Applying Fundamental Analysis to Distressed Investing – Part 3 of 3

Distressed Investing Process (continued)

Investing and Negotiating

Based on the analysis of the valuation of the enterprise and the various parts of the capital structure, investors will make investment decisions based on expected returns and the risks associated with those returns. Distressed investors generally preserve the right to invest across the capital structure. Occasionally, if the investor believes that various parts of the capital structure are mispriced relative to each other, there may be an opportunity for a capital structure arbitrage trade: being long one part of the capital structure and short another part, with the expectation that the spread between the two will either contract or expand depending on the thesis.

An investment manager employing a trading investment style may go long or short various parts of the capital structure (and may do both simultaneously if they perceive a capital market arbitrage opportunity). Trades are typically executed through broker / dealers, although there are instances when they are executed between counterparties. The trades can be expressed by either buying or selling the relevant security, a loan or a derivative instrument such as credit default swaps ("CDS"). As the thesis plays out or changes, the investor will unwind (close out) the trades.

In an active management strategy investors will typically continue to accumulate securities and loans before and during the restructuring process. The active manager's goal is to gain control of the class, either individually or with "like-minded" investors to allow them to be in a position to influence the negotiations and control the votes during the restructuring process. Control can be either "positive control" (where the investor has enough of the class to dictate the vote) or "negative control" (where the investor has a large enough block to prevent another investor from gaining control). What constitutes control is dependent on the language of underlying documentation (credit agreement, bond indenture etc.) and local bankruptcy law.

The focus for the active manager tends to be on the "fulcrum" asset. However, in addition to the fulcrum asset, the investor may invest in other parts of the capital structure either because they believe that the return on that asset is attractive or they can positively influence the results of the restructuring by gaining control of the asset.

All investors, but especially investors employing an active management style, should try to understand the investor base and their motivations. Banks and collateralized loan obligation funds ("CLOs") may be more inclined to amend and extend a loan rather than restructure ("kick the can down the road") in order to avoid owning post reorganization securities or take the mark-to-market losses that may accompany a restructuring. Equity holders may purchase classes of debt to influence the restructuring in such a way as to preserve the optionality of their equity or as a means to re-invest in the business while squeezing out junior creditors. Investors tend to prefer to invest in situations that are controlled by “like minded investors”, and a review of the current holders and the trading patterns is helpful in understanding these risks.

Engaging in active management of a distressed process is time consuming and requires working with other claimants on committees, attending court hearings and negotiating settlements.

Given the complexities associated with the distressed investment process, most successful investors have developed a repeatable investment process to analyze and invest in distressed assets.

Characteristics Inherent in Distressed Investing

As may be obvious, there are certain idiosyncrasies that are associated with distressed investing and a distressed portfolio.

- Liquidity – Often distressed assets will have limited liquidity in the market, trade with a wide bid / offer spread and exhibit a J-Curve. This is particularly true in the event of a restructuring, but can also be true in situations outside of a restructuring. In the fall of 2008 and into the spring of 2009, there were very few bids in the market for distressed assets and supply significantly outstripped demand (providing a great opportunity for investors with “patient” capital).
- Valuation – When there is limited liquidity and no active market for the distressed assets, they can become Level 3 Assets. Valuation of these assets are generally established by way of a financial model. Distressed investors should clearly articulate their valuation policy and process to investors and must remain diligent to that policy and process.
- Concentrated portfolios – Due to the time it takes to analyze a distressed opportunity and work on a restructuring, most distressed managers run fairly concentrated portfolios in situations they believe they know very well.
- Expertise and Experience – Distressed investing is a sophisticated process and requires both financial and legal capabilities. Additionally, many distressed teams are staffed with professionals who have experience in certain industries, who can be additive in the sourcing of investments and who can quickly assess distressed situations and develop a thesis.
- Countercyclical – Distressed investing tends to be countercyclical with the volume of opportunities increasing as money supply tightens, default rates rise and other assets are trading down. As mentioned above, this will often follow a period of loose lending standards resulting in excess leverage. However, it’s important to note that opportunities in distress exist at all points along the credit cycle as companies experience financial distress and require reorganizations or restructurings for a variety of reasons outside the supply of capital. It’s the job of the investment professional to be proactive in sourcing such opportunities and to remain disciplined in their investment process.
- Contrarian Investment Strategy – Distressed investors are typically deep fundamental value investors and recognize opportunities when others are forced to sell or when the market becomes fearful about the prospects for a company.

- Inconsistent Bankruptcy Laws – Bankruptcy laws can differ significantly across various jurisdictions which effect rights and recovery. Funds that invest in cross-border distressed situations must understand the local laws and regulations that would govern the particular case.

Conclusion

While distressed assets have historically been a good source of alpha generation and have demonstrated low correlations to other asset classes, investors who allocate to this asset class must be able to tolerate limited liquidity along with other idiosyncrasies associated with the asset class. Additionally, distressed investing is a highly sophisticated discipline that should be entrusted to professional managers that have experience in analyzing, investing and negotiating distressed situations and bring a unique set of skills, knowhow and experience necessary to capitalize on the opportunity set.

Twelve Lions Capital is an investment management firm focused on investing in distressed, stressed and undervalued corporate securities and bank debt in North America and Europe. The firm employs a fundamental bottom-up valuation approach to investing and invests across the capital structure in special situations where it believes it is creating the investment cheap to fundamental value and with the expectation of creating alpha through either a restructuring or reorganization process or asset appreciation.

Twelve Lions Capital is led by Marc Schneider, an investment professional who brings over twenty years' of relevant experience. Prior to forming Twelve Lions, Mr. Schneider was a senior investment professional at Avenue Capital where he had a highly successful track record of investing in distressed situations. Mr. Schneider also has experience as a Wall Street lawyer and investment banker.

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