

Dangerous opportunities: Understanding the M&A market during the recession and the ten keys to successful due diligence

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In any acquisition, due diligence is vital. But in the current troubled and uncertain economy, the consequences of ineffective due diligence are more dire, and the issues due diligence should address are markedly different than they were in the growth economy of the past several years. Stressed companies looking for a buyer have a variety of ways to mask poor financials and negative trends, and they may be making operational decisions that could have long-term harmful effects on the value of their business. In addition, the tight credit market means buyers will have more equity on the line. A poorly researched acquisition in these harsh times can put the buyer itself in jeopardy.

The good news is that the distressed economy makes for a buyer's market. The growing number of troubled companies means there are many attractive targets looking for buyers – and those targets can be purchased at favorable prices. A sound acquisition today may help your company survive the current recession and position you for significant growth when economic conditions improve.

How the deal market has changed

A quick look back at the tumultuous last year gives a picture of the factors—the frozen credit market and slumping economy—affecting the landscape for mergers and acquisitions. In the home mortgage market, the easy-credit policies of the past decade resulted in a rash of defaults. Hundreds of billions of dollars in mortgage-related investments collapsed. In September, when government-sponsored mortgage lenders Fannie Mae and Freddie Mac teetered on the brink of failure, the Treasury Department took them over. Just days later, the giant investment bank Lehman Brothers was poised for bankruptcy, but the government refused to step in and rescue it. Its failure reverberated through the world's banking system, and banks clamped down on lending to businesses as well as consumers. At the same time, the stock markets of the United States, Europe and Asia have plunged, slashing companies' stock value and exacerbating banks' unwillingness to lend. Legislative initiatives in the closing months of the Bush administration, and new initiatives underway in the Obama administration are pumping billions of dollars in stimulus funds into the economy, but the effects of those efforts are still uncertain.

Just half a year ago, observers were hoping the sagging economy would turn around. Now, it is obvious that the U.S. economy is indeed in a recession. This makes for a very different playing field. The recession has caused softness in companies' reported numbers. Sales are off, profits are off, and banks have tightened credit. Companies are looking back at their last twelve months' results to try to project what will happen to them in the next twelve months. They must try to determine if their customers will buy as much from them next year as last year – and also if those customers will be able to pay. Six months ago, certain trends such as falling sales and higher inventories weren't obvious, but now they are clear. To evaluate and to project the impact of these trends is very difficult, which significantly complicates due diligence efforts in any acquisition.

Where is the credit market now?

The credit market continues to be very tight. The \$700 billion Emergency Economic Stabilization Act, signed into law in early October, has had very limited impact. Many of the big lenders virtually closed up shop in the last few months of 2008. While there have been some tentative signs of liquidity easing back into the credit market, lenders are far more cautious. Lenders who had been using a debt-to-cash-flow ratio of 4-1 are now using a ratio closer to 3-1.

The landscape has changed dramatically in the last year. At that time, buyers were buying at high multiples of EBITDA (earnings before interest, taxes, depreciation and amortization) — in other words, with a lot of debt. Now all players are extremely cautious, and there is less buying volume. Buyers can't pursue the highly leveraged transactions that were prevalent in the last decade. What's more, because many companies being purchased today are troubled, they must be examined more carefully and in different ways than healthy companies.

With the stock market continuing to gyrate, daily news reports of corporate failures and bailouts, and a new presidential administration promising to take strong economic steps, the market is still very much in a state of apprehension.

Effect on private equity groups

Private equity groups have been a driving force in the deal market for the past several years. The changed M&A landscape will affect them in several important ways. They will have to invest more equity in each transaction to cover the gap between purchase price and debt. They will pay less for companies, and because of the higher risk they are taking, they will look for targets with higher internal rates of return. In the past, they looked for an internal rate of return of 20 percent; now, it would be up to 25 percent. What's more, they are paying a lower multiple of EBITDA.

Still, private equity groups, which have played an increasingly active role as a source of growth capital or as an exit strategy for companies in a number of industries, are sitting on a sizable pool of capital and looking for places to invest. Odds are they will be key players as the growing number of troubled companies looks for financing or exit options.

Where are the opportunities?

The silver lining in the cloud of the poor economy is the wealth of strategic opportunities. A significant number of businesses have fallen into trouble and are looking for buyers.

If one of your competitors is experiencing financial difficulties or wants to sell a product line to generate cash, this can be a well-timed purchase. You also may be able to pick up a non-core business of a large or public company at a favorable price. Whatever your target, however, you will have to understand the difficulties the target company has experienced. Then you need to determine what steps will be needed to shore up the operation.

Examining targets in a troubled economy

Normally, due diligence examines the target's operational performance -- customers, products and markets; human resource policies, practices and issues; information systems and management information systems; contracts and commitments; and tax and legal compliance and exposure. It typically lasts between one and three months depending on the quality of information, the target company's information systems, and the accessibility of the target's management. Due diligence is different from a financial audit in that most financial audits do not concern themselves with one-time events or sustainable profitability levels. In addition, audits do not take into consideration special terms of the transaction as specified in the letter of intent, such as a carve-out situation or a related-party transaction.

Audit financial footnotes provide some company details, but in a difficult market, buyers need more in-depth disclosure. There are some key differences in business environment that should be taken into consideration during due diligence. It is critical to look for dangerous trends. Sales may be falling or sales growth slowing. There may be increased pricing pressures on both customers and vendors. Inventories may be growing. There may be slower collection of accounts receivable and more bad debts. There may be increasing accounts payable. Monthly performance may be eroding. You may find reductions in compensation, increased turnover and issues with morale. Order backlogs could be declining, returns and allowances may be up, and debt and loan compliance issues are possible. The company also may be deferring capital expenditures – even vital expenditures. Other areas of concern include more seller addbacks to EBITDA; such as, restructuring charges, extraordinary legal expenses, severance costs, unusual bad debts, one-time inventory writeoffs, addbacks for losses on discontinued product lines or lost customers, and annualization of revenue and EBITDA from new customers.

Other areas to be scrutinized include historical EBITDA run rate, quality of assets, protection and structuring; undisclosed liabilities, working capital, future cash flows, and business trends. There should be more emphasis on key areas and on leading indicators such as backlog and market analysis. The buyer needs to have a complete understanding of what constitutes early warning signs of trouble in the target company or industry. At the same time, it is necessary to differentiate between declining results due to the troubled economy and those due to falling market share. There is always the risk that the economic downturns will last longer than expected or that the seller's weaknesses are underestimated.

Ten key due diligence issues in a down economy

Following are ten key areas a buyer should be sure to thoroughly investigate in due diligence if you are considering a deal in this economy:

Last Twelve Months (LTM) results. In a difficult economy, trends can be as or more important than raw numbers. LTM EBITDA

(earnings before interest, taxes, depreciation and amortization) may be falling, so a close review of the most current results and a comparison to historical results is critical.

If results are trending down, the target company may be slow to release current financials to delay that information from becoming known. Also, watch for accounting changes, such as treating some costs as prepaid that used to be expensed, or changes in accounting for inventory. The target also may attempt to accelerate revenue by offering incentives and discounts to customers. Normalize for any such activities to get a true picture of results.

Backlogs. Falling backlogs can be a leading indicator of declining financial performance. In the current market, sellers may try to avoid disclosing their current backlog, or may delay reflecting cancelled orders. Backlogs also may not be in saleable condition. Be sure to look at comparative backlogs over time so you will know which way this indicator is trending.

Sales/Revenue. In a declining market, it is vital to examine not only the amount of sales and revenue, but also their quality. Take a close look at recent lost customers, or at customers who have stated an intention to move their business, and find out what is driving those decisions. With credit a top concern for every business these days, it is wise to evaluate the creditworthiness of the target's client base. Is the target offering more generous warranty terms, discounts, credits or volume rebates in an attempt to maintain sales volume? Look for increases in barter activity, changes in return policies, and increases in customer revenue concentration

Gross Margins. Gross margin trends by product line and customer require closer review. A target company may take a variety of steps in a declining market that could adversely affect margins. For example, companies often discontinue less profitable or unprofitable product lines in tight markets, but that could mean a higher percentage of overhead will be allocated to the remaining product lines, adversely affecting their margins. Product lines discontinued due to slumping sales could mean the loss of volume discounts that the company enjoyed in better times. The target's suppliers and vendors may be increasing prices or otherwise changing terms.

Accounts Receivable and Bad Debts. In a troubled economy, an increase in bad debts is common, which slows cash flow. Examine the target's receivables aging to see if it is trending upward. Look to see if customers are disputing invoices in an effort to lower costs, or if the target is tightening credit limits, which may lead to lower sales. It is important to remember that receivables will affect the company's borrowing base and loan structure.

Accounts Payable and Purchasing. Companies in trouble may adjust their purchasing and accounts payable practices in ways that could affect their value. The target may be slowing payments to vendors and suppliers to conserve cash, or may be having more

disputes with vendors as it tries to return merchandise in an effort to return unneeded inventories. Take a close look at the target's purchase obligations: Volume guarantees and associated penalties may become an issue. Check to see if the target is switching vendor relationships to control costs. This could lead to quality issues. Even if the target is healthy, the failure of a key vendor could lead to interruptions and higher costs as the company scrambles to find a replacement, so you also must assess the health of the company's key suppliers.

Inventories. If sales are falling, a company's inventories often will creep up, which creates a higher risk of excess inventory and obsolescence write-downs. If the target's customers are experiencing slower sales or other issues, then returns are likely to increase, which also can cause inventory to increase. The target also could be allocating idle costs into inventory. All of this puts a drain on cash as increased inventory costs push working capital requirements higher.

Compensation, Bonuses, and Staffing. Payroll is usually the largest expense for an employer, so it is no surprise that a troubled company may take steps to reduce its personnel costs. Look to see if the company has reduced, eliminated or deferred bonus payments, or has forced salaried personnel to take unpaid leave. Those moves may have a negative effect on morale and retention of key personnel. They may also force future costs to make up for skipped or delayed payments. If the company has laid off workers, determine whether or not those cuts are sustainable. The owner may cut his own bonus or compensation to conserve cash flow. Conduct a close review of the company's management team. Managers who built a company during a period of strong growth may not be the right team to lead it through a downturn or turnaround.

Restructuring Charges. Depending on the size, restructuring charges could cripple or destroy the target company. Watch for targets establishing restructuring charges and adding the results back to EBITDA. Also look for changes in reserves designed to artificially boost earnings. The business may never fully recover, depending on the market environment and competition.

Add-backs. At closing, sellers may propose add-backs to EBITDA that could drive up the price. Add-backs can include:

- Restructuring charges
- Extraordinary legal or professional services fees
- Severance costs
- Unusual bad debts
- One-time inventory write-offs
- Losses on discontinued product lines or lost customers
- Amortization of revenue and EBIDTA from new customers

The buyer should analyze proposed add-backs carefully to ensure they are calculated properly, that direct costs are identified accurately, and that there is appropriate support for these adjustments.

Choose due diligence advisors carefully

This is no time for a buyer to make a cursory assessment of the target company. In this stressed economy, sellers have more motive than ever to mask problems and misstate earnings to hide slumping numbers. That means buyers need more in-depth disclosure developed during due diligence and additional comfort that the seller's represented information is accurate. Working with skilled due diligence advisors who understand how the economy is likely to have affected target companies and how those companies may have responded is vital.

The quality of information a buyer needs to consider in this environment is extremely important. Each due diligence project needs a specialized plan based on the unique risks and circumstances involved. It is important to have due diligence done by firms experienced in the marketplace and in the current economic environment.

An economic downturn can present once-in-a-lifetime acquisition opportunities. Companies that pass over too-troubled targets and pursue the right ones will emerge stronger when the economy eventually recovers. A deeper level of due diligence can ensure that the buyer of troubled companies does not become a troubled company itself.

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