Hogan Lovells

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Thinking ahead: Distressed M&A in uncertain times

Almost a decade into the current bull market, many economic prognosticators are warning of a coming downturn. At the same time, political upheaval and uncertainty around the world is changing the landscape for cross-border trade—including mergers and acquisitions activity.

Hogan Lovells partners Richard L. Wynne and David A. Gibbons recently discussed how that macro environment is impacting distressed M&A today, and what steps business leaders and dealmakers should be taking to prepare for a shift in the economic winds.

Is the M&A market giving off any signals about when a downturn might arrive?

Gibbons: We have yet to see a significant shift in M&A activity. The market has slowed slightly from the first half of 2019, but that's coming off a very strong 18 months, which was largely driven by megadeals during the first half of the year. We've seen fewer of those more recently, but the middle market remains very active.

Wynne: That said, there's a lot of uncertainty out there at both the micro and macro levels. And of course, everywhere we look the political situation is challenging—with Brexit in the EU, Hong Kong protests, an on-again, off-again U.S.-China trade war, a very tense situation in the Middle East and impeachment proceedings in the U.S., plus an election coming up that presents some diametrically opposed views on economic issues.

Is that uncertainty finding its way into boardrooms, or giving dealmakers pause as they consider transactions?

Gibbons: We do see certain boards, at large conglomerates for example, rethinking their portfolios in preparation for a shift in the economic cycle. Leadership is starting to look at what assets will perform better or worse in a down cycle, and in some cases starting to consider shedding some assets while there is still a decent market for them.

Where there are real, immediate concerns for sellers, distressed or otherwise, is where the potential buyers could include entities that would invite government scrutiny. For the first time, we've seen the U.S. government block bankruptcy sales through the Committee on Foreign Investment in the United States (CFIUS). That's certainly catching leadership's attention, as it should.

When CFIUS scrutiny comes into play, how can it impact deals?

Gibbons: It can greatly impact the timing. Traditionally in distressed M&A, time is a critical factor. Sellers in need of cash want to know how quickly a potential buyer can close. That can get complicated on its own, but when you layer on mandatory filings under FIRRMA (the Foreign Investment Risk Review Modernization Act of 2018), it can have a huge impact.

Wynne: We recently had a distressed transaction where the federal government asked the Bankruptcy Court for a four-month delay in the sale process, based on a combination of CFIUS and national-security issues. But the seller didn't have four months of available financing. We had to explain the financial situation to the agencies involved, and once we did, they were able to expedite the process and get it done in three weeks; but they clearly hadn't considered the financial ramifications of a long delay until we raised them.

What industries do you expect to be hardest-hit in a potential downturn – and what opportunities might be created?

Gibbons: There could be opportunities for acquisitions in commercial aerospace if the fallout from a recession compounds the ripple effects that Boeing's issues are having. And in industries where we're already seeing struggles, such as auto parts and energy, where oil prices still haven't fully recovered. In pharmaceuticals we're seeing a lot of activity in certain segments, like antibiotics, and the fallout from the opioid crisis; a recession could accelerate that activity.

Wynne: Retail is another area struggling tremendously even in a robust economy. Most traditional retailers still haven't figured out online selling, and a downturn will only exacerbate that problem. We still don't know where the bottom is.

Gibbons: The retail challenge will also have a follow-on impact in real estate, with more shopping malls being repositioned and changing hands.

What should companies preparing for bankruptcy be thinking about today, knowing that the economic cycle could turn any time?

Wynne: Successful restructurings require advance planning and clear strategies. Restructuring is a team sport in any cycle, so it's never too early to start assembling, or at least thinking about, the financial and legal players you'll want on your side. You obviously need counsel who understands all the dynamics of your business and all the macro issues.

Timing will be key, as will an honest assessment of the market. When you have to ask a financial sponsor or the buyer to fund the process, which is common in restructurings, they'll want to see you have the right strategy and team to implement it.

Gibbons: Similarly, on the acquirer's side, it's not too early to start identifying the companies where there is a reasonable expectation for potential distress and considering whether they might have technology or other assets that would be valuable. You want to have a strategy for approaching them and a team that can execute a transaction quickly.

For a distressed seller in a declining market, the window for due diligence and risk assessment will be very narrow—the ability to close these transactions quickly will really set a buyer apart.

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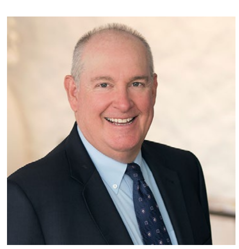

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