LUISS Guido Carli
LIBERA UNIVERSITA' INTERNAZIONALE DEGLI STUDI SOCIALI

*Department of*
Business and Management

*Chair in*
Performance Measurement
and Financial Reporting

# WHY DISTRESSED M&A ARE MORE PROFITABLE DURING DOWNTURN: THEORETICAL AND EMPIRICAL EXPLANATIONS

SUPERVISOR
Prof. Giovanni Fiori

ASSISTANT SUPERVISOR
Prof.ssa Elisa Raoli

CANDIDATE
Alessandro Calabrese
663181

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# Abstract

The goal of this study is providing explanations behind the higher profitability of distressed M&A during downturn periods.
Generally speaking, it was shown that, on average, M&A transactions concluded during recessions (also at a global level) bring to higher returns for bidders than in upturn periods.
This effect is more emphasized when dealing with distressed M&A: by definition, distressed M&A are transactions in which the acquired company faces difficulties in generating profits and repaying its liabilities.
It could be sound as a paradox that acquiring a firm during crisis may result in higher value creation, as well as it is strange that this is particularly true in case of distressed operations that are, in general, even more risky.
Anyway, what can be considered extremely negative just like a distressed business or the current economic trend, can hide new growth opportunities, that may reshape the general framework by giving new companies the chance to become market leaders. Thus, distressed mergers and acquisitions represent an important tool to achieve this goal, and they can be exploited better just during financial crisis, in which the fear and excessive caution of many players can provide further chances to overcome its own competitors.

To explain such a paradox, the study begins with a general overview of distressed M&A operations. As it will be shown, some of their peculiar characteristics well fit with the issues of economic crisis and, just because of such uncertain environment, this kind of transaction is more likelihood to generate positive returns.
Obviously, distressed M&A remain risky strategies, because of the large amount of issues that a bidder has to face in managing a firm in troubles. Higher due diligence, coordination with all the parties involved and continuous monitoring over the whole process are the key ingredients to conclude positively a distressed deal.

The second part of the work analyzes the theoretical explanations provided by literature behind the higher returns of distressed acquisitions/mergers in downturn. Even if there is not any strict rule about, it was shown that, if particular conditions correlate each other, it is likelihood that bidders gain from distressed operations despite the difficult economic environment around.
At the base of this theory, the general success factors of distressed M&A and the advantages of crisis periods will be explained.

In the last part, empirical cases of distressed M&A concluded during the current recession will be analyzed. They had different backgrounds and features if compared each other and, just for this reason, they represent a further proof in favor of the theory about distressed deals in downturn.
In particular, besides enhancing the validity of theoretical explanations, other ones will be provided. Even if some of them are "firm specific" and fit with their own particular case study, they are the demonstration that no certain rule exists for distressed M&A, and depending on different cases several specific variables must be considered.

# Chapter 1:
# Introduction to distressed M&A

## 1.1 Introduction

The recent financial crisis, like many other similar ones during past years, has brought dramatic consequences on the global economy, changing the whole business environment by creating new market leaders and provoking the default of several existing ones.

In such a scenario, companies recurred to mergers and acquisition strategies to enhance their position or find a way to survive to potential losses by exploiting synergies with other partners. These factors provoked a huge wave of the so called "distressed M&A": the goal of this chapter is to explain in details what they are and to describe all their characteristics and implications, as well as their path during past years. Even if they may be considered risky strategies, in particular during downturn, they represent an important chance for firms to recover from crisis, both from a seller and a buyer point of view.

## 1.2 Definition of distressed M&A and its characteristics

In general terms, a "distressed M&A" is a merger/acquisition transaction in which the target company is distressed. More deeply, the target is not able to face its liabilities (mainly represented by debts) both in terms of payments (principal or coupons) and in terms of covenants, as well as it has difficulties in getting new loans to increase its liquidity (Sandager, 2014).

As it can be easily observed, this condition is very common during economic crisis, where losses make companies unable to cover their debt causing default. To avoid that, distressed firms try to sell (usually at discount) their assets and, just for this reason, acquisitions are the most common type of distressed M&A.

In particular, global crisis pushes assets' price further below than in normal, inflated conditions, making them particularly attractive for buyers. In fact, target firms have usually low bargain power in such circumstances, attracting the interests of other companies, also competitors, that can exploit their higher power to enlarge their position also in other industries.

More deeply, according to a study based on several investment banks analysis, the most common types of distressed M&A are the ones based on Chapter 11 reorganization (58%) and Section 363 asset sale (38%), that will be explained further in paragraph 1.3. The other main types are the sale out of bankruptcy, pre-packaged bankruptcy deals and liquidations (Schulte Roth & Zabel, 2012). As it can be analyzed in next paragraphs, buying a distressed firm inside or outside bankruptcy determines certain conditions that can be very convenient for buyers especially during downturn.

### 1.2.1 Signs of distressed situation and its consequences

A distressed company usually shows particular signs that may be taken into consideration by a potential buyer before a transaction. Even if the most common one is represented by a huge percentage of leverage, there are many others that a correct due diligence process should consider.

Among them, the most important ones are (Kagunya, 2015; Recovery & Turnaround Ltd, 2016; Sandager, 2014):

- *bad capital structure*
- *hostile industrial environment*
- *poor performance/ cash flows*
- *management/stakeholder conflicts*
- *excessive amount of debt with respect of enterprise value; difficulties in repayment*
- *continuous need of liquidity injection and difficulties to capital access*
- *credit downgrade*

- *pending regulatory investigations (e.g. by banks)*
- *cost/debt emergency reduction program*
- *high personnel turnover*

The more the time runs, the more these factors may have a negative impact on the company, provoking even greater loss of shareholder value
So, a potential buyer should keep in mind all of these factors to avoid misunderstanding in evaluating target company and in recovering it: for example, if management problems are the main cause of distress, acquiring the target and just injecting more liquidity would adjust its capital structure but not its forecasted performance. So, as it will be described more deeply in next paragraphs, the first step for a buyer is to identify the main causes of distressed conditions and adapt its strategy to them in order to turn around the target. Obviously, just few alarm signals do not mean distressed conditions for sure, but they have to be examined before entering in a potential risky transaction.

The consequences for a distressed company are several: at first, they may be just "alarm signals" like a little credit downgrade, profit slowdown or potential covenant breaches. Anyway, they may provoke more several damages: creditors' control over management, difficulties in refinancing and equity value negligible are the first significant that make a firm "distressed". As time passes, a company may become insolvent and the risk of bankruptcy may be very high: the first reaction usually is selling assets to repay creditors at the expense of shareholders, as well as the total loss of control by management. The new main goal becomes satisfying the different interests of stakeholders and it obviously represents a difficult challenge to face.

Due to all these problems, from a theoretical point of view, distressed M&A usually do not involve insolvent business or bankrupt firms, since managing with them would be too uncertain and dangerous, in particular during a global downturn. For this reason, general literature states that distressed companies fall in the middle of underperforming business and insolvent business, representing a good trade-off between risk and opportunity. Anyway, the number of acquisition of bankrupt companies is significantly growing in last years, also because they can give to the buyer several benefits (like according the U.S. law), as it will be explained in the paragraph 1.3.

### 1.2.2 The role of stakeholders

One of the main challenges that a distressed company has to face is represented by its stakeholders. Usually, they have different interests and requirements and managing them is the key success factor for every rescue plan. One of the main goal of advisors is just dealing with a heterogeneous stakeholder base, from investors to shareholders and so on (PWC, 2014).

In the table below the main types of stakeholders are represented, grouped by category.

**Table 1.1: main stakeholders involved in distressed companies**

| Regulatory | Operational | Employees | Shareholders | Creditors |
|---|---|---|---|---|
| Pensions | Suppliers | Management | Listed | Secured |
| Tax | Customers | Employees | Private | Unsecured |
| | Landlords | | Private equity | |
| | Credit Insurers | | | |
| | | | | |

**Source: Luigi De Vecchi (Luiss Guido Carli, 2015)**

Depending on the stage of distress, the needs of the above players may vary.
For example, management may suffer because of a severe default situation, with the risk of being fired as well as judicial implications. A similar circumstance may happen to common employees, that may be suspended from work or see their wages reduce.
Operational stakeholders and creditors care about the ability of a company to address its covenants and liabilities, to avoid a consequent risk of default. In particular, they are interested in business performance and, consequently, in the activity of board and, for this reason, they may push for a management change.

Shareholders are the more critical ones, because of their lack of priority in asserting their rights (for example in case of bankruptcy) and lower return on investment. Moreover, they carry also the risk of consequences in a financial market perspective, like the fall of share price and the impossibility to ask for more capital increase from investors. In extreme cases, they, together with management, may lose the control of the firm on behalf of creditors for example.

The difficulties of meeting such different interests may support the acquisition by another entity, in order to turn around distressed conditions. For this reason, stakeholders represent an important part of distressed transactions, just because their support is needed to make efficient the transaction, without spending too much time or using excessive resources. For example, also unions may put pressure to facilitate the transaction in order to ensure the interests and rights of employees. The same may happen in case of government, interested in the rescue of public companies or large ones for the national economy, like happened in the case of Alitalia - Etihad transaction (chapter 2).
Hostile stakeholders not only may extend the length of the whole process, but also may give a negative signal to external environment, with the risk of undervaluation of the target or adverse financial market sentiment. Company board should have a proactive role in identifying them and negotiating to reach a common agreement. For example, before the transaction it is usually made the so called “standstill agreement” among the main financial creditors, to find a solution to face the target issues (Practical Law).

### 1.2.3 Common legal issues about distressed M&A

Managing with a distressed company is linked to a huge variety of problems both for buyer and for seller, mainly legal ones.
At first, if the target company falls beyond distressed conditions, its control is get by creditors, and dealing with them can make the transaction more difficult, unusual and uncertain, also due to lack of current and past information about the distressed asset. This has effects also on the general due diligence process, since it has to take into account the creditors’ perspective and meet their interests before the ones of

other stakeholders by law. Moreover, legal documentation in a distressed M&A deal can be complex and heavily negotiated due to opposite interests of players: buyers want to protect themselves from uncertainty of transaction and post-transaction period. On the other hand, sellers try to constrain confidentiality, exclusivity and standstill provisions on buyers (Ball - Kane, 2003).

The problems may worsen if the target firm goes in bankruptcy before the deal closing: in fact, the purchase agreement can be interrupted or considered as "fraudulent selling (trading)", with the aim of going against the interests of creditors and defraud them. For example, according to the Section 544 of the U.S. Bankruptcy Code, a bankrupt trustee has the power to stop a transaction within a year from the filing in bankrupt petition. Even if there is not the threat of a fraudulent selling, law requirements remain binding: buyer has to give a fair and reasonable evaluation of the assets and guarantee that the proceeds of the selling aim to reduce debt and increase the cash of the seller in order to turn around from bankruptcy.

Furthermore, from the seller point of view, there may be also the case of "wrongful trading": it happens when the seller directors continue to trade the company even if they know insolvency would be unavoidable and do not act to protect creditors from losses (De Vecchi, 2015; Practical Law). This is regulated in particular by UK Insolvency Law (Insolvency Act 1986), but it can be punished also in other legal frameworks worldwide.

Last but not least, an "in-court transaction" due to bankruptcy has high monetary and time costs, as well as "mandatory" information disclosure and publicity that can threat the image of both target and seller if the deal goes wrong. Moreover, deals under U.S. Chapter 11 may also be subject to scrutiny, attack and overbidding. For this reason, buyers have to valuate carefully which kind of transaction put in place, choosing if needed other forms like assignments for the benefit of creditors or even judicial foreclosure.

Despite the problems described above, legal frameworks can also incentive transactions involving insolvent companies, mainly just in case of bankruptcy (as it will be explained further in paragraph 1.3).

The main advantage deriving from Chapter 11 is that the Bankruptcy Code guarantees, in most cases, the buyer will get the asset free and clear of all constraints. Therefore, the only liabilities the buyer will acquire are those it specifically agrees to assume. In this way buyer does not have the effort to face liabilities like employee legacy costs, environmental liabilities, tax liabilities, litigation and so on. Furthermore, the approval of the deal by the Bankruptcy Court protects from any following state law claims about fraudulent transfer and fraudulent conveyance.

From the seller point of view, its obligations and warranties are temporary after the buyer takes the asset free from any constraint, except the ones it agrees to assume. By doing so there is no need for post-closing protection. Moreover, after the filing for bankruptcy, the seller is also protected from the continuous requests of its stakeholders, being able to manage the transaction more quietly.

## 1.3 Common practices in distressed M&A transactions

For all the reasons explained in the first paragraphs, it came out that distressed M&A process is very different from usual, due to a large number of particular cases that can arise in distressed conditions. High uncertainty, need of recovering and interests of external stakeholders are the key points that a diligent process should take into account. As a consequence, due to such an unusual scenario, the goals and the strategies of both target and buyer may differ from common M&A, as it will be explained in the next paragraphs.

### 1.3.1 Particular features of distressed M&A

Distressed M&A have particular features in contrast with ordinary transactions. In case of general downturn macro-context, M&A can be "transformational M&A", that modify the structure of entire industries, and "restructuring deals", that change the business focus of companies (BCG, 2008).

Distressed M&A can be of any type, but they have common features due to the particular conditions of the target. Some of them are crucial for the success of the deal and, as it will be explained in chapter 2, some of them can be exploited more effectively during general downturn periods.

Just from the beginning of the deal, it is important to note that the decision of selling a distressed firm is usually driven by creditors (Mirus Capital, 2016). Their power over ownership (in particular during bankruptcy) and their need to take back loans push for seeking a potential buyer. By selling assets as soon as possible they have the priority in getting the proceeds, so this is the reason why in such scenarios "cash" is considered predominant. More deeply, in this context seller usually prefers a "share selling" to avoid taking liabilities also after the transaction, whereas buyers wish simple asset sale. Therefore, unlike ordinary M&A (in which decision makers are usually the shareholders and the board of directors), in distressed ones the decision is taken by this kind of external stakeholders, who usually care more about their return than the future of the company.

Another important feature is represented by timing: if a company goes in bankruptcy because of time passing, the likelihood of getting back credits is lower, as well as the chances of setting a higher valuation. By planning early and moving on time over the process phases, this risk is minimized until the firm has sufficient bargain power to put pressure on creditors. Advisors have a fundamental role in this case since they coordinate the whole process and, as a consequence, the timing of the steps, which is shorter than healthy M&A. Moreover, as introduced in paragraph 1.2.2, they coordinate more diversified parties than ordinary deals (e.g. crisis managers, bankruptcy attorneys), meaning a higher effort and possible overlapping of stages. In addition, conflicts among parties are very common in particular in severe business conditions, so even buyer has the risk not to have sufficient consideration during the process on behalf of creditors.

About due diligence, in distressed deals it is possible that information about the target is wrong or manipulated due to past mismanagement. To avoid that, external advisors are enrolled to prepare it, as well as sale memorandum and data room.

Things differ further in case of M&A inside bankruptcy: bankruptcy procedures must to be known deeply to face for example a Chapter 11 transaction, also because it represents several advantages to support the protection and recovery of the target (par. 1.3.4). This is the reason why pre-packaged administration processed are submitted, implying the lack of future liabilities for the target.

To protect by the risk of covenants breach, buyers try also to have warranties and retentions on price by the target as further guarantee.

As a conclusion, it is important to keep in mind that in case of distressed transactions management and timing are two crucial aspects. High profile professional figures in legal, financial and business fields must be taken into account to face all the different situations and issues that can born. All of this happens in time-limited periods, so a high general coordination is crucial to avoid lack of interests by the buyer, unsatisfied claims on the company and its failure.

### 1.3.2 Buyer and seller strategies

In distressed M&A, like ordinary transactions, different strategies may be implemented by players, each of one with its own goals.

In the table below, common companies' strategies are presented. In general, "preys" and "liquidators" are the sell-side of deals, whereas "predators" and "cyclical leaders" are the buy-side (BCG, 2009).

Just as it happens in distressed acquisitions, financial instability is the main reason behind the decision of companies to disinvest their assets or sell the whole business. On the other hand, firms that have strong financials are more likelihood to afford the purchase of a target.

**Table 1.2: Roles and strategies in (distressed) M&A deals**

| Operational stability | Financial stability: Low | Financial stability: High |
|---|---|---|
| High | **Prey**<br>◇ Preserve intrinsic value of businesses<br>◇ Pay down debt<br>• Sell nonstrategic businesses to pay off debt<br>• Restructure debt schedule to reduce risk of default | **Predators**<br>◇ Enhance competitive advantages<br>• Gain market share profitably<br>• Invest wisely where returns are above cost of equity<br>• Acquire prey when long-term value can be added<br>• Acquire good pieces of business (that is, products that fit) and avoid toxic portions of liquidators |
| Low | **Liquidators**<br>◇ Sell off assets to reduce debt<br>◇ Improve profitability of remaining businesses<br>◇ Liquidate if unable to improve profitability above cost of capital | **Cyclical leaders**<br>◇ Improve near-term EBIT as quickly as possible; reduce operational volatility in order to become less vulnerable in future downturns<br>◇ Avoid excessive debt that would turn the company into a liquidator |

**Source: BCG 2009**

From a distressed seller perspective, the main goal of a transaction is to keep the highest possible value for its company to avoid bankruptcy. As previous said, it is preferred that this happens with the consensus of creditors, as they carry major interests toward company (par. 1.2.2). So, the target strategy is built around this main focus, represented by a rational recovery plan.

The most common preliminary actions taken by sellers are: (Hastle - Jones, 2008).

- *Cost cutting in predetermined business areas;*
- *evaluating poor performing employees and management members;*
- *re-negotiating or terminating unfavorable contracts or resolving time-consuming litigations;*
- *divesting previously undervalued assets;*
- *assessing any potential value in tax losses that the buyer could exploit;*
- *identifying opportunities to increase revenues.*

As it can be easily observed, the goal is to give a preliminary turn around in order to increase the value of the firm and to get a higher price. By doing so, bargain power of the target remains relatively high, avoiding the risk of selling at discount or at unfavorable conditions (e.g. total replacement of management, loss of competitiveness).

Another key point is the choice of the buyer. A distressed company want to survive from crisis, so a big and well-performing purchaser is the perfect candidate for a selling strategy. Moreover, such a buyer would guarantee secure future earnings, certain financing, better access to new markets, further investments and so on.

From a buyer perspective, it chooses a company mainly for synergies advantage, through the acquisition of a competitor or of a complementary firm. In a distressed scenario, this strategy is the basis to enhance its own position and become a market leader.

From a technical point of view, the driver of the buyer's action plan is reducing the purchase price, considering the fact that the seller has not much time before its assets "depreciate" even more.

Moreover, the buyer could try to let the time passes to acquire the target within a pre-packaged administration process, by putting more pressure on the boarder of the counterpart and to get a better price.

Furthermore, it has to be considered that, in severe distressed conditions, the buyer has very little guarantees from the target, just starting from the due diligence phase because of the incomplete and not accurate information about the counterpart and restricted time limits. This factor may be used by the acquirer to renegotiate the price ad try to reduce it even more.

More technically speaking, any buyer strategy should rely on a stress test approach to evaluate options (BCG, 2009). Through such a method, target company has to be split in all its business units. Each of them must be evaluated by considering different scenarios, many of them very critical (e.g. continuous downturn). After doing that, the next step is identifying the units that may reduce the value of the firm, and try to recover or sell them (this latter alternative can generate superior returns also during crisis - par. 2.5). An important rule to respect is that evaluating a distressed company differs from healthy cases: as it will be explained in paragraph 1.3.3, traditional indicators (e.g. free cash flows, comparable valuations) cannot be used as usual since their value may not capture the exact trend of the target business and, also, may be influenced by downturn scenarios. They have to be analyzed in proportion with the slowdown conditions, like the volatility of the market. Also a target that seem to face well global recession may enter into a distressed condition in relative few time. A stress-test approach can reduce the likelihood of a wrong and unprofitable acquisition.

Due to the general risk in entering a distressed deal, any buyer should base its strategy taking into account several traps that may come out during the process (Sandager,2014).

First of all, choosing the right approach is crucial. Even if it seems undoubted, a buyer has to consider a wide range of variables, from the activities and assets of the seller to legal constraints. Moreover, pending liabilities, stakeholders' hostility and time constraints are factors to be consider independently deal by deal, to avoid the unsuccessful of transaction or an overuse of resources to complete it.

Another important element is flexibility: it consists in dealing with many different interests of the players of a distressed acquisition (e.g. creditors, banks, regulators), keeping in mind that these may be in conflict each other, as introduced in the paragraph 1.2.2. So, a buyer should adapt its action plan to the stakeholders' needs and to let them support the transaction, avoiding in this way pending issues after the acquisition. Negative activism by third parties not only makes the deal more complicated to conclude, but may reduce the attractiveness of the target, threating the value creation of the buyer through the deal. For example, senior creditors could put pressure for an earlier asset selling or deny further financing to the seller, so the acquirer has to be able to negotiate with such parties.

Finally, another risk to be avoided is been overcame by another bidder. To avoid that, its own interests must be protected right soon, and shaping the deal to discourage any potential entering bidder.

### 1.3.3 Valuation techniques on distresses companies

Valuation techniques for distressed assets and companies differ for several reasons by ordinary ones. It must be kept in mind that for different asset types there are different tools to use to give an evaluation, in particular in distressed scenarios.

First of all, as introduced in the previous paragraph, a scenario analysis is the base of any distressed evaluation: different future outcomes are forecasted and, for each of them, it is measured the likelihood and the correlated risks, as well as how the potential acquirer can react to each scenario. This analysis is valid also in case of distressed companies: depending on the future strategy, the cash flows generated by the business can vary both in the amount and in the time. This would change the returns got by the different players: in a restructuring context for example, creditors could be repaid in large part at the expense of shareholders whereas, in case of new equity injection, the repayment would be lower and existing ownership would be diluted. A wide range of techniques is available to make future estimates: among them, the most popular ones are the "decision trees" and Monte Carlo simulations, that need less data than comparable analysis or other similar methods.

More deeply, two particular general techniques are used in case of distressed assets: asset-based and income-based. The first method is used when dealing with liquid assets/companies, so it is near to the market approach (for example, this is the case of companies' securities). Instead, the latter is used in case of illiquid conditions, when market price cannot be found out easy (like for asset-backed securities), and it is based on the revenues generated by the acquired entity.
Anyway, what is important in evaluating a distressed company is that traditional multiples cannot be used like in ordinary time. At first, distressed conditions must be taken into account when comparing different companies. Valuation should be adjusted for the risk of the specific firm, independently on the similarities in terms of business and size of entities. In particular, during crisis, an investor does not accept to pay the entire value of the distressed target, and a kind of discount should be applied to that. The most common risks that the buyer would like to evaluate refer to operational and fundraising issues, management instability, performance erosion and agreements' breach. All these factors reduce the value of a distressed company, and the acquirer has to use the due diligence to avoid wrong estimates on purchase price. Alternatively, buyer could use comparisons with other distressed firms following the same market trend. Also in this case, it must be considered that

there can be different causes of distress, so relying just on similar poor performances could not be enough.
Finally, also an intrinsic valuation could be difficult to use: in severe distressed conditions past performance history of the target can be distorted or not sufficient, so past statistics can conduct to wrong estimates (Financier Worldwide, 2014).

### 1.3.4 Focus on distressed M&A in bankruptcy: Section 363 Sale vs. Plan Sale

When talking about distressed M&A during crisis, a fundamental role is on bankruptcy framework. As introduced in the paragraph 1.2, in such a context it is more likelihood that a firm in troubles become insolvent, and this can cause just the implementation of bankruptcy process.
In the U.S. bankruptcy context there are two typical approaches (related to the general discipline of "Chapter 11") that can be used to divest a company and its assets: "Section 363 Sale" of the Bankruptcy Code and the so called "Plan Sale" (Ball - Kane, 2003). The first process consists in the selling of assets "outside the ordinary course of business", whereas the second one is linked to the selling of the business in accordance with the reorganization plan of the debtor, and it is more connected to the Chapter 11 itself. Both these methods present advantages that may help in a downturn environment, as it will be explained in chapter 2.

Section 363 of the Bankruptcy Code permits an insolvent company to sell its assets after the approval of the Bankruptcy Court, that usually asks it to provide a business purpose for their future use. This approach also permits debtor not to enter in a mandatory plan confirmation process, so no vote to begin this kind of selling is required (this can be considered one of the disadvantage of this method, in particular by creditors' point of view). Anyway, this feature enables a quicker divestiture that can avoid, for example, the depreciation of assets, so it can favor also creditors' interests.
A sale under Section 363 begins with the choose of a potential bidder. It signs a purchase agreement (or a simple letter of intent) with the target firm, whose goal is to protect and complete the transaction through a binding accord. Usually, this

agreement is then provided to constituencies, who can either accept or refuse the offer of the buyer. In this way, the highest and better offer is supposed to be selected by a wide range of bids. Better offers should include considerations about non-monetary factors. When the best offer is found, the Bankruptcy Court approves the sale and ensure the buyer that the assets will be “free and clear of liens”, as well as the seller will be free of any constraint, apart the ones that it accepted to respect.

Plan Sale is much more different by Section 363. In fact, it involves the selling of an entire business or large part of it. It is linked to the reorganization plan of the target, and it is used to go out from bankruptcy with a new equity. This process can be very similar to a common private acquisition, but one of the advantages is that, also in this case, the buyer takes the business “clean” and with less regulatory involvement. Moreover, buyer and seller can work together to find an agreement without competitive pressures from external environment, since a debtor subject to Chapter 11 has the exclusive right to record its reorganization plan within three months after the protection filing.
An important difference with the Section 363 is the approval process. In fact, the reorganization plan must be approved by the Bankruptcy Court as well as by the holders of 2/3 of the claimed amounts and the majority of each class of impaired creditors (the ones that receive less than what is owed). In some cases, also the approval of 2/3 of voting shareholders is required. Anyway, according to the Bankruptcy Code, the plan can be accepted is it considered “fair and equitable”.

As it can be noticed, Plan Sale approach is longer and more difficult to complete, but it is a good way to buy an entire company in a protect environment and with more guarantees, due to the involvement of regulatory framework. Section 363 is indeed used in case of simple assets selling and, also in this case, this approach brings to higher returns for the buyer during slowdown, as it will be shown in chapter 2.

## 1.4 Stages in the acquisition process

To conclude the analysis of distressed M&A characteristics, it is time to discuss about the general stages that occur over the process. These can vary according to the type of transaction, in particular if it happens under bankruptcy procedure or not.

### 1.4.1 Initial Call

The starting point of any distressed M&A deal is the initial call. It represents the willingness of some interested parties to begin a transaction to recover the future target or disinvest its assets.

The initial call can start from the creditors of a firm, simply because they are the most damaged stakeholders due to the missing debt repayment. Moreover, the initial decision can also be taken by the corporate itself, by its board members or main executives. In this case there is the evidence that the company cannot continue its activity anymore, due to severe issues like abnormal leverage or violation of covenants. For these reasons, a divestiture or a business selling is seen as the last chance to recover.

### 1.4.2 Evaluation process

After the willingness of selling the company is agreed, it is time for the target's advisor to estimate a value for its client. This process implies the analysis of the causes that provoked the crisis, as well as the possible opportunities for a future good performance. Unlike ordinary deals, the advisor has to identify also the best possible restructuring alternatives and new capital structures.

The valuation of the seller is based, in general, on three levels of assessment (Roston, 2010):

- *Liquidity assessment:* It consists in evaluating the business plan adopted by the firm and analyzing its results in terms of profitability. After that, the value of the company is got by using cash flow models (e.g. Discounted Cash Flows model), to capture the value of the business itself.

- *Operational assessment:* After liquidity assessment, operations implemented by the seller are analyzed. This means that also potential improvements are evaluated, together with their impact in case of implementation. Like for the first assessment type, the agreement of the seller is required to go on with the estimation of the business value.

- *Integrated assessment:* Then, different scenarios are developed according to different combinations of liquidity needs and operational changes, with the support of (usually) cash flow models. At the same time, also different capital structures alternatives are tested according to variable scenarios. The combination of liquidity and operational assessment and capital structure estimation bring to the optimal alternative to present to the bidder.

Then, the advisor helps and stimulate the acquirer in implementing a successful purchasing strategy on the basis of the finding made by it. Obviously, the following step is getting the agreement with the target, that has to accept the plan proposed by the bidder and the advisor for the acquisition.

### 1.4.3 Preliminary agreement, due diligence and purchase agreement

Preliminary agreement represents the first direct contact between bidder and target. Like in common transactions, confidential information is protected, in particular if there are signs of an upcoming filing in Chapter 11. Moreover, distressed firms may include in preliminary agreement a standstill provision that can exclude potential bidder to get claims or securities against the seller itself. The signing of a preliminary agreement gives every potential bidder the access to the next steps to the process. In distressed scenarios it is less likelihood that some buyers obtain any exclusivity right on the transaction: in fact, if the process is under Bankruptcy Law, it must be set like an auction, permitting the parties to have the same information and rights.

After preliminary agreement is accepted by the interested parties, due diligence process begins. As already stated, this step is extremely important in case of distressed conditions. In fact, cases of fraud or wrong management may occur, so the due diligence is needed to avoid such factors threat the interests of the purchaser. In addition, this step is crucial to identify what is the business scope that will be acquired: that is, in distressed M&A, the seller can choose which assets, liabilities and so on to be acquired, so it is important to define their business purpose for the future. Instead, in ordinary M&A, the whole company is purchased, and its scope is already defined.

Due diligence is also needed to find up what is linked to the assets, in particular in terms of contracts and liabilities. Moreover, other questions to address may regard employees' retention, creditors' landscape, the interested parties on the assets of the seller, potential synergies and so on.

Then, the following step is the purchase agreement. In this stage, the bidder and the target reach an agreement about the purchase terms.

Anyway, this phase is not simple in case of distressed scenarios. In fact, if the seller decided not to enroll into the bankruptcy process, the bidder can simply go on with the negotiation with the seller and, if the latter accepts, conclude the deal.

On the other hand, in case of acquisition in bankruptcy, the bidder has to choose if it wants to take the role of "stalking horse" or not (Ball - Kane, 2003; Friscia - Goldstein - Mrofka, 2009): in case of accepting the role, the buyer set the parameters of the bids, as well as the rules of the following auction (it substantially "tests the market"). This strategy is preferred if the seller knows that it can offer something more than other competitors, or if the bankruptcy regulator decides not to begin an auction (even if this is uncommon).

Anyway, when dealing with a bankruptcy transaction, too many parties are involved (that are all the stakeholders of the seller), so the role of stalking horse could be difficult to implement (this is also due to the risk of bidding too much). In this case, bidder prefers to let another player to assume that task and, after the final decision of Bankruptcy Court, to make its own offer.

Purchase agreement is signed between the seller and the stalking horse. This document differs from the case of non-bankruptcy: for example, it specifies the contracts that the buyer wants to assume and can contains less conditions for closing, as well as there is the submission under the Bankruptcy Code.

### 1.4.4 Bidding procedures, auction and closing

Always in case of bankruptcy, the Court approves the rules about bidding (e.g. participants, bids' minimum level, deadlines, break-up fees). Before that, such procedures are agreed between buyer and seller and accepted by all the interested parties. The goal of bidding procedure is guarantee the maximization of the selling price, as well as helping the stalking horse during its activity.

It is important to note that if no bid is made within the deadlines (apart the one of the stalking horse) the auction may also be canceled. However, this is usually not seen positively by creditors and regulators, since they are more advantaged if further offers are made and also because this can be a way used by the seller to make the stalking horse to reduce its offering price, due to lack of competition.

Then, after the bid deadline, the auction itself takes place. All the potential bidders, previously contacted by the target advisor, compete each other and the seller will decide the best and highest offer among them (almost like traditional M&A). The potential buyers base their bids on information available and, in the following round, they can also have access to data room.

Anyway, the final approval by Bankruptcy Court is needed: in fact, the winning offer must be the "highest and best", also to guarantee the interests of creditors and of the other parties interested in the seller.

After the best bid is approved, the transaction goes on with the conclusion and the ownership transfer of the assets agreed (Ball - Kane, 2003; Dunbar - Hughes, 2015).

## 1.5 Overview of past downturn periods and historical path of M&A volume

As introduced at the beginning of this chapter, the historical path of distressed M&A volume is highly correlated to the stages of world economy. As downturn periods come, the number of distressed firms inevitably increases as well as transactions involving them.

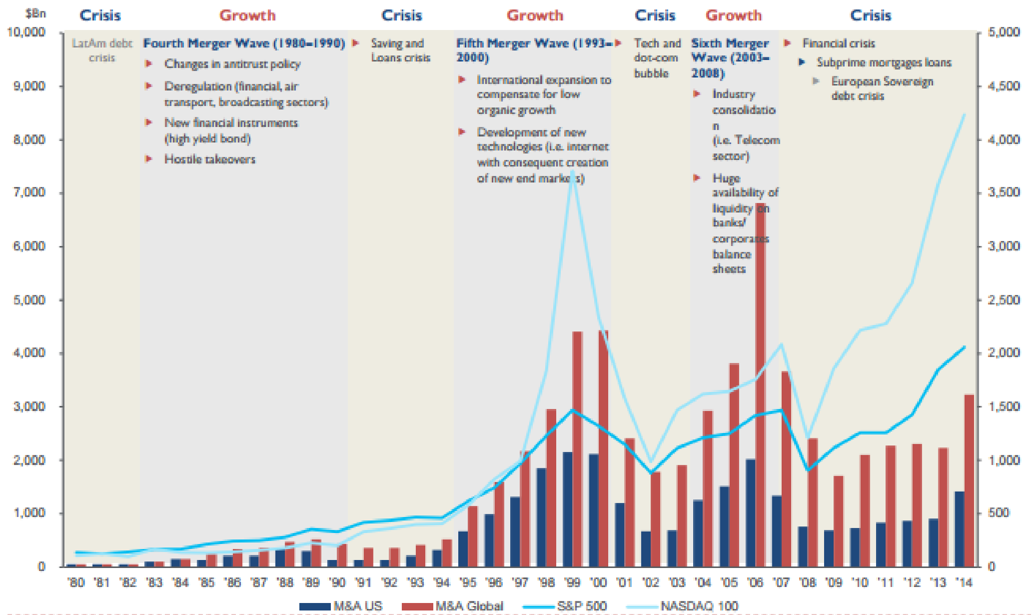
In this paragraph the historical path of their volume will be described, taking into consideration the economic crisis of the last years, with a focus on the current depression started in 2008.

### 1.5.1 General trend in M&A volume over last years

From 80s to present the general path of M&A transactions was cyclical. As explained before, it is influenced by the overall trend of world and local economies: during downturn, transactions volume decreases due to less purchasing power of companies whereas, in growth periods, the trend is the opposite, characterized by huge volumes of mergers and acquisitions.

In the table below, it is highlighted the recent path of M&A transactions, together with the main economic "macro-periods".

**Figure 1.1: M&A path over past years**



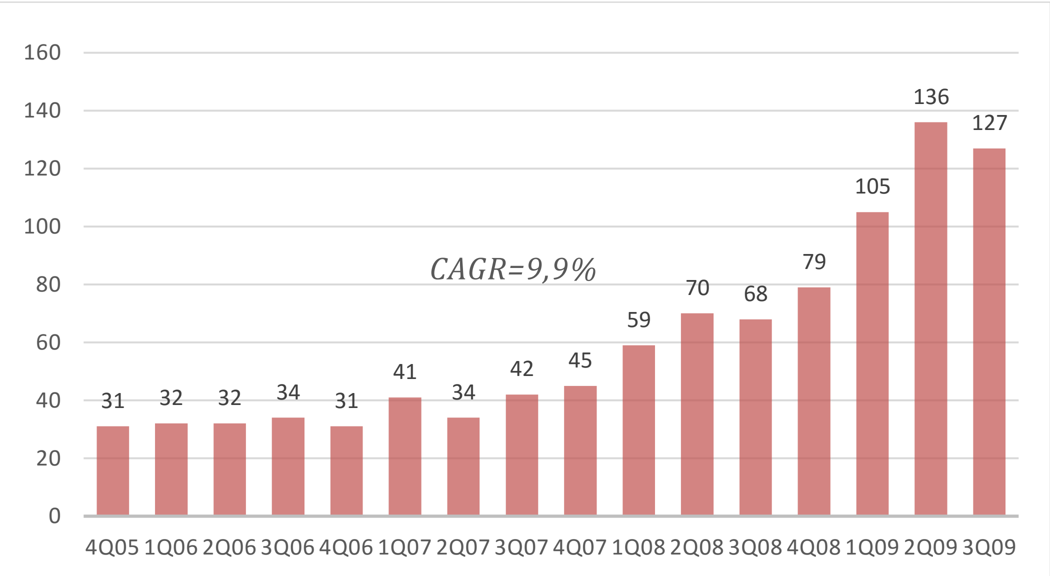

**Source: Thomson SDC; Dealogic; Mergermarket; Luigi De Vecchi (Luiss Guido Carli, 2015)**

As it can be observed, M&A volume is strictly linked to financial market (i.e. Nasdaq 100, S&P 500), that is one of the main indicators of the global economic state of health. Also technological innovation can influence indirectly the amount of transactions (like happened in last 90'), by influencing the business of companies at first. On the other hand, any crisis, regardless from its dimensions, has consequences on these two indicators. In last years the current recession was the one having the most severe consequences, as it will be explained better in the next paragraphs.

Despite the sudden fall of M&A volume in 2008, it is showing signals of uptrend in last years. This is due to a series of factors, such the stabilization of the crisis itself, restructuring of deals process to incentive M&A activities, higher support of regulatory, rise of strategic buyers and changing of the main players of M&A industry (see paragraph 2.5). In addition, the general attention in entering in acquisitions is growing as well as overall caution during the whole process, and this is creating a climate of confidence in M&A activities. Last but not least, if volume of ordinary M&A is declining, the one of distressed M&A is following an opposite trend, due to a larger number of firms going in troubles because of financial crisis (Roston, 2010).

In the table below is shown the recent path of M&A involving companies in distressed conditions. It is emblematic the changing trend quarter by quarter close to the beginning of the recession in 2008-09.

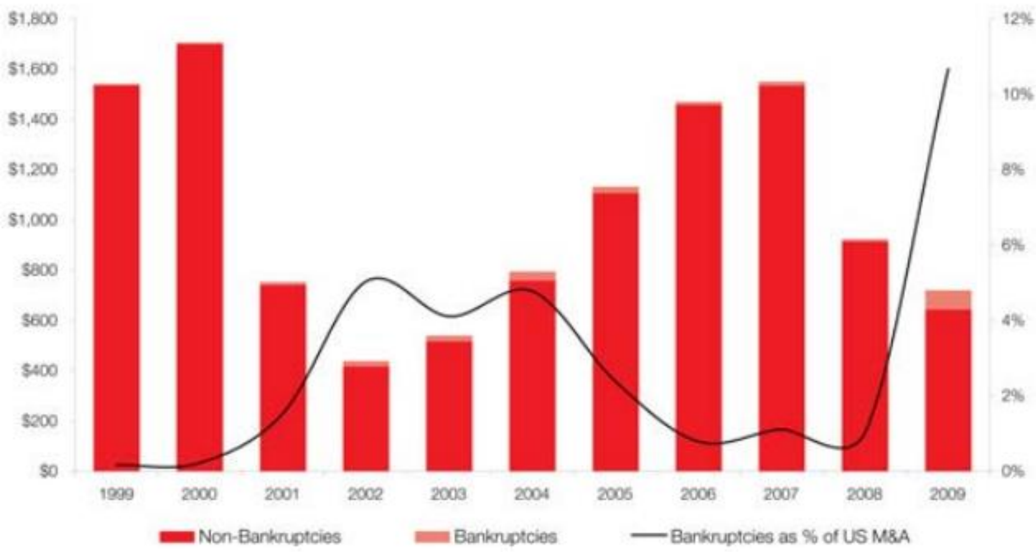
**Figure 1.2: distressed M&A activity quarter by quarter between 2005 and 2009**




**Source: Capital IQ; Roston 2010**

An important cause of the rising of distressed M&A (that will be explained in chapter 2) was an even better bankruptcy approach to rescue firms. This, associated with a higher loan default rate, resulted that the volume of transactions made under this approach rose sharply, as shown in the graph below in case of U.S. market.

**Figure 1.3: bankruptcy as percentage of U.S. target volume (millions $)**



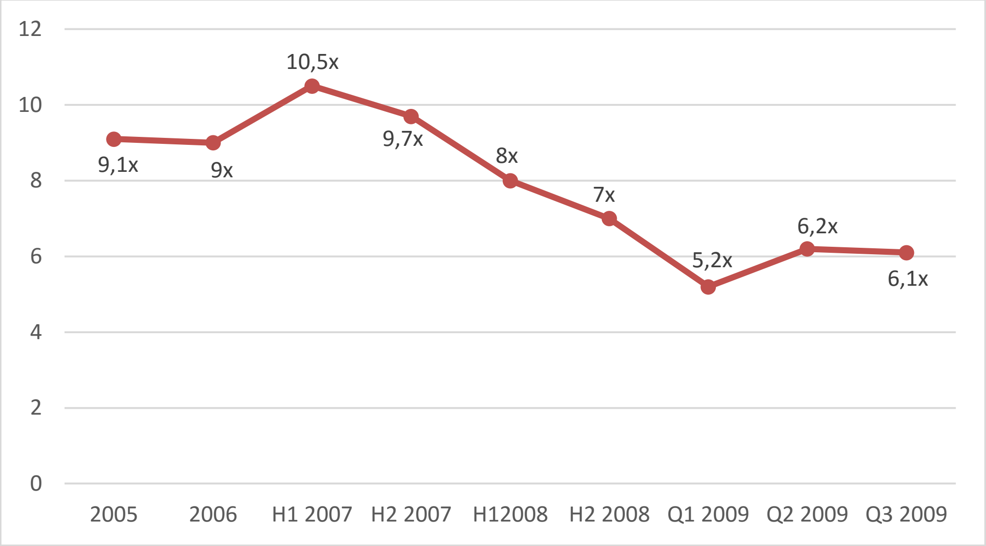

**Source: Roston 2010**

## 1.5.2 Trend of transaction multiples during crisis

The low trend of M&A volume during crisis is associated with the similar path of multiples value. The poorer access to credit contributed to reduce purchase price multiples, which can grow only in case of an increase in debt multiples and a general economic uptrend (Roston, 2010).

In the graph below it is represented the path of EV/EBITDA multiples during crisis in US.

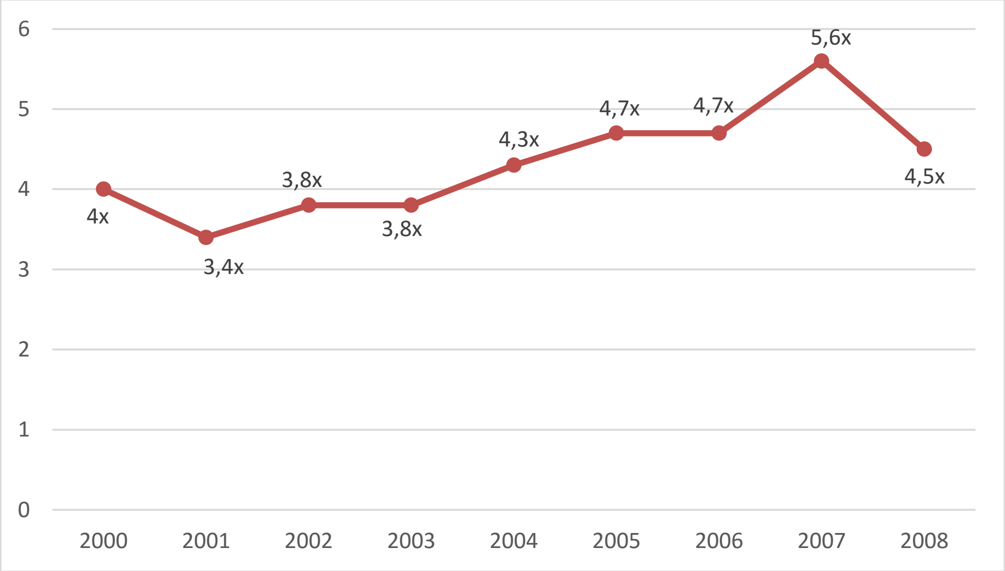
**Figure 1.4: EV/EBITDA multiples (at announcement date) trend in U.S. middle market**




**Source: Capital IQ; Reuters; Roston 2010**

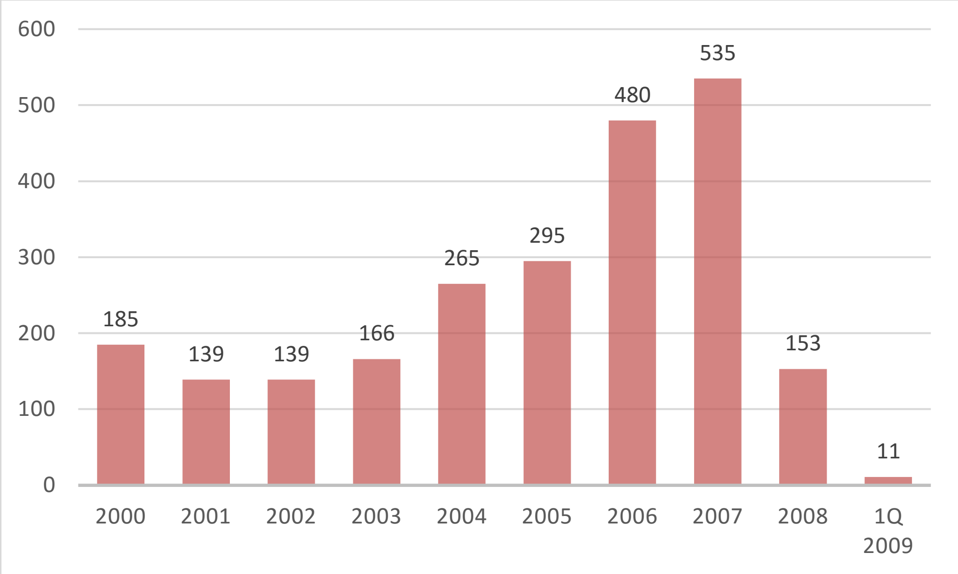
Also leverage multiples decreased after the crisis, in particular for middle market LBO deals, as well as general new issuance loans (see figures below). Such a scenario can accentuate the use of distressed M&A or bankruptcy transactions to turn around companies in difficulty.

**Figure 1.5: leverage multiples trend (Debt/EBITDA) for middle market LBO loans**




**Source: S&P LCD; Wall Street researches; Roston 2010**

**Figure 1.6: new issued leveraged loan volume between 2000 and 2009 (billions $).**




**Source: S&P LCD; Roston 2010**

### 1.5.3 M&A volumes in 2015

So far the path of M&A volume over recent years was described. About 2015, the signals from data collected are positive: according to Dealogic (2015), the amount of transactions reached a value of around 5 trillion $, the highest since the beginning of the crisis.

This level was reached thanks to a limit number of huge deals, in particular in the healthcare sector (723.7 billion $) and technology (713.1 billion $).

In the table below the main M&A deals of 2015 are ranked together with their value.

**Figure 1.7: top 10 announced M&A deals in 2015**

| Deal Value $bn | Acquiror | Target | Target Nationality | Target Industry |
|---|---|---|---|---|
| 160.0 | Pfizer | Allergan | United States | Healthcare |
| 117.4 | Anheuser-Busch InBev | SABMiller | United Kingdom | Food & Beverage |
| 81.5 | Royal Dutch Shell | BG | United Kingdom | Oil & Gas |
| 79.6 | Charter Communications | Time Warner Cable | United States | Telecom |
| 68.6 | Dow Chemical | EI du Pont de Nemours | United States | Chemicals |
| 66.0 | Dell | EMC | United States | Technology |
| 62.6 | HJ Heinz | Kraft Foods | United States | Food & Beverage |
| 55.2 | Anthem | Cigna | United States | Healthcare |
| 55.0 | Energy Transfer Equity | Williams Companies | United States | Oil & Gas |
| 53.1 | Cheung Kong (Holdings) | Hutchison Whampoa (50.0%) | Hong Kong | Holding Companies |

**Source: Dealogic**

The positive trend of last year is explained by a series of factor, some of them already explained before, like easier debt access, general confidence in the market, less negative effects of the crisis and desire to acquire rivals to enforce its own market position in this uncertain economic environment.

## 1.6 Conclusions

During this first chapter the main characteristics of distressed M&A were analyzed. As it was demonstrated, they differ from common M&A transactions for several reasons. Some of them will be the starting point for the explanation of distressed transactions' higher returns during downturn than in growth periods. In fact, some peculiar characteristics of the periods of crisis can be exploited easily in case of distressed companies. On the other hand, growth periods usually do not give the same profitable opportunities. Even if it may be considered a paradox, rational explanations exist, and they will be studied in the following chapter.

# Chapter 2:
# Success of distressed M&A during crisis: theoretical explanations

## 2.1 Introduction

So far the main characteristics of distressed M&A were introduced. As already demonstrated, even if this kind of transactions is quite risky, it carries particular features representing further possibilities of success than ordinary M&A (e.g. the case of M&A in bankruptcy). These factors, if associated with a general downturn environment, may turn in greater returns on investments with respect to growth periods: in general terms, M&A deals are more likely to create value (e.g. in terms of total shareholder return) during crisis than in ordinary periods, and this effect is further enhanced in case of distressed M&A (BCG, 2009).
Anyway, it must be pointed out that downturn scenarios advantage bidders more than sellers (in particular in terms of acquisition price). So, the superior value creation is got in large part by acquirers, even if, on the other hand, an M&A deal can guarantee a future for distressed sellers, avoiding the entire loss of business (Deloitte, 2009).

The goal of this chapter is analyzing the most important theoretical explanations about that, looking for the reasons that can prove it in order to find common factors for which distressed M&A are more profitable during crisis.

## 2.2 General success factors

According to a study of the Boston Consulting Group (2009), there are four main success factors for a general distressed M&A:

- *The financial strength of the buyer;*
- *The reasons of distress in the target;*
- *The size of the buyer with respect to the size of the seller;*
- *The core sectors of the buyer and the seller.*

Concerning point (1), if the buyer is in healthy conditions and it is able to maintain a high profitability level, the financial market reacts positively to its attempt of turning around a distressed target, increasing the likelihood of success of the transaction. Moreover, it is important to have a strong human capital as well, to guarantee good performance also after the transaction end.

About point (2), if the target has only financial problems and not operating ones, it can be turned around through recapitalization. If there are also operating problems, transaction returns are good if there are capital structure issues as well, because the target price would be lower and the attractiveness higher. Such a situation may also lead to transactions within bankruptcy, that carry a lot of advantages as explained in paragraph 1.3.4.

Point (3) refers to the capacity of bigger buyers to provide financing and dilute risk, with respect to relative lower size of the target. This would lead to higher likelihood of success since small targets carry less risk in proportion to the size of the acquirer and they are easier to finance. Bigger size of the buyer means also higher bargain power, so the market sentiment about the success of the deal is confident, thus higher returns are more likely to be got.

Finally, about point (4), acquisitions made in the same sectors carry the risk of overconfidence by the buyer. This may lead to overpayment or wrong valuations, reducing investment returns. On the other hand, transactions made in different sectors require higher attention and due diligence, so the likelihood of success is greater, as well as the chance to exploit opportunities in different sectors by using existing, controlled players.

These general success factors may have more sense and effectiveness during downturn, as it will be explained in next paragraphs. In periods of crisis they may be more "emphasized", and their effects could be even better than in common periods.

## 2.3 Advantages and opportunities of downturn periods

In the previous paragraph the success factors of general distressed M&A were described. To understand why they bring higher returns during crisis, a preliminary analysis of the general advantages of downturns can help. Even if the most specific pros of crisis related to M&A deals will be explained in paragraph 2.5, the following analysis will be useful to find out what are the benefits that a depression scenario could bring at a global level.

### 2.3.1 Innovation factors

As first, downturn periods push companies to innovate. Innovation represents the main tool to survive from a crisis, in particular if it is a "product innovation" (Chandran, 2009): in fact, the most instinctive reaction that companies have in facing a crisis is recovering market demand. To do that, they try to offer even better products to stimulate consumers and turn around their revenues. New and improved products are got by innovation processes, to add them new features and to attract new demand. This can be obtained just through innovation development, that represents also a way to win competition.

Anyway, innovation is not only related to products. During crisis innovation is also used to save costs ("process innovation"), to increase productivity and to permit companies to reduce their costs. So, also in this case firms invest to improve their "income statement": in this context, such an opportunity is particularly exploited

by companies that, for example, produce hardware and equipment for other business customers.
Innovation is also used for other purposes: for example, after the 2001-02 crisis, enterprises started to use Internet as advertisement channel. The “cost-per-click advertising” (made through search engines) permitted companies to hit consumers in a very cheap way, that it was never used before crisis. Also in this case, the aim was cutting costs, and the web represented the best way to implement this philosophy.
A race to innovation stimulated by downturn not only provides firms with new tools, but it has also positive advantages for consumers: as introduced before, they can enjoy new and better final products, as well as stable prices in case of growing competition by market players to get more demand.

### 2.3.2 New chances to grow

Every downturn period represents for many companies a great occasion to grow and gain new visibility in the market. As said in the previous paragraph, this is mainly due to further innovation (both product and process). Apart that, there are other factors that can be exploited thanks to recession.
One of the most obvious ones is connected to unemployment: during crisis many people lose their job due to financial difficulties of their companies, independently by their skills. Thus, firms have the chance to hire the best talents, improving its human capital, with an easier recruitment. Such new employees may bring new skills, new ideas and new knowledge. All of this can help companies to get better by learning from that and to recover by crisis, in particular if such changes happen at a management level, in which they have more visible effects.

Moreover, during downturn firms have more incentives to diversify their business, like happened for example to IBM that shifted from conventional hardware to IT services. Diversification permits to discover new, profitable markets that were hidden during growth periods.

Another important advantage of crisis is that a company can understand earlier if its strategy is profitable or not: in fact, it was observed that, if a company fails in making profits in the first stages of a crisis, it is unlikely that it will be able to change such a trend, even if there will be a recovery of the whole economy.
On the other hand, another related benefit of recession is that earnings made in difficult periods are likely to persist also in the future and vice versa. According to statistics, around 70% of companies that made profit during slowdown years were able to maintain it in the coming periods, whereas less than 30% of firms succeeded in recovering after the losses of crisis (Harvard Management Update, 2009).

There other marginal but still important pros of downturn: for example, recession decreases the rents for spaces (e.g. offices, fields, equipment). This is an important advantage in particular for small business, which usually do not have too much financial strength to sustain a huge rent. So, they can also extend their spaces in new areas with lower capital investments.
Moreover, if an economic crisis hits a particular country, its central bank reacts by lowering interest rates to stimulate consumption (Forbes, 2013). So, credit access and loans cost less, and this can have also a positive impact on investments by companies.
There are also particular categories of investors (so called “angel investors”) that prefer to invest in a company than in the stock market as usual. So, funding may become easier in downturn if such players are present, since they would rely even less on financial market because of general slowdown.
Finally, downturn permits companies to renegotiate with its own suppliers, getting in this way better contract terms that can last also after crisis, with a consequent cost saving.

In conclusion, downturn does not represent a negative period at all. It can offer new opportunities for market players, some of which can be exploited further in a (distressed) M&A perspective (e.g. less competition), as it will be explained in paragraph 2.5.

## 2.4 M&A returns comparison between downturn and growth periods

As said at the end of chapter 1, over recent years, the present financial crisis reduced the ordinary M&A volume, whereas the number of distressed M&A increased because of the larger number of firms that went in troubles due to business depression (Harvard Law School, 2009). As a result, the total amount of transactions remained quite stable, even if it usually follows a cyclical trend correlated to the global welfare. In 2008, M&A transactions were just 2.4% less than the previous year, and higher of the volume of transactions since 2000 (BCG, 2009). Anyway, as seen in the graph below, the impact of the crisis was not indifferent at all if considered the monthly volumes.

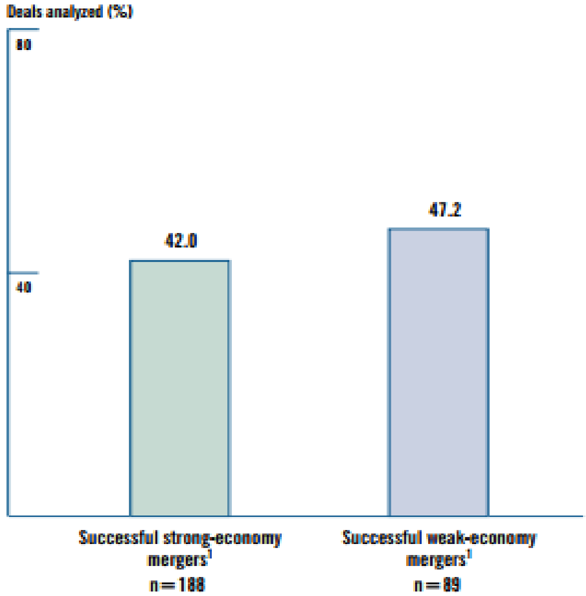
**Figure 2.1: M&A volume and value between 2007 and 2009**


**Source: BCG 2009**

It must be taken into consideration that there are huge differences among sectors: the most industries damaged by crisis were banks, technology, retail and construction whereas, on the other hand, pharmaceuticals, transport and industrials sectors resisted better to slowdown. As a consequence, in this latter case the M&A deals completed were higher than in the opposite case.

Anyway, such a period represents a good occasion to create shareholder value and positive returns both for buyer and target. As it was introduced at the beginning of this chapter, it was noticed that M&A deals made during downturn get higher return than in normal periods (BCG, 2009) as shown in the exhibit below, and this effect is more present in case of distressed transactions over crisis periods.

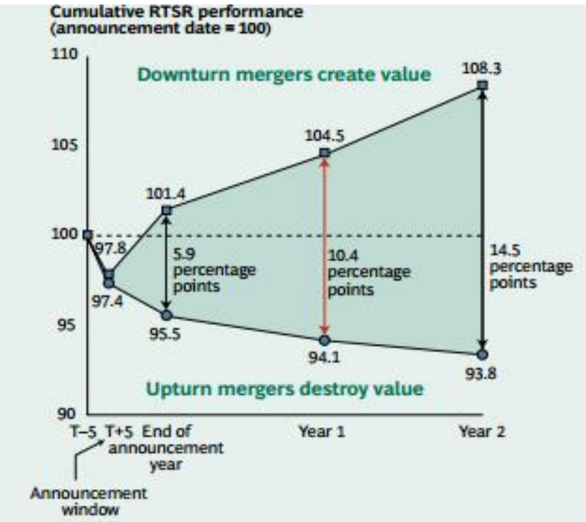
**Figure 2.2: percentage of successful deals between growth periods and downturn**




**Source: BCG 2003**

From the perspective of the acquirer for example, upturn mergers destroy value unlike downturn deals, as described in the following graph.

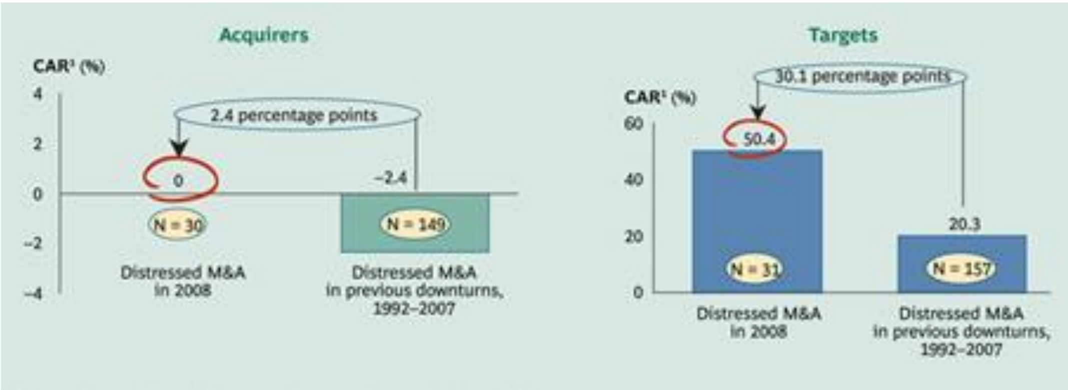
**Figure 2.3: shareholder value creation comparison between upturn and downturn M&A (RTSR=Relative Total Shareholder Return). Source: BCG 2008**



Always from the buyer point of view, distressed M&A in downturn bring a cumulative abnormal return (CAR) equal, on average, to 1%, against the one of -1.1% in upturn (BCG, 2009).

More surprisingly, even if the current financial crisis is considered the most severe one over last years by public opinion, deals' returns were higher in 2008 if compared to the ones generated in other downturns periods (like happened during 90s), as shown in the graph below.

**Figure 2.4: returns comparison between distressed M&A over past downturns for buyers and targets (CAR=Cumulative Abnormal Return)**

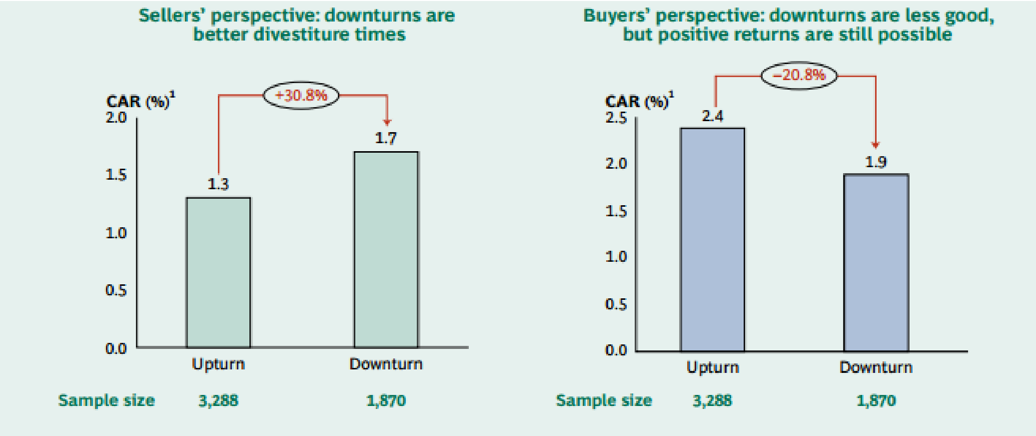



**Source: BCG 2009**

It can be easily observed that the difference in cumulative abnormal return is quite high, both for buyer and target.

About divestiture of private assets, also in this case there is difference between healthy periods and downturn. From a seller perspective, the abnormal return is higher during crisis, whereas for the buyers it is the opposite. Anyway, their returns stay at good levels also during crisis, meaning that depression periods bring, on average, higher returns on divestiture of private assets than in normal years, as shown in the exhibit below.

**Figure 2.5: comparison between assets divestitures' returns between upturn and downturn periods for buyer and seller (CAR= Cumulative Abnormal Return)**




**Source: BCG 2008**

All the cases presented so far further demonstrate that, on an empirical basis, downturn brings higher returns than healthy periods. In the next paragraph it will be provided support to these numbers, analyzing the reasons about the differences in returns and deepening the key success factors of distressed M&A that can be exploited more effectively over troubled years.

## 2.5 Theories about distressed M&A higher return during crisis

The particular features of general downturn periods and the characteristics of business environment within crisis are the drivers of the success of distressed M&A during recession. Following, the main factors will be analyzed, to find the reasons why such operations bring to higher returns than in growth times, like happens for general transactions.

As it will be described, it is not simply a "buying at low and selling at high" rule, but there are several variables that concatenate each other during slowdown. Crisis represents a great opportunity for every industry to change its competition environment, to create new players and enhance the position of existing ones.

## 2.5.1 Correlation between buyer's size and distressed deals

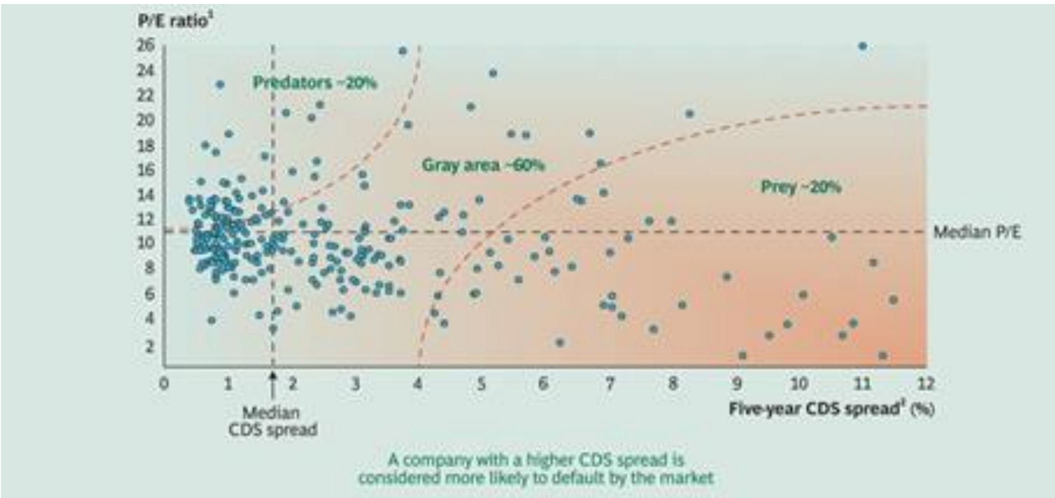
Back to paragraph 2.2, it was said that the bigger is the size of the acquirer, the higher is the likelihood of transaction success.

This rule is particularly proved in downturn: during such a scenario, it is rational to state that only the biggest and the most profitable companies survive and can make acquisitions thanks to their financial strength (so called "predators", par. 1.3.2). Moreover, they are the only ones that can turn around a distressed firm by using their own managerial expertise and business/financial support. As a consequence, in periods of crisis, M&A transactions are led by top companies, so the likelihood of success is general higher than in ordinary periods, in which more deals are made but the average success index is lower.

All of this is a strong incentive for such a kind of players, that support a higher M&A volume to emerge from competition.

In the exhibit below companies are shown on the basis of their financial strength/size to make a M&A transactions minimizing risk. As it can be noticed, the more is the default risk, the less is financial strength and, as a consequence, the highest is the likelihood to be acquired and vice versa.

**Figure 2.6: correlation between CDS spread and financial strength of companies (P/E ratio). CDS (a particular type of credit derivative contract) is a measure of the risk of default.**

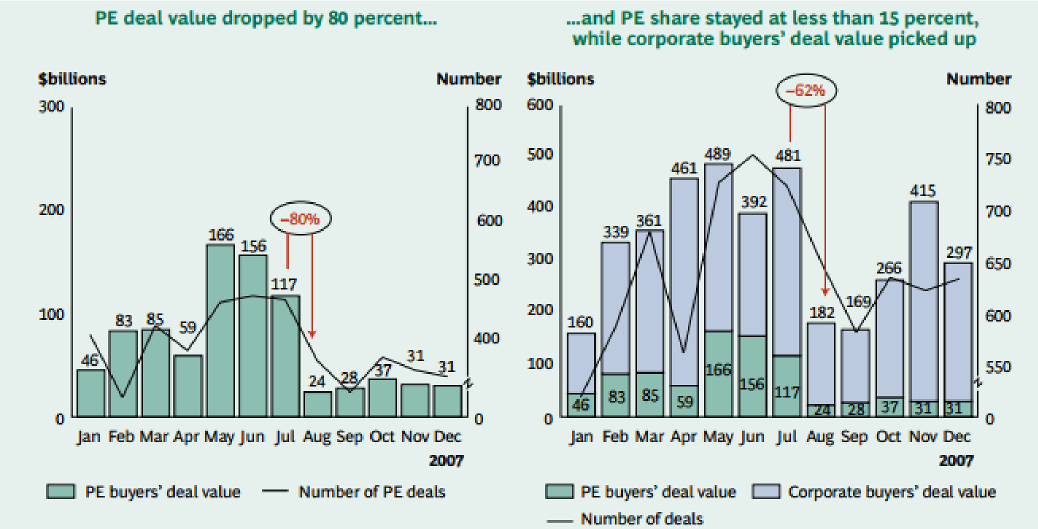



**Source: BCG 2009**

### 2.5.2 Changing in competition environment

Another reason of higher profitability of M&A in the current depression scenario is the changing of players in this industry. Because of the credit crunch, private equity funds lose their share in the market, displaced by corporate buyers, as shown in the graph below (BCG, 2008).

**Figure 2.7: value path of private equity funds during crisis**




**Source: BCG 2008**

These new players can rely on high cash and profitability, and are more independent in making deals unlike private equity funds that, in generals, make transactions by using huge amount of debt. In such a crisis, this latter method is highly risky and disapproved by the market, so corporate buyers rose as market leaders exploiting a lower competition and more reasonable valuation multiples (e.g. P/E ratio for S&P 500 declined on average of 61% - BCG, 2008).

As a result, the market is now led by players that have better characteristics to face downturn, in particular represented by huge cash reserves (well above the pre-crisis levels). Higher cash means less need of debt, so less risk in submitting a deal. Moreover, also coverage ratio of corporate buyers is higher nowadays (i.e. the ability to repay expenses), so the current M&A market leaders are more likelihood to conclude success M&A operations.

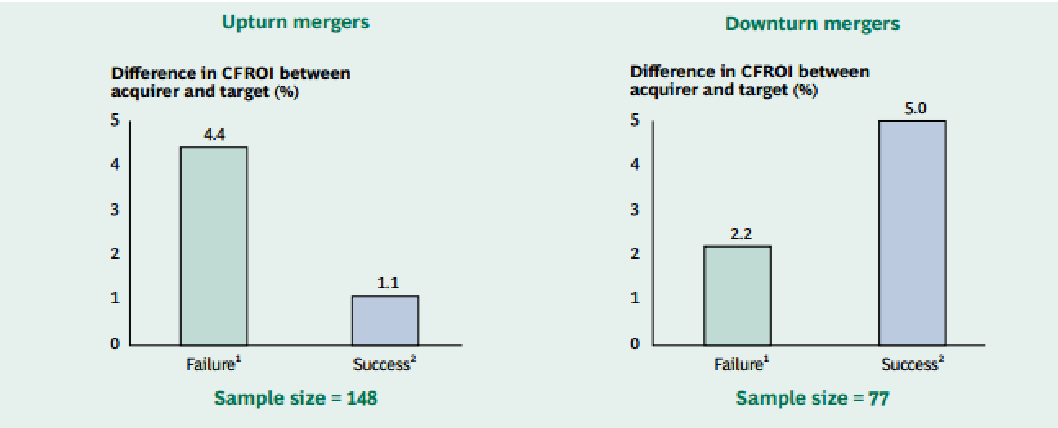
What it was just explained makes more sense in case of distressed M&A: in such a scenario, the acquisition price is lower than healthy firms, and this is further enhanced by economic crisis. In addition, more financial solidity is required for bidders. Corporate buyers represent the ideal (and the only) candidates to enter in risky transactions, and they can exploit higher returns in downturn thanks to lower competition by PE funds: from a "microeconomic" point of view, if competition decreases, current players have more bargain power, and it is more likely to get high returns on investments, also in proportion with lower investment (i.e. targets' price).

### 2.5.3 Profitability differences between buyer and target

Back to paragraph 2.2, it was said that a general success factor of distressed M&A is due to the financial strength of the buyer.

This effect is enhanced in successful downturn M&A: in such a scenario, the profitability spread between acquirer and target is observed to be five times higher than in positive upturn deals. This difference is measured by taking into account the cash flow return on investment (CFROI), as shown in the graph below.

**Figure 2.8: correlation between CFROI differences and M&A success in upturn and downturn mergers**




**Source: BCG 2008**

It was noticed that, when buyer's returns are higher than the ones of target before transaction, the result of the deal may outperform the market index of more than 10% (BCG, 2008).

The reason why this happens is that buyers can exploit this spread in profitability by implementing operational improvements: as a general rule, if they are the most profitable players of the transaction, buyers can achieve higher returns than their counterpart and with respect to transactions in normal periods. Operational improvements bring to higher productivity and, as a consequence, to higher margins, guaranteeing protection for the acquirer.

Distressed M&A in such a context are more successful if all these conditions are presented (buyer's financial strength, profitability differences), as well as potential good business plans to be implemented to recover the acquirer. As introduced in the paragraph 2.2, a healthy acquirer is more likely to implement a post-merger integration since it has the resources needed to turn around a firm in troubles.

More important, if profitability of the target is lower, it has less bargain power over the deal. As a consequence, the buyer would face less difficulties in acquiring it, and this is seen ex-ante as a positive success signal by the market. If power of the seller is lower the buyer can manage it better, so higher returns are more likely to mature due to less constraints during and after the deal by the buyer (BCG, 2009). General economic crisis would reduce even more the bargain power of the target, so the positive effect of differences in profits would be higher, increasing the returns of the buyer.

Anyway, as it can appear obvious, a base of financial strength is preferable also for the seller, since in this way a good new business plan can be implemented right after the deal, even if in this case the target would not be in distressed conditions in every sense of the word.

### 2.5.4 The role of regulators and employees

Distressed M&A have more opportunities during downturn also thanks to the support of regulators and institutions. Governments incentive mergers and acquisitions among companies if that can avoid failures or state bailouts (BCG, 2009). Moreover, monopoly situations are more tolerated: in ordinary times M&A deals can be seen as anti-competitive transactions and, sometimes, they are not approved by regulators, with the result of growth opportunities losses by

companies. Instead, during crisis, it is preferred to save distressed firms even if their acquisition can threat competition, in order to defend national economies.
As a consequence, potential buyers are more free in submitting such operations, and regulatory support may lead to simpler deals, with less time and resources spending. This causes a high degree of success of transactions as well as more growth opportunities for companies who buy other firms. Such a scenario is more common during crisis as it was already said, so distressed M&A are more likely to generate higher return in a downturn environment.

Also employees can support (distressed) M&A deals during downturn. Their goal is to preserve job, so they are more supportive in transactions made to save their struggled firms. Also this factor leads to smarter processes and less constraints both for buyer and for target, with higher likelihood of success.
Moreover, employees are more willing to reduce their wage and working conditions to help the firm in sustaining its financial problems: this can cause a cost reduction, improving the chance of turning around of distressed businesses. These favorable conditions are more difficult to find in good economic periods, so also in this case downturn can help in getting higher returns from distressed operations.

### 2.5.5 The bankruptcy advantages

In chapter 1 the main advantages of bankruptcy process under U.S. law were described. Such a selling approach is commonly used just in downturn, since cases of insolvent business are more likely to happen (it can be considered like an extreme case of distressed M&A). Most probably, the most important benefit of deals in bankruptcy is the fact that the buyer can get the target free of many liens and clear, without further liabilities held by the bidder. This aspect is very appreciated in an uncertain scenario like downturn, so this approach is largely diffused in crisis periods.
Such a protection both for target and acquirer increases the successful of distressed M&A transactions. Seller can manage its troubles with more confidence and without any pressure, as well as it can select more easily the offers presented by potential bidders. On the other hand, buyer has the guarantee of the regulator about

the liabilities that it will get after the deal, so it is more attracted in entering into such an operation.

Beyond the general features of bankruptcy process, it has to notice that the entire process has changed over time, becoming even more in favor of many parties interested in the transactions. For example, Debtor-in-possession (DIP) financing and Key-employee-retention-plans (KERP) are two of the tools that improved this kind of approach, making it more friendly towards creditors.

These factors make the acquisitions have a higher ratio of success, as well as higher returns both for the seller and the buyer. Even if the core of bankruptcy process remained stable over years, its features were exploited ever better. According to Meyer, Servayes (2014), it was proved that distressed M&A made in 2000s result more profitable than common M&A made 20 years ago, just thanks to the development of these legal measures. In particular, bidders are favored, so they can enjoy higher returns on investments than past decades.

The rationale behind acquisitions in bankruptcy under U.S. law is common also in other countries.

An emblematic example is the Italian case. The actual Bankruptcy Law, deriving from the Royal Decree 16 March 1942 (no. 167), was continuously changed and improved in last years. The substantial goal was trying to maintain unchanged the main activities of the business to be rescued and sold, also from an employment perspective (Delfino - Seminara, 2009): in this latter case, employees shift under the new company owner as a typical production factor.

Moreover, to favor as more potential acquirers as possible, an auction process is made towards all the interested parties: in this way not only the likelihood of getting a better price increases, but also more information about selling assets is shared. The base price is set by an independent expert, to guarantee transparency during the whole process.

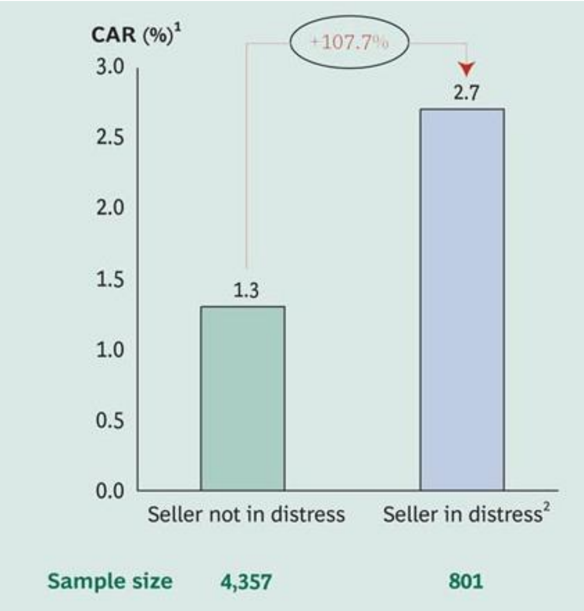
Last, similarity to the U.S. case, the acquirer does not take any debt pending on the target arose before the transaction, unless it explicitly agrees.

Thus, in many legislative frameworks bankruptcy acquisitions present a huge range of benefits that can increase the likelihood of positive returns both for purchasers and sellers.

### 2.5.6 Divestiture opportunities during crisis

Downturn causes higher returns also in case of public divestitures of assets (par. 2.4). In general terms, sellers get on average higher profit than in upturn (1.7% vs. 1.3% - BCG, 2008): this is explained, at first, by the fact that they are more careful in the transaction, so their effort brings them to get the highest possible value from the selling and leave less money on the table. This attention is not always paid in growth periods (due for example to overconfidence), so the likelihood of potential earnings' loss is higher.
Moreover, in case of distressed firms that try to divest to improve their position are "rewarded" by the market, that sees positively this effort by the sellers. The difference in divestitures' return between distressed and not-distressed firms is robust, as shown in the graph below.

**Figure 2.9: divestitures' returns comparison between distressed and not-distressed sellers**




**Source: BCG 2008**

As a result, the cumulative effect of downturn climate and financial conditions of the seller bring to above average returns.
Like every kind of transaction, sellers would prefer cash payment also in case of divestiture of assets. In this way, it would also reduce the risk related to stock price volatility in the opposite case of stock payment. So, sellers would gain not only for higher payments but also for lower risk, maximizing profit.

### 2.5.7 The role of competition

In a general distressed environment, competition between bidder, target and other buyers involved in the transaction has a key role (Meyer - Servaes, 2014).
As introduced at the beginning of chapter 1, if a firm is distressed, its bargain power over the potential acquirer is lower. Its urgency of selling its own assets (as well as the whole business) makes it to accept also low prices. In such a context a buyer not only can exploit a lower acquisition price with respect to potential returns, but also less effort in conclude the deal, since the target risks to see its value reduce even more. In period of crisis this condition is quite common, so the relative earnings compared with low acquisition price make any potential bidder to get a higher proportionate return that in case of healthy periods/sellers.
Moreover, during crisis there is less competition also between potential buyers: as said in paragraph 2.5.1, just the biggest companies can afford such deals due to their financial strength. Less competition plus the need of buyer to sell its business decreases again the acquisition price, letting the winning bidder to get higher returns at a discount price and to conclude the transaction with less interferences.
What was just explained makes more sense if a deal focuses on a particular industry hit by crisis: in general, firms make transactions in the same sector to exploit synergies and to win competition. An industry in crisis presents the advantages described above, so strong companies can emerge from competition and get high returns from acquisitions if, paradoxically, its sector is in troubles, since this discourages also potential bidders from outside. Making acquisitions in such a context permits the acquirer to emerge as market leader in a less competitive landscape, and this double advantage can lead to future higher performance.

In case of divestiture of assets, another factor to be considered is their possible usage for other purposes: it means that, if an asset can be used also in other activities/industries thanks to its flexibility, it can attract other potential buyers. On the other hand, high degree of specificity restricts the spectrum of competitors, with a consequent lower auction price. Like explained before, less competition means lower price, and so higher relative possible gains.
In conclusion, if crisis damages an industry whose activity and assets are specific and difficult to adapt elsewhere, it represents a good chance for strong buyers, with more emphasis in case of distressed target.

### 2.5.8 Long-term vs. near-term vision

Another possible explanation to the superior return of distressed M&A in downturn is related to business vision (BCG, 2003).
During ordinary times, after an acquisition the bidder usually set a near-term strategy to create profit. On the other hand, during downturn the goal focuses on long-term value creation to survive to the crisis and to maintain stable incomes in the future. To do that, a higher integration between buyer and target is needed, in particular from a cultural point of view. Such a vision permits the conglomerate company to get higher returns, thanks to the urgent incentive not to go insolvent and to higher motivation by the acquired entity.
In case of distressed M&A, this factor is enforced: target is more involved in the activity of the bidder since it has less power and freedom to act independently. As a result, integration is stronger as well as the common goals. Lack of conflicts or misunderstanding lead to an easier achievement of positive results than in growth periods, in which overconfidence and cultural differences among firms can cause loss of potential gains

### 2.5.9 Higher diligence

So far several reasons behind the higher success of distressed M&A were discussed. Anyway, one of the most common ones is represented by the highest attention that both seller and target pay during a distressed deal. It is implicitly presented in most of the cases previously analyzed and, even if it can be seen as an obvious factor, it

is not the case of ordinary periods: in fact, sometimes potential buyers are too much confident about the target future forecasts, so there is the risk to take hasty decisions or overpay. These mistakes are usually driven by the sentiment of a general growing economy, so firms rely on the fact that any loss can be recovered fast.
The recession scenario is the opposite: companies want protect themselves first, and then trying to enter into acquisitions or mergers. The feeling of fear and uncertainty pushes them to care more about target potential profitability and price. Just from the due diligence process (as explained also in chapter 1), acquirers consider any detail of the target business, to be sure about what it is going to pay. Price is another important factor: overpayment risk is tried to be reduce in order to minimize any loss.
Because of this higher attention, it is less likelihood that M&A made during crisis result in a failure. This factor is enforced when dealing with distress acquisition, since the due diligence is even higher.

### 2.5.10 The advantages by a seller point of view

At the beginning of the chapter it was said that distressed M&A completed during crisis typically bring advantages to buyers and not to sellers. In fact, the value created shifts towards the shareholders of the bidder, better than in upturn M&A. Moreover, targets are often forced to sell at discount their assets to repay debts, without any substantial gain.

Anyway, distressed M&A during downturn can give to targets also benefits.
At first, proceeds from the selling of assets are a kind of financing that can be used not only to adjust its own financials, but also improve rating position or making investments for the future (Protiviti, 2009). Just this latter feature can be exploited further during downturn: because of cheaper asset prices and business valuations, liquidity can be used more easily to enlarge. This is more difficult in growth periods also due to higher competition among potential buyers.
In addition, distressed companies can exploit their condition to attract bigger acquirers: by doing so, not only they can be recovered by them, but also gain in terms of share of knowledge, market, financing and solidity from the bidder.

Downturn represents an easier way for firms in troubles to grow with the support and protection of market leaders. This can have positive impact also in the future, guaranteeing stable cash flows and minimizing the likelihood of new distressed scenarios.

Substantially, target companies can exploit the same advantages from a buyer perspective to be acquired and to recover from crisis. Also in this case, internal distress added to general recession can represent a turning point for potential sellers to improve their business.

## 2.6 Limits in making distressed M&A during downturn

So far it was demonstrated that (distressed) M&A made during recession can bring to higher returns than in ordinary times. Anyway, few companies adopt such a strategy to survive from crisis for a series of reasons (BCG, 2003).

First of all, one of the most common reasons for not entering into an M&A deal is related to the affordability of a firm: in recession, few companies can buy another business without exposing to a consequent risk of lack of liquidity. Moreover, stock price of a potential bidder is likely to decease just due to market depression, so a cash-for-cash payment would be more difficult. Despite the valuation price and stock price decline after recession (in particular in case of distressed companies), many firms think that they cannot afford such a transaction, leaving on the table all the pros that an acquisition can bring.

Moreover, companies often do not want to acquire other players not to lose the focus on their own business. In downturn the goal remains maintaining near-term profit, concentrating efforts on the original strategic objective. An additional business carries higher risk, and in recession companies are usually risk adverse. In particular, if the target is distressed, it implies further effort in turning around it, and not all the companies would be able to manage such a difficult scenario if considered their existing issues to be solved.

Finally, M&A in general are not considered the best tools to grow. Even if they can lead to high results (unreachable with a stand-alone strategy in most of the cases), public opinion is still suspicious about that, mainly due to all the risks that M&A usually carry. A better "consumer education" about this fact could provide benefits to many companies and give them the chance to grow even more, in particular if their size is limited.

## 2.7 Conclusions

In this chapter the theoretical reasons behind the superior returns that distressed M&A can generate during downturn were analyzed. Anyway, it must be taken into account that these reasons do not represent a strict rule, and successful weak-economy M&A can take place if other more factors correlate each other.

Every acquisition/merger transaction, in particular during crisis, carries a lot of unpredictable variables that do not ensure a successful result. So, also distressed acquisitions remain risky strategies, independently from the stage of economy.

However, theoretical explanations are the base to find other reasons about the higher likelihood of distressed M&A to generate positive returns in slowdown. Thus, in the next chapter the reasons behind some of the largest M&A deals of last years will be described, to find up what other variables can affect the result of such transactions and to further demonstrate the validity of the theories already analyzed, basing the analysis just on empirical examples.

# Chapter 3: Empirical cases of successful distressed M&A in downturn

## 3.1 Introduction

In the previous chapter the theories about superior returns of distressed deals during crisis were explained. They represent the most common factors that permit buyers to create value from a distressed acquisition. As it was already analyzed, these are not strict rules so, even if they are present, the result of the transaction can still be uncertain.

Anyway, there are other reasons why such M&A operations can bring to higher returns just during global recession. Some of them are firm specific and related to a particular industry or conditions of the players, so they can vary from pure theoretical explanations.

The aim of this chapter is analyzing other possible reasons about this kind of paradox and giving an empirical proof to the theories. During last years, many M&A deals were made, and the following analysis will focus on some of the most emblematic ones in which the target was in troubles. Starting from the performance history of both the acquirer and the purchased company up to the peculiar characteristics of the deals, it will be furnished an explanation of the positive returns from the perspective of both the parties.

## 3.2 Alitalia – Etihad acquisition

The first analyzed case is the Alitalia - Etihad acquisition. Made in 2014, it represented a typical case of distressed M&A in which a weak player (Alitalia) recovered from crisis thanks to the help of a market leader in the same sector (Etihad). Moreover, this transaction was characterized by a very large number of stakeholder (also institutional ones), as proof of the great impact that the deal had on the market, both Italian and foreign. Despite the difficult environment and the severe crisis that hit both Alitalia and the general Italian economy, it was one of the most successful acquisitions between 2014 and 2015 (WAM, 2015).

The following analysis will begin with an overview of the two companies to understand the general set up. Then, it will continue with the analysis of the transaction and its consequences in terms of performance, to find up the reasons of its success.

### 3.2.1 The perspective of the target: Alitalia

At the time of the deal, Alitalia was the most important air company in Italy. Founded during 40s, both its organization/ownership and brand changed many times over following years.

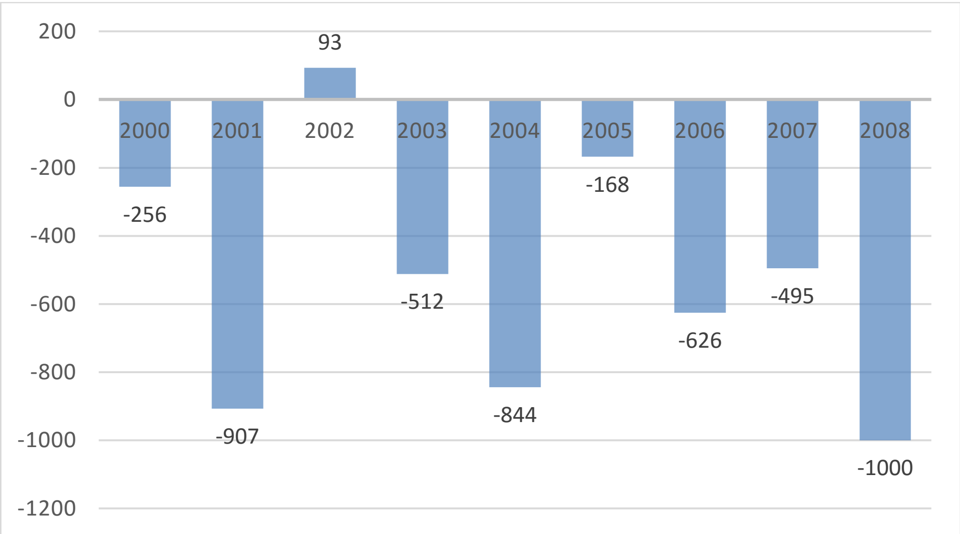
Since 50s it was known as “Alitalia - Linee Aeree Italiane S.p.A.” (because of the merger with Linee Aeree Italiane in 1957) and, after the bankruptcy of 2009, it changed into “Alitalia - Compagnia Aerea Italiana” until 2015.

Alitalia was the historical market leader of the Italian air sector. In 2009 it owned around 50% of market share, well above than other direct competitors like Ryanair and Meridiana (OAG, 2009) and, at the time of the transaction, its revenues were higher than 3 billion $. About the flying activity itself, the company provided around 100 destinations (mainly abroad), 180 routes, 4700 weekly flights and over 20 million passengers carried worldwide (Alitalia annual reports).

Despite the numbers, the company was in troubles since 2000, mainly due to the general crisis of the air industry, that pushed Alitalia to change its business and focusing more on domestic market. In those years, a large part of the ownership was held by the Government, that tried to sell it after the troubles through a recapitalization program. Anyway, this tentative of privatization failed, and between 2008 and 2009 the company entered in extraordinary administration due to continuous losses and financial instability, culminated with bankruptcy. The new, private owner was Compagnia Aerea Italiana (that acquired 1 billion € of assets from the old business), becoming "Alitalia - Compagnia Aerea Italiana". As other major changes, in 2009 AF-KLM bought 25% of shares and, at the end of 2013, there was a capital increase of 300 million € (Alitalia annual reports).

The general poor performance of Alitalia is represented in the graphs below. Even if there was an improvement after the period pre-bankruptcy until 2011, before the acquisition by Etihad the firm was not still able to maintain good profit margins, also due to the severe downturn that limited many chances of improvement.
In addition, as any typical distressed firm, Alitalia was affected by huge debt (equal to 1'029 million € in 2012 and 936 million € in 2013) and high Net Debt/EBITDA ratio: the latter had a volatile path between 2009 and 2013, reaching the peak in 2012 with a value of 9.5x and stabilizing at 6.8x in 2013.
Such a huge debt was not "guaranteed" by enough operating results, as proved by the decreasing EBITDAR trend, that from 2011 to 2013 fell by 45.5% (448 vs. 244 million €). As a consequence, also a portion of market shares was lost, from 23.9% in 2009 to 21.7% in 2013 (Alitalia annual reports).

**Figure 3.1: Alitalia LAI net income trend before bankruptcy (millions €)**




**Source: Alitalia annual reports**

**Figure 3.2: Alitalia CAI net income trend between 2009 and 2013 (millions €)**


**Source: Alitalia annual reports**

### 3.2.2 Buyer side: Etihad

Etihad Airways started its activity on 2003 in United Arab Emirates, whose it is the main air company. In few years it became one of the most appreciated firms in its sectors by consumers and, in 2013, it reached the value of more than 11 million passengers carried and almost 5 billion $ of revenues (Etihad annual reports).

The young history of the company is more linear than the one of Alitalia, with a continuous expansion worldwide thanks to several partnerships with other air companies (e.g. Air Seychelles and Air Berlin, whose it is one of the major shareholders since 2011). In this way, Etihad expanded its network over more countries and continents year by year, becoming one of the market leaders.

In absolute terms, at the time of the transaction with Alitalia, Etihad was smaller than its counterpart according to the numbers: for example, Alitalia had more employees (nearly the double) and a larger fleet, as well as more destinations. Anyway, these factors have to be considered in association with other ones: first of all, Etihad had a solid and supportive shareholder basis, thanks to the strong presence of the local government in the ownership (characterized by great financial power and stability). This permitted the beginning of partnerships and acquisitions, increasing the revenues well above than Alitalia (4.57 vs. 3.41 billion $).

Moreover, Etihad set its business on high-end, distinguishing from other competitors, and it succeeded in winning competition with other direct air companies. In this way it created a kind of market niche in which it is one of the main players (another one is Fly Emirates from the same country). The different market segment of Alitalia would have permitted both companies to exploit the synergies of the counterpart, enlarging their business and avoiding risks of overlapping.
Finally, Etihad belongs to a healthy nation that suffered less by the global economic crisis, so the firm itself was less damaged and more stimulated by the government.

All the factors described above made Etihad a good and credible candidate for the role of buyer, thanks also to its successful M&A history.

### 3.2.3 Stakeholder perspective

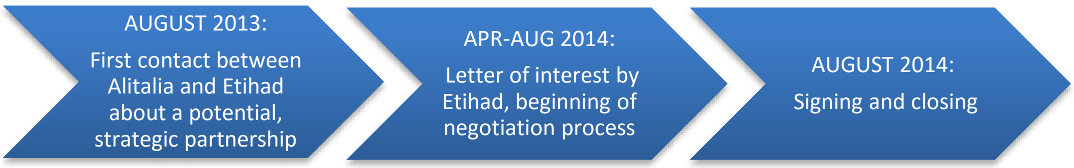
As in the case of any distressed company and transaction, also the Alitalia - Etihad deal was much influenced by stakeholders. The important role that Alitalia had at a national level attracted also the interest of institutional players, alarmed by the uncertain future of the firm.
Apart the main shareholders and lenders (which will be discussed about in the next paragraph), many different parties were involved in the transaction: first of all, the suppliers looked at the deal as a good chance to maintain Alitalia as customer and enlarge their business. For example, Aeroporti di Roma, the company owning the airports of Rome, could have exploited the entrance of Etihad under its air traffic management, with a consequent increase of tariffs for the usage of the airports services and a larger passenger traffic.
About the latter, also customers would have been advantaged by the deal, thanks to more hauls and destination leaving by Italian airports. The entrance of Etihad in the local market would have guaranteed more direct flights toward new destinations (mainly in Middle East and Asia).
Then, as introduced before, the interest of public stakeholders was also very huge: at first, Italian Unions looked at the deal as a tool to avoid personnel layoff (around 2’200 - Alitalia annual reports 2013-14) or mitigate it. This argument would have

been revealed extremely critical, with a series of interrupted agreements between Unions and Italian government about the cut of Alitalia employees.
Just Italian government played a key role: not only it had the goal to negotiate with the Unions (without their consensus the deal would not have been closed), but it supported the transaction as signal of economic recovery, despite it did not have any ownership in Alitalia since 2009.

### 3.2.4 Deal history, features and the role of stakeholders

The transaction between Alitalia and Etihad took place officially on 8th August 2014 through the signing and the announcement of the deal. Obviously, such a large operation lasted long time, as summarized in the graph below.

**Figure 3.3: main steps of Alitalia - Etihad transaction**

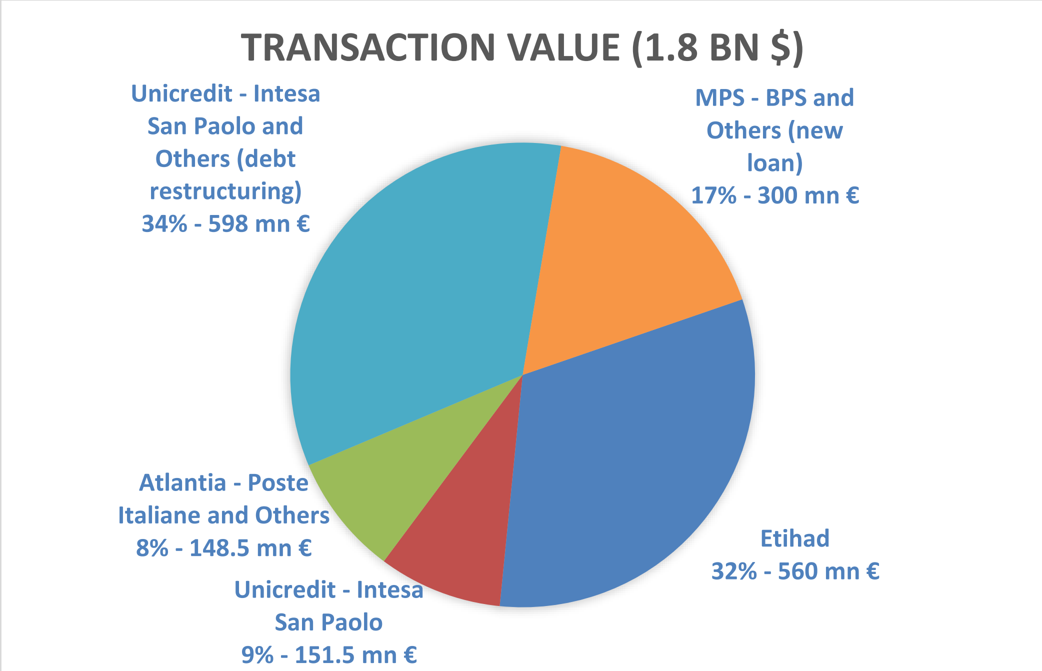



**Source: Alitalia annual reports**

Among these main steps, other important phases succeeded one another: in December 2013 there was a capital increase of 300 million € as well as an initial due diligence process by Etihad. In January 2014 further financing was provided to Alitalia by existing lenders whereas two months later the due diligence phase was completed.
Despite the long time spent, the previously forecasted closing date was on 31 December 2014, so not only the transaction was successful, but also on time.

Etihad agreed with the target for the acquisition of 49% of shares, guaranteeing in this way a huge stable ownership basis.
The total value of the deal was 1.8 billion €, with the contribution of other parties for different quotes, as highlighted in the following graph:

**Figure 3.4: composition of total Alitalia transaction value**




**Source: Companies press releases and websites**

All the players involved had different roles: Etihad acquired existing shares and became the major shareholder whereas Unicredit and Intesa San Paolo (for the amount of 151.5 million €), together with Atlantia, Poste Italiane and other investors (e.g. IMMSI, Pirelli), made a capital increase. The two banks provided also a short-medium term debt restructuring for 598 million €, whereas Monte dei Paschi di Siena and Banca Popolare di Sondrio provided new loan for 300 million € (companies' annual reports; WAM, 2015). This was possible thanks to the cooperation with other financial institutions, as proof of the huge amount of stakeholders involved in the transaction.

About the Etihad investment, the amount of 560 million € was split as follows: 388 million € were used to buy existing shares whereas 113 million € to buy "Alitalia Loyalty", a branch of Alitalia whose business focused on loyalty programs toward customers. The remaining part of the investment (60 million €) was dedicated to the purchase of landing slots in the airport of Heathrow (London - UK): in this way Etihad got the right of scheduling departures and arrivals on that hub, in line with its strategy of expansion within the European market.

After the deal, the “new” Alitalia (NewCo) ownership was split as follows: as already said, 49% of shares was owned by Etihad, whereas the remaining part was owned by MidCo, an intermediary entity owned and controlled by Intesa San Paolo, Unicredit, Immsi, Atlantia and other firms (through a new established company named “HoldCo”), and Poste Italiane. All the assets previously owned by Alitalia CAI (but not the debt amount not related to the air fleet) flowed to NewCo: in fact, like MidCo, it was a newly incorporated created after the transaction.

### 3.2.5 Future forecasts and current results

The expectations about Etihad - Alitalia partnership were optimistic at the time of the transaction closing. From an operating perspective, the alliances could have relied on a larger fleet and destination network, with two important hubs like Fiumicino (Rome) and Dubai, as well as more than 30’000 employees. The passengers traffic was expected to reach a value of more than 30 million people, with new hauls over a huge network of countries. Also, Etihad planned new investments in fleet for a value of 690 million € (companies’ annual reports).
These factors would have also advantaged Alitalia, thanks to new international hauls offered and Dubai as additional hub.

Despite the expectations, the process to turn around the financial troubles of Alitalia is not so easy: such a big company requires much time and a continuous effort by all its stakeholders., especially the internal ones.
Anyway, the path is looking to give the first, positive results: according to the directors of the Italian company, the accounting results of the first months of 2015 were in line with the forecasts, and it is expected a positive net income by 2017 as previously set in the business plan of the firm (Il Tempo, 2016). This achievement is being possible also through several operating improvements, such as an enlargement of the air network both at a domestic and international level (like new hauls toward South America and Asia over 2015) as well as the modernization of the whole fleet and facilities within airports.
More deeply, the first half of 2015 resulted in net losses of 130 million €, in line with the goal of containing losses within a range of -200 million €. Moreover,

during 2015 the company succeeded in a bond launch for a value of 375 million €, affording new investments in all the services provided. Moreover, it got around 122 million $ by its ownership (in particular Etihad) as new financing, so the chances for an operating improvement remain in line with the expectations (Alitalia press releases, 2015).

Even if passenger traffic decreased, in 2013 Alitalia was the company that carried the highest number of passengers in Italy (around 24 million), better than other important competitors like Ryanair and Easyjet. The goal of getting a net profit in 2017 does not look too far, and it is forecasted to be equal to 46 million €, whereas the revenues will reach 3.9 billion € (with an annual growing rate of sales equal to 7.2%) (Press releases, 2014-15).

On August 2014 the company name changed into “Alitalia - Società Aerea Italia S.p.A.”, and it started its activity on January 2015. 49% of ownership is still controlled by Etihad, whereas the remaining part is owned by Compagnia Aerea Italiana through MidCo (Alitalia website).

Just the new ownership of Alitalia is the key of the recovery. Etihad is looking the good choice as new equity partner, as proven also by its strong financials: at the end of 2014 it got 7.6 billion $ as total revenues and 73 million $ as net profit (growing with respect to 2013). Moreover, in 2015 it improved its revenue passengers (i.e. passengers that pay transport operators for their trips - Business Dictionary) up to 17 million, implying growing revenues also for 2015 (Etihad annual reports).

Such an owner will likelihood guarantee secure financing to Alitalia also for the upcoming years and, if the actual trend of Alitalia will be respected, the results of the acquisition will be even better for the Arabian company.

## 3.3 Safilo case

The acquisition of the Italian company Safilo by HAL Investments represents another emblematic case of distressed M&A occurred during current downturn. Happened between 2009 and 2010, unlike the Alitalia - Etihad case this transaction was characterized by the fact that the two parties did not belong to the same industry

(in particular, HAL Investment is a subsidiary of HAL Holding N.V., an international investment company).
Thus, as it will be explained in next paragraphs, this transaction based the performance results on the financial strength and size of the bidder over the target, independently by any operational synergy and mutual support in its own business.

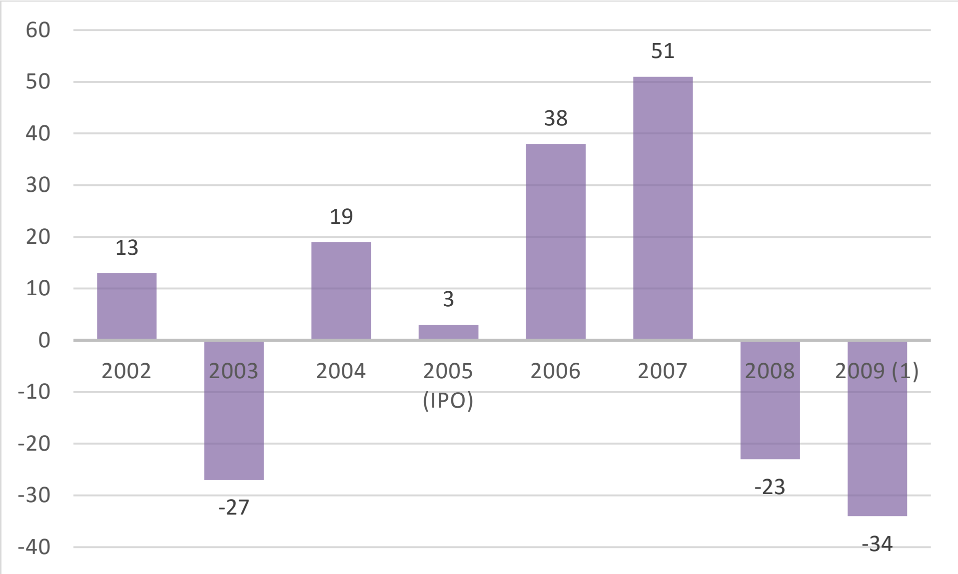
### 3.3.1 History of Safilo

Safilo ("Società Azionaria Fabbrica Italiana Lavorazione Occhiali") is an Italian manufacturer and designer company of eyewear products, one of the most important ones worldwide. It owns several brands like Carrera and Polaroid and produces for other brands under license (e.g. Dior, Fendi and Gucci). The major production plants are located in Italy, but over last years other ones were opened abroad, like in China and USA.

The firm was founded in 1934 in Northern Italy and it was owned for many years by the family of its founder, Guglielmo Tabacchi. In 1987 it was listed on the Milan Stock Exchange then, in 2001, it was delisted through a leveraged buyout and relisted four years later. At the time of the transaction with HAL, the Tabacchi family owned around 40% of shares (Safilo annual report, 2009).
The financial troubles of Safilo began just in 2001 after the LBO, that provoked a lack of funds needed for future investments and strategies. Neither the 314 million € IPO made in 2005 solved the problems of the firm, that accumulated losses in the following years. Distressed conditions were amplified also by wrong strategies, higher competition and general economic crisis. These factors, together with huge amount of debt with respect to the performance indicators, risked to lead the company to bankruptcy.

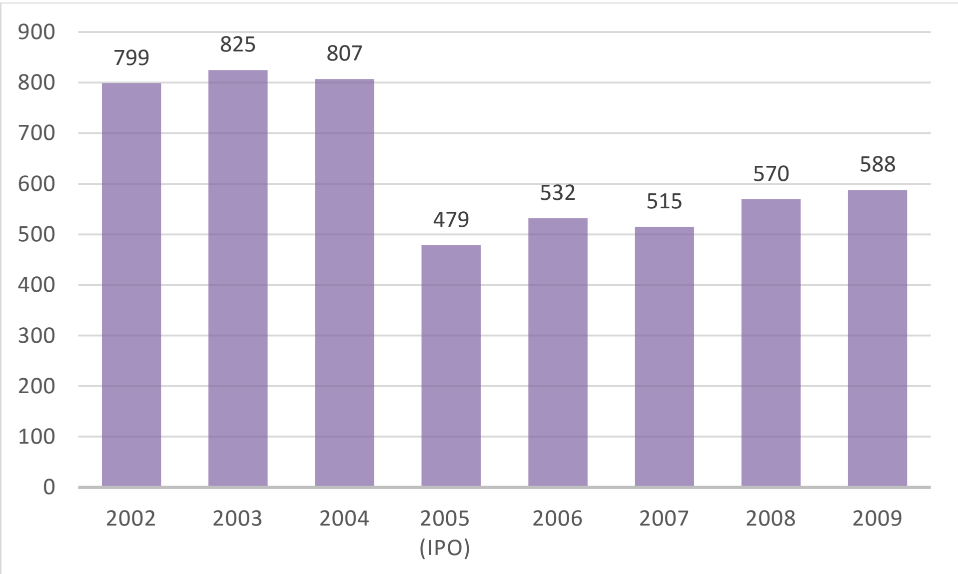
The poor financial performances of Safilo before the HAL acquisition are highlighted in the exhibits below.

**Figure 3.5: net income attributed to Safilo Group path before HAL acquisition (millions €)**



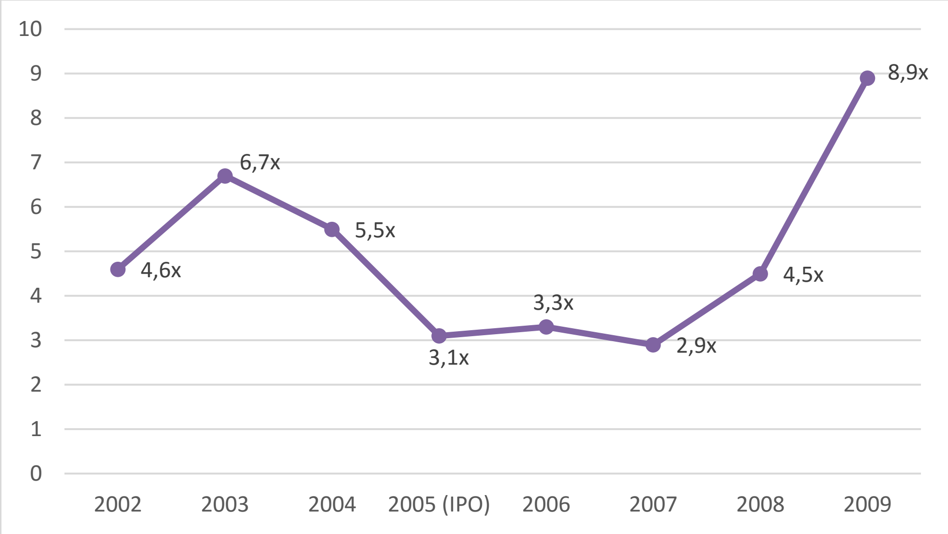

**Source: Safilo annual reports. (1): before non-recurring items**

**Figure 3.6: Safilo net debt path before 2010 (millions €)**




**Source: Safilo annual reports**

**Figure 3.7: Safilo Net Debt/EBITDA path before 2010**




**Source: Safilo annual reports**

As it can be observed, the 2005 IPO mitigated the problems of the firm but did not solved them at all. After few years the performance decreased again and the existing management/ownership was not able to turn around itself.

## 3.3.2 Overview of the bidder

As introduced before, HAL Investment, the bidder of the transaction, is a long history diversified Dutch holding company whose business consists in acquiring significant shareholdings in companies belonging to different sectors.

One of the main characteristics of its way of doing business is the high participation and involvement that it has in the ownership and boards of its controlled firms. The mission is not just get returns by simply controlling a percentage of stakes, but also to play a proactive role in defining strategies and business plans (just like in the case of Safilo takeover) over a long term horizon.

The investment portfolio of HAL includes both quoted and non-quoted companies like GrandVision N.V. (global leader in optical retail by number of stores), SBM Offshore N.V. and Koninklijke Boskalis Westminster N.V. (both operating in maritime sector).

The experience in the optical retail industry was one of the major reasons behind the choice of HAL to enlarge its ownership in Safilo: in fact, before the takeover, the Dutch company already owned around 2% of its stakes (Safilo annual report, 2009).

Moreover, at the time of the deal, HAL had also enough financial power to enter in the transaction: in 2009, its controlling company "HAL Holding N.V." got revenues equal to 3.4 billion € and a net income of 347 million €.

In addition, the excess of net asset value for the value of 5.4 billion € and the market capitalization of 5 billion € would have permitted HAL to absorb relatively fast the total investment in Safilo (HAL annual report, 2009).

Thus, even if it belongs to a different industry, HAL was a good candidate to take the control of Safilo and turn around it, thanks to a high financial strength, good knowledge of the market and already established participation in the ownership of the bidder.

### 3.3.3 Deal structure

The rescue plan managed by HAL started in 2009 and was completed the following year.

The overall strategy of HAL can be split in two parts: at first, the Dutch company implemented a recapitalization to improve the existing capital structure of Safilo (affected by huge debt). By the way, HAL acquired 50.99% of Senior Notes and the non-core retail activities of the Italian company (valuated almost 20 million €), together with a senior debt restructuring plan (agreed by the lending banks of Safilo). Moreover, HAL supported a reserved capital increase of 50 million € and another capital increase on the market (guaranteed by itself and the banks) of 250 million € rights issue. Such a strategy had the goal to reduce significantly the debt of the target that, in 2009, was equal to 592 million €.

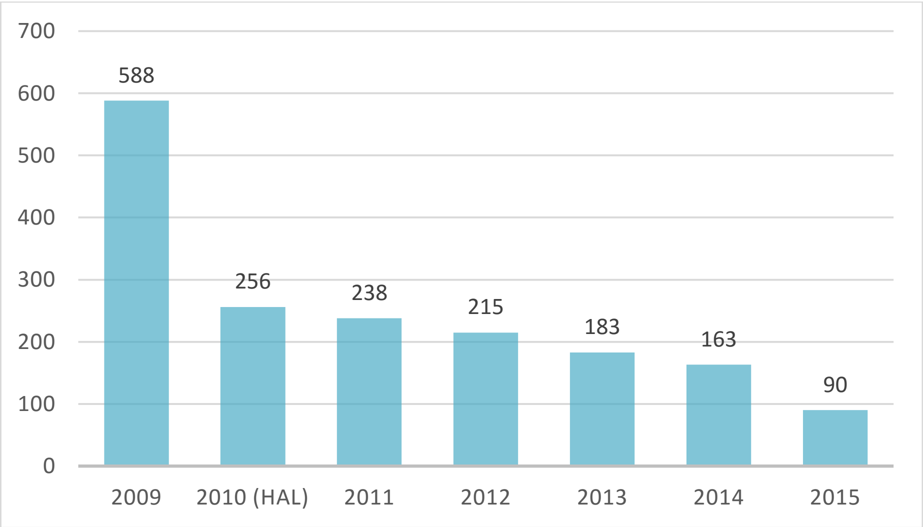
About the ownership itself, HAL accepted a percentage of stakes between 37% and 49.99% (finally equal to 37.23% at the end of 2010, for a purchase price of 148 million €), whereas the Tabacchi family decreased its quota up to 10%.

The announcement of the takeover was immediately “approved” by the market: the share price of Safilo increased by 4% in the days next to the news. (Safilo annual report, 2009-10; Il Sole 24 Ore, 2009).
Apart the ownership itself, HAL managed actively also the operational strategy of Safilo after the takeover: first of all, new management and board was settled, as well as new organizational framework.
Then, higher focus on licensed brands was implemented: 13 brands were renewed and one new license was agreed.
Finally, new business segments were opened, together with a renovated global positioning and product innovation/distribution (companies’ annual reports, 2009-10).
This strategy was possible thanks to the established presence of HAL in the optical retail market, so a kind of synergy was created between Safilo and the controlled firms of the Dutch company.

### 3.3.4 Results after the acquisition

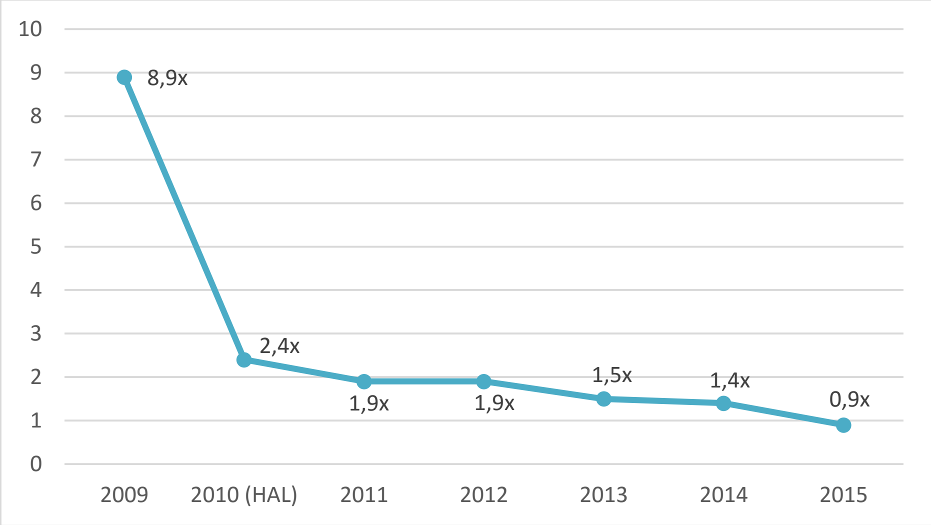
The takeover by HAL improved the performance of Safilo in few time. As it can be observed by the graphs below, the rescue plan succeeded in decreasing the amount of debt of the target and improving the net income with respect to the year before the transaction, in which huge losses were generated.

**Figure 3.8: Safilo net debt path since 2009 (millions €)**



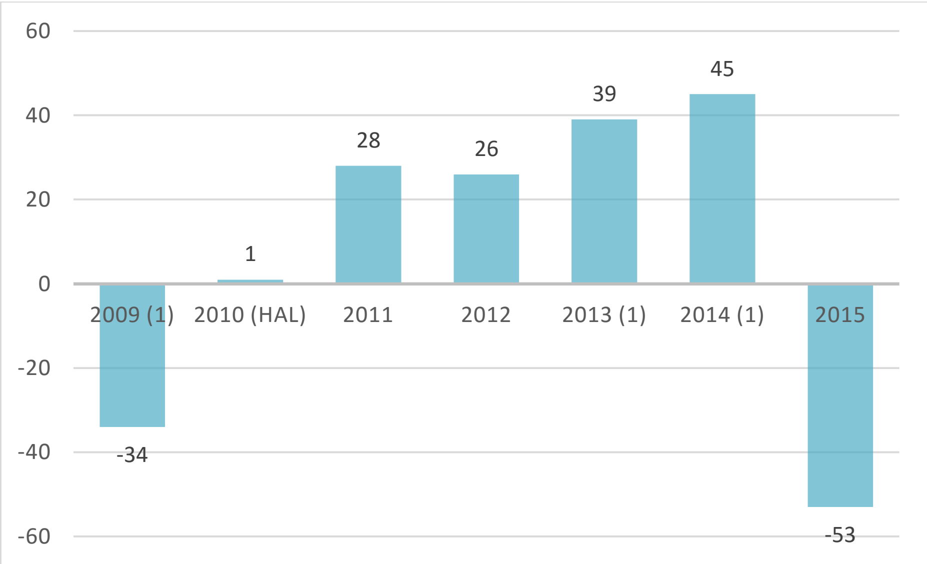

**Source: Safilo annual reports**

**Figure 3.9: Safilo Net Debt/EBITDA trend since 2009**




**Source: Safilo annual reports**

**Figure 3.10: net income attributed to Safilo Group path since 2009 (millions €)**




**Source: Safilo annual reports. (1): before non-recurring items**

On 31 December 2015, HAL Investments owned 42.23% stakes of Safilo, whereas the Tabacchi family had 9.22%. From 2013 to 2014 the net income passed from 15.5 to 39 million € (if not considering non-recurring items); also the revenues increased, from 1.12 to 1.18 billion €.

In 2015 the company generated net losses for 52.4 million €, even if gross profit increased from 719 to 757 million € (with revenues equal to 1.3 billion €). This is

explained by a higher incidence of non-recurring items, mainly due to impairment of the goodwill allocated in the Far East.
Also net debt improved, reaching a value of 89.9 million €, lower than 2014 (-44.9%) (Safilo annual report, 2015).

Thus, the financial results after the takeover by HAL improved. Safilo is expanding its market shares worldwide (mainly in Europe) and it was not more in distressed conditions since 2010. Even if in 2015 net losses were generated, they were also the consequence of an accounting reconciliation process and, most important, of a series of investments (around 48 million €) made by the company to rearrange its business as part of the general strategy for 2020. The business remains profitable as shown by the growing sales, and it is expected to bring to even better results in future years (e.g. revenues equal to 1.7 billion € by 2020 and decreasing debt) (press releases 2015).

The effect of Safilo on the consolidated financial results of HAL Holding revealed very huge: in 2015, the Italian company, together with Vopak (another firm controlled by HAL), counted for around 1/4 of the operating profit of the Dutch holding (452.5 million € over 1’284.1 million €). Safilo itself was able to generate revenues for 1’279 million € in 2015 (1’101.9 million € in 2011), as proof of its growing importance for the whole group.
The effect of Safilo consolidation can be found out also in the assets of the holding (net value of 998.6 million € attributed to the Italian company in 2015) and in capital expenditures. These values are following a growing trend year by year, meaning the success of Safilo business within the economics of its buyer. Again, together with Vopak, Safilo contributed to 1/3 of total assets of HAL (5’493 million € over 15’618.1 million € in 2015).

The general optical retail operating income had also a growing trend in favor of HAL accounts, and in 2015 it generated 390.3 million € (341.7 million € in 2014). Also the investments in this sector increased, from 35 to 40.5 million € between 2014 and 2015.

As a result, the outcomes of HAL Holding are continuously growing: the net profit increased from 408.5 million € in 2012 to 890.6 million € in 2015, as well as revenues and operating profit. As introduced before, the key factors for such an increase were the acquisitions made by HAL in last years (just like Safilo) and the growing percentage owned within the shareholder base (HAL Holding annual reports).

## 3.4 Parmalat – Lactalis

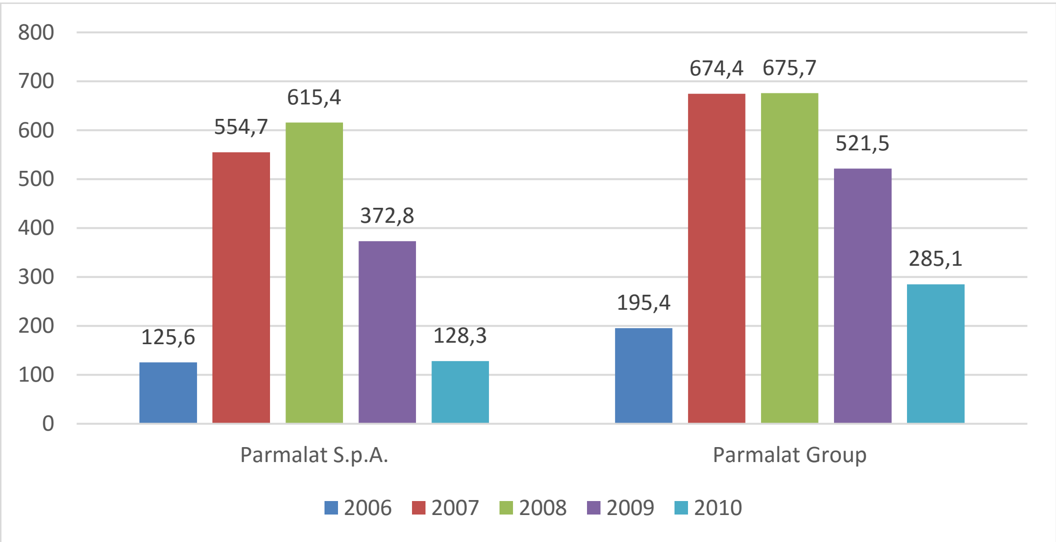
One of the most severe cases of distressed M&A during last years was represented by the acquisition of Parmalat by Lactalis in 2011. In fact, at the time of the transaction, the Italian company has just recovered by the financial scandal started in 2003, that provoked the bankruptcy of the firm. Anyway, Parmalat was still weak and far from economic stability, also because of the financial crisis of 2008.
Such a big but unstable company (with huge amount of cash and low share price) attracted the attention of another leader of the milk and dairy industry, that was just Lactalis. The acquisition represented not only a clear example of distressed M&A incurred during downturn, but also an emblematic case of how such a recession (both at a firm and global level) permits existing market leaders to enhance their position, providing further opportunities of growth than ordinary periods.

### 3.4.1 History of Parmalat

Parmalat is the Italian leader in the dairy and milk industry. Founded in the first 60s, thanks to a continuous innovation process (e.g. in the packaging of milk) it expanded rapidly, gaining even more market shares and enlarging its business not only within its home country but also abroad (for example in South America). The expansion of the company itself was possible through a series of acquisitions, also in other different industries, and through a product diversification strategy.
Anyway, this huge growth was based on excessive leverage (in particular towards banks). In 2003, due to the lack of debt repayment by the company, several inquiries made by Italian regulators were started. As a result, it was found out that the company had manipulated accounting bookings and hided a complex network of

controlled firms (around 200 all over the world), as well as its huge debt. After this scandal (one of the biggest all over Europe, for a value higher than 8.5 billion €), Parmalat and other subsidiaries entered into extraordinary administration, and a restructuring plan was proposed for them together with an agreement with creditors. In 2005 "new" Parmalat was born (named "Parmalat S.p.A.") and, since the same year, it is listed on Milan Stock Exchange (Parmalat annual reports).
Since then, it is the parent company of the Parmalat Group, collecting several brands, some of them focused on different products (e.g. beverages). Also the business abroad is very strong, especially in European countries and in America: for example, in 2013, 44% of revenues was got in North America (Parmalat annual reports).
Even if the company was able enough to recover the business, it suffered because of the crisis of 2008: general consumption rate decreased (consumers shifted to discount, cheaper products), as well as interest rates that affected net income. This was particularly emphasized in emerging markets, in which price/quality ratio is still the main driver of purchasing decisions. As a consequence, the financial results fell, as shown in the graph below in the case of net income. Also the share price fell suddenly (around -49% during 2008), in particular after that American Court condemned Parmalat to refund Citigroup by 364 million € (La Repubblica, 2008).

**Figure 3.11: net income trend of Parmalat S.p.A. and Parmalat Group between 2006 and 2010 (millions €)**




**Source: Parmalat annual reports**

### 3.4.2 Bidder side perspective: Lactalis

Founded in 30s in France, Lactalis, thanks also to the acquisition of Parmalat, is the biggest company in the dairy industry all over the world (Economic Times, 2014). Like its Italian counterpart, its business is spread at a global level, in particular in Italy: through a series of acquisitions of other local important brands (e.g. Galbani, Invernizzi), Lactalis gained even more market shares during last years. In 2007 "Gruppo Lactalis" was born as brand collecting all the Italian companies previously acquired by Lactalis itself.

Acquisitions were the main tool used by the company to grow year by year: during 80s it purchased several French firms located in different regions, whereas starting from 90s it focused on the European market (in 1996 the Italian firm "Locatelli" was purchased). In the third millennium Lactalis expanded also out of Europe, like in U.S., Africa and Asia.

Due to its restricted policy about the diffusion of financial and economic data, little information is provided by Lactalis. Anyway, according to the data published in the years of the acquisition, the French giant owned more than 200 production plants over 35 countries. It is the leader in Europe as milk collector and cheese producer and the fifteenth agri-food group worldwide. In 2013 it got 16 billion € of revenues, and its products were exported in 150 countries. In Italy the group reached 1.3 billion € in revenues, with a market share of 23.4% in dairy sector (Lactalis annual reports).

The French company, since its foundation, is owned by Besnier family, that is the main shareholder and whose members lead the board of the firm.

### 3.4.3 Features of the acquisition process

The acquisition of Parmalat by Lactalis took place in 2011, after several months of negotiations.

The whole process, that concluded in the acquisition of the majority of Parmalat stakes, lasted several months and it was articulated in several steps.

Back to March 2011, Lactalis showed the first signals of interest in controlling Parmalat: it succeeded in buying 11.42% of shares in order to exploit the

complementary synergies between the two companies (Parmalat could have exploited the huge markets of Lactalis, whereas the French company would have made its counterpart even more strong and powerful).
Few time later, Lactalis improved again its ownership, getting in total 29% of Parmalat stakes, for a value of 1.3 billion €. Such a quote was owned through Groupe Lactalis (1%) and BSA S.A. (28%), the latter controlled by Lactalis itself.

On April 2011 Lactalis continued its strategy of acquiring all the remaining shares of Parmalat (around 71%), and it announced its willingness of takeover. Such news was appreciated by the stock market, and the share price of the target increased up to 2.56 €.
The final deadline approved to accept the offer was set on July 2011, and the offer price would have been equal to 2.60 €. Lactalis would have used its controlled company "Sofil Sas" as vehicle to conclude the transaction.

The offer made by the French giant resulted in a great success: in fact, because of the high level of consensus by existing shareholders (54% of them accepted the offer made by the buyer) Lactalis resulted in controlling 83.3% of the Italian counterpart, as anticipated by Sofil Sas on 8$^{th}$ July 2011. Few days before the conclusion of the deal, the share price of Parmalat decreased, mainly due to the difficult economic scenario characterizing European countries. A similar decreasing trend was followed also some months after the closing because of the same reason.

On 14$^{th}$ July 2011 the transaction concluded definitively, and Lactalis got 83.33% of stakes at a price of 2.60 €/share as previously set (Varesco, 2014).
Anyway, such a large success had also negative consequences: at the end of the day, the price paid by Lactalis was 2.4 billion €, too much if considered that, to have the leading power within the shareholders' meeting, 55% of ownership would have been enough by law.
Thus, the total spend by Lactalis for Parmalat reached an amount equal to 3.7 billion €, and this worsened its leverage ratio, as proved by the total debt of the French

group equal to 5.4 billion € after the takeover (Il Sole 24 Ore, 2011). Such a huge amount is in part justified by the hostility of a part of stakeholders (in particular institutional ones) that disagreed with the acquisition of one of the most important Italian companies by a foreign entity, so that can be considered the price needed to have the full consensus to go on with the takeover.

### 3.4.4 Results after the takeover

The first and most visible results of the transaction were in favor of Lactalis: after the acquisition of Parmalat, the French group confirmed itself as the absolute leader of dairy industry. In particular, it surpassed other two important competitors in terms of revenues, that were Nestlè (10 billion € of turnover) and Danone (9.7 billion €): by the way, in 2012 Lactalis Group was able to generate 15.7 billion € of revenues.

The company is continuously growing year by year. In 2015 its revenues reached 16.5 billion €, with almost 240 production firms spread in 40 countries and 75'000 employees (Lactalis annual reports; Il Sole 24 Ore, 2011).

Through Sofil Sas, in 2015 Lactalis resulted in owning around 86.6% of Parmalat.

About Parmalat, the results for the company were more complex.

In 2012 the Italian company began an acquisition strategy towards several companies, thanks to the high amount of cash that Parmalat collected after the bankruptcy of 2003. Among the purchased firms, the most important ones were Lactalis American Group (LAG) for 774 million €, Lactalis Brazil, Lactalis Mexico (bought from its French counterpart), Lacteos do Brazil (190 million €) and Brf (700 million €), together with their production plants. Other acquired companies are located in Australia and also in Italy (e.g. Latterie Friulane).

Many of the acquisitions were related to emergent countries, in particular South America: in this way, Parmalat was able to increase its market shares in such a region, as well as to increment its revenues (Parmalat became the third market player in Brazil).

Also the acquisition of LAG represented an important step, since it was the entrance in one of the most important markets all over the world (i.e. USA) and near to another important one, that is Canada. Even if its results were slightly below the original business plan, LAG contributed significantly to the operations of Parmalat Group: in 2014 it generated 835 million € of revenues and a net profit of 26 million € (Milano Finanza, 2015).

This strategy based on several acquisitions resulted that, in 2012, Parmalat Group surpassed for the first time the threshold of 5 billion € in net sales. During the whole management by Lactalis up to 2015, the Italian group increased its revenues by 45%, resulting in 6.5 billion €.
The total amount invested by Parmalat was equal to almost 2 billion €, compensated by a turnover of 2.7 billion €, mainly originated just in emerging countries. It is expected that the profitability of the controlled firms around the world will reach even higher levels. (Repubblica, 2015; Il Fatto Quotidiano, 2013; Parmalat annual reports).

Anyway, such a success is not associated to an increase in the share price of Parmalat. It is still floating below the value of 2.60 €, even if the market should have appreciated the recent growth worldwide. This lack of confidence is due mainly to few information provided by Lactalis to investors and the small amount of public float: in fact, in last years Sofil Sas continued to increase its ownership over the Italian company and, at the beginning of 2016, it owned 87% of stakes.
Below the stock price trend of Parmalat is shown since the takeover by Lactalis.

**Figure 3.12: share price trend of Parmalat since 2011**

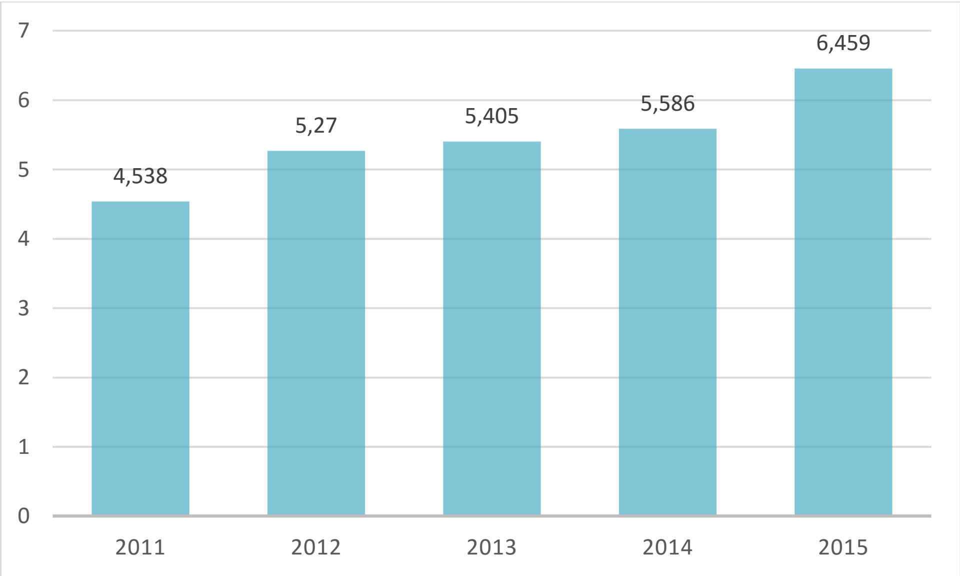

**Source: Yahoo Finance**

The acquisitions promoted by Lactalis increased the stock price of Parmalat after the slowdown due to crisis, but the price is still under 2.60 €.

Moreover, Italian authorities cared a lot about intercompany acquisitions between Parmalat and Lactalis: since this kind of deals were the basis of the disaster of 2003 for the Italian firm, much transparency was required to protect minority shareholders and investors, in particular because these transactions involved a huge liquidity transfer from Parmalat to Lactalis, impoverishing the cash reserves of the Italian counterpart.

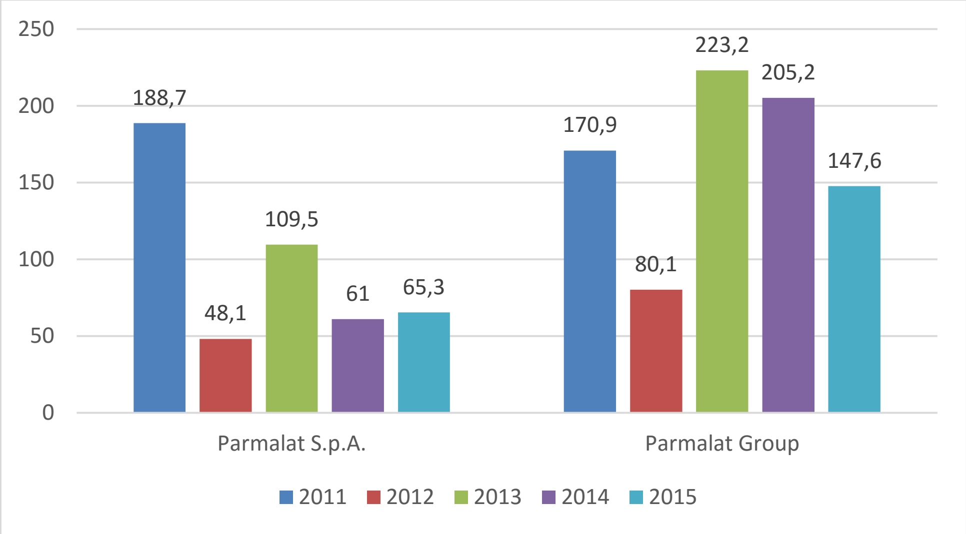
In the graphs below are represented the trends of revenues and net income for Parmalat.

**Figure 3.13: Parmalat Group revenues trend since 2011 (billions €)**




**Source: Parmalat annual reports**

**Figure 3.14: Parmalat Group and Parmalat S.p.A. net income path since 2011 (millions €)**




**Source: Parmalat annual reports**

About Parmalat S.p.A. itself, the volatile trend of net income was mainly due to the lack of dividends received by its controlled companies (e.g. the Canadian one) and to huge amounts spent for them. This is not to be considered as a negative result at all, since the subsidiaries are making a series of investments to grow further. In 2015, thanks to the optimization of operating expenses, higher EBITDA/net profit was generated, even if offset in part by impairment losses, lower financial income and higher costs of some raw materials. The revenues are quite stable, and in 2015 they increased up to 926 million €.

As it can be observed, the business of the whole Parmalat Group is growing, as shown by revenues trend. The strategy based on acquisitions brought important results for the group, as proved also by a growing EBITDA (in 2012 it was equal to 439 million €, the highest of Parmalat history, whereas in 2015 it was 444.5 million €).

The slowdown of net profit from 2013 is mainly due to the increase in price of raw materials: from 2013 to 2014 the price of milk increased by 7.2% (in particular during the first semester), as never happened in past years. Moreover, as anticipated before, the acquisitions were subject to impairment tests/losses, that decreased the EBIT like in 2015.

On the other hand, in 2012 the net profit "suffered" the wave of acquisition, concluded in a huge payment by Parmalat, and other non-recurring transactions, together with a poor net financial income.
Anyway, such a plan based on the network of subsidiaries seems to give the first positive results, as proved by the results strictly related to the core business of Parmalat, and it is expected to make the Italian group grow even more over next years (Parmalat annual reports; presentations).

## 3.5 LVMH – Bulgari

The last analyzed case study regards the acquisition of the Italian luxury brand Bulgari by LVMH in 2011. That is another clear example of distressed M&A whose success was correlated to the high level of synergies between bidder and target, as well as to the strength of the acquirer.
Also this transaction happened in a general downturn scenario, in which the Italian firm suffered from the decrease of the luxury business, despite its long and appreciated history. For this reason, it represented an ideal "prey" for the French leader, that exploited this condition to enlarge its brand portfolio even more and to absorb another competitor.

### 3.5.1 Overview of Bulgari

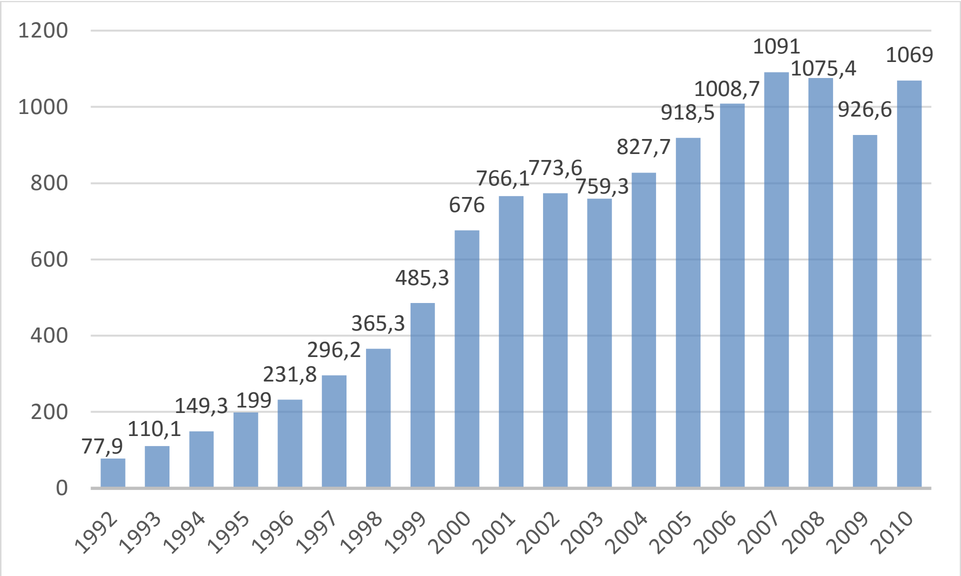
Founded in Rome in 1884 by Sotirios Boulgaris, Bulgari is one of the most known jewelry and luxury brands worldwide.
Since its foundation it distinguished from other brands for the high quality and design of its products, that increase its popularity exponentially. For this reason, from 70s, the company started to expand abroad through the opening of several stores in some of the most important cities (e.g. New York, London), enlarging its activity even more.
Furthermore, the company began to expand its business "horizontally", by adopting a diversification plan. Even if such a strategy had roots during 70s through the production of watches, 90s represented the period of highest growth: Bulgari started to produce perfumes and, few years later, accessorizes and glasses. The

diversification process continued with the acquisition of other watch brands and the opening of a hotel in Milan.

Meanwhile, the company decided to list on the Milan and London stock exchanges in 1995. This event was the sign of the high growth of the brand both in terms of reputation and financial: between 1992 and 2002 net revenues grew by almost nine times, and a similar path was followed also by operating and net income, as well as other indicators like the investments volume (that passed from 5 to 97 million € between 1992 and 2000) and the cash flows (Bulgari annual reports; website).

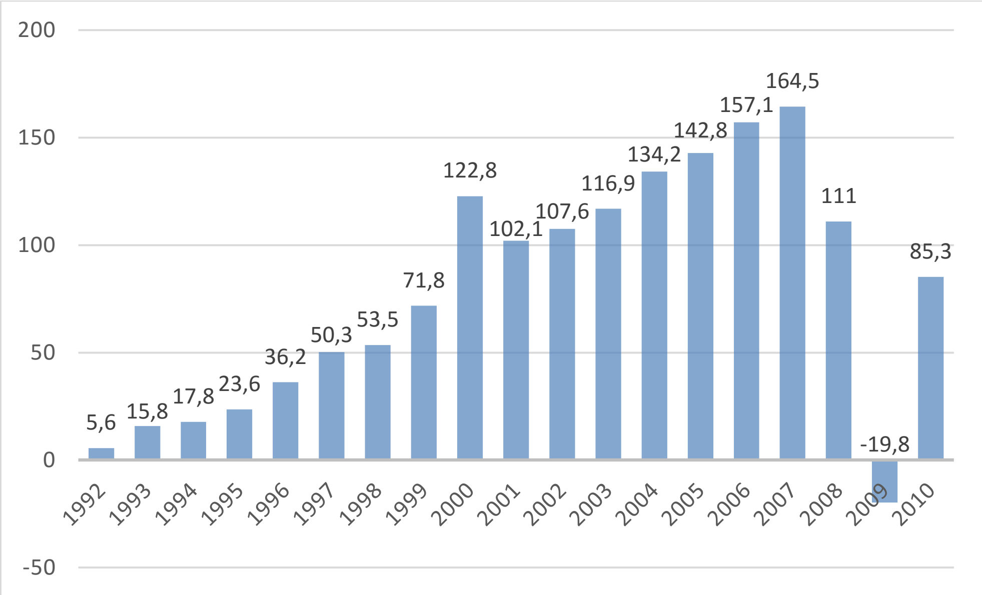
This growth continued constantly also in 2000s until the beginning of the current financial crisis in 2008. Even if Bulgari looked a big and stable company, it suffered a lot for the global recession, as highlighted by the graphs below.

**Figure 3.15: Bulgari Group net revenues trend from 1992 to 2010 (millions €)**



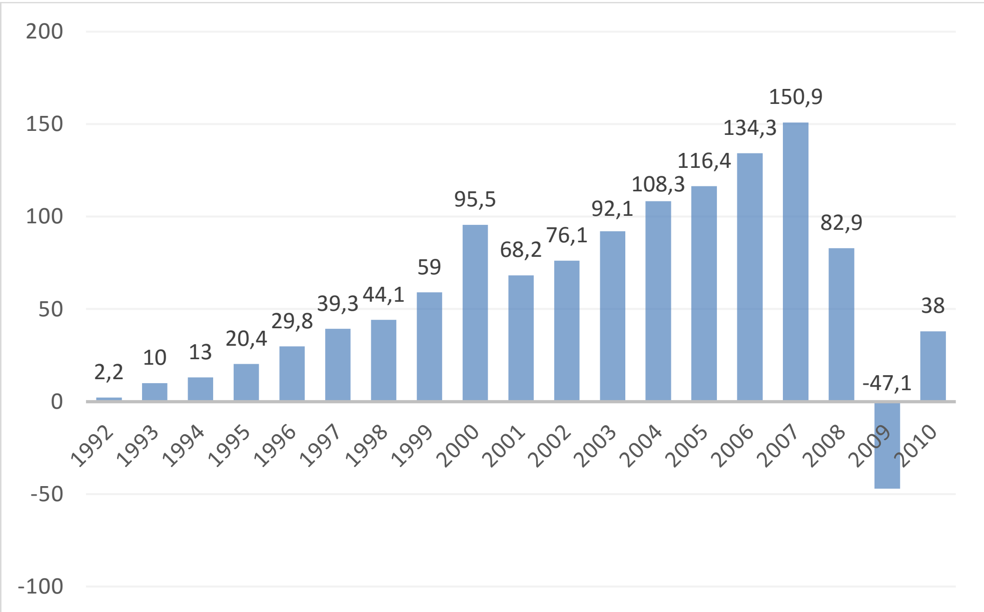

**Source: Bulgari annual reports**

**Figure 3.16: Bulgari Group operating income path from 1992 to 2010 (millions €)**




**Source: Bulgari annual reports**

**Figure 3.17: Bulgari Group net income trend from 1992 to 2010 (millions €)**




**Source: Bulgari annual reports**

Other data prove the distressed situation of the Italian firm: from 2008 to 2009, the EBITDA decreased from 164.9 to 52.3 million €, the dividend per share reduced by 50% (from 0.1 to 0.05 €) and there was the risk not to be able to repay debt because

of low operating income. Just about debt, it increased up to 2008-09, reaching a value of 217 million € in 2009 after the peak of 304 million € in 2008.
Also the share price fell and, after the announcement of the poor results of 2009, it was little more than 6 €. To face that, the company was forced to buy and sell its own stocks to increase their liquidity, together with a convertible bond issue made in 2009 for the amount of 150 million € to improve the debt structure: anyway, such a transaction caused additional financial expenses that decreased the net income further (press releases, 2010).

Thus, the crisis affected Bulgari more than it could be forecasted before 2008. The negative effects hit the sales of all the business lines of the company of any region, in particular Europe and America (respectively -16.7% and -31.6% in 2009). Similarity with the case of Parmalat, the global crisis had negative repercussions on the purchasing power of consumers, so the firm reacted by restructuring its costs and increasing efficiency. Even if this strategy looked to generate better results and a slight recovery in 2010 (when, in any case, it was registered a net loss in the first semester equal to 7.7 million €), the stability of the company remained in troubles until the acquisition by LVMH.
Moreover, such a luxury brand is exposed to the risk of fluctuations in the price of gold and other precious commodities: in 2010 gold price increased up to 1’392 $/ounce, (1’297 €/ounce in the case of platinum), and this caused an obvious increase of expenses, just in part offset by sales (Bulgari annual reports; press release).

### 3.5.2 Bidder side: LVMH

Founded in France in 1987 after the merger between Louis Vuitton and Moët Hennessy, LVMH is one of the most important holdings in the luxury industry. It owns around sixty brands that cover a wide range of sub-sectors (e.g. jewelry, perfumes, wines). Such a leadership was possible thanks to a strategy based on M&A transactions, promoted by the major shareholder of LVMH, Bernard Arnault (at the time of the transaction its group controlled 47.6% of LVMH stakes).

Several acquisitions were made during 90s involving important brands like Dior and Fendi, and this permitted the holding to grow year by year. As additional success factor, every controlled firm maintained its autonomy and image, without too much influence by the group.

Also the French group was hit by the financial crisis of 2008-09, anyway it succeeded in recovering as shown by the data pre-acquisition: in 2010 LVMH generated 20’320 million €, higher of 19% with respect to 2008 and 2009, together with a gross profit equal to 4’169 million €. Also the net income increased, from 1’755 to 3’032 million € between 2009 and 2010.
Unlike Bulgari, that in part recovered by the crisis but did not reach the volumes generated in the years before recession, LVMH performed better: for example, from 2004 to 2010, its revenues increased constantly apart in 2009, in which the drop was in any case very low. The net income path was more complex, and the fall between 2008 and 2009 was more severe, but also in this case the company reacted well, generating in 2010 a net income much better than all the past years.
The highest source of revenues remained fashion sector (37%), whereas Asia and U.S. confirmed as the most profitable markets. Despite the crisis, many of the business lines of LVMH grew after the slowdown of 2008-09, as proof of the stability of the whole company.

The positive signs of recovery had impact also on the share price of the group: at the beginning of 2009 it was equal to little more than 40 €, whereas on December 2010 it reached the value of 123.10 € (the dividend per share increased too, from 1.60 € in 2008 to 2.10 € two years later).
Thus, it means that the financial market was confident about the recovery of the company, and that the improvement applied over the whole business brought positive results (LVMH annual reports).

### 3.5.3 Acquisition process

On 7$^{th}$ March 2011 LVMH announced the acquisition of Bulgari. As introduced previously, there were several reasons behind this decision: among them, the French

holding could have enforced the jewelry and watches sub-sector, that was the only one that did not follow the path of the other business of the company. Second, there have would been also a stronger presence in Asia (in particular Japan), where Bulgari was much appreciated. Last, the acquisition of such an important competitor would have permitted LVMH not only to enlarge even more, but also to overcome other important players (e.g. Richemont, Kering).
On the other hand, Bulgari had the chance to get a secure financing source that could provide liquidity and turn around the Italian company from slowdown, by maintaining its core business and identity (LVMH annual reports; website).

About the transaction itself, the parties agreed for the selling of 152.5 million of target shares to LVMH (previously owned by Bulgari family), equal to 50.4% of the total ownership of Bulgari. In exchange for that, the French company issued 16.5 million shares to Bulgari family, valued 1.9 billion € (exchange ratio of 0.108407), that became the second "familiar" shareholder after Arnault family. Furthermore, LVMH submitted an offer for purchasing the remaining stakes for 12.25 € per share (for a premium equal to 61%), whereas the share price of Bulgari increased by 60%.
Also the public offer was successful, with 92% of consensus among the remaining, minority shareholders. In this case the purchase was made in cash (Forbes; press releases, 2011).
After the approval of European Commission (that did not consider such a transaction would not have threated the competition in the luxury industry), on July 2011 LVMH resulted in owning 98.09% of shares. The total amount spent was equal to 3.7 billion € (both in cash and for stocks), to which it must be added the value of stock options, together with convertible bonds, bought to complete the transaction, for a total value of the deal equal to 4.3 billion € (El Pais; Bloomberg; press releases 2011).

### 3.5.4 Results after the acquisition

LVMH gained from the acquisition very soon: at the end of 2011, the revenues increased by 16% from 2010, for a value of 23.7 billion €. Also the net income

increased up to 3.07 billion € (+1% from 2010) and, as a consequence, the same trend was followed by dividends, that increased by 24% for an amount of 2.60 € per share.
The increase in the business was mainly lead just by the purchase of Bulgari: the revenues of the buyer related to the core business of the Italian brand (i.e. jewelry and watches) grew by 98% with respect to 2010, for a total value of 3.2 billion € (LVMH annual reports; press releases, 2011-12).

Such positive results continued, and in 2013 LVMH generated revenues for more than 29 billion € (more than 28 billion € of 2012). Consequently, the net profit increased too, and an important contribution to that was provided by watches and jewelry sector, whose net profit resulted in 375 million € in 2013 (334 million € in 2012).
Thus, the takeover of Bulgari generated high returns for the French group and impacted much on financial results. Moreover, also investments increased in the sub-industry of the Italian firm (+41% than 2012), as proof of the growing business despite recession and the difficult years of Bulgari before the acquisition. Such strong results permitted LVMH to go on with acquisitions of other brand, like happened in the case of Loro Piana in 2013.
The growing trend continued also in 2014 and 2015, when LVMH made revenues for 35.7 billion € and a net profit of 3.6 billion €, both higher than previous years. Also the share price continued to grow over time, reaching the peak of 173 $ in 2015.
The fact that the data linked to the business itself are increasing year by year means that the group is succeeding in reacting to the crisis, by adapting to the consumers changing behavior after the current crisis. (LVMH annual reports).

The success of LVMH is based on the success of its brands, included Bulgari. The Italian company recovered well from the crisis: in the first semester of 2011 generated revenues for 548 million € and net income for 9.1 million € (both higher than 2010), and in 2015 it was one of the most successful companies of the group.

Just in 2015 it began to build a new site in Northern Italy, that will be the biggest jewelry workshop in Europe (LVMH annual reports; press releases).
Furthermore, its new products launched on the market had a great success, with an increase not only in revenues but also in profits. The drop of 2008-09 was totally surpassed and LVMH is helping the growth of the firm even more, thanks to its strong support in promoting the brand and in financing further investments.
In 2015, the whole sector of jewels and watches generated 432 million € as profit from recurring operations (283 million € in 2014), as well as revenues (3.3 billion € in 2015, 2.8 billion € in 2012), with a growing number of stores and investments worldwide (204 million € in 2015), meaning again the growing importance of this niche for the French group and the strong contribution of Bulgari (LVMH annual reports).

## 3.6 Comparative analysis

After having analyzed the cases, it is time to focus more deeply on the reasons behind their success. As it will be explained, they can differ according to the framework and the features of both bidder and target, as well as the influence of third parties.
The following comparative analysis will be split in two parts: at first, it will be provided evidence about the theoretical explanations of higher distressed M&A returns during crisis, and it will be explained how they fit with the previously analyzed cases.
Then, new, “firm specific” explanations about the success of such acquisitions will be described, together with their connection with the distressed condition of targets and the general downturn.

### 3.6.1 Evidence of theoretical explanations

In chapter 2 several common reasons behind the success of distressed M&A were explained (par. 2.5). Some of them were present behind the deals analyzed so far, as summarized in the table below.

**Table 3.1: success factors of the analyzed distressed M&A**

| | Vision | Competition | Size | Profit | Regulators | Bankruptcy |
|---|---|---|---|---|---|---|
| **Etihad Alitalia** | ✓ | ? | ? | ✓ | ✓ | |
| **HAL Safilo** | ✓ | ✓ | ✓ | ✓ | | |
| **Parmalat Lactalis** | ✓ | ? | ✓ | ✓ | ✓ | ✓ |
| **LVMH Bulgari** | ✓ | ✓ | ✓ | ✓ | | |

**Source: own elaboration**

At first, all the four deals were characterized by a long term strategy implemented by the bidders towards the targets. The common goal was not only to recover the acquired counterpart, but also establishing a kind of mutual partnership that would have lasted for many years. This was justified mainly by the fact that both the targets and the buyers were leaders in the same respective industries, so the potential of future success would have been very high. Moreover, their activity was complementary each other, so a long term relationship would have brought advantages for both all the parties, as well as reducing possible risks of conflicts.
In the case of HAL - Safilo (the only scenario in which the players belonged to different sectors), the general business vision of the bidder was just establishing a proactive role towards the target, in order to integrate it in the whole group and make it grow even more, thanks to the established experience of the bidder in the optical retail industry.

About competition, in chapter 2 it was said that, if it is low by the target and other potential buyers, the degree of success of the transaction is higher.
That was the case of HAL - Safilo and LVMH - Bulgari, in which the acquirers had not much competitive pressure by external environment, so the deal was quite linear.
On the other hand, about Etihad - Alitalia and Parmalat - Lactalis, the framework was different: a kind of pressure was put by third parties, like institutional

stakeholders, and not by the acquired companies or other buyers. In the case of Alitalia acquisition for example, the Unions set their conditions so that the transaction could be completed, and Etihad was forced to accept them, implying longer time spend and further costs related to employee retention.
Instead, Lactalis faced the opposition of Italian institutions, disagreed with the fact that another Italian company could have been sold to a foreign company. This pressure resulted in a higher price spent by Lactalis to minimize the hostility of such stakeholders, so also in this case competition represented a disadvantage, even if it was created by external parties not directly related to the deal.

The higher size of the bidder was another success factor common to all the four deals. Such big buyers had more likelihood to complete successfully the transactions, thanks to their bargain power and financial strength, as well as the management capabilities and resources provided to the acquired companies.
The only case in which, in absolute terms, the target was bigger than the bidder regards the Etihad - Alitalia deal: in terms of employees, fleet, destinations and history, the Italian air company was superior to its Arabian counterpart. Anyway, what counted was the higher financial and economic stability and performance of Etihad, that could afford the acquisition of a large part of Alitalia stakes. Thus, size is intended to be a success factors if it involves good profit parameters more than absolute dimensions themselves.

About profit, it was stated that, if there is significant profitability spread between target and buyers, M&A transactions are more likelihood to generate positive returns. Such a difference in profitability was common to all the studied cases: bidders performed well above their counterpart, so they could implement operating strategies aimed to increase the conditions of the acquired companies. That was possible even if the finances of the targets were not much healthy, since they were largely offset by the economic support of the buyers.

The regulators support was another factor of success in case of Etihad - Alitalia and Parmalat - Lactalis mainly: in the latter deal the regulatory authorities guaranteed

the transparency of the whole process, together with a high control over the intercompany operations after the end of the operation. This was made to avoid the same problems that caused the default of Parmalat in 2003, and it resulted in a clean transaction with stable and secure performance after the deal.
About Alitalia - Etihad, the support of Italian institutions favored the positive conclusion of the deal, since they were interested about the recovery of one of the most important and appreciated local companies. They played a proactive role in participating to the agreements and negotiations, trying to balance the different interests involved by stakeholders.

About the bankruptcy process as success factor, none of the analyzed cases regarded the acquisition of a firm within bankruptcy. Anyway, the acquisition of Parmalat was somehow influenced by the results of the bankruptcy happened some years before: as already said, the Italian company leaved from the default with large amount of cash and, before the crisis of 2009, it was able to recover quite good.
Lactalis exploited this condition, and thanks to the cash reserves of the target it could enlarge the Parmalat Group itself by supporting a series of acquisitions. So, the success of Parmalat after the takeover was possible also thanks to the bankruptcy consequences.

### 3.6.2 Other specific success factors

More than the common, theoretical success factors just explained, any single M&A deal brings to positive results if other variables concatenate each other. Some of them can well fit with the general economic downturn and with a distressed scenario of the target, like happened for the cases analyzed so far.

In the case of the acquisition of Alitalia, one of the main reasons of success was the activity of external stakeholders: in distressed conditions, such players are often seen as an obstacle to the conclusion of the transaction because of their conflicting interests. In the case of Alitalia it was the opposite: in fact, institutions, financial lenders and many other stakeholders supported the transaction in order to facilitate the recovery of the target and protect their own interests.

Thus, to success in a distressed operation, a proactive and supportive role of stakeholders is a value added, especially if such a transaction occurs in uncertain periods like downturns: in this way, new possible solutions can be found out for the positive conclusion of a deal, over the ones previously set by bidder.

About Safilo, its takeover by HAL had positive results thanks to the strong control implemented by the bidder. The Dutch holding "imposed" its management background and capabilities in running the acquired counterpart, and it was the key for the recovery.
In distressed companies in which the management is not able to change the negative trend and does not implement the right strategies, a shift of board members and a renewable of culture and skills can be needed, and it can be promoted just in a M&A scenario. In particular, it can be necessary within a general recession, when the margin of error is smaller and any mistake may worse the conditions of a firm more than in upturn periods.

On the other hand, LVMH gained from the acquisition of Bulgari for the opposite reason: it maintained unchanged the brand image and the core business of the target, exploiting the established popularity and quality of the Italian company. LVMH simply provided financial support and encouraged the investments, giving much freedom to is controlled entity.
Thus, another success factor to recover a distressed business through an acquisition is not denaturalizing its fundamentals, but exploiting them if they are still good and providing any possible support. Back to Bulgari case, it did not reduce the quality of its products suddenly, neither it lost its appreciated image. The poor economic results were caused by global recession and change in consumer behavior, but the basis of the brand were still solid. What it was needed was stronger financial incentives and reshaping of the offer, without revolutions in the business.

The success of Parmalat acquisition was similar to the case of HAL - Safilo. After the transaction, the French company managed Parmalat by replicating the structure of Lactalis Group itself (i.e. enlarging through several acquisitions), together with a strict monitoring. In this way, it would have known better the strategies to be implemented and all the potential growth factors to make be exploited by Parmalat. So, such a method of running an acquired company can be considered another success factor, in particular if the bidder and the target are similar just like Parmalat and Lactalis: by doing that, there would not be the risk related to the implementation of a new and uncertain strategy by the buyer, bringing to unsecure future performance. This risk would be enhanced during a general slowdown as well as in a distressed condition, so it can be preferable to shape the business of the controlled counterpart specular to the one of the bidder.

Finally, as previously introduced, another rational success factor common to all the analyzed cases is related to business complementarity: by acquiring a company whose activity could improve a gap in the business of the bidder would bring to a mutual growth. Thus, M&A are considered a chance to achieve this goal, and just for this reason they can be more successful. If there is complementarity, risks of conflicts and of "cannibalization" are minimized between bidder and target, that can learn each other from the activity of the counterpart and improve even more. The acquirer would be more willing to support and control carefully the target in order to exploit any possible synergy, so the likelihood of future better performance would go up thanks also to this higher diligence.
Rationally, all of this is more emphasized in distressed M&A, in which mutual support and diligence are further enhanced to help the target to recover.
Similarity, within a downturn environment, a potential buyer could try to grow and protect itself by expanding in new business lines to gain additional profits, so it would be more stimulated to look for complementary firms.

# *Conclusions*

During the present study, several different reasons about the higher profitability of distressed M&A in recession were described and analyzed.
The basis was the analysis of the general distressed M&A field, with all its features and characteristics distinguishing them from ordinary mergers and acquisitions.
Then, it was provided a theoretical analysis about the reasons why distressed M&A seem to generate higher returns during global recession. They have roots just in the peculiar features of distressed M&A and downturn periods, concluding with the fact that also in negative conditions good chances of improvement and growth may exist. Such explanations provided a good, general overview about the topic, but they were not enough to give a univocal answer to the argument of the present thesis.
For this reason, some emblematic cases of successful distressed M&A were studied, in order to provide further reasoning about the paradox of their superior outcome during downturn periods. From the analysis it was emerged that, even if the theoretical explanations previously stated are a valid basis behind the analyzed topic, further factors have to manifest, strictly correlated to the characteristics of both bidder and target as well as of their industry and environment.

Literature and the empirical cases provided enough evidence to state that distressed M&A are actually more likelihood to generate higher profits during crisis than in upturn periods. As already said during the study, this is possible thanks to a series of opportunities and situations that can manifest only in distressed conditions (e.g. bankruptcy) and in downturn periods. Their correlation facilitates the conclusion of the deal as well as the work of the bidder, that can control easier its counterpart and set the strategies with more freedom. The acquired company can benefit from this condition, exploiting the support and the synergies of a strong, big and experienced partner. As a consequence, its performance is more likelihood to increase, translating in higher value creation for the buyer.

Anyway, like in the whole M&A discipline, nothing is certain, and even if the fundamentals for the positive conclusion of a transaction look good, there may be other unpredictable variables that can make it fail.

Also during last years, there were transactions that went wrong despite the optimistic forecasts: for example, in 2011, Paris Group Dubai (a holding owning several luxury brands) acquired the Italian company Gianfranco Ferrè. Even if the buyer was financially strong and the target was appreciated all over the world, in 2014 it was announced the closing of the Italian firm in its home country, followed by a series of divestitures.

What it was argued and proved during this study is true in general terms, but the success of any kind of M&A remains in any case linked to the behavior of all the parties involved and to the changeable framework in which they operate.

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*Department of*

Business and Management

*Chair in*

Performance Measurement

and Financial Reporting


# WHY DISTRESSED M&A ARE MORE PROFITABLE DURING DOWNTURN: THEORETICAL AND EMPIRICAL EXPLANATIONS


SUPERVISOR

Prof. Giovanni Fiori

CANDIDATE

Alessandro Calabrese

663181

ASSISTANT SUPERVISOR

Prof.ssa Elisa Raoli



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# *Abstract*

The goal of this study is to explain the reasons why distressed M&A are more profitable during downturn than in ordinary periods.
During the present financial and economic crisis, even more companies went into distressed conditions and, in the most severe cases, they declared bankruptcy.
In such a downturn, it is rational to state that firms have more difficulties to grow and to turn around from recession. Anyway, even periods of general slowdown can hide new opportunities of high profits.

One of these is represented by M&A strategies: according to several studies, mergers and acquisitions are more likelihood to generate positive returns during economic crisis than in upturn periods, especially in favor of acquiring companies. In particular, it was demonstrated that such an effect is more emphasized when M&A involve distressed targets (i.e. firms that are in economic and financial troubles): this kind of paradox is explained by the fact that during any economic crisis peculiar factors show up, and they well fit with the characteristics of distressed companies.
Thus, the mix of downturn scenario and single business distress can favor the activity of potential acquirers, that can exploit them to enhance their market position through the purchase of other competitors hit by crisis.

In the first part of the work, it will be provided a general overview of distressed M&A transactions, explaining the features distinguishing them from common deals.

The characteristics and the general success factors of both distressed M&A and economic crisis are the basis for the analysis of the second part, in which it will be analyzed the reason why such deals are more profitable during recession. In this context, the theoretical explanations provided by literature will be studied, keeping in mind that there is not strict rule confirming that distressed M&A get higher

returns during crisis, but rather it is the consequence of the correlation of several factors.
In the last part it will be provided empirical evidence about the topic of the present study, focusing on some emblematic cases of successful distressed M&A transactions completed in last years. It will be furnished further evidence of theoretical explanations, as well as other "firm specific" reasons why distressed deals create more value during economic recession.

# 1 – Introduction to distressed M&A

By definition, "distressed M&A" are merger or acquisition transactions in which the target company is in distressed conditions, that means it has difficulties in repaying its debts and getting new loans (Sandager, 2014). Such a condition is showed up by a series of signals, like net losses, credit downgrade, cost cutting strategies, bad capital structure and internal conflicts. In the most severe cases, distressed deals can also involve companies in bankruptcy.
Such deals are particularly common during periods of economic crisis, since even more firms accumulate losses and go into financial problems with respect to upturn scenarios.

Distressed deals have peculiar features that distinguish them from ordinary M&A. Among these, the most important one is represented by the role of stakeholders (i.e. operational ones, shareholders, creditors, employees, regulators): when dealing with a distressed company, they further act in order to protect their own interests, causing often several conflicts delaying the stages of the whole process.
Thus, their activity is crucial for the successful conclusion of the deal. Thanks to a proactive support for the recovery of the distressed target, stakeholders can help the bidder in the acquisition process, but they can also have a hostile behavior if they care mainly about their return. Thus, the role of the advisor is to balance all the conflicting goals of the different parties, trying to achieve a common contact point.

Among all the stakeholders, creditors play an important role at the beginning of a distressed M&A. In ordinary deals, the transactions begin because of the willingness of target shareholders, that can see in the support of the bidder a way to grow further. On the other hand, in case of distressed targets the process is pushed by creditors, since they can take back their loan if there is an ownership shift or an asset sale. By the proceeds of the purchase, this type of stakeholders can be more easily satisfied.
Moreover, timing represents another important peculiar factor of distressed M&A. The more time passes, the more is likelihood that a company in troubles goes in bankruptcy. If this happens, it is more difficult for creditors to preserve their interests, as well as the value of the company decreases fast. So, it is extremely important to set carefully the whole acquisition process, to avoid time wasting and overlapping of stages.
Another feature typical of distressed M&A is represented by due diligence: in fact, in case of bad performing firms, financial and economic information about the target can be manipulated because of past mismanagement. For this reason, this stage is particularly monitored by advisors, that have to elaborate a rational purchasing price by few data available.
Finally, one of the most interesting characteristics of distressed M&A is related to bankruptcy process. As said before, if too much time passes the financial issues of a company could worse, provoking insolvency. In this case, bankruptcy process may begin, and the control of the firm is taken by creditors.
Anyway, even if this might look as a negative result, it is not at all: for example, under the "Section 363 Sale" and the "Plan Sale" of U.S. Bankruptcy Code, the insolvent target enters into a "protected" selling process, after that it is not linked to any constraint (apart the ones that it accepts) and the bidder takes the company "free and clear of liens" (Ball - Kane, 2003; Mirus Capital, 2016; BCG, 2008).

Because of the particular characteristics of distressed conditions, also the strategies of both buyer and seller can vary from ordinary M&A.
In case of the seller, its first goal is to reduce the distressed situation of the company through cost reduction programs, personnel layoff, divestitures and other similar

strategies. In this way, the purchase price of the target could increase, permitting higher returns for the seller.
Moreover, distressed firms seek for buyers that can recover them and guarantee a future good performance. For this reason, distressed targets set their purchase strategies towards big and well-performing bidders.
About acquirers, they may try to buy target companies within the bankruptcy process, to exploit the advantages of this methodology (e.g. more guarantees, less constraints).
In addition, since buying a firm in troubles is always a risky strategy, bidders focus on reducing the purchase price even more, also because they could have very little guarantees and information about the target. About the latter, a fundamental part of the purchasing strategy is linked to due diligence process, in order to get a complete and right overview of what is it to be acquired.
Finally, it is extremely critical the valuation process itself promoted by the acquirer: usually, distressed firms are evaluated unit by unit according to stress tests, identifying the underperforming business lines and trying to recover or sell them. Traditional multiples and valuating approaches must be used carefully, since their value can be influenced by the distressed context of the target, so they may not capture its real value (Hastle - Jones, 2008; BCG, 2009).

About the steps of a typical distressed M&A transaction, they can differ from ordinary M&A just because of the critical conditions of the target (Ball - Kane, 2003).
Every deal begins with the initial call, in which it is expressed the willingness of entering into the operation. As already said, it is usually promoted by the creditors of the target, that hope to have their receivables repaid through the proceeds of the selling.
Then, there is the evaluation process, in which it is tried to understand the reasons of distress and the potential future forecasts of the target. Traditional multiples may not be accurate enough, so other valuation methodologies are applied, such as stress tests, scenario analysis, liquidity and operational assessments (based on the results generated by the target and the potential operational improvement to be

implemented), together with an analysis of the possible alternative capital structures to be adopted.

The next step of the process is the preliminary agreement, that in case of distressed targets can contain the so called "standstill provision", that can exclude potential bidders to get claims or securities against the seller itself.

Then, due diligence process begins, whose goal is identifying the business scope of what is going to be acquired (i.e. whole target company or just a part of its assets) and the obligations linked to that.

Then, there is the purchase agreement, followed by bidding procedure and auction, mainly in case of bankruptcy: in fact, to maximize the purchase price for the target, Bankruptcy Law of several countries (e.g. US), together with regulators, can imply an auction between all the potential buyers. The original bidder can accept if taking the role of "stalking horse", being able in this way to set the bidding rules and testing the market on the basis of the competitive environment composed by other interested purchasers.

At the end of the auction, the highest offer is accepted and, after the consensus of the target, the transaction can conclude (Ball - Kane, 2003; Roston, 2010).

In conclusion, distressed M&A can provide a huge range of chances for target companies to rescue, as well as they represent an interesting opportunity for buyers to enlarge further. In periods of downturn these operations can rearrange the competitive scenario of an industry, since they can change the ranking of the market leaders.

From 2005 to 2009 the volume of distressed transactions grew by 9.9 %, whereas the average value of valuation multiples decreased, as proof of the severe consequences of the present financial crisis on M&A field (Capital IQ, Reuters, S&P).

# 2 – Success of distressed M&A during crisis: theoretical explanations

After the analysis of the main characteristics of distressed M&A, it is time to explain why they are more profitable during downturn.

Before doing that, it is rational to analyze the general success factors of distressed M&A and the advantages of downturn periods.

About the first topic, according to the Boston Consulting Group (2009) there are four main variables that make distressed M&A successful: the financial strength of the buyer; the reasons of distress in the target; the size of the buyer with respect to the size of the seller; the core sectors of the buyer and the seller. It was proved that, if the bidder is big and financially strong enough and it operates in a different sector with respect to the one of the target, distressed deals are more likelihood to create value. This is enhanced if the target has just financial problems or a combination of operational and capital structure issues.

About the positive aspects of the crisis, it was shown that downturn periods encourage innovation, permit companies to hire the best vacant employees and to diversify their business to reduce risk and can make the capital access cheaper.

So, also negative periods like recession can present several advantages. According to the numbers, distressed M&A in downturn generate a cumulative abnormal return (CAR) equal, on average, to 1%, against the one of -1.1% in upturn.

Moreover, downturn deals create value for the shareholders of bidders unlike upturn mergers, that destroy value. The spread in relative total shareholder return between them is equal to 14.5% just in favor of transactions concluded during crisis.

Furthermore, it seems that the more the recession is severe, the more this benefits M&A profitability: for example, it was observed that distressed deals made in 2008 got higher results in terms of cumulative abnormal returns than during 90s, when global crisis was weaker.

The positive effect of downturn is reflected also in asset divestiture, in which the return for the seller is, also in this case, higher than in upturn (BCG, 2008-09).

General literature provides several theories about the higher profitability of distressed M&A during crisis.
At first, it is rational to state that, in a recession scenario, only the biggest and the most profitable companies survive and can make acquisitions thanks to their financial strength. Thus, M&A deals are led mainly by top firms, so it is more likelihood that such transactions conclude positively, thanks to the high experience and skills of the bidders that decrease the chances of failure.
In case of distressed M&A, this effect is more emphasized, since even less companies have enough skills to turn around target firms in troubles and can afford huge investments to do that. Thus, it is even more likelihood that only very strong and stable companies enter in such transactions, increasing the chances of success for the reasons previously mentioned.

In addition, after the recent credit crunch, private equity funds lose their share in the M&A market, displaced by corporate buyers. These can rely on high cash and profitability, and they are more independent in making deals unlike private equity funds that, in generals, make transactions by using huge amount of debt, considered a risky method during crisis and disapproved by the market.
Thus, companies can exploit lower competition by PE funds, with a consequent increase in bargain power. In case of distressed M&A, in which acquisition price is even lower if considered also a general downturn context, corporate buyers can enjoy higher relative returns just for a general low pressure by other competitors and low prices for distressed target firms.
Anyway, lower competition is also among companies themselves: as already stated, during downturn only the best firms can afford M&A transactions, in particular if they involve distressed targets (that are more difficult to make profitable). So, this context advantage even more the market leaders, in particular if they operate in underperforming industries, that are less attractive for players of other sectors and that have low internal competition (BCG, 2008).

Another reason of the success of M&A made during downturn is the profitability spread between bidder and target: it was shown that, in successful acquisitions, the cash flow return of investment spread between bidder and target is five times higher than in positive upturn deals (BCG, 2009). If there is such a huge difference, bidders have more bargain power, can guarantee positive post-acquisition results and, in particular, can easily implement operational improvements on the target. All these factors have more effect in case of distressed M&A, since the CFROI spread is more pronounced, bringing to higher results just in downturn.

Moreover, downturn M&A involving distressed firms are more supported by regulatory and institutional authorities, that usually put less constraints on anti-competitive actions (just like acquisitions of other competitors) to facilitate the recovery of targets in troubles. This is more frequent during crisis in order to turn around also the whole national economy. Thus, in such a scenario bidders are less hindered, and the chances of success of deals are higher.
Also employees can support the success of M&A during downturn, in particular if the acquired company is in distress. They have the goal to preserve their job, so they would encourage any action (including M&A) to save their company. The support is given as acceptance of bidder's conditions, flexible job schedule, further effort at work and so on, that can undoubtedly make easier the acquisition process both for the buyer and the target, increasing the likelihood of success and of future positive returns (BCG, 2009).

Also Bankruptcy Law is a success factor of distressed M&A in recession periods: in fact, it can be changed by regulators to facilitate the acquisition process of firms in bankruptcy, in order to turn around them. These law improvements are implemented more in downturn, since it is more likelihood that companies fail. Acquiring a firm within bankruptcy process can bring to a series of advantages that cannot be exploited out of that, so the chances of getting positive returns from the purchase are stronger (Meyer - Servaes, 2014).

In addition, when dealing with distressed M&A, bidders adopt a long term strategy to ensure future profitability of their controlled companies, in particular during downturn when there is uncertainty about the performance trend. Such a vision permits a higher integration between the target and the buyer, as well as less conflicts and much more cooperation by the acquired entity, that aims to recover from distress. All of this increases the future likelihood of success of the transaction, unlike upturn mergers/acquisitions in which it is implemented a more fragile near term mission (BCG, 2003).

Finally, another reason of the superior value created by distressed M&A refers to general higher diligence, that can avoid overpayment mistakes and low attention along the whole process. In this way, bidders can evaluate better if buying or not a target in troubles, in particular if this happens in downturn (in which the margin of error is smaller). Thus, the possibility of making a right choice increases, as well as the likelihood of good results from the transaction.

This effect was shown in particular in asset divestiture, in which the return for the buyer is much higher if the seller is in distress (BCG, 2008).

Beside the advantages of making a distressed transaction in downturn, still few companies decide to enter in such deals. This is explained mainly by few financial reserves needed to acquire firms/assets (typical in recession), as well as by higher interests on its own internal issues and lack of confidence in M&A strategies as a way to grow.

# 3 – Empirical cases of successful distressed M&A in downturn

So far the theoretical explanations about the higher returns of distressed M&A during crisis were analyzed. Anyway, there are other variables behind this "paradox", depending in many cases by the peculiar characteristics of both bidders and targets, as well as by the context in which the transaction is made.

To find out such other success factors, some of the most important cases of distressed M&A concluded during the present economic crisis are going to be analyzed.

The first analyzed deal is the one between Etihad and Alitalia of 2014. Before that, Alitalia, the main Italian air company, was characterized by severe financial troubles, incurring in huge debt and net losses starting from 2000s, culminated in the bankruptcy of 2008-09.
On the other end, the Arabian company Etihad emerged in few years as one of the market leaders in the high-end of air industry, thanks to a series of partnerships with important foreign firms and the enlargement of its destinations network. Between 2013 and 2014 the negotiation process to acquire Alitalia began, in order to enhance its market shares in Europe.
The deal concluded on August 2014, for a total value of 1.8 billion €, of which 560 million € was the total investment by Etihad, that got 49% of Alitalia stakes plus other assets of the Italian company. The remaining part was split among other players (in particular financial lenders), that implemented a capital increase together with new loan.
Even if the transaction involved the participation of a huge amount of different stakeholders (e.g. institutions, lenders, Unions, suppliers), they played a proactive role in supporting its positive results, so much so that the acquisition concluded earlier than previously forecasted.
After that, the deal revealed a success: even if it will take some years before Alitalia recovers totally, several positive signals are showing: it generated net losses of 130 million € in the first half 2015 (in line with the limit of 200 million € previously set by the management), and in 2013 Alitalia carried the highest number of passengers in the Italian market. Such an initial success was due to a series of operational improvements encouraged and financed mainly by Etihad and, if the growing trend remains stable, positive net income is forecasted within 2017 (Alitalia - Etihad annual reports; press releases).

Another emblematic case of successful distressed M&A during recession is the takeover of Safilo by HAL Investments happened in 2010, characterized by the fact that the two parties did not belong to the same industry.
Safilo is one of the most known Italian manufacturers of eyewear products. Before the acquisition, it suffered by huge amount of debt (up to 825 million € in 2003),

and neither the 314 million € IPO made in 2005 resolved definitively the problems of the Italian brand. As a consequence, Safilo was not able to generate positive results, incurring in net losses (-34 million € in 2009) and in a growing trend of Net Debt/EBITDA ratio (Safilo annual reports).

About the bidder, HAL (a subsidiary of HAL Holding N.V.) is a Dutch holding company, whose business consists in acquiring a large percentage of stakes in different companies and manage them actively to improve their performance.

In line with its vision, in 2010 HAL decided to acquire Safilo: the process did not limit just to the purchase of shares (around 42%), but also two capital increases (for a total amount of 300 million €) and the purchase of Safilo 51% of Senior Notes by HAL were implemented, in order to improve the capital structure of the target.

After the takeover, the performance of Safilo improved quickly: debt amount decreased year by year (up to 90 million € in 2015), whereas net profits increased constantly. This was possible to a series of operating strategies decided by HAL itself, thanks to its experience in the eyewear manufacturing industry through the control of another similar company, that was GrandVision N.V. (Safilo - HAL Investments annual reports).

One of the most severe cases of distressed M&A of last years was the acquisition of Parmalat by Lactalis, concluded in 2011.

At the time of the transaction, Parmalat (the biggest Italian company in the milk and dairy industry) has just recovered by the default of 2003. Anyway, even if it reached good performance results, it was still unstable. Its condition (and the one of the whole Parmalat Group) was worsen by the financial crisis of 2008, that decreased the general demand of products and reduced heavily the profits of the company.

Such a big and weak player, with huge cash reserves originated from the bankruptcy, attracted the interest of another market leader, that was the French company Lactalis, interested in exploiting the complementary synergies of Parmalat. After a series of acquisitions started during 80s, it enlarged its group even more, owning 200 production plants over 150 countries and reaching 16 billion € of revenues in 2013.

The acquisition process of Parmalat followed different steps, culminated with the ownership of around 83% of shares (through another controlled company of Lactalis, that was Sofil Sas), for a total price of 3.7 billion €.
The takeover was a success for both the parties: Lactalis, after controlling Parmalat, increased its market shares in the Italian market, becoming also the global leader of milk and dairy industry, surpassing other important competitors like Danone and Nestlè, whereas Parmalat improved its results after the slowdown of 2008. In particular, the Italian company was supported by its French counterpart in acquiring several firms worldwide, permitting the whole group to reach 5 billion € of sales in 2012 (EBITDA of 439 million €) and 6.5 billion € three years later (EBITDA equal to 444.5 million €).
Even if the net income suffered by huge investments in controlled companies, it is forecasted a growing future trend both for Parmalat itself and the group in the upcoming years (Parmalat annual reports; Lactalis website; press releases).

The last analyzed case study is the acquisition of Bulgari by LVMH in 2011.
Bulgari, one of the most Italian luxury brands, was characterized by huge growth before 2008, thanks to a general strategy based on horizontal diversification to expand in new markets. Year by year it increased its revenues and net income, that in 2007 was equal to 151 million €. Anyway, with the beginning of the current financial crisis of 2008, the performance of the firm decreased suddenly: the fall in general demand provoked a slowdown of revenues and, because of the increase of raw materials price, in 2009 a net loss of 47 million € was generated, just in part recovered the following year. Moreover, the company suffered also from huge amount of debt, equal to 304 million € in 2008.
On the other hand, LVMH, a French holding owning several luxury brands, improved its economic and financial indicators during past years, and it was hit just in part by the financial crisis of 2008. Its success was based on the freedom given to the controlled companies in setting their strategies, limiting in providing financial support and expertise.
A similar strategy was adopted also in the case of Bulgari: on July 2011, LVMH succeeded in controlling 98.09% of Bulgari stakes (together with stock options and

convertible bonds), for a total investment value of 4.3 billion € (paid both in cash and in stocks).

After the acquisition, the French holding increased its position in the jewelry and watches industry, and the revenues related to it grew by 98% between 2010 and 2011. In 2013 it increased the investments just in this sector (+41% with respect to 2012), and in 2015 LVMH generated revenues for 36 billion € and net profits for 3.6 billion €.

Also Bulgari gained from the acquisition: in 2011 it generated revenues for 548 million € and net profits for 9.1 million € (both higher than 2010). Moreover, in 2015 it opened a new jewelry workshop in Northern Italy, that will be the biggest in Europe. This was a signal of the growing importance that LVMH gave to its Italian counterpart and to the whole sector, permitting Bulgari to recover completely from the crisis of 2008 (LVMH - Bulgari annual reports; press releases).

Back to the theoretical explanations about the success of distressed M&A during crisis, they were the basis of the positive results of the analyzed cases.

All of them benefited from the long-term vision implemented by the bidders and from their higher profitability with respect to target firms, that permitted the buyers to set solid operational strategies for the future with much freedom.

In addition, apart in the Alitalia - Etihad case, all the other purchasing companies were much bigger than their counterpart, increasing the likelihood of success of the transactions thanks to their established experience. The bidders exploited also low competition from other potential buyers, getting high bargain power on the targets, even if in the case of Lactalis - Parmalat and Etihad - Alitalia there was a kind of pressure by external stakeholders (e.g. Unions, institutions) that hindered many times the conclusion of the deal, made possible only after the acceptance of particular conditions by the acquirers (e.g. high purchase price, employee retention). Just these two transactions benefited also from the support of regulators, that guaranteed the transparency of the transactions and played a proactive role in balancing opposite interests of the involved players. Finally, Parmalat - Lactalis was the only case advantaged by bankruptcy process, since it helped in partially recovering the target (Parmalat), endowing it of huge amount of cash, that revealed crucial for the acquisitions supported by Lactalis after the takeover, that benefited the whole Parmalat Group.

Apart the traditional explanations, there were other peculiar factors at the base of the success of the analyzed deals.

Alitalia - Etihad was particularly advantaged by the support of external stakeholders: usually, in distressed scenarios, they are seen as a limit for the positive conclusion of a transaction, but in this case most of them facilitated the process in order to improve the performance of Alitalia and preserve their interests.

Safilo recovered from financial distress thanks to the strong control of HAL over it, that set new strategies and exploited its experienced knowledge on the eyewear products industry to improve the operations of the Italian firm.

A similar result was reached also by Parmalat, that was deeply influenced by Lactalis in implementing a growing strategy based on several acquisitions: in this way, Lactalis could rely on its successful established business philosophy in turning around and enlarging Parmalat, together with a strict monitoring and influence on the management.

On the other hand, Bulgari recovered from crisis thanks to the strong financial support of LVMH, that did not change the business scope and vision of the Italian brand. Not denaturalizing the business of distressed companies and exploiting its fundamentals can be another success factor behind acquisitions, in particular if their brand image is still appreciated by consumers (just like in the case of Bulgari). What is needed can be just higher financial support in investments, without any disruptive changing.

Finally, business complementarity is another peculiar factor characterizing all the studied cases: in this way both bidder and target can benefit from a mutual growth, without the risk of conflicts or "cannibalization" in the case they operate in the same business line or market. This is emphasized just in downturn, in which companies try to survive and grow in other potential profitable business. To do that, M&A are seen as a good tool, in particular if they involve distressed targets to be recovered thanks to a reciprocal support.

# *Conclusions*

During the present study, several reasons behind the higher profitability of distressed M&A during downturn were discussed.

Starting from the general characteristics of distressed transactions, theoretical explanations provided by literature were analyzed. They have roots just in the peculiar features of distressed scenarios and economic crisis, and through their correlation M&A deals can bring to superior returns both for bidders and targets.

Anyway, such theories are valid only in general terms and, depending by each particular case, many other factors explain the higher value created by distressed deals concluded during slowdown.

For this reason, in the last part of the study some emblematic empirical cases were analyzed, providing further evidence to the theoretical explanations and finding out other ones, strictly correlated to the characteristics of the parties involved in the deals and to the context in which they operated.

Both literature and empirical analysis provided enough evidence to state that distressed M&A are more likelihood to generate higher returns during crisis. In such a context, new opportunities can emerge that well fit with the condition of the companies in financial troubles, bringing to positive outcomes after the conclusion of deals.

Anyway, what is argued during the present study is true in general terms but it does not represent a strict rule. M&A remain strictly correlated to the particular conditions of the players and their business environment and, even if the fundamentals of a transaction look good, there is no certainty about its positive results. These latter may be dependent by other unpredictable variables (that can manifest also after a transaction), making M&A risky strategies despite any optimistic forecast.