Special Situations Investments in Germany

A Viewpoint from PwC's Business Recovery Services

Current economic situation

The pace of global economic expansion started to slow in 2018. After the very high growth of 2017, GDP growth rates fell back to an average level in the course of 2018 and 2019. Considering the most recent economic development, the German Council of Economic Experts has lowered its outlook for the German economy to 0.9% in 2020. The main reasons are ongoing trade conflicts and risks regarding the uncertain outcome of Brexit negotiations resulting in negative impacts on German exports.

The German automotive sector is also facing some industry-specific challenges. Falling demand has led to a drop in domestic production since September 2018. A fair share of this may be attributable to the Worldwide Harmonised Light Vehicle Test (WLTP) regulations coming into effect, which resulted in an approvals backlog and production cutbacks. Despite favourable economic conditions thereafter, new vehicle registrations in Germany have risen only slightly. In order to remain competitive, investments in alternative drive technologies, digitalisation and autonomous vehicles were announced. The German automotive industry has good chances of successfully mastering structural change, as regional agglomeration of vehicle construction and important suppliers makes cooperative research and development possible. However, high levels of investment are weighing on company margins and costs resulting from the diesel scandal have had an additional negative impact. Companies are reacting by cutting costs, downsizing their workforces and reducing the complexity of their product portfolios. Some players have started to realign portfolios by selling entire business units. Other industries, too, are facing challenges. The plant and engineering sector's outlook has been deteriorating for four consecutive quarters, while shortages of skilled workers and investment in digitalisation and employee training are driving up costs and increasing the need for investment.

Overall, these developments have increased the level of stress in the market and increased the number of businesses in distress.

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Distressed opportunities: succeeding in uncertain times

Challenges may be addressed in many ways, the sale and acquisition of part of a business or an entire business being one of them. Distressed M&A is well known as the sale and acquisition of companies in crisis. It is an accelerated transaction process, representing a possible restructuring measure for companies facing operational and financial challenges. Properly executed, transactions can limit destruction of value or even provide owners and stakeholders with value-creation potential. Whatever the situation, however, it is essential to act quickly and effectively.

As such, corporate crises represent an opportunity for potential buyers and financial investors. 'Active' investors specialising in crisis management and suitable management capacity will try to create value in challenging times. Successful restructurings might realise synergies that the previous owners had not identified or not taken advantage of.

A highly specialised class of such 'active' investors are distressed and special situations funds. These funds are an established class focusing on corporates in distress or even insolvency.

They have restructuring-specific skills and the ability to drive complex processes both in and out of court, along with the required financial resources.

For more than a decade, this class of investors has raised ever-increasing amounts of capital, which was found to be difficult to put to work in a booming economy. While waiting for the long-anticipated economic downturn, investors had to compete for a limited number of distressed targets or look for opportunities beyond their primary investment strategy, such as by sourcing them in other jurisdictions or considering smaller tickets. As of August 2019, distressed investors looking for investment opportunities were carrying some $113bn of dry powder. Times of economic uncertainty, structural shifts within sectors and large corporates realigning their portfolios may yield various unexpected opportunities for professional distressed investors with a variety of investment approaches including equity, debt and debt-to-control.

Time and procedural challenges of distressed investing

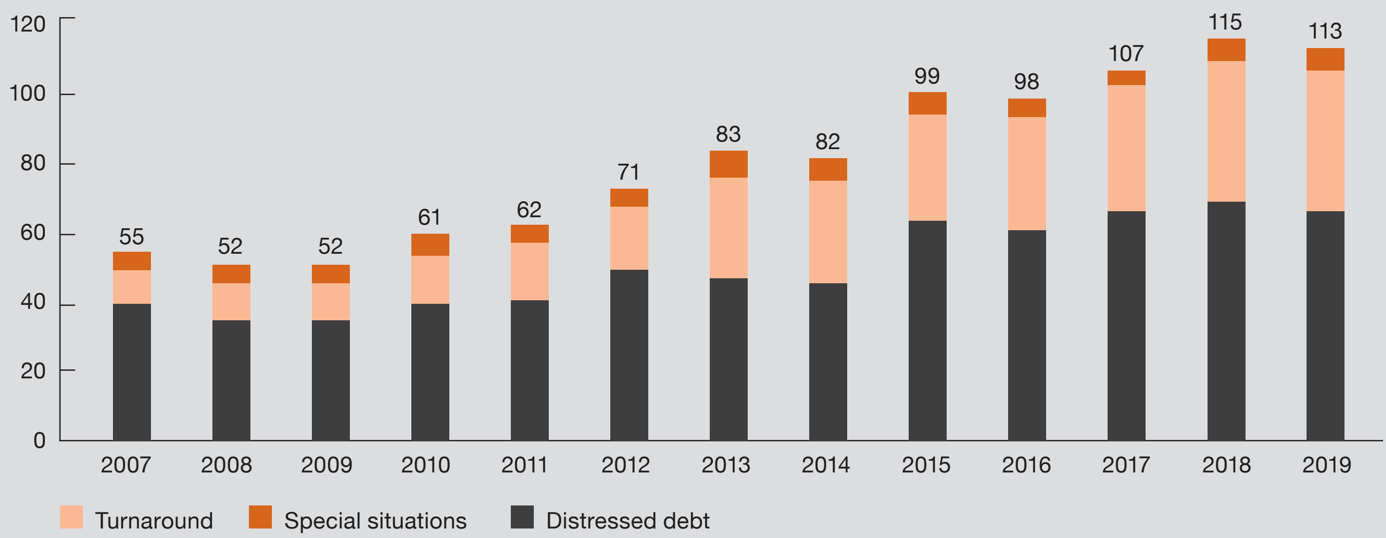
In general, a corporate crisis develops in three stages: strategic crisis, earnings crisis and liquidity crisis. The stage and degree of the crisis also impact the value of the company. As a company approaches an existentially threatening situation and insolvency, value destruction peaks. Digitalisation has recently become a catalyst of crisis development. Companies with low degrees of digitalisation tend to experience downswings from strategic to liquidity crisis faster and find it harder to master the challenges ahead. The ability of financiers to enter refinancing negotiations and initiate counter-measures to help decelerate the downturn is also often limited by covenant-lite structures.

Hence, quick action is required in crisis situations. Time pressure arises as worsening corporate crises narrow down the toolkit for shareholders and management to take independent action, reducing the probability of a successful turnaround. Value destruction continues and the time available for a transaction process is limited by the company's ability to survive. Survival depends on the availability of the financial resources necessary to maintain business operations, so time is crucial and short-term liquidity planning and safeguarding are of major importance.

A major problem with distressed investments is the determination of transaction prices. The transaction price is based on the future earnings prospects of the asset, also considering risk discounts. In particular, two questions need to be answered during the valuation: to what extent has a non-optimal capital structure influenced business activity? What is the time and cost involved in restructuring the company? Multiple-based approaches frequently used as rough indicators in healthy companies are only applicable if the multiples reflect a 'crisis' factor. Determining this factor requires a great deal of experience, as reliable comparative data are scarce. In any case, break-up values indicate the lower limit.

While distressed opportunities may seem attractive in terms of a timely process and a discount for the buyer, risks associated with investments in crisis situations should not be underestimated. Cultural barriers need to be addressed, while legal restrictions from labour, insolvency and tax law raise serious hurdles and may result in material liability risks for all parties, including seller, buyer and

Distressed investors' dry powder ($bn)



Source: Preqin 2019, data points 2019 refer to August 2019 management. Therefore, operating at the verge of insolvency requires experienced corporate restructurers, who are only available to a limited extent and not easy to find.

In addition, not all companies are suitable for a transaction during crisis. Proper analysis of the initial situation and setting clear transaction goals, including a clear view of the future business model, are essential for defining the steps going forward and eventually reaching the desired outcome. In particular, the business model plays a crucial role in assessing the prospects of success of a transaction. The key questions in this context are: does the company have a viable core business? Are the reasons for the crisis clearly identified? Is there a comprehensive restructuring concept? Is management capable of successfully restructuring the company? What resources are necessary to continue the business? Is high-quality financial information available and how robust is it?

For investors who decide to enter into distressed transactions, meticulous process management is key to ensure value creation in the long run.

Transactions within insolvency proceedings require particularly in-depth, interdisciplinary knowledge of traditional due diligence work and the specifics of insolvency law. A range of stakeholders must be addressed and their individual needs kept in mind.

Relevant parties may include shareholders, financiers, employees, customers and suppliers. In an insolvency case, additional decision bodies become relevant, including the administrator, custodian, creditors' committee, creditors' assembly, employees' representatives and many more.

Their conflicting interests need to be identified, understood and dealt with. Likewise, transaction security has become an issue in recent years. Trust can be reinforced by demonstrating sincerity and reliability through a professional team set-up and a credible acquisition story communicated in a clear, concise and consistent manner. Quick and decisive decision-making makes it possible to realise opportunities as they emerge.

PwC's buy-side methodology

PwC's structured approach to distressed acquisitions ensures minimisation of associated risks and increases the likelihood of successfully closing a deal.

Distressed transactions require a goal to be defined first. If an opportunity comes up, the strategic fit needs to be analysed in a due diligence process for each case. PwC also continuously screens the distressed market for investment opportunities and is able to identify relevant targets to match specified requirements.

The due diligence process is designed to 1) reveal risks and opportunities associated with the acquisition of a target, 2) assess restructuring measures (implemented, planned and any others that may be required), 3) identify synergies and 4) determine the purchase price. It covers relevant aspects of the target's business and operations, and the transaction itself. Addressing key questions with a competent expert team and including external support where needed is highly recommended.

Based on the due diligence findings and the transaction goal, an acquisition concept should be drafted. In the acquisition concept, 1) the structure of the company going forward is set out, 2) assets to be acquired are identified and a bid price (range) determined, 3) measures are defined to yield the desired transaction outcome along with implementation costs and 4) a timeline is set out. A well thought-out acquisition concept identifies milestones for value creation and is a solid basis for an investment decision.

If the acquirer decides to proceed, the deal is structured and executed accordingly. Execution varies between deals and may include setting up deal financing, right-sizing the target, addressing various legal risks relating to issues such as labour law, and hurdles such as antitrust approvals. These transactions, particularly those out of insolvency proceedings, contain multiple legal pitfalls that must be avoided at all costs.

Following a successful acquisition, the acquirer will need to make sure that they gain full control over the target. Depending on the case, this may be achieved through reporting mechanisms and/or by expanding or replacing the management team. Under new ownership, implementation of the measures outlined in the acquisition concept and identification of the steps necessary to complete the transaction will require a dedicated post-merger integration team to ensure the desired deal value is realised. The target will usually be fully integrated or divested at a later stage.

Selected aspects specific to distressed investing

	Out of court	In court (i.e. following the German Insolvency Statute [Insolvenzordnung])
Legal entity	Mostly share deals; acquisition of legal entity including various risks (liabilities, litigation, tax, warranties, etc.)	Mostly asset deals; legal risks remain with seller
Restructuring measures	Restructuring measures 'at cost'	Lower costs for headcount reduction and termination of adverse contracts
Cramdown	Consensual solutions required	Cramdown possible with regard to creditors and shareholders if insolvency plan has majority support
Market view	Reputation 'as is'	Risk of damage to reputation from insolvency proceedings

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About us

Our clients face diverse challenges, strive to put new ideas into practice and seek expert advice. They turn to us for comprehensive support and practical solutions that deliver maximum value. Whether for a global player, a family business or a public institution, we leverage all of our assets: experience, industry knowledge, high standards of quality, commitment to innovation and the resources of our expert network in 157 countries. Building a trusting and cooperative relationship with our clients is particularly important to us – the better we know and understand our clients' needs, the more effectively we can support them.

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