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Voice of the deal economy

## Distressed deals: Here come the strategics

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The recent [chess match](#) over the fate of **Sirius XM Radio Inc.** is the kind of M&A drama that doesn't come along every day. Satellite television pioneer Charles Ergen, the founder and CEO of **EchoStar Corp.**, tried to wrest control of the financially weak satellite radio company by buying some of its debt and offering a much-needed capital infusion. With a big slug of that debt coming due, Sirius CEO Mel Karmazin seemed to face a choice between bankruptcy and turning the company over to Ergen. At the last minute, though, Karmazin [struck a deal](#) with John Malone's **Liberty Media Corp.**, getting \$530 million in fresh loans in exchange for preferred stock convertible into a 40% stake in Sirius.



-- [See related story: One media maven on the upside of the downside](#) --

But if the personalities stand out, the tactics may soon look more routine. The pursuit of businesses and assets in financial distress or bankruptcy, once mainly an activity for specialists at restructuring firms and hedge funds, is becoming an attractive option for an increasing number of strategic acquirers like EchoStar. So far, most deals have been small. The corporates are learning as they go, and most will proceed with caution, mindful of their own balance sheets and attuned to the inherent complexities and risks. Still, amid the worst downturn in a generation, distressed deals will likely become much more mainstream than they have been in the past.

"It's early days in the cycle," says Jim Lavelle, co-head of the industrials group at **Houlihan, Lokey, Howard & Zukin Inc.**, an investment bank known for its restructuring business. "But we do expect the strategics to be circling and getting involved in these distressed and bankruptcy situations. We've had a number of inquiries from quite large companies -- 10 times as many as six months ago."

For companies that stay financially healthy, the wave of corporate distress now building promises plenty of targets. S&P predicts a record default rate of 13.9% by issuers of high-yield bonds this year, for example. Among other factors, the late, great buyout wave is expected to produce many opportunities for corporate dealmakers, sometimes for assets that they earlier battled private equity buyers to win.

"A lot of the strategics are watching portfolio companies of the PE firms, where the PE firms went and overleveraged them and pulled out all those special dividends," says Ed Bartko, global leader for **FTI Consulting Inc.**'s transaction advisory services practice.

What's more, when companies do go into bankruptcy, a dearth of debtor-in-possession financing -- which can buy time and give a firm at least a shot at re-emerging more or less intact -- is pushing them toward sales, in whole or in part.

Strategic acquirers have different motives for going after these targets. Sometimes an important supplier gets in trouble. When Plastech Engineered Products Inc. foundered last year, **Johnson Controls Inc.**, whose auto interiors business relies on Plastech products, considered acquiring the \$1.2 billion (sales) company.

But Johnson, which didn't respond to a request for comment, held back. Plastech ended up in bankruptcy, and in July Johnson, partnering with a **Goldman, Sachs & Co.** lending unit, [bought](#) Plastech's interior and underhood business (plus a controlling interest in a joint venture) for \$177 million. Smaller pieces of Plastech went to other auto suppliers.

More recently, several foreign buyers have sought to improve their positions in the U.S. by buying assets out of bankruptcy. One is **Mecalux SA**, a \$762 million (sales) Spanish maker of warehouse storage systems. In January, through two subsidiaries, Mecalux [bid](#) \$30 million for a bundle of assets from **UFC Interlake Holding Co.** Another is Taiwan's **Grand Home Holdings Inc.**, a gas appliance supplier that [bought](#) retailer and manufacturer Barbecues Galore Inc. for \$15 million in August.

Meanwhile, for acquisitive U.S. companies with active watch lists of potential targets, interest in distressed deals is rising in the normal course of business. The head of corporate development at a big, acquisitive industrial company describes the situation inside his firm, where in monthly M&A meetings with the CFO his team routinely notes targets that are looking fragile, sparking discussions about whether and how to take advantage of the fact.

"If it's a publicly traded company," he asks, "do you actually go out and acquire some of the debt and look to get some of the assets you want through a bankruptcy process?"

That path, of course, is only one among many that financially healthy corporate dealmakers are contemplating in the current climate. Some paths, such as bidding for a rival that's suffering from a depressed stock price, merely pass through the outskirts of distressed-deal territory. But others -- such as entering a bankruptcy auction as a stalking-horse bidder -- go right through the middle of it.

Indeed, it looks like strategic stalking horses aren't such exotic beasts anymore. Mecalux is one. Another is printer maker **Printronix Inc.**, which [bid](#) \$36.6 million for bankrupt rival **TallyGenicom LP** in January. Other bidders could emerge but aren't expected, and if Printronix should lose it's eligible for a \$2 million breakup fee and expense reimbursement. Owned by San Francisco private equity firm **Vector Capital Corp.**, Printronix's deal reflects a broader interest among PE shops in using distressed deals to build their portfolio companies. Amish Mehta, a partner at Vector, says the firm is pleased with how its first bankruptcy transaction is turning out. "We expect to do more," he says.

From a strategic standpoint, bankruptcy is just a plot twist in the story of Printronix and TallyGenicom, both mature tech companies in a consolidating sector. Printronix pioneered line matrix printers more than two decades ago and still dominates the mostly industrial market for them. Before going private with Vector about a year ago, its managers discussed transactional possibilities with TallyGenicom, a portfolio company of **Arsenal Capital Partners** and itself the product of an earlier merger.

According to Mehta, Printronix thrived under Vector's ownership by emphasizing its line-matrix business and the steady cash flows it produces. Meanwhile, TallyGenicom was suffering in the global slowdown. Vector reintroduced the idea of a deal but balked at the price Arsenal wanted. "We thought this was not a company that had the strength to withstand any global shocks," Mehta says. "And so we just waited until the point in time when TallyGenicom had to do something. And that's when we approached them again."

After laying plenty of groundwork, TallyGenicom filed for bankruptcy -- and Printronix came in with its bid.

As the recession grinds on, other long-running stories may also reach a turning point in someone's

Chapter 11. Before it [entered bankruptcy](#) in January, telecom equipment maker **Nortel Networks Corp.** was [trying to sell](#) its Metro Ethernet unit, said last fall to be worth as much as \$750 million, but found no takers. The bankruptcy put the sales process [on hold](#), but with Nortel likely to be liquidated, potential buyers (which reportedly include **Nokia Siemens Networks, Ericsson AB, Huawei Technologies Co. Ltd.** and **Cisco Systems Inc.**) will probably have another chance to buy.

Maybe that's even what one or more of them were waiting for. In this connection, the Mecalux-UFC Interlake deal is worth a closer look. Mecalux said in a release that in January 2007 it paid €5.8 million (\$7.3 million) for a call option entitling it to buy UFC Interlake for a multiple of between 7 and 8 times the group's consolidated Ebitda before the end of 2008. On Nov. 4, 2008, Mecalux said it wouldn't exercise the purchase option; on Jan. 12, Interlake filed for bankruptcy. Mecalux, which did not respond to an e-mail request for comment, will now get two plants, a sales network and Interlake's Mexican subsidiary if its \$30 million stalking-horse bid succeeds.

Straightforward is not the first word these deals bring to mind. In a field renowned as legalistic and technical, and with so many variables to consider -- the target's capital structure, creditor mix, supplier and customer relationships, among others -- it's easy for a dealmaker unfamiliar with distressed deals to put a foot wrong. Expert advisers recommend hiring expert advisers, and while they would say that, they have a point.

The most obvious factor setting distressed deals apart, of course, is the role played by the target's creditors. "In a distressed deal the sales price is typically not enough to pay lenders in full, and therefore the lenders are the party of interest and their opinion really matters," says Jeff Marwil, a bankruptcy lawyer at **Proskauer Rose LLP**. With dozens or even hundreds of lenders involved in different parts of the capital structure, framing an offer and creating interest among the different constituencies is not simple.

But buying a distressed target outright to keep it out of bankruptcy is only one of many ways to play these situations. Some strategics are looking at deals that give them a say in the target's fate, but with some protection against loss, should a bankruptcy occur. "We're having a lot of discussions with clients where it might make sense to make a loan to the company, as opposed to taking an equity position," says Ivan Lehon, a partner in the restructuring group at **Ernst & Young LLP**. The loan might be secured with some assets, which the acquirer could claim if the target goes bust. The acquirer might also get an inside track on acquiring the target later on when it's prepared to commit more capital.

A more common scenario for strategics -- at least so far -- is simply buying the target, or pieces of it, post-bankruptcy. So-called 363 sales (named for the relevant section of the U.S. Bankruptcy Code) get you the assets free and clear of other claims. Going for a 363 sale, however, requires another decision: stalking-horse bidder or not?

Like nearly everything else in this realm, a lot depends on the specific circumstances. Doing the due diligence necessary to make an initial bid and set the floor for a subsequent auction requires significant effort. The compensation -- typically expenses, a breakup fee and, most importantly, an inside track on the sale -- often makes it worthwhile. But Paul Crimmins, a restructuring specialist at **Mayer Brown LLP**, says he's also heard horror stories from stalking horses who had the auction rules changed in midstream. Still, he says, "on balance, there's an advantage to being the stalking horse."

#### The shape of deals to come?

Buying assets out of bankruptcy is new territory for strategic acquirers, but in a world full of distressed targets, some corporate buyers are taking the plunge. Here are a few noteworthy deals from the past six months.

Target	Acquirer	Price (\$mill.)	Bankruptcy filing	Deal closed	Deal summary
TallyGenicom LP	Printronic Inc.	\$36.60	1/26/09	Pending	Printronic, owned by PE firmVector Capital, is the

					stalking horse bidder in TallyGenicom's auction
<b>Interlake Material Handling Co.</b>	<b>Mecalux Inc.</b>	<b>30.0</b>	1/12/09	<b>Pending</b>	Spanish storage solutions manufacturer Mecalux is the stalking horse bidder for Interlake assets in a March 4 auction
<b>ArtSelect Inc.</b>	<b>Art.com Inc.</b>	<b>1.6</b>	12/4/08	<b>1/21/09</b>	Online art seller Art.com picked up rival ArtSelect from liquidating stock image and artwork supplier a21 Inc.
<b>Library House Ltd.</b>	<b>Dow Jones &amp; Co.</b>	<b>NA</b>	12/5/08 (administration)	<b>1/6/09</b>	Dow Jones purchased the venture capital database assets of U.K.-based Library House to expand its VentureSource product
<b>Archway Cookies LLC</b>	<b>Lance Inc.</b>	<b>31.0</b>	10/6/08	<b>12/4/08</b>	Lance was the stalking horse bidder for the cookie maker, one of two bankrupt units of Catterton Partners-owned Archway and Mother's Cookie Co.
<b>Mother's Cake &amp; Cookie Co.</b>	<b>Kellogg Co.</b>	<b>12.0</b>	10/6/08	<b>12/4/08</b>	Kellogg topped Lance Inc.'s bid for Catterton-owned Mother's by \$5 million
<b>Barbecues Galore Inc.</b>	<b>Grand Home Holdings Inc.</b>	<b>15.0</b>	8/15/08	<b>9/11/08</b>	Taiwan-based gas appliance supplier bought the barbecue retailer and manufacturer after heavy debt and slumping home market pushed the PE-owned firm into bankruptcy

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NA = Not Available

Source: **The Deal Pipeline**

It's important to remember, though, that the inside track doesn't guarantee a victory in a 363 sale. **Lance Inc.** was reminded of that in December, when **Kellogg Co.** topped its bid for Mother's Cake & Cookie Co., which became available in the bankruptcy of Archway Cookies.

Lance did [get](#) the Archway brand, however.

Even when an asset is free of other claims, it isn't necessarily free of other complications. One perennial worry is the way bankruptcy frays a target's customer relationships. That concerned **Dow Jones & Co.**

in January, when it **bought** the venture capital database assets of Cambridge, U.K.'s **Library House Ltd.**, which was in administration. "You always have to move quickly on acquisitions," says Clare Hart, president of Dow Jones' enterprise media group. "But on this one we didn't have a lot of time. The reason is you don't know what's going to happen if the company goes forward with administration or bankruptcy, the whole thing could get dissolved. If customers start to hear about that, they can lose confidence. You want them to realize it's finding a good home."

Relationships with the target's suppliers are another big issue. Some may be creditors, and all of them may be mad. And if you're buying assets rather than a company's stock, there are questions about the contracts with them. Says Marwil: "How do I make sure those contracts and relationships can be assigned when the assets are assigned? You probably have key contracts and key vendors you have to reach out to."

Not that buying the whole business and taking legal possession of all the relationships is a cure-all for contractual problems. Russell Clarkson, a veteran corporate development executive in the telecom industry who is now chief information officer at **Matrix Business Technologies**, can attest to that. Matrix, a provider of voice and data services to small and medium-size businesses, is a portfolio company of **Platinum Equity LLC** and a consolidator in a consolidating sector. Clarkson's role there has mainly to do with integrating targets, which tend to be troubled.

Since the companies are struggling, Clarkson says, they often have contracts with large suppliers of software or telecom services that are unfavorable to them. Some may have automatic renewal clauses to boot. So while all acquirers care about contracts, it's standard practice for specialists in restructuring and turnarounds to do a comprehensive review of a target's contractual relationships at the earliest opportunity. When you're burning cash, there's no time to dally.

Such is life in the trenches of the restructuring world, where the devil lurks in a host of operational details. Steve Liff, a partner at **Sun Capital Partners Inc.**, another restructuring-oriented private equity firm, describes the work this way: "It takes not just financial, but operational expertise. That's where the limiting factor is. If you're going to come into a company that's burning cash, with excess inventory, with problems with management, you have to have the stomach and expertise to deal with it."

Adds Lavelle of Houlihan Lokey: "Watch for the quality of inventory -- and be very careful on the accounting side. You want to make sure that all the things on the balance sheet are worth what they say."

Strategics do have some natural advantages, of course. Untangling impaired operations may not be a strong suit, but if a strategic is acquiring in a business much like its own, knowing how to run it is almost a given. Management problems at a target may be less daunting for a strategic that has a deep bench of talent to deploy, just as is often the case in a more conventional deal.

And last but not least, in a bidding situation, a strategic with significant synergies to realize should be able to pay more than a financial buyer -- again, just as it would in a nondistressed deal. As the industrial company corporate development executive explains: "Being the largest player in our industries, we can assign a value to assets that even other people in the industry couldn't match, never mind private equity."

These factors, together with their comparatively strong financial positions and access to capital, could make strategics formidable in the wave of distressed and bankruptcy M&A all sides agree is coming. As John Zieser, corporate development chief for media company **Meredith Corp.**, observes there may be some opportunities for strategics and more traditional distressed investors to collaborate. There will probably be more chances for them to compete, however.

First, though, the strategics will have to start testing the waters in greater numbers.

It's a lot easier for an Ergen -- not just chairman and CEO at EchoStar, but also a pioneering entrepreneur in his industry -- to go before the board and recommend a plunge into a distressed deal

than it is for a corporate development chief, no matter how well respected, to do so. With many companies coming off a dreadful fourth quarter, few boards are probably ready for that discussion just yet. With just a bit more economic stability, though, that's likely to change.

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