PRIVILEGE PARTNERS

Curing Zombie Companies via M&A

A Zombie Company is over indebted but is kept alive by the banks. The reason for the existence of Zombie Companies are loose lending policies by the banks encouraged by the lowest interest rate environment in the history of mankind. Under normal conditions, such companies would have gone already out of business. Many of those business owners view financial debt as free money and ask for high valuations for personal reasons. This poses a significant challenge for many M&A transactions, which actually could help to cure the Zombie. Sophisticated buyers can bring in new know-how, expertise and apply a more conservative debt/equity financing structure so that the Zombie firm has a chance to become a sustainable business again. In recent years many possible M&A transactions were postponed instead of curing the Zombie.

December 11th, 2015, Cyrill Haenni

During the last years I came across a specific type of company, which created quite some challenges in our Mergers & Acquisitions (M&A) practice. The companies were mostly privately owned Small and Medium Sized Businesses (SMEs) in various industries, had significant revenues and showed positive Earnings before Interest, Taxes, Depreciation and Amortization (EBITDA). Quite a number of those companies were of interest to our clients on the buy side. The difficulty was always that they came with a significant amount of financial debt (>6x EBITDA). I suddenly realized that we were dealing with a specific type of company that required some different thinking: The Zombie Company.

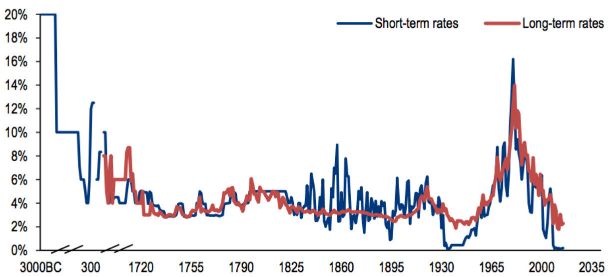
What is a Zombie Company?

A Zombie Company is kept artificially alive due to generous bank lending policies. This definition includes

companies, which obtain excessive debt above any sustainable threshold and also companies, which benefit from artificial economic activity trigged by such generous lending policies. For M&A purposes, the definition of a Zombie Company is a company, where (1) the enterprise value is lower than the amount of debt, thus equity value actually is negative and (2) the company can only pay for interest but not for principal repayments.
Further symptoms normally are (a) the company might still be profitable, (b) current capital expenditures (CAPEX) are minimal, (c) the company might have done some bad capital expenditures in the past, (d) operating assets serving as bank collaterals, (e) liquidity is low and net working capital is tight. A Zombie Company is heavily exposed to the risk of rising interest rates, which could lead to insolvency. Thus the company is still alive but in reality is halfway dead and at some degree of risk to default.

Why do we have Zombie Firms?
Interests rates during 5,000 years of civilization have never been so low as today according to the Bank of England's chief economist Andy Haldane. The main reason for such low interest rates are the monetary policies of the central banks in the US and Europe aimed to artificially trigger economic growth and save jobs in the short-term. This exceptional environment of all-time low interest rates is creating a financing bubble, whereas – according to Jon Moulton, the Founder from the Turnaround Investment Group Better Capital in the UK - the low interest rate environment saved many companies, which normally would have gone out of business. Thus many companies got access to cheap financing, which otherwise they would not have obtained. In some other cases the banks did the mistake to lend against asset value and not against cash flow in order to grow their lending business. However for businesses, operating cash flow is needed to keep servicing the debt. At a certain debt level it becomes unfeasible to downpay the debt and thus turns the Company into a Zombie.

The lowest interest rates in 5000 years



Source: Bank of England, Global Financial Data and Sylla 'A History of interest Rates', Business Insider Deutschland, 18th Sept 2015

Are Zombie Companies Good or Bad?
The following Pros and Cons summarize in general the benefits for the economy and stakeholders of allowing Zombie Companies to exist:

Pros

- Saving businesses and keeping jobs
- Allowing businesses more time to adjust
- Avoiding loan write-offs for the banks

Keeping Zombie Companies alive, allows the government to save jobs and avoid further social problems in the short term. However in the long term, the effects are rarely sustainable. As soon as the created bubble bursts, the Zombie firm will have to adjust.

Cons
One could argue Zombie Companies do not hurt anybody but there are several disadvantages to the economy as well:

- Inefficient allocation of capital
- Distortion of the free market
- Eating market share of healthy companies
- Paying interest rather funding expansion
- Higher job risk
- Artificial high business valuation

Access to cheap financing allows the funding of projects with poor long-term financial viability which otherwise would not have been undertaken. Since the cost of capital (debt) is very low, it misleads management in its capital allocation decisions. Furthermore, Zombie Companies take away market share from healthy businesses which otherwise could perform better. Given the financial leverage, jobs at Zombie Companies are at higher risk than jobs at a healthy company, as they are not based on a sustainable business. If debt is higher than the enterprise value of the business, it implies that it becomes more expensive for a buyer to buy the company, as he needs first to repay debt till he can start to get his money back.

Buyer's motivation to acquire a Zombie Company
Why would anybody be interested to acquire a Zombie Company where the business value is lower than the amount of debt? - The answer to this is, because one can get the equity very cheap (at a low dollar value) and by bringing in new know-how it improves the profitability and valuation of the company. In addition the money mostly will go into the company and not into the pockets of the seller. Thus the buyer will receive an attractive return on his investment.

Prerequisite for buying a Zombie Company is solid industry know-how, management and turnaround expertise. Thus the best buyers for Zombie Companies are mostly Strategic Buyers who are highly familiar with the industry and know how to run the operations in an efficient manner. Financial buyers are less likely to be suitable buyers for Zombie Companies, as they see less synergies which can be realized and fear the excessive debt – unless they are speculators.

The Management Issue

Many Zombie Companies have operational management issues such as missing know-how and processes, especially SMEs. In addition there might be a lack of financial resources to implement efficiency improvements. Symptoms are that fixed costs are too high, the volume of sales is too low and the company has done some unfortunate capital expenditures in the past. From an M&A perspective this opens up opportunities for a buyer to create synergy gains and create additional enterprise value.

Owners Rationale and Perceived Irrationality

If the equity value is negative, any rational owner would use the opportunity to sell the company if he could. Surprisingly, many business owners especially for SMEs have no intentions to sell - based on very rationale reasons for themselves:

- Low costs of debt financing and generous banks provide financing for free - a once in a lifetime opportunity.
- Controlling a company has value, the control premium.
- Alternative investment options are missing. Given banks currently pay nearly no interests on deposits, it might be a better alternative to keep the company and view it as an inflation protected asset.

From the outside the owner seems to behave irrational, as he seems to neglect his risk by using such a high degree of leverage. From an external point of view, the best option for the owner would be to sell at any price. In reality there is an arbitration game going on here: The owner thinks he can manage the risk better than a newcomer since he knows how to run the business. Nevertheless, the risk assessment is subjective, a small mistake might actually wipe out the owner's equity stake and the bank might take over.

The owner's rationale includes the bank, which will play along with his risky game as the bank heavily depends on the owner to keep the business running in order to avoid a debt write-off as long as possible. However, the longer this game goes on, the higher the likelihood that things go South, thus its in the banks and the owners interests to cure the Zombie.

The Role of the Banks

The amount of financial debt put on a Zombie Company normally breaches any reasonable covenant in the bank loan agreement (e.g. relationship between interest bearing debt and EBITDA). Due to their internal risk management policies, banks will refuse to lend more money to the business. Since their outstanding loans are at risk, their main interest is to reduce such risk and get out of this uncomfortable situation by avoiding a debt write-off. The bank now has two alternatives, either to let the owner continue running his company or force the company into bankruptcy by requesting immediate repayment of the outstanding loan. In most cases the bank decides for the first option as a bankruptcy will materialize into a loss of their loan and will devalue even further if collaterals are valued using a liquidation scenario. Prerequisite to this is that the bank keeps trusting the owner, otherwise they will have to step in.

By dealing with Zombie Companies, the bank needs to be especially careful in reviewing and continuously monitoring the company's situation in order to avoid getting screwed. I have seen cases where business owners extracted cash from the company under the bank's nose. In other cases, business owners are using complicated legal structures and diversify their bank loans among different financial institutes to disguise their real distressed situation.

From an M&A perspective, when buying a Zombie Company, the banks ongoing support or even a haircut (debt write-off) will be needed. During deal negotiations and due diligence, close attention to the banks loan agreements needs to be paid.

The Cure for Zombie Companies

In the TV series The Walking Dead, the only solution to end the misery of a Zombie is the carefully placed headshot. In business, a Zombie Company has more hope, as a Zombie Company is a temporal anomaly in nature and in many cases there exists a cure.

Curing a Zombie Company means finding a way to reduce the financial debt of the company and improving operations to generate more cash flow. In most cases an additional equity injection will be needed to adjust the debt/equity financing structure to a more sustainable level. In some cases, the bank would actually have to agree to a debt write-off to make the financing structure work.

On the operational side, restructuring needs to be checked for hidden improvement potential among costs and revenues. Normally the low hanging fruits can be found among the costs while expanding revenues might take a bit longer till they materialize. The main challenge with operational improvement might be the (missing) know-how. If it cannot be organized in-house, it needs to come from outside.

The Business Owner's Dilemma

Especially the owners of privately owned SME companies have tied nearly their whole net worth to the company. Thus business owners have every incentive to keep the status quo as otherwise they might loose everything. I have seen cases where the owner appears to be a Zombie as well – most likely personally indebted. Faced with such situation, the business owner might have every incentive to prevent any M&A deal and prefers to keep operating at high risk.

A Zombie Company de facto belongs to the banks and not to the shareholders, as the company is over indebted in that moment and on the verge to become insolvent. However on paper the shareholders are the rightful owners and as long as the bank is not interfering, they will make the decisions.

The owner will have to decide if he wants to be part of the problem or part of the solution by putting the company's interests before his own interests. A Zombie Company most likely will need external help to get out of this situation, thus the opportunity of securing a sophisticated buyer might secure the future of the employees for his company. The owner most likely will have to make personal sacrifices and offer a controlling equity stake almost for free in order to make the M&A transaction work. In best case he gets something from the upside if the transaction works out for the buyer.

M&A with Zombie Companies Remains a Challenge

From an M&A perspective, a Zombie Company poses quite a challenge, as business owners behave as financing of the company is for free and ask for high business valuations. For that reasons many M&A deals which otherwise would have been possible were postponed during the last years.

Sophisticated buyers, which possess the required industry know-how will value the company quite accurately (below the debt amount), will need to find synergies / improvement potential to find their upside and also want to implement a more conservative debt/equity financing structure.
They seek ways to reduce the risk as they don't want get into troubles themselves later on. If needed, they will require the bank to accept a debt write-off.

Conclusion

Todays lending environment of lowest interest rates in the history of mankind combined with lax lending practices by the banks led to the existence of Zombie Companies. Under normal circumstances those companies would have been out of business by now. Surprisingly, business owners of such Zombie Companies behave quite rational, as they benefit from a fully debt financed investment vehicle and can ask for compensation for their controlling equity stake as long as banks do not interfere. From an external risk-adjusted point of view, it would be advisable to sell the company since the debt amount is higher than the enterprise value.

Buyers interested in pursuing a M&A transaction with such Zombie Company need to be especially careful in their due diligence process, will have to analyze the company in depth and identify synergies and improvement potential to find a way forward. They will also need the bank's cooperation if not even willingness to write-off some of the debt in order to implement a more conservative debt/equity financing structure. This way the M&A transaction will work and will cure the Zombie.

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