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MARKET ANALYSIS

Investing in distressed businesses

BY SONIA KALSI AND MARK WILLIAMS

In the midst of booming profits and low default rates in recent years, distressed investors have had relatively few opportunities. Troubled companies were kept afloat by cheap, flexible loans provided by eager lenders and syndicated to willing investors. Covenant-lite and PIK toggle structures were propelled by the theory that risk had been taken out of the market. Excess liquidity meant that many businesses, which probably would have defaulted sooner, benefited from loose terms. But in the middle of 2007 the market suddenly changed, fuelling speculation that companies could soon face the consequences of excess leverage in their debt structures. Prices for debt have already increased and credit spreads are widening. Terms and conditions, such as tight ratios, have become more stringent, and creditors are demanding increased disclosure and reporting from borrowers to track performance and assess risk.

Recent figures point to rising trouble for companies. According to Standard & Poor's, distressed issues soared from $8.6bn in October 2007 to $36.2bn by the middle of November. Fitch Ratings reported that downgrades of corporate bonds rose in the third quarter of 2007 to $92.1bn, their highest level in two years. The disappearance of easy credit could be the door of opportunity that distressed investors – including private equity firms, strategic investors and hedge funds – have been waiting for. Beneath the surface, many companies are suffering from problems that were not corrected while debt was plentiful, and it may be too late to fix them. Although the groundwork appears to be laid, it remains to be seen whether conditions actually lead to a surge in distressed M&A.

Where the opportunities lie

Certain sectors and regions will present more distressed investment opportunities in the coming months. Eyes are on the manufacturing industry, and automotive in particular, where North American companies are struggling with legacy costs and competition from low cost rivals. Retailers are also under pressure as any drop in disposable income or the availably of personal credit will curb consumer spending. The housing market, including home building and products, should also provide interesting prospects for distressed investors. Experts argue that financial services are entering a period of intense restructuring as they fight to reconcile recent losses. In terms of active regions, a July 2007 KPMG report, *Distressed Debt Investment and Exit Strategies*, put the German market at the top of the list for the value of total NPLs, with €150.3bn. Second was China with €142.3bn, due to rapid economic expansion, lax regulations and inflation driving companies into trouble.

Distressed investors are also monitoring recent leveraged buyouts in the US and Europe, looking for signs of instability. The increase in buyouts over the last few years has left many companies vulnerable to the rising cost of debt, particularly those which are contractually obligated to reduce their debt over time. Most LBOs were structured to reflect available liquidity and healthy growth projections; but if growth targets are not met and new capital cannot be raised to fill the gap, restructurings and workouts will follow. Turnarounds will be difficult when there is no liquidity allowing the company to manoeuvre, and no cash to pay professional advisers or incentivise key managers.

Against this backdrop, aggressive debt structures will be easy targets for distressed investors as a good number of existing creditors with first or second lien positions will be looking to sell at or close to par. "Advantage will go to the investor with the liquidity, flexibility and expertise to invest throughout the capital structure – to convert first and second liens and debt to equity on various proportions," says Deborah Hicks Midanek, president of Solon Group. "Experience doing this will be in short supply; many inexperienced newcomers may try it, which may create another round of opportunities. There will be a premium on analytical skills that can understand the enterprise and its position, its management and its markets, its capital structure, and the rights and remedies and pressure points of all the parties."

But not all leveraged buyouts will be susceptible because of the original debt structure on which they were based. As Curt Cornwell, a partner at PricewaterhouseCoopers, points out, it is important to differentiate between the underlying credit quality of the debtor and the terms of the debt. "There are many high-quality credits out in the marketplace with covenant-lite structures or no covenants at all," he says. "Those companies will have a much better chance of avoiding restructurings, at least for the next few years. But there are also companies which are operationally challenged and do have covenants in place. Banks that hold positions in such companies will need to be forthcoming about their exposure, and are likely to seek suitors in the marketplace."

The composition of distressed investors

Private equity firms and hedge funds are expected to play a much bigger role in the distressed market going forward. "Those who have money are going to be the kingmakers," says Kenneth Kraft, a partner at Heenan Blaikie. "They will ultimately be able to call the shots. They will be constantly on the lookout for opportunities and will provide much needed liquidity to the market. Moreover, they will probably be able to extract very good pricing terms for any funds they advance." But experienced investors will not dive into the market recklessly. Research revealed by Grant Thornton in August 2007 shows private equity firms are exercising caution. When it comes to investing in troubled companies, poor management is the number one deterrent, followed by poor prospects for the sector in which the company trades. These investors must be sure they can work with existing management to fix the company and that there will be long term demand in the market for the products it sells.

As Matthew Feldman, a partner at Willkie Farr & Gallagher LLP, notes, private equity and hedge funds have learnt the loan to own game and understand that taking control in a company is critical to success in the new environment. "The difference between success and failure is to fully understand the operational side of a distressed business and to recognise that this level of expertise is necessary to achieve high returns," he says. "I definitely see more money invested in this way. The problem for hedge funds, however, is that very few of them are in a position to affect operational change." As a result, hedge funds may take positions of influence rather than control. They may demand a seat on the board or insist that certain advisers are brought in to effect change, for example. They can also operate nimbly, unencumbered by onerous legal provisions. "Hedge funds have the advantage of freedom from certain regulatory constraints or reporting requirements. They can therefore play broadly across the capital structure, quietly accumulating significant positions in debt and equity. And they can sell easily," says Ms Midanek.

The ability of an investor to extract maximum value is based on two main factors: cash availability and understanding the operations of the distressed business.

Both private equity and hedge funds can expect serious competition from sovereign wealth funds, which have the advantage of being huge pools of capital with less reliance on leverage and lower returns expectations. In the US, these overseas investors will gain ground on domestic funds due to the weakened dollar, and coul d price Western competitors out of the market. "Countries such as India and China are increasing their appetite to invest directly into the US by buying companies in the world's most established distressed debt market," says Mr Cornwell. Sovereign wealth funds will recycle dollars and enhance global liquidity. Some of the investments we have seen recently indicate that liquidity needs to be built back in after the early credit problems, and now the credit crunch. In particular, more and more banks will seek investments whether from sovereign funds or otherwise."

Corporate buyers will also be more active in distressed debt, since they are able to extract value through synergies faster than a fund manager. With obstacles for distressed investors that rely on leverage, sovereign wealth funds and corporate buyers will find themselves in a competitive position, due to the speed with which they can complete transactions. But they will certainly not push sophisticated private equity and hedge funds out of the equation. "These asset classes are going to be on both sides of the distressed trade," predicts Mick Cochran, a partner at McKenna Long & Aldridge. "Some private equity funds will have significant portfolio issues, and some hedge funds will have significant asset issues, which will prohibit them from participating in the market. But a number of funds will have a lot of dry powder and clean portfolios, and it will be their day in the sun."

Strategies for extracting value

The ability of an investor to extract maximum value is based on two main factors: cash availability and understanding the operations of the distressed business. Hedge funds, one of the largest buyers of distressed securities, and private equity firms which have the necessary capital, will remain key players in the market if they adopt an appropriate strategy. Each distressed investor has a different approach. "Some are looking for short term investments characterised by a three to six month timeframe and planned exit. For example, they may seek to buy unsecured debt at a discount and negotiate a premium in the region of 10-15 percent. Others follow the 'loan to own' strategy, focusing on taking control of the business to generate high returns over a longer period of time, perhaps three to five years. They buy at a discount and fix the underlying business before disposing of their interest, ideally at a multiple of EBITDA," says Mr Kraft. He adds that some firms manage multiple funds, each targeting a specific value generation strategy.

A loan to own strategy can boost commercial returns if the investor understands the financial options available and also the operations of the business – an area in which private equity firms excel. "For the past few years the market has been susceptible to financial engineering strategies, but if we are to see a deep wave of restructuring, there will be a shift to buy and hold strategies focused on maximising the balance sheet," says Mr Cochran. "Investors will need the financial capacity to wait out the cycle. This would favour the more patient capital of private equity, versus the more liquid inclination of hedge funds."

Inexperienced investors can easily be exposed, especially when a quick exit financial engineering investment is mistakenly made when an operational restructuring is required. To end up in a favourable position, investors need to give careful thought to the reasons behind the company's poor financial condition, the restructuring options available to the company, the debt's position within the capital structure, the type of bankruptcy proceeding it has undertaken or is contemplating, the investment time horizon and the likely exit strategy. They need to find value wherever it can be released. "For consumer or even industrial businesses, investors are going to look to the value of the underlying brand," says Mr Cornwell. "They will look to monetise certain assets, either through outright sales or sale-leasebacks. You could see more hedge funds teaming up with real estate funds, especially from a commercial real estate perspective."

Furthermore, many financial institutions have little appetite to hold onto underperforming debt, which gives investors the chance to capitalise on that lack of patience, lack of operational knowledge and inability to identify the events driving down the value of a company's securities. Distressed investors will calculate whether the purchase price of the debt is below not only its potential value, but its bare-bones liquidation value. Holders of an asset will place a different value on a financially constrained company compared to a distressed investor with a unique opportunity to unlock value because their financial and management capabilities are superior. Techniques include buying the good parts of a business and either spinning them off or rolling them up with other operations in a portfolio.

Funds that are not geared up for a loan to own strategy can still make healthy returns, just by providing debt liquidity into a market that is starved of options. These investors will seek senior pieces of paper at expensive rates for borrowers. In that sense, the credit crunch has changed the playing field for distressed investors. "Where banks are reluctant to lend to borrowers, distressed investors with large cash reserves and deep pockets will negotiate very good terms," says Mr Kraft. "Also, we are already seeing more aggressive distressed debt investors look at speculative, riskier investments; here the pricing goes up significantly, particularly if the borrower has underlying businesses which may not be viable. In these circumstances distressed investors could demand prices akin to what unsecured bonds go for in today's market, if not higher."

Credit committees at financial institutions have enhanced their analysis in an effort to understand the risks associated with their investments, and the cost of debt has risen accordingly. In fact, Mr Feldman describes today's credit markets as outrageous. He cites two companies, which he is not directly involved with, that are about to emerge from Chapter 11 after receiving commitments from large lenders. "Those commitments contain so much price flex that if the financial investor stays in the company for 24-36 months and the lenders used maximum flex, the effective interest rate on these deals would be north of 20 percent," he says. "There's a phenomenal log jam in the leveraged loan market that allows investors to negotiate better terms and makes it very difficult to finance these companies at reasonable rates. I don't think people realise just how bad the market is."

But the credit crunch also affects distressed investors when they are raising capital themselves. When considering their deals, they must be mindful that the finance environment has changed in a way that could impact their returns. "One of the most significant deal trends for 2008 will be the need for increased equity and reduced debt terms," says Mr Cochran. "The biggest challenge for distressed investors will be their ability to utilise leverage to further maximise their returns, in a market where access to the leverage loan market is much narrower. Traditional covenant based financing, such as asset-based lending, will come back to the fore in place of cash flow lending, for example," he says.

Will companies sink or swim?

Although all signs point to a downturn, the market is still divided on the outcome of the credit crunch. It is still unclear precisely how economic conditions will shape up in 2008. Liquidity will be a core issue. "Never has a prospective upsurge in defaults been more eagerly anticipated," says Ms Midanek. "This very anticipation, and the money lining up to take advantage of it, may well blunt its impact. In addition, the Fed has moved strongly to reduce rates and keep market jitters managed, despite the negative impact this has on the dollar, and we are heading into a hotly contested election year. Liquidity in distressed markets will likely remain higher than it has been in prior corrections, and the outsized returns earned in the earlier environments will be rarer." It may be that we are experiencing the calm before the storm, but some experts think a renewed injection of liquidity will temper the business climate. "The market is going to get busier as companies imminently approach default," says Mr Feldman. "But it's not certain whether that will result in more restructurings. What we can say is that there will be a lot more companies for distressed investors to be look at over the next 12 months. It will be up to them to find the diamonds in the rough, but the rough is far more active than a year ago. Consequently, the distressed investment community is optimistic."

As the number of company defaults increases, we will see many distressed debt investors scooping their rewards on the back of a fragile leveraged loan climate. Investors should apply caution however, as what may seem like a golden era could turn sour if the wrong strategy is applied. In the current climate, those with abundant capital will be in the driving seat. Private equity firms and hedge funds will have to maximise strategies to achieve high returns. Success will be based on an investor's knowledge and patience to turnaround a company's balance sheet and look at available restructuring options. Sovereign wealth funds and corporate buyers are also an unknown bet; they may snatch a good portion of deals away from traditional distressed debt funds. The next few months will see competition mount among investors as distressed M&A activity heats up in 2008. ■