they were two or three years ago, especially in the current climate.

"They're more interested in looking at a basket of lending solutions that add up to a whole," says Honess.

Springboard to growth – for buyer and seller

These kinds of deals may allow companies in distress to reduce debt and improve their working capital positions to assist in weathering the downturn. Selling under distress is not a negative if it provides the seller multiple options to realize future growth.

During down cycles, assets and divisions in distressed companies often migrate to better capital structures, where those with the better balance sheets take on the businesses and provide an opportunity to grow as market conditions improve. Purchasers must not cut corners to save time in closing a deal where they may risk not realizing full benefit of an acquisition.

Ready to talk? KPMG's Deal Advisory team can counsel you through the multiple options available to maintain or grow your business in a cyclical industry. Our forward-looking specialists have business acumen, deep sector knowledge and technical know-how to help you stay ahead of the issues and make the best decisions to meet your goals.

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