Diamonds in the rough: Buying distressed businesses

Diamonds can be found in the most obscure and hard to find places. Failing businesses, whilst often raising a myriad of red flags, can also on occasion be a gem worth investing in.

Most Investors are concerned when it comes to buying distressed businesses, however, if assessed and transacted appropriately, significant benefits can be obtained through purchasing a business on the rocks - even those subject to an insolvency proceeding.

Can the gem be extracted from the rock?

It's an unfortunate reality that many business sales promoted by insolvency practitioners never actually eventuate. This is because their appointment comes too late and any goodwill has been eroded or the timeframe to execute a transaction is so limited that it is difficult to conduct any thorough due diligence. There is simply no business worth saving and it potentially becomes a fire sale of assets.

When investigating the merits of purchasing a business in administration, it is critical to consider the following when developing a comprehensive due diligence program that addresses the key financial, commercial and legal risks involved with purchasing a distressed business. Prospective buyers must also be mindful that insolvency practitioners will likely have limited information and a short period of time to achieve a sale.

Financial performance:

Does the underlying business have the potential to produce future maintainable earnings or a contribution margin that justifies a purchase? Consider the benefits of removing the debt burden and the savings from consolidating or 'bolting on' operations to your existing structure. One of the key attractions of purchasing businesses through an insolvency proceeding is that unfavourable contracts (i.e. leases and employment agreements) can be eliminated prior to purchase. You have an ability to leave behind unwanted/unprofitable/burdensome contracts and contingent liabilities.

Customer retention:

Consider what impact the external administration has had on key customer relationships. Standard customer contracts normally include 'ipso facto' provisions which allow the termination of the agreement upon insolvency. Whilst there is widespread support for the Federal Government legislating against the use of these provisions as part of the current insolvency law reform process, interested parties should review existing contractual terms and recent customer dealings (i.e. historical sales levels) to check the status of key relationships.

Identifying and retaining talent:

The most valuable asset of any business is its management and staff. Ensure the due diligence process includes interviews with key staff and a review of their terms of employment. Be mindful to consider the extent of liability being assumed in respect of outstanding employee leave obligations. Whilst insolvency practitioners will normally do their utmost to secure ongoing employment for all employees, the fact is the purchaser can pick and choose.

It is also vital that the management team is engaged, ready and willing to lead the business into its next chapter. Often when a business has been through a period of deep distress, the pressures of managing cashflow daily and deal fatigue set in. The new owner must make every effort to motivate and incentivise the team so they are 'up for the challenge' ahead.

Investment required:

It is extremely rare to see a transaction where a purchase price is paid and the purchaser runs off into the sunset with a perfectly operational business. Often, businesses find themselves subject to an insolvency process in part due to a lack of investment. Capital has been spent in keeping the company afloat rather than investing in core operational needs such as IT, financial systems and working capital. Build a thorough 100 day plan that considers the capital expenditure required and whether significant other financial investment is needed in the immediate term (e.g. for marketing, staff retention or to re-stock the business etc) when assessing the financial merits of the purchase.

Be aware of the gem's flaws

Insolvency practitioners are cautious creatures. Normally, when marketing a business for sale, their involvement may have been short term and they often do not possess an intimate understanding of the entire operations of the business. Consequently, potential purchasers should not expect:

- Large volumes of financial information to be available during due diligence – after all, one of the most common factors leading to insolvency is a lack of sufficient records.
- Any form of forecast or prospective financial information to be available. If it is available, it will normally be so heavily caveated that it is essentially meaningless.
- The usual representations and warranties to be included in the contract of sale. Given the insolvency practitioner's short-term involvement, normal warranties provided are limited to physical existence, right to sell and clear title. Achieving additional warranties will be difficult.

All the above, of course, increases the perceived risk to the prospective purchaser. Some buyers will inevitably be turned off by this level of risk, whereas others who have an appetite for risk, will reflect the increased risk in their purchase price and associated conditions.

Make me an offer

Insolvency practitioners are always motivated sellers who have a limited period in order to realise assets to achieve the best possible return for creditors. Therefore, the emotional attachment, and often associated unrealistic price expectations that business owners have, do not apply. Accordingly, insolvency practitioners will look to strike commercial deals that provide a meaningful return and importantly, transfer risk quickly, wherever possible.

Consider the following advice and challenges when formulating an offer to purchase a business in insolvency:

- Highly conditional offers that operate on an earn-out basis or require significant warranties will not be acceptable. Insolvency practitioners prefer low risk alternatives that can be consummated quickly, even in some circumstances if the financial return is less favourable.
- The financial terms of an offer should reflect a quick process that incorporates a limited due diligence period, where limited representations and warranties are required.
- The simplest way to structure a transaction is a sale of business and assets, thereby leaving the corporate shell to be liquidated. Sales that require control of the insolvent entity to change hands (i.e. share sales) are more complicated, although are possible through a 'Deed of Company Arrangement' or DOCA.
- When making an offer, a buyer should consider the alternative recovery scenarios that are open to the insolvency practitioner, for example liquidation value, and develop their purchase offer accordingly.
- In noting the above, purchasers should be aware that in reality, 'fire sales' rarely occur. Insolvency practitioners have statutory duties and obligations to creditors to maximise value when selling assets. They need to justify to all creditors that they achieved the best possible outcome.

The true value of a distressed business (or lack thereof), is often only discovered by experienced investors and advisors. Opportunity certainly exists for those with the professional expertise, patience and a healthy risk appetite, to unlock the value that remains in a business following insolvency. Caution is always warranted when addressing the critical due diligence issues, and with the right advice around price and the associated terms, buyers may just find themselves presented with a diamond in the rough.

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