Investing in distressed*

Even as the economy stabilizes, opportunities remain. What should private equity firms know about this attractive market?

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The heart of the matter

After growing inexorably since the beginning of 2006, the number of business bankruptcies reported in the US finally dropped in the third quarter of 2009, ending the string of 13 consecutive quarterly increases.

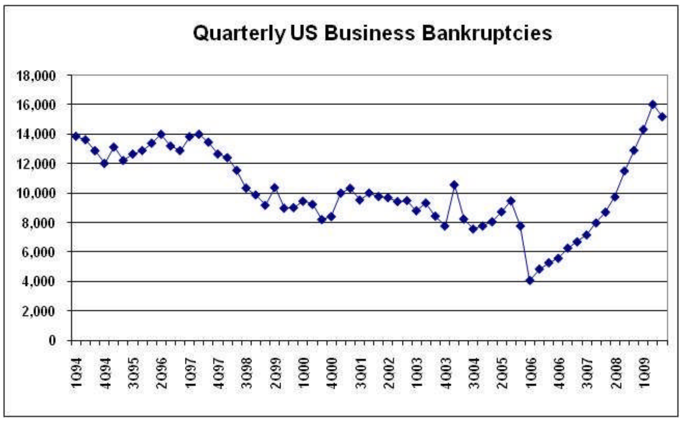
However, the decrease from 16,014 in the second quarter of 2009 to 15,177 in the third quarter still left business bankruptcies at their highest level in decades. In addition, the third-quarter figure marked a nearly 32 percent year-over-year increase from the same period in 2008.

The decline in bankruptcies may reflect a general stabilization of macroeconomic conditions. As potential sellers come to realize valuations will not likely return to the heady days of 2005 soon, more deal opportunities are emerging for buyers. This suggests continuing opportunity in the coming months for investment in distressed companies.

There are several ways for investors to seize distressed-company opportunities, including purchasing debts of distressed companies, providing financing to companies that lack bank options, utilizing a "loan-to-own" strategy, and buying assets via a section 363 process.

While these options offer significant opportunities for solid returns, those willing to take control positions offer higher rewards — with potentially higher risks.

There are several key considerations for private equity funds looking to invest in distressed assets.



Source: US courts

An in-depth discussion

No dabbling in distressed

When dealing with distressed, you're either in or out. Experienced players know the stakes are high and the level of return may hinge on solving a multitude of a target's operational and strategic variables. Funding and liquidity constraints, financial reporting issues, high turnover, and the lack of formal controls are often associated with distressed companies. Therefore, interested players must have the proper turnaround talent, process, and infrastructure to evaluate, plan, and manage such investments.

This is true even in section 363 bankruptcy asset deals where acquirers are clear from most liabilities. They require thorough due diligence. For example, when evaluating distressed deals in a bankruptcy, it is important to remember that in asset deals certain liabilities such as product liability and warranty can transfer to the buyer. Complexity also can arise from a human resources perspective should the buyer wish to retain a majority of the seller's workforce or maintain the continuity of the business operations. In this situation, the buyer could become a successor of the seller and be required to recognize any unions and negotiate the terms of a new collective bargaining agreement.

In addition to hidden liabilities, other bankruptcy-specific matters include analysis of cure payments, stretched payables, and status of rejected contracts. For distressed situations, important factors investors need to consider include liquidity, cash burn, supplier relations and terms, working capital management, customer relationships, debt covenants and going concern issues, and subjective acceleration clauses in credit agreements.

Different investment structures require varying levels of due diligence

With the deal market finally improving in the wake of the financial crisis, and general economic activity perhaps beginning to stabilize, there are increasing opportunities for private equity firms to invest in distressed companies that are in bankruptcy.

The firms that are doing so are acting on their own terms with perhaps greater deliberation than during the typical peak periods of private equity activity. In many cases, private equity funds are insisting on the exclusive right to negotiate with potential targets, consciously seeking to avoid auction situations.

Due diligence has become even more important both for private equity funds themselves and their sources of financing. Even as the deal market has gradually improved, lenders have reduced the amount of financing they will commit to a deal and are paying closer attention to diligence reports.

This focus on risk and due diligence is sharpened when private equity firms make controlled illiquid investments. Thorough due diligence is required to uncover hidden potentials and risks — especially when it comes to investing in distressed where the private equity acquirer takes control of the troubled company and restructures it. Thorough due diligence may uncover additional liabilities, inefficiencies, and potential opportunities that may influence the acquirer's turnaround plan.

Similarly, as acquirers purchase controlling positions in targets or embark on a "loan-to-own" strategy, thorough diligence is equally important as it often yields surprises that need to be included in the turnaround plan.

In either case, the teams and advisors conducting the due diligence should have the requisite managerial, operational and industry skills to ascertain the quality of management, operations, and company- and industry-specific positions in the business cycle. Understanding the operating and liquidity trends on a monthly basis is critical to reviving the troubled business. Experienced distressed investors conduct diligence that is as focused on identifying opportunities as it is on risks. By applying traditional "risk only" focused due diligence to a distressed situation, inexperienced investors end up missing opportunities.

Seasoned investors seek out mismanaged companies that have sound business strategies or unique offerings and identify hidden value through market analyses and operational improvement opportunities. In many instances, investors look for noncore assets that can provide liquidity for or can be managed more efficiently outside of the current ownership. Sometimes these ancillary businesses are part of a structure that is either too vertically or horizontally integrated. For example, a paper manufacturer may sell off its timberlands or a consumer goods company may sell off selected brands. Attaching a liquidation analysis to different assets gives investors a floor on which to value the business and thus an idea of the minimum proceeds to be expected should a turnaround plan prove to be unsuccessful.

What this means for your business

While the number of distressed businesses stays at or near record levels, investing in distressed will become an increasingly attractive option as the deal market stabilizes.

Private equity buyers have an advantage over corporate buyers in a distressed environment; it is usually more difficult for public companies to purchase distressed assets or companies because of investment constraints. This is particularly true given the funding, liquidity, and financial reporting challenges associated with distressed companies.

Often, distressed companies have experienced significant turnover in the financial accounting group, lack formal controls, or have seen their control environment (Sarbanes-Oxley compliance) decline markedly. Given the challenges inherent in restructuring a distressed company, private equity acquirers can take the company private, while a corporate buyer won't be able to do so. This allows the private equity buyer to repair not only the operational but also any reporting concerns of the target away from public pressure.

These acquirers are putting more equity in their deals with the option to lever up later when economic conditions are better. Since "work-outs" typically require two years or more, this is not a problem for funds with five- or ten-year horizons. Although near-term equity returns may not be like those of the immediate past, buying at or near the bottom should help returns in the longer term.

That said, only a few private equity or hedge funds have robust distressed investing platforms and for them the future is bright in terms of reputation, deal flow, and returns. In many cases, distressed investors began as traders and moved up the investment value chain — bridging the illiquidity risk into higher returns. Others should beware as distressed investing is not for the faint of heart and solid due diligence is a prerequisite.

PricewaterhouseCoopers' private equity practice brings a full-range of capabilities to clients looking to invest in troubled companies. Our clients can readily leverage PwC’s transactions, restructuring, and sector-specific expertise in the service of sound investment strategy.

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