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DISTRESSED M&A

A confluence of disruptive geopolitical events and economic instability has had an inevitably adverse effect on many businesses in 2022, leading to increased opportunities for distressed M&A. Amid this 'new normal', some fledgling, highly volatile industries are experiencing distress, while others more acquainted with the market also face uncertain trajectories. On balance, uncertainty provides openings for distressed investors but also presents a host of risks – a new cycle of distress invariably producing winners and losers. ■

THE PANELLISTS

Michael Milani
Executive Managing Director, Baker Tilly Capital, LLC
T: +1 (312) 729 8034
E: michael.milani@bakertilly.com
www.bakertilly.com

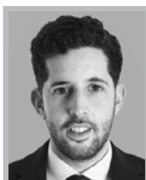
Mike Milani is an executive managing director and principal with Baker Tilly Capital, LLC, and leader of the firm's distressed M&A effort. With more than 30 years of experience, he specialises in providing consulting and advisory services to business owners, stakeholders, management teams and corporate boards related to healthy and distressed transactions, financial restructurings and corporate finance. Baker Tilly Capital, LLC is a registered broker-dealer, member FINRA and SIPC.

Ben Hughes
Senior Managing Director, FTI Consulting
T: +44 (0)7795 640 462
E: ben.hughes@fticonsulting.com
www.fticonsulting.com

Ben Hughes leads FTI Consulting's special situations M&A practice in the UK, where he utilises the skills he has developed in over two decades of acting as an adviser to help his clients achieve their goals through M&A activity. Mr Hughes and his team provide the full suite of special situations M&A services, including lead sell-side and buy-side advisory, fundraisings, strategic option reviews and sale process monitoring.

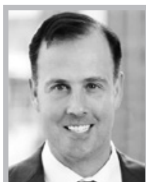
Chad J. Husnick
Partner, Kirkland & Ellis LLP
T: +1 (312) 862 2009
E: chad.husnick@kirkland.com
www.kirkland.com

Chad Husnick is a partner in Kirkland & Ellis' restructuring practice group. He represents debtors, creditors, equity holders and other stakeholders in all aspects of corporate liability management, restructuring, bankruptcy and insolvency proceedings. He has represented clients in a variety of industries, including energy, retail, real estate, infrastructure, manufacturing, transportation and distribution, hospitality and gaming, automotive and printing.



Marc Hecht
Counsel, Simpson Thacher & Bartlett LLP
T: +44 (0)20 7275 6204
E: marc.hecht@stblaw.com
www.stblaw.com

Marc Hecht is counsel in Simpson Thacher's restructuring practice. Based in London, he regularly advises the full spectrum of stakeholders, including, debtors, creditors, investors, sponsors and management teams, on complex domestic and cross-border restructuring and insolvency situations. He has extensive experience of both contentious and non-contentious restructurings and also advises clients in connection with acquisitions of distressed assets.



James J. Mazza, Jr.
Partner, Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates
T: +1 (312) 407 0521
E: james.mazza@skadden.com
www.skadden.com

James Mazza represents debtors, lenders, creditors, asset purchasers and private equity investors in corporate restructuring transactions, both in and out-of-court, involving clients' interests across the globe. His experience extends to a wide variety of industries, including automotive, airlines, energy, financial services, healthcare, gaming, real estate and retail. He also regularly advises companies' management and boards of directors regarding fiduciary duty issues in financially distressed situations.

FW: What are some of the key drivers of distress in today's business world? Do any sectors or industries appear particularly susceptible?

Mazza: Inflation levels harking back to the 1970s, coupled with steady interest rate increases by central banks to curb inflation, are two of the primary drivers of distress in today's business world. Secondarily, the effects of unemployment resulting in labour shortages and supply chain disruptions have presented serious business challenges. The strong US dollar has also played a role in making US companies' goods more expensive abroad with imports becoming cheaper. The expectation is that these drivers will begin to dampen manufacturers' earnings, which are particularly susceptible to exchange rates, supply chain and labour issues. And while significant levels of capital remain undeployed, interest rate increases are starting to affect companies reliant on a steady flow of capital market access to finance their operations and roll-over debt maturities – particularly in the financial services sector. These drivers also are expected to impact distress in the commercial real estate sector, which is also grappling with what a return to a post-pandemic normal will look like. Finally, Europe is bracing for winter with escalating energy prices, and it remains to be seen if businesses have planned appropriately for these costs.

Husnick: Distressed investors are seeing increased activity relative to the prior two years. Most current distressed activity has been secular in nature, with significant disruption in the cryptocurrency market and the increase in mass tort Chapter 11 cases. Restructuring professionals believe that we are one to two quarters away from a large influx of market-driven restructuring work resulting from, among other things, cessation of quantitative easing and increasing interest rates. Industries most at risk during the next downturn likely include healthcare, commercial real estate, automotive and whatever is left of retail.

Hughes: Businesses are currently facing a barrage of challenges including inflation, rising interest rates, falling consumer confidence, staffing shortages and supply chain disfunction, and the UK's balance sheet means that it is unlikely the government can provide the same level of financial support as we saw during the 2008 global financial crisis and the coronavirus (COVID-19) pandemic in 2020. These factors combined with the recent tightening of the capital markets make it reasonable to assume there will be a significant increase in the number of businesses facing distress in the coming years. While some sectors, such as retail and automotive, are also having to deal with specific structural challenges, from what we are currently seeing, stress is being felt across most, if not all industries.

Hecht: The period following the global financial crisis has been one of sustained economic growth. Inexpensive debt has been readily available, driven by a prolonged period of loose monetary policy and the explosion in private capital. As the low number of corporate defaults illustrates, companies have been extremely robust in the face of external market disruption, including the fallout from the pandemic. It is widely accepted, however that we are entering a distressed cycle. Interest rate rises in response to inflation are resulting in a greater debt service burden for businesses. Those in need of liquidity, particularly companies that did not address their maturities in 2021 or earlier this year, are discovering that the public debt markets are closed for business and where direct lenders are willing to step in, they have a different risk appetite, which is reflected in pricing and terms. Inflation is also squeezing margins and, coupled with rising interest rates, will likely result in a fall in consumer discretionary spending. Few, if any, industries will be entirely insulated from these issues. Those that rely heavily on energy, such as manufacturing, are consumer facing, such as retail, hospitality and leisure, and have revenues in sterling with costs in other currencies, may be particularly susceptible. The extent to which businesses can pass through costs to customers will be key.

Milani: Key drivers of distress include the increase in costs due to rising inflation – an issue that has been caused largely by the global supply chain issues and the labour shortage – and the rapidly rising cost of financing through taking on debt. Historically high valuations and the associated financial leverage on businesses are another significant factor. These issues have had a heavy impact on the consumer discretionary sector, such as home goods, and certain sectors of real estate, including senior living. Additionally, special purpose acquisition companies (SPACs), which were booming just a couple of years ago, are currently facing a steep slowdown in M&A activity. This is particularly true for companies whose sole objective is to make acquisitions.

FW: For distressed investors, what are the advantages – and potential disadvantages – of participating in this market?

Husnick: We are coming out of one of the, if not the, slowest distressed market in history, so there is a great deal of pent-up energy in the space. There is plenty of available capital because many investors raised distressed funds over the last couple of years in anticipation of a market downturn. There are some new industries facing distress, such as cryptocurrency, where the investment is highly volatile, adding to the already uncertain nature of distressed investing. Even industries with significant experience with distress, including commercial real estate, are facing uncertain trajectories in the post-pandemic era. This level of uncertainty can provide significant opportunities but also present a host of risks for distressed investors.

Hughes: Financial investors are attracted to the distressed M&A market by the opportunity to secure attractive returns through acquiring a business at a discount, delivering a turnaround and then exiting at a value based upon higher multiple and post-turnaround earnings before interest,

taxes, depreciation and amortisation (EBITDA). We have also seen various strategic investors pursue a distressed M&A investment strategy, as this presents them with opportunities to remove competitors, increase market share, enter new products or territories and drive revenue and cost synergies. Turnarounds may sound straightforward but new entrants to this space should not underestimate the time and resources, and an element of good fortune, required to successfully recover an underperforming business, particularly when the target was experiencing a high degree of distress prior to acquisition.

Hecht: This cycle will present investors with opportunities to acquire businesses at a material discount to the fundamental value of the business which they will look to turnaround or clean through a process. Overseas investors may look to take advantage of the fall in value of the pound which will represent a further discount. Investors who can, in the face of negative market sentiment, identify businesses with strong fundamentals, versus those that are unlikely to recover as the market turns, will be rewarded. However, uncertainty in the markets makes it difficult to forward project and therefore arrive at an appropriate value for a business. If investors consider that values have further to fall, they may look to avoid the perils of 'catching a falling knife', and instead wait for prices to bottom out. Further, acquisition financing may be more difficult to secure in this market or may come at a higher cost.

Milani: The primary advantages for distressed investors are that quality businesses and other valuable assets could become available at attractive prices, given the appropriate financing structure and operating plan. Potential disadvantages include the uncertainty surrounding the depth and duration of the macroeconomic factors that are causing distress, such as inflation and interest rates. The higher cost of capital to finance transactions is another significant disadvantage that many investors are dealing with.

Mazza: Every cycle of distress invariably produces winners and losers, with companies facing existential questions about their future relevance. Corporate bond debt trading at cents on the dollar may be doing so for a good reason – the efficient market predicts that such debt will be significantly impaired in a restructuring or even wiped out. That is the downside to participating in the market. On the upside, discounted debt can offer opportunities for an investor group to take control of a restructuring process, inject new capital on favourable terms, and reap the benefits of post-restructuring equity ownership in a company with a right-sized balance sheet. That is why a meticulous evaluation of a business' fundamentals and its capital structure are so important to a successful distressed investment strategy.

FW: Have any recent, high-profile distressed M&A transactions caught your eye? What lessons can we draw from their outcome?

Hecht: One distressed M&A transaction in the UK to keep an eye on is Matalan. The outcome remains uncertain at this time but two points are worthy of note. First, the company is taking steps to amend the maturity dates on certain of its debt instruments to ensure that it has a sufficient runway to deliver a transaction. This will provide the company with a stable platform from which to run a sales process on a sensible, albeit accelerated, timeline, which should have a positive effect on participation rates and bid levels. And second, an unequivocal statement has been made to the market that there is an alternative transaction available with the group's lenders that will result in a positive outcome, if the M&A transaction does not complete. This may add competitive tension to the sales process and disincentivise bidders from seeking to pick up the business on the cheap.

Mazza: In the US, it would be remiss not to mention the so-called 'Texas Two-Step'. In a Texas Two-Step, an entity seeking to manage its mass tort liabilities avails itself of the Texas divisional merger statute by dividing into two entities – a so-called AssetCo and a so-called LiabilityCo. The LiabilityCo then files for bankruptcy to restructure its tort liabilities, while AssetCo funds LiabilityCo in an amount capped at AssetCo's value or some other referenced amount. As a result of this split, the AssetCo's assets and operating business stay outside of Chapter 11. Practitioners are paying close attention as these transactions are being tested in various US courts. Meanwhile, distressed M&A activity in the

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> Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates

crypto space is also garnering significant interest as the so-called 'crypto winter' has arrived. Crypto cases present numerous novel legal issues, such as whether crypto assets held by an exchange are property of the bankruptcy estate or its customers. Given the unanswered questions regarding cryptocurrencies, it would not be surprising to see additional regulation spawn out of these situations. The role social media has played in recruiting crypto holders as members of ad hoc committees to actively participate in crypto cases also has added a unique dynamic to these situations.

> INVESTORS WHO CAN, IN THE FACE OF NEGATIVE MARKET SENTIMENT, IDENTIFY BUSINESSES WITH STRONG FUNDAMENTALS, VERSUS THOSE THAT ARE UNLIKELY TO RECOVER AS THE MARKET TURNS, WILL BE REWARDED.
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> MARC HECHT
> Simpson Thacher & Bartlett LLP

Husnick: Hertz and Washington Prime Group are particularly notable in the US. In Hertz, the company sought Chapter 11 protection in the midst of the pandemic with its debt trading at a significant discount and its equity delisted from the New York Stock Exchange. The company saw some initial interest from retail stockholders that drove the price of its equity up during the bankruptcy, causing the company at one point to consider an equity offering during the bankruptcy. Unlike so-called 'meme stocks', many believed the pop in the value of the Hertz stock was a true indicator of the company's post-pandemic potential. Ultimately, outside investors stepped up with value significantly in excess of what was proposed in the original Chapter 11 plan, forcing a public auction, paying creditors in full and providing a material recovery to equity holders. This is a great example of how recoveries can shift meaningfully during a restructuring process. Washington Prime Group is another recent M&A transaction, albeit on the opposite end of the spectrum. The company negotiated a prearranged Chapter 11 case with a single creditor that was both the largest secured creditor and the largest unsecured bondholder. Recognising the difficulty of valuing a mall operator using a traditional desktop valuation on the heels of the pandemic, Washington Prime Group negotiated for the ability to run a full marketing process for the business to provide market evidence in support of the plan valuation at confirmation. While the official committee of equity security holders focused much of its attacks on the marketing process and the need to satisfy creditors in full, it was difficult for the committee to challenge the market evidence of value in the absence of a purchaser or investor willing to step up at a higher price. The parties settled their disputes before the bankruptcy court had to make a final decision on the evidentiary weight of a desktop valuation versus the results of a marketing process.

FW: Based on your experience, what particular considerations need to be made when structuring and financing a distressed M&A deal? How do aspects such as valuation and risk management directly impact return on investment?

Hughes: We always encourage potential purchasers to remain open minded when it comes to structure, as creative solutions often deliver the optimal solution for both buyer and seller. Adopting a narrow-minded approach where only a vanilla share sale or business and assets sale are considered can result in a missed opportunity to unlock further value. When it comes to financing, offers subject to securing funding are not viewed favourably by the sell-side in a distressed M&A process, so having sufficient capital to drawdown for the purchase price and post-transaction funding is paramount. One thing to bear in mind is that the funding need is often greater than expected given some of the operational and stakeholder issues that can arise in the months following the acquisition.

Mazza: Time is typically of the essence as distressed companies face liquidity or 'melting ice cube' issues that force investment decisions to be made quickly and with less than perfect information. It is important for investors to look for assets or collateral that minimise downside risk in the event the distressed target is unable to achieve a turnaround. Additionally, the process around distressed transactions is often highly scrutinised by stakeholders, making process and corporate governance considerations paramount to mitigating potential post-hoc litigation challenges. Risks – whether real or perceived – in distressed M&A deals are often reflected in pricing of deals and return on investment expectations. While valuations take a downward trajectory compared to where things were just a short time ago, investors that focus on targets with sound business fundamentals generally fare better than those trying their luck on catching a falling valuation knife.

Husnick: One issue that often arises in distressed or potentially distressed transactions is solvency. A distressed company may not be able to find a third party willing to provide an opinion to

support a solvency representation, which can lead the counterparty to question the party's ability to close the transaction and potentially lead to post-closing litigation related to whether the transaction constituted a constructive fraudulent conveyance – a transfer of property for less than reasonably equivalent value. These issues can be mitigated in most situations with a robust marketing process and a fairness opinion, but the risk is very difficult to eliminate altogether. Instead, these risks become part of the overall deal dynamic and must be 'priced-in' to the transaction.

Milani: It depends on the situation, but liquidity considerations, such as the cash flow outlook, are among the major factors. Will the transaction help bridge the execution of a recovery or a restructured operating plan? Collateralisation of assets is another key consideration. Who will own the assets if the operating plan fails? And how much secured debt can or will be used in financing the transaction? Finally, it is important to consider the management team. Does the business require new management? And is existing management a primary reason for the distressed situation?

Hecht: A distressed M&A deal is more complicated than a 'traditional' M&A deal. A distressed investor is required to be comfortable with the trade of taking on increased risk. It is not possible to allocate risk to the seller in the same way as one would do in a traditional M&A deal, in return for a higher discount. Increased risk arises because of having to acquire the assets on an 'as is' basis, on a compressed timeline with little opportunity for proper diligence and against the potential backdrop of insolvency, which could have an adverse impact on the target asset. It may also be necessary to transact via an insolvency practitioner, which needs to be properly understood. To be a successful bidder and to make a desired return on its investment, a distressed investor should have a clear view on how to transact, be it through or outside of a process, and whether a share deal or business and asset deal, an appreciation for the motivations of and outcomes for the stakeholders to the transaction, including the company's lenders, employees and counterparties, and the needs, including new money requirements, of the business following the transaction.

FW: Could you provide an insight into some of the legal aspects and issues that typically arise in distressed transactions? How might such issues affect the way agreements are drafted?

Husnick: Parties in distressed M&A transactions must pay particular attention to the level of conditionality and deal certainty. In a regular-way transaction, failure to close often leads to some sort of break-up fee, expense reimbursement and dry powder for the next deal. In a distressed M&A transaction, however, failure to close may lead to a bankruptcy or, worse yet, a liquidation and loss of jobs. As such, parties to the transaction often have competing motivations that drive their deal negotiation strategy regarding conditionality and deal certainty. It is incumbent upon professionals to find common ground and address conflicting concerns.

Milani: We frequently see complications surrounding the transaction structure. More specifically, is the transaction an asset sale or a stock sale? The buyer's due diligence should be a thorough process that is mindful of the liabilities and other obligations being assumed. Of course, consent may be required from certain third parties, such as existing shareholders and lenders, to assume commercial contracts and ownership of assets. Additionally, all parties involved need to be aware of fraudulent transfers. Distressed transactions are at risk of being deemed fraudulent transfers if it is determined that they were intended to hinder, delay or defraud creditors, or if the transaction was made for less than fair consideration or reasonably equivalent value. Transaction agreements clearly outline excluded assets and liabilities and include protections for the buyer if certain third-party consents are not obtained, including the ability to terminate the purchase agreement. With this in mind, buyers should consider obtaining a fairness or solvency opinion to validate the transaction value.

Hecht: A seller of a distressed business is looking for certainty of outcome and price. It will have limited, if any, appetite to include provisions in the sale agreement that could impact price after completion, such as representations and warranties, price adjustment mechanisms and indemnities, particularly when transacting

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> Kirkland & Ellis LLP

via an insolvency practitioner which may become necessary if directors are not prepared to transact. A buyer will need to consider other ways to address this risk, such as insurance. If an insolvency practitioner is not transacting, a buyer may require additional comfort around the solvency position of the seller and the valuation of the target or assets to mitigate clawback risk. On a business and assets deal, the buyer will need to take proper account of the assets and liabilities that are to remain with the seller and those that are to travel to the buyer. There are a number of additional thorny issues to contend with, such as the treatment of pension liabilities, the transfer of employees and tax that could materially affect the value of the business going forward and the return that an investor will make on its investment. Careful planning and well-considered documentation is key.

“ADOPTING A NARROW-MINDED APPROACH WHERE ONLY A VANILLA SHARE SALE OR BUSINESS AND ASSETS SALE ARE CONSIDERED CAN RESULT IN A MISSED OPPORTUNITY TO UNLOCK FURTHER VALUE.”

BEN HUGHES
FTI Consulting

Mazza: Negotiating and documenting distressed transactions centres around allocating the risk and uncertainty faced by a distressed target company. There is typically a competing tug of war between the target company and the investor or acquirer in this regard. The target company seeks to create a durable set of transaction documents that commit the investor to the transaction, and provide as few ‘off ramps’ as possible between signing and closing. On the other hand, the investor will want to ensure flexibility in the event of a change in circumstances. Some common drafting tools that reflect this dynamic are escrow mechanics and holdbacks, designed to protect the investor against the risk that the seller will not have the liquidity to pay an adjustment to the buyer. Meanwhile, the seller will push back against monies sitting in escrow for extended periods of time. Moreover, while indemnification provisions for breaches of representations and warranties are common in the non-distressed context, a distressed seller may be unable to perform on an indemnity and the buyer may have difficulty recovering on the same, in the absence of a holdback or escrow agreement designed to support such an obligation. A buyer may also attempt to include solvency representations. Such provisions, however, are often disfavoured by distressed sellers, and are of little value post-closing. Where investors will generally focus is injecting conditionality into a deal allowing them to walk if the target does not meet certain conditions.

Hughes: Imperfect or incomplete information, limited time with management and an accelerated timetable are par for the course in special situations M&A, so a pragmatic approach to legal due diligence is required, with a focus on the key risk areas. If the transaction is expected to be delivered via an insolvency mechanism, legal documents can prove somewhat of a challenge for the uninitiated, with buyer protections typically pared back. Some insurers offer a warranty and indemnity product to help mitigate this risk for a buyer, but I have rarely seen it used in accelerated M&A processes given the truncated timetable. Finally, in cross-border deals, you need to be prepared for the nuances of different insolvency regimes. As such, we always encourage interested parties to engage appropriate restructuring lawyers and financial advisers when participating in a distressed M&A process.

FW: What advice would you offer to distressed investors on working with various stakeholder groups during a deal process, and understanding their interests?

Mazza: A qualitative assessment of the motivations, experiences and any institutional limitations of stakeholders, and their investment thesis at large, can help drive a deal to a successful outcome and maximise returns. For instance, some incumbent creditors may be short-term lenders that do not have an interest or institutional ability to own equity or long-term debt in the distressed company. These players might be motivated to sell their position at some loss over a liquidation. Others may buy into the capital structure at a discount with an eye toward long-term value post-recapitalisation. These players, whose consent could be necessary for recapitalisation, might be natural allies for a strategic investor. Finally, certain historical equity holders, such as founders, may be out of the money from a valuation standpoint, but may be critical to a revitalisation of a business.

Hecht: Communication is key, both during a deal process and following the transaction. If stakeholders understand how a transaction affects them, and it is not to their detriment when benchmarked against the alternative, they will be less likely to agitate in a way that could result in the destruction of value – silence and conjecture can be alarming. Timing of that communication is also critical. Early stakeholder engagement is usually

important and stakeholders recoil at the idea of being 'jammed' into a transaction, but there may a good reason to delay if it could be detrimental to the process. In almost all cases, having a clear PR strategy to be rolled out to employees, suppliers and customers can make a significant difference to the viability of the go-forward business.

Milani: There are three primary pieces of advice for investors to consider. First, focus on the importance of opening communication lines between the various stakeholder groups. It is imperative to communicate proactively, frequently and candidly. Additionally, as it pertains to stakeholder interests, you need to understand all stakeholders' must-haves and their dealbreakers. Once you can bookend their requirements, you can then start to create the framework for a potential deal. Finally, assess potential outcomes for each stakeholder group using a model that outlines different transaction scenarios, including those where no transaction takes place.

Hughes: Conducting a stakeholder mapping exercise early in the sale process is an important workstream as it allows you to assess each party's drivers, goals and degree of influence. This process then allows investors to focus their efforts on developing and implementing a strategy to win the hearts and minds of the stakeholders holding the most influence. I would caution against trying to circumnavigate the process and engaging with key stakeholders without the sell-side's knowledge as this can lead to distrust in what may already be a delicate situation. Rather, investors should aim to build a good rapport with the sell-side adviser to leverage their knowledge of the stakeholder dynamic and be at the front of the queue when the sell-side present opportunities to engage with key parties.

Husnick: Distressed M&A requires an inordinate level of transparency relative to regular-way deals. In-court sale processes obviously require public disclosure of the terms and conditions of the deal and, in most cases, a public auction if there are other interested buyers. Even out-of-court M&A transactions, however, require significant transparency when there is distress because of different constituencies. For example, in a regular-way transaction, parties can assume that knowledge of the transaction will be generally limited to the seller, its board, its senior management, and its legal and financial advisers, on one hand, and the buyer, its board, its senior management, and its legal and financial advisers on the other. Of course there may be other outside parties such as shareholders, if there is a shareholder vote required, lenders to the transaction and regulatory authorities. In a distressed M&A transaction, all of these parties will be involved and potentially more, including existing lenders and bondholders to the extent either of the parties to the sale transaction needs relief from their debt documents or is in need of a broader restructuring transaction. As the list of parties 'in the know' expands, so does the risk of leaks and the concomitant risk of operational disruption and competition. This risk is especially acute where there are transitory stakeholders looking to arbitrage shorter-term movements in value.

FW: What is the current outlook for the distressed M&A market? What are your predictions for future activity levels?

Hecht: The increased cost and limited availability of acquisition financing and a desire on the part of businesses and their lenders to buy time for a recovery or turn in performance may slow what would otherwise be a swathe of distressed M&A transactions. However, there will be a number of businesses encountering financing distress for which a restructuring or other solution is not achievable given what are expected to be recessionary conditions in the coming 12 to 24 months, coupled with the sea-change in credit markets which has made vanilla refinancings an expensive, if not impossible, endeavour for many companies. In the round, we expect a busy period for the distressed M&A market in the coming years.

Milani: In looking at the current state of the market, expect distressed M&A opportunities to become increasingly available starting in quarter four of 2022 and lasting for roughly 12 to 18 months. This viewpoint is in line with what professionals in special assets and workout groups at financial institutions are expecting.

Hughes: Given current macro and micro dynamics, I think we are heading

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>
> MICHAEL MILANI
> Baker Tilly Capital, LLC

for a period of increased activity in the distressed M&A market that will cover large corporates seeking to exit non-core divisions, company rescues where a transaction needs to be delivered ahead of a pending liquidity event, and sale processes that are conducted to benchmark value to support a financial restructuring. While I do not think it will be the tsunami of mandates that some have previously predicted, I believe distressed M&A will be a trend for the coming years.

Husnick: The US appears headed to a potential recession, yet the US Federal Reserve shows no signs of slowing or stopping interest rate increases as it battles inflation. The pound and euro currencies face significant pressure. And Russia's war on Ukraine rages on while tensions increase in other parts of the world, including China and Taiwan and the Korean peninsula. These facts and others foretell a tsunami of restructuring work in 2023 and beyond. But history shows it is nearly impossible to predict whether there will be an uptick in restructuring work and how long it will last.

Mazza: I am optimistically pessimistic. This oxymoron carries with it the fact that as markets cool there will be real opportunities for players that understand the rules of distressed investing to make handsome returns. Many market observers had been waiting for the knock-on effects of COVID-19 since the lockdowns in March of 2020. Capital markets, however, stabilised and were very active in 2020 and 2021. Now, as central banks try to control the inflation bogeyman, companies will likely look to other strategic alternatives such as high-yield financing, opportunistic M&A, or in-court processes to implement financial restructurings. With these trends, there is likely to be some industry consolidation. Companies that can continue to access the capital markets and engage in strategic deleveraging transactions are likely to have stronger balance sheets and be less impacted by any recessionary environment. On the other hand, companies and assets with more execution risks and uncertainty around their businesses are going to have fewer and more expensive strategic options. ■

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