TALKINGPOINT: Successful distressed investing

*FW moderates a discussion on successful distressed investing between **Evan D. Flaschen**, a partner at Bracewell & Giuliani LLP, **Joanna Anderson**, a managing director at Cortland Capital Market Services LLC, and **Graham R. Lane**, a partner at Willkie Farr & Gallagher (UK) LLP.*

FW: How would you describe the climate for distressed investing through 2014 to date? Are investors demonstrating a strong appetite for these assets?

Anderson: There have been some interesting and unique distressed opportunities to date in 2014, but generally, the climate for distressed investing in 2014 has been idle. Mature distressed funds have shown great profits this year from bets made in past years, which is one reason it has been relatively easy for managers to attract new money to the distressed space. However, currently, modest supply of distressed opportunities coupled with swarming demand have presented investors with a playing field where they must be extremely patient, resourceful, and particular when seeking and making distressed investments.

Flaschen: Most of 2014 has seen a relatively stable distressed investing market, but recent activity suggests a potential uptick as 2014 comes to a close. Investors are demonstrating a strong appetite for these assets, but supply continues to lag demand as sell-side optimism sometimes chills the market and continued low interest rates allows banks and other investors to continue weathering the economic storm. With demand outstripping supply, prices are being driven higher, sometimes outside of distressed price ranges. As an example of demand, we are seeing transactions in which the buyer of distressed assets is willing to sign a 'big boy' letter and buy bonds 'as is, where is', regardless of being aware the seller has material non-public information it can't share and wants to sell. Funds are looking to place capital designated for distressed investing; there's always significant risk, so even a blind purchase is tempting if the price is low enough. While amend and extend is still prevalent, distressed companies in certain sectors with enough diversity to sell non-core assets are creating opportunities for distressed players.

Lane: Strong demand for distressed investment opportunities continues, particularly from US funds seeking to capitalise on distressed opportunities in Europe whilst the previous quantative easing has meant that the cost of risk is low, leading to a slow domestic distressed market. US funds are bulking up their European operations but there is definitely an expectation gap between demand and supply and the number of opportunities coming to market is falling below earlier predictions. Nevertheless, opportunities remain for keen investors – including shrewd trade investors seeking to acquire distressed businesses or assets at attractive prices. On the other hand, macroeconomic events, such as unprecedented geopolitical risk arising from Middle East instability and the EU economic slowdown, are creating some market jitters and volatility, and there is clear evidence of credit differentiation whereby investors are increasingly looking to new jurisdictions to find value, particularly in central and southern Europe, especially Italy.

FW: How would you characterise valuations for distressed assets and companies in recent months? What overarching issues are influencing pricing and investment decisions?

Lane: Increased demand for distressed assets and a fundamental oversupply of money into the distressed market has led to higher pricing, frequently exceeding investor perceptions of value. However, one positive of this upwards pricing trend is that lenders may feel encouraged to offload non-core assets at the currently more attractive prices, thereby minimising their write offs and stimulating secondary trading. Investors will also undoubtedly be digesting the outcome of the European Central Bank's recently published Comprehensive Assessment, and particularly the asset quality review data. Whilst there are some suggestions that the AQR has not uncovered the full extent of European banks' capital deficiencies, it has nevertheless succeeded in identifying further non-performing loan portfolios which may spark significant market activity in due course.

Flaschen: Valuations for distressed assets and companies in recent months are increasingly dependent on an assessment of the underlying hard assets of target companies, including an analysis of whether commodities prices will rebound – whether commodities themselves are the primary assets or are components of the final products. With falling commodity prices, there are increasing distressed opportunities within the oil and gas exploration and production, as well as mining and other commodities suppliers, and shipping debt and equity investments also remain in high demand. Many companies are over-levered and cannot withstand the liquidity crunch without lender concessions, either to provide new money, sell assets or restructure debt. If oil or LNG reserves are significant, even failure to make near-term coupons won't dissuade investors bullish about rebounding prices.

Anderson: Throughout 2014, valuations for all assets have been robust, which is a great feature for firms monetising on past investments but is a frustrating characteristic for firms seeking to make new distressed investments. Valuations in general are too rich to enable firms to generate returns typically sought by distressed investors. Cheap financing in addition to fierce competition has driven up valuations and pushed down expected returns. The vast majority of opportunities characterised as 'distressed' in the market today would require a distressed investor to take higher risk with lower expected returns than they traditionally seek. As a result, many investment professionals have taken to employing a multi-strategy focus and have been looking to invest in other asset classes while they patiently wait for the market to move in favour of the distressed investor.

FW: How are investors funding their deals? To what extent are financing markets supporting distressed M&A transactions and do you expect this to continue?

Flaschen: Investors continue to fund a significant portion of deals with internal cash that is 'burning a hole in their pockets', but look for a potential increase in debt funding in the coming months if the potential uptick in available distressed assets materialises at current rates. I would expect financing markets to persist in their support of distressed M&A transactions at about the same rate as they do currently for at least the next six months. As demand for distressed assets rises, financing markets play a key supportive role, especially in larger acquisitions.

Anderson: Depending on where in the capital structure the distressed investor is making their investment influences how the deal is funded. For example, if an investor is buying leveraged loans or bonds at a discount in the secondary market, such investments are typically funded as a direct investment of the fund. Similarly, a distressed investor may lend directly to a company in the primary market with a direct loan or DIP loan to a stressed or distressed company that needs rescue financing, for example. Alternatively, if a distressed investor buys the equity or the assets of a distressed company, the purchase price is typically funded with a combination of debt and equity. The strong financing markets are open and available to support these distressed M&A transactions.

Lane: Investor appetite to commit capital to distressed opportunities is strong and fund managers have significant deployable capital at their disposal. M&A transactions continue to be funded on a case specific basis. Some buyers will rely on cash reserves whilst others will raise finance – but, for the latter, the high yield bond issuance market has now fallen somewhat flat, with many commentators not expecting it to recover until 2015. As regards traditional bank finance, the much predicted retreat from lending has not occurred to the extent envisaged and 'cov-lite' financing has made a comeback. There is ongoing evidence of some market creep of US norms into European credit documentation. Direct lending from alternative capital providers is another source of corporate borrowing but some non-sponsored corporates may view this with mistrust and suspicion given that 'traditional' bank finance is a comfortable and well known area for many board members.

FW: What strategies and techniques are distressed investors employing to get deals done? Have you seen any notable innovations in this market?

Anderson: Distressed investors are currently underwhelmed with the lack of attractive investment opportunities and therefore need to be creative. As a result, we have seen a handful of cases where investors are being opportunistic – arguably more opportunistic than we've seen in the past – as they seek potential returns and employing strategies, including but not limited to, using legal interpretation in underlying credit documents to manipulate capital structures.

Lane: Pre-pack administrations remain an extremely useful and 'tried and tested' method of acquiring distressed assets. Pre-packs are particularly effective as a platform for acquiring distressed debt and then 'credit bidding' for the assets in a subsequent administration sale. European restructurings continue to take advantage of the flexible approach of the UK courts and their willingness to sanction schemes of arrangement where UK connections could be viewed as limited or engineered. One example is the very recent High Court sanction of the *Apcoa Parking* scheme. The recent *ATU* 'flip up' restructuring is a further example of the innovative ways in which UK insolvency procedures – in that case, a pre-pack administration of a newly incorporated obligor – can deliver results for European stakeholders where the debtor's pre-restructuring links to the UK are limited.

Flaschen: Bid early, bid strong and close quickly with minimal requirements. Riskier, to be sure, but particularly in the market, the earlier birds are getting the better worms. We're also seeing an increase in secondary M&A transactions, where former lender equityholders have seen further declines in liquidity as a going concern but are still able to liquidate assets with surprising success. While not innovation per se, we're seeing successful auctions result in prices well in excess of estimated value.

FW: What are some of the key legal issues that need to be considered when making distressed investments? Are there any relevant legal or regulatory developments on the horizon?

Lane: Respect for the 'buyer beware' principle is very important as contractual protections such as warranties and indemnities will typically be of little practical value or will not be available – in particular, in sales from insolvency officeholders. Tax is also a key area of risk, particularly when acquiring discounted debt and then seeking to deal in the target's equity as adverse tax consequences may arise on a subsequent release of debt. As far as recent developments are concerned, the June 2014 Graham Review of pre-pack administrations in the UK evidences some media and governmental mistrust and scepticism towards the procedure. Whilst insolvency practitioners have been requested to implement voluntary reform, future legislative intervention cannot be ruled out and may have a prejudicial effect on the process' effectiveness in future. In the distressed equity sphere, the Alternative Investment Fund Managers Directive contains provisions restricting valuation extraction following an equity buyout. It will be interesting to see if and how the market will take this into account through structural innovations.

Flaschen: In an increasingly international arena, the key legal issues vary by jurisdiction, but investors should be keenly aware of their claims in a downside scenario. It is surprising how little due diligence some investors conduct on foreign insolvency laws until it's too late. Whether it's off-balance sheet instruments and liabilities, environmental claims, employee benefit claims, priorities assigned to certain tax liabilities, or a host of other potential claims, all could eat into ultimate recoveries depending on the insolvency regimes involved. One legal problem we see in Australia, for example, is the inadequacy of indentures and note purchase agreements in providing a mechanism for secured noteholders to provide funding or an indemnity to a receiver. Practitioners and investors alike are accustomed to banks holding security and simply offering an unlimited indemnity and extending working capital lines of credit to fund a receivership. Equally sharing indemnity risk and receivership funding among noteholders is nearly impossible without careful planning – and investors don't always have much time to prepare. Distressed investors abroad shouldn't be reluctant to invest, but they should seek counsel with respect to insolvency mechanics and the obligations they'll have to fund to recover in receivership or liquidation, for example.

Anderson: In the United States, the legal issues are relatively straightforward, albeit the recent negative case law related to credit bidding, which should be considered by investors with loan to own strategies. In Europe, where a flood of US asset managers have opened offices in recent months in search of distressed investments, the laws are not as straightforward and each jurisdiction needs to be analysed and understood from a legal and regulatory perspective. There has been widespread belief that distressed investors will be the beneficiaries of an abundance of supply of distressed loans caused by forced selling by the banks. There have been some noteworthy portfolio sales in 2014 to date but thus far the supply has been far less robust than expected. The results of the Comprehensive Assessment were announced on 26 October 2014 and the expectation is that this should create opportunities for distressed investors, although the specific ramifications of the test results remain to be seen.

FW: What steps can investors take to deal with the constrained timeframes often associated with distressed investing? How can they adequately manage risk and mitigate potential liabilities?

Flaschen: Investors can maximise efficiency by creating jurisdictional and sector-specific issues checklists. A significant part of the angst and, frankly, the danger of an expedited timeline is the fear, and reality, of failing to ask the right questions and spot the issues in the limited time available. Investors should glean not only from successes and failures within their own hallways, compiling information from myriad sources and individuals. By maintaining checklists in a centralised network where everyone can access and update as warranted, investors can decrease their risk – and increase their comfort level – by creating and depending on a complete pool of institutional knowledge. Moreover, it almost always pays in the long run to ask for advice. Find advisers you can work with on a one-off basis to bounce ideas off of and to confirm your understanding of the relevant finance documents, both internally and externally.

Anderson: Some of the obvious steps to help deal with constrained timeframes are not always possible to achieve but to the extent you are able, try to do as much of your due diligence ahead of time as possible. Once you are involved in a transaction, if you need to solicit multiple parties in order to successfully consummate a specific transaction, try to keep constituents in the information flow as much as possible early on so they are able to act quickly when it's time to make a decision or provide consent. If you have the right advisers and agents by your side, this will also help you facilitate transactions more quickly. In order to adequately manage risk and mitigate potential liabilities, it's important to maintain your investment discipline and not let credit standards be influenced by inflated valuations.

Lane: Prioritised or exclusive access to information is hugely advantageous but not always commercially realistic in the current over-subscribed market. However, slim opportunity windows can be mitigated by maintaining good links with experienced lawyers and other professional advisers who can review key documents at the outset and quickly highlight any significant potential liabilities or non-standard or off market provisions. The negotiation of suitable contractual protections is an obvious line of defence to manage acquisition risk, but often their limited value or non-availability will leave pricing and diligence as the only bastions of risk management. Investments in real estate and businesses with historic ties to pensions schemes in deficit can involve significant hidden liabilities, so particular care in those areas is essential. Instructing restructuring lawyers and other professional advisers with experience of coordinating specialists in key risk areas can offer valuable assistance where the available diligence window is very tight.

FW: What final advice can you offer to investors looking to make successful distressed investments in today's market?

Anderson: Be patient: the market for distressed investors will rebound, and it will likely happen soon. In the meantime, maintain your discipline and credit standards. Be resourceful: spend time developing relationships with various market participants so when the market does turn, you are able to benefit from having a seat at the table. You will also benefit from having partners and professionals that you trust to help facilitate your investments and transactions.

Lane: Be prepared to move very quickly and ensure your professional advisory team are as well, and push for information access at the earliest possible opportunities to facilitate prioritisation. Negotiate for contractual protections – especially outside of an insolvency scenario – but recognise their practical limitations in this field, and, if possible, price risk accordingly. Consider purchasing business assets via an insolvency process – the extra time and cost involved may be worthwhile to ensure a 'clean sale' and accordingly minimise claw back risk. If you are reviewing opportunities in other EU jurisdictions, ensure that you are aware of the nuances of the relevant legal regime – some jurisdictions are significantly less creditor friendly than others and an understanding of key legal issues in multiple jurisdictions will often be required. Finally, it's notable that many investors are now adopting a 'buy and hold' strategy in connection with portfolio acquisitions. That will require a flexible and patient approach in order to generate returns.

Flaschen: Stick to the basics. Fundamental investment strategy still applies to distressed investments, and underlying business flaws that caused the distress won't often heal on their own. Companies will typically point to market forces beyond their control as the reason for a liquidity crisis. The alibi may prove true, but an investor will have a better chance at assessing risk by identifying management and operational decisions and personalities that may also share the blame. By identifying the reasons for distress, the distressed investor improves his likelihood of recognising a situation that simply won't yield results because of fundamental flaws. Quick arbitrage gains are always welcome, but you're less likely to be left holding the bag if you can accurately assess the problem before diving in.

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