An outlook: the rise of distressed infra M&A

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The current economic downturn is expected to bring about a growing niche of investment opportunities in distressed infrastructure and energy assets and businesses.

Infrastructure in crisis mode

As a result of the COVID-19 pandemic, many industries worldwide are in crisis mode. While there is no generally accepted definition of a crisis, a crisis begins long before insolvency, as soon as a business is threatened with insolvency without far-reaching performance or financial restructuring measures, or is likely to soon be unable to meet its current liabilities or maintain business operations.

Looking at the infrastructure world, a material under-performance as well as a shortfall of revenues in the transportation sector – airports, railways, motorways, ferries etc. – is only the most prominent example. However, other sectors such as energy generation will also have to respond to new challenges as a result of decreasing demand for electricity and steam-offtake, in particular from industrial customers, as well as from the disruption of supply chains.

Infrastructure assets not built for crisis mode

As balance sheets of the typically rather conservative and long-term oriented infra businesses are built for more stable times and cash-flow expectations are not equipped for such unprecedented challenges, a re-examination of business models and underlying contractual frameworks may be required for those businesses that are materially affected by the COVID-19 crisis.

Investment opportunities in distressed infra assets a solution?

On the one hand this means that public shareholders and also financial and strategic investors may wish to bring fresh equity and operational experience on board but may primarily wish to dispose of their respective interest in order to create liquidity, to reduce the cost burden caused by the non-performing asset and to focus on other core activities. Firefighting therefore has priority.

On the other hand, the opportunities for buyers are obvious, as the valuations of affected businesses will be under pressure and buyers would be presented with the opportunity to realize an investment at a comparably low purchase price considering where the market stood just a few short months ago.

Against this background and given the enormous upside potential of infrastructure assets under pressure, infra investors are readying themselves for upcoming distressed opportunities, an area many investors have shied away from in the past due to its complexity, higher risk profile but also due to the sufficient availability of well-performing assets.

Thus, it is critical to carefully assess the risks despite a potential time pressure, to focus the due diligence on the appropriate issues and to set the right priorities in the negotiations.

But what precisely is there to get right?

Get the timing right!

The implementation of a transaction prior to insolvency has the significant advantage that the buyer and seller themselves control the M&A process. Once a target becomes insolvent, an insolvency administrator usually takes control, and in any case, creditors are given a decisive say. From the buyer's point of view, the phase before insolvency also offers the advantage that the target is not yet afflicted by the stigma of insolvency. If the company goes bankrupt, the business may be permanently damaged by business interruptions, customers jumping ship and the (usually best) employees are the first to leave the sinking ship.

In addition to the already mentioned significant adverse effects of insolvency on business operations, the acquisition of an infrastructure business from the insolvency administrator has the further disadvantage from an M&A point of view that insolvency administrators generally do not provide any guarantees in the context of the sale, with the exception of the guarantee of ownership of the assets sold. With this, we would like to promote transactions before insolvency despite a corporate crisis. The risks are manageable and can be mitigated by legal measures. The damage that is often inflicted on a company in insolvency is often much greater than the savings made due to a possibly (even) lower purchase price.

Get the due diligence focus right!

By nature, infrastructure assets require a different approach to due diligence.

While it may be sufficient in "traditional" M&A to summarize the key provisions of agreements (such as termination and change of control) and to examine whether the agreements are legally binding, this is not enough when dealing with infrastructure projects. The traditional approach tacitly assumes that the agreements are implemented according to their provisions, without any “problems” arising.

This approach is too simple for the infra world. It tends to be the rule rather than the exception that, during long-term projects, situations will arise that deviate from normal/standard operations. The current COVID-19 crisis is a very illustrative example for this thesis.

Therefore, it is important to conduct a risk-based due diligence by analyzing the project agreements as part of a stress-test, by taking the specific characteristics of the respective project into account. The outcome of the stress-tests will reveal to what extent it may be possible to amend, renegotiate or terminate the terms of potentially disadvantageous project agreements with negative impacts on cash-flows and underlying business models – this is a significant success factor for any infrastructure M&A transaction and its future implementation.

In this regard, a careful examination of the project agreements yields the best results if it is carried out by the lawyers with the appropriate drafting and negotiating experience. Only they are able to rapidly and reliably understand which scenarios may have which effect on the project agreements. As a result of the due diligence, buyers should not only be aware of the current status of the agreements, but also of precisely what may lie ahead – and what does not.

Get the stakeholder's expectations right!

While a normal M&A transaction is often negotiated directly between only buyer and seller and often even the management of the target company is not directly involved, the group of critical stakeholders is larger in distressed transactions: the success of the transaction depends to a large extent on the support of the management of the target company, its employees, but also its creditors (especially banks and credit insurers) and customers. Everyone can and must make their contribution to the success of the transaction; everyone can only win with a transaction if the alternative is the liquidation of the business.

The buyer has to inspire the management with his recovery plan, creditors have to agree to a haircut of claims, and customers can show their solidarity and promise their further support. Finally, the seller has certain expectations with regard to a face-saving exit and may also wish to participate to a certain extent in a successful recovery of the business. One of the core tasks of the transaction consultant is to understand the various interests of all stakeholders, to mediate between the stakeholders and to secure support for the transaction.

Get the SPA focus right!

As time is of the essence, it is particularly important that the transaction is led by a small, professional and experienced team. The market standards and contractual conditions of distressed infrastructure M&A transactions differ significantly from normal M&A transactions. Nevertheless, there is room for negotiation. It is crucial to know the market standards and negotiation margins, not to over-negotiate and not to take off-market positions.

And finally: Get the Restructuring right!

The buyer needs a plan for the restructuring. In most cases, cutting off liabilities through the transaction is not enough if the business continues to burn money every day. The restructuring know-how of the buyer dictates the success or failure of the transaction and the future of the company.

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