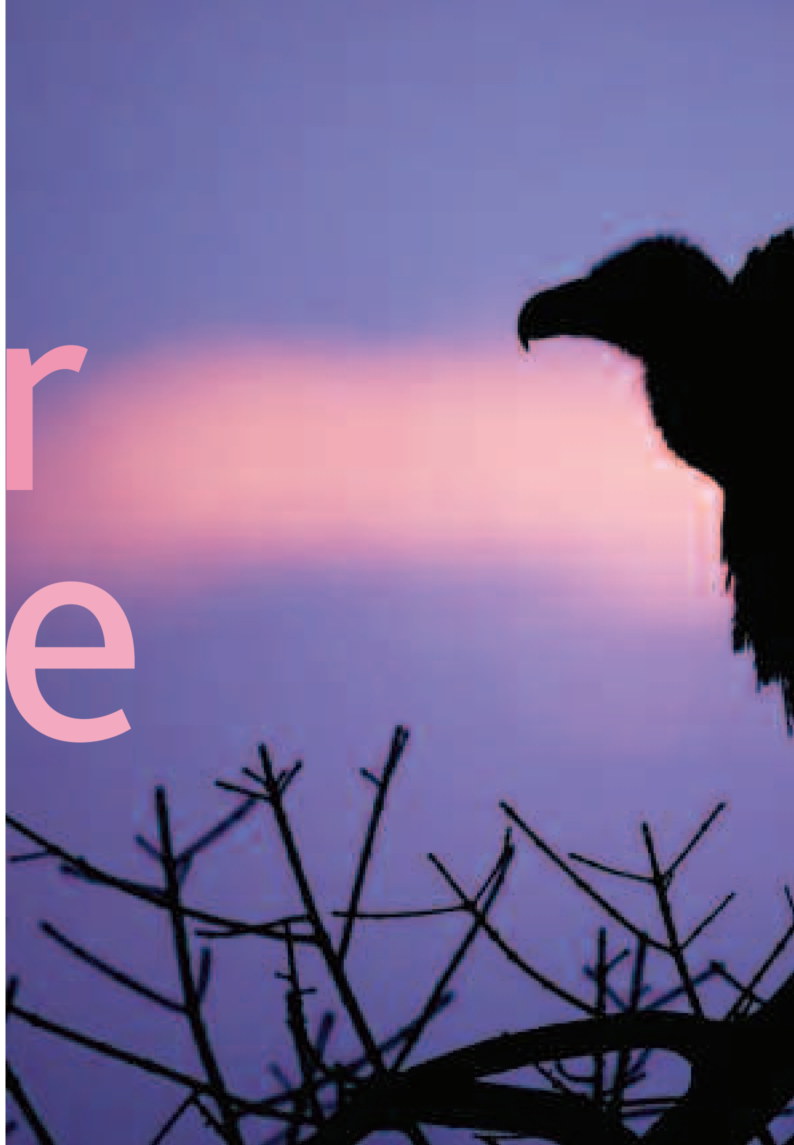
Danger zone



Executive summary

- Many banks saddled with bad debts are expected to embark on disposal strategies over the coming months. As a result, companies may find their distressed debt snapped up by vulture investors keen for them to fail. Treasurers should recognise that their companies will not necessarily be fine.

Reflecting the current hard times, this autumn has seen the ranks of distressed debt funds augmented by some of the biggest launches to date. In late September it was the turn of hedge fund GLG Partners, which began pursuing a distressed debt investment strategy in mid-2008. The firm has now set up a fund specifically to invest in the debt of troubled companies in the UK and elsewhere in Europe.

The following month it was followed by Sothic Capital, founded by Gerjan Koomen, former head of the credit proprietary trading desk at JP Morgan, and Didier Matineau, who until recently was a senior executive and risk specialist at hedge fund administrator GlobeOp.

These latest arrivals join a group of hedge funds adopting "distressed" strategies in a bid to enjoy potentially generous returns. Other names include Oaktree Capital Management, Towerbrook, Intermediate Capital and Alchemy. Their strategy has often been to buy distressed debt directly from banks, which are seeking to strengthen their balance sheets by offloading liabilities.

Distressed investing typically focuses on the discounted bonds, loans or other debt of companies that have defaulted on loan repayments, are verging on bankruptcy or have been financially restructured, in the hope that the business can still be turned around and subsequently provide strong returns.

As a result the downturn has seen a wide range of different funds set up to provide companies with the funding and liquidity that has often become unavailable from the traditional banks. However, a number of these distressed funds are opportunistic and seek to take advantage of companies trading at less than fair value.

With the lengthy period of ample liquidity and easy borrowing now ended, and no early return to those halcyon days likely, the prospects for distressed debt funds are good. Many banks saddled with bad debts are expected to embark on disposal strategies over the coming months. Much of the distressed debt comprises commercial or real estate loans that are in default, under bankruptcy protection or in weak financial condition and nearing bankruptcy.

At the same time the appeal of distressed debt investing, which has traditionally been a niche area, has shown signs of drawing in mainstream investors. In many cases, investors are attracted by the fact that distressed strategies have provided some of the strongest investment performances since the start of the year.

In August the UK's largest pension fund, the BT scheme, announced plans to invest in distressed debt. Reports quoted Frank Naylor, head of investments at Hermes Pension Fund, which manages BT's scheme, as describing investment in distressed debt as "a very good opportunity". Naylor predicted: "Even though people are talking about the outlook improving, we still think there will inevitably be a lot of bankruptcies and insolvencies. We will be able to get quite powerful returns."

Not everyone is convinced. Some of the newer funds have found that an aversion to illiquidity among investors has made it difficult to raise capital. For example, the launch of another hedge fund specialising in distressed debt, MCapital, has been delayed after it encountered problems in attracting startup funding.

A SUBDUED MARKET The forecast at the start of 2009 was that the year ahead would be marked by a high level of distressed debt investing. To date, though, there has been only limited activity in the secondary debt market. This is largely because banks have opted to delay the moment of reckoning until 2010, suggests Fenton Burgin, a partner in the debt advisory team at Deloitte. There have been circumstances in which debt has either been written down or traded in the secondary market – and in such cases demand has been strong and well in excess of supply. But most banks have endeavoured to

DISTRESSED DEBT INVESTING WAS SUPPOSED TO BE A MAJOR STORY IN 2009. IT DIDN'T PAN OUT THAT WAY BUT, AS **GRAHAM BUCK** REPORTS, EXPERTS ARE WARNING TREASURERS THAT THE SUBDUED MARKET COULD STILL ROAR INTO LIFE.

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restructure their capital, holding back from any sale and keeping debt on their balance sheet by extending facilities and rolling up interest rather than writing the loans off and crystallising losses

"A wide range of midmarket companies have been through the first stage of restructuring during 2009 and there are a large number of overgeared balance sheets," Burgin says. "In 2010 and 2011 the banking syndicates will have differing objectives, which will create much more activity in the secondary market. Quite a few of them will want to sell, but others will prefer to maintain their support."

The level of secondary activity is accordingly set to pick up next year as more banks steel themselves for the inevitable write-downs; hence GLG's new fund and other secondary debt funds currently being established. Among the most active has been Intermediate Capital Group, which launched a heavily discounted £366m rights issue in July specifically to "capitalise on the investment opportunities" in the market for buy-out capital and to win a share of the refinancing of existing buy-out transactions.

ICG's managing director, Christophe Evain, says the group regards itself as more of a "recovery investor" than a distressed debt fund, in much the same way that a friendly acquisition is far less threatening to a target company than a hostile takeover. "Investors who start buying into the company's debt may try to force a restructuring through and this can involve quite an aggressive stance," he says. "These types of investors are more prevalent in the present climate. We take a more consensual approach and make sure that we talk to company FDs, treasurers and their banks to determine the best solution.

"There have been a number of difficult cases in which the company has not only had too much leverage, but has been particularly hard hit by the recession and its cash default has arrived that much earlier."

However, Evain anticipates that the soon approaching next round of corporates in need of a cash injection will mostly involve companies less badly bruised by the downturn, even though their repayment schedule poses an increasingly serious problem. "These companies will have had more time to address problems and discuss it with their banks and shareholders," he suggests. "The banks should prove amenable to a recovery investor coming in as it will be in their interests to have a potential reduction of the debt level through a capital injection."

SHOULD YOU WORRY? So what are the implications for treasurers of companies that attract the attention of distressed funds?

As Permjit Singh, proprietor of Applied Corporate Finance, remarked in these pages last year: "Just as there's money in muck, so there is in distressed debt. For treasurers the advice is to keep the dialogue open with the lender, whoever it is. They may not be a predator but a saviour after all."

Yet many distressed funds are highly cyclical and have a lifespan of no more then two or three years. Burgin adds that any treasurer who anticipates that their company's bad debt could end up being traded in the secondary market should consider how well they know their relationship banks and whether they would necessarily be informed if any sale of that debt was planned.

His colleague Stuart Opp, partner and global investment management leader at Deloitte, adds: "If I were a treasurer, I'd welcome the fact that investors are purchasing the company's debt and enabling it to trade at a more reasonable level. At the same time, if an investor is taking a large position in the company, they may prove opportunistic."

And there lies the crucial question: what are the objectives of the distressed debt investor? Can the company expect to see its passive bank replaced by an aggressive investor looking to secure high returns? If so, it is highly likely that such an investor will take advantage of opportunities to extract value from the business at the expense of the ordinary equity holders.

But as Burgin points out, a number of distressed debt funds can also be regarded as positive investors. While also aiming to generate higher returns, they will see their interests as being more aligned with those of the management. "They take over the place of a disillusioned bank, which won't be keen on any requests for new money as it regards its asset as impaired," says Burgin. "By contrast, these funds are primarily interested in seeing the value of the debt increased and so may be prepared to put in new money."

VULTURE OR SAVIOUR? The difference in intent on the part of the investor distinguishes a distressed debt fund from a so-called vulture fund, although both seek to take advantage of market opportunities to invest in what appear to be undervalued companies. But while

investors in distressed assets believe these businesses can be turned around and restored to health, vulture investors focus on the company failing and its break-up value being realised.

Distressed investing is based on the premise that provided a once-distressed company can emerge from bankruptcy as a viable firm, its once-distressed debt will sell at a significantly higher price. A small subset of distressed funds acquire debt with the specific aim of taking control of the company and installing their own management team. Asset management firms, as opposed to private equity or finance firms, may not be among their number as they are in the business of managing money and seeing financial market opportunities rather than operating companies, adds Opp.

But the success of distressed debt investing is very much determined by its timing. Funds can find the strategy backfiring when they underestimate the length and severity of a downturn and invest before the economic cycle has reached its lowest point. Move in too early and losses will ensue if the market continues to deteriorate.

Among those warning potential distressed debt investors that the time isn't right at present is Gerson Lehrman Group. A recent posting ("Buyer Beware: distressed debt investing is a different game this time") advises: "Many institutions, endowments and pension plans are considering increasing their investment in distressed debt. However, despite many managers showing excellent returns in the space in the past, the current distressed debt cycle could be very different, and returns could be disappointing for those electing to invest in the space in the traditional manner."

The posting goes on to warn that a significant number of corporate bankruptcies still lie ahead in the current economic cycle. It points out that many companies benefitted from easy credit in the last bubble to mid-2007 "and otherwise may not have had an economic reason to exist".

Gerson Lehrman observes that many distressed debt managers have traditionally profited by turning around operationally strong companies with "troubled capital structures, insufficient capital or over-levered balance sheets". But while they may be skilled in engineering financial turnarounds, "few, if any, have had any experience – let alone success – in operational turnarounds".

The firm adds: "Most distressed debt hedge funds and private equity funds try to bring in new management teams to turn around ailing companies. However, the only people they can typically hire are either retired executives, who may not be up to speed on current trends, or executives who have been fired from other companies (often for suboptimal performance)."

BULLS START TO SNORT Dissenting voices aside, 2010 is likely to see distressed debt funds highly active. Opp says that within the asset management sector, a more positive and bullish outlook is evident. More institutional investors are being attracted to diversification and are therefore making allocations to distressed debt. Distressed debt pricing has recently risen as risk appetite has revived, although it is generally agreed that it will take time for normal conditions to be re-established in the financial markets and for liquidity to be restored.

Burgin says: "If you look at leveraged entities, the bulk of restructuring activity during the first half of 2009 involved companies that had seen a dramatic change in the business environment and were about to breach a covenant as a result." Examples include Crest Nicholson, Countrywide and British Vita. "We're now seeing a range of companies that have very little room for manoeuvre on their covenants. So we can expect a much bigger wave of restructurings in 2010-11 as more companies either fail to meet their covenants or are forced to renegotiate them."

Recent high-profile examples include Cattles, Incisive Media and Linpac, but there is a "big wave" of secondary midmarket deals. Banks are responding to the growing number of distressed situations by asking key questions, adds Burgin, such as:

- Are we being asked to provide new money for a capital injection into the transaction?
- Where does the valuation break – at the senior debt, mezzanine or equity level?
- What does the sponsor intend to do?

As for treasurers, Burgin says it is essential to recognise an employer will not necessarily be fine. Many companies are experiencing warning signs, with limited headroom going forward on their financial covenant and cash tight. These red lights will also be evident to the banks, which will be considering whether to trade in their debt.

Burgin puts it like this: "Ask yourself when you last saw your bank relationship manager and his boss. There are a number of banks in the midmarket that are exiting the London market leveraged space. A big issue for many companies is how much information they provide to their bank syndicate, and whether they should limit it. The finance director needs to be very sophisticated in this respect, as the data is quite likely to be widely disseminated."

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