REPRINT FINANCIER WORLDWIDE

JANUARY 2015

FINANCIER WORLDWIDE corporatefinanceintelligence

DISTRESSED M&A AND INVESTING

Distressed debt investing – finding value and opportunities in a hot market

ROBERT D. KATZ

EXECUTIVE SOUNDING BOARD ASSOCIATES LLC

Earlier in this decade the number of distressed deals significantly outpaced the funding sources – many deals chased fewer dollars. However, in the last couple of years those roles have significantly reversed. There is now more money chasing fewer deals. The number of distressed investing funds of all sizes continues to grow across the globe, with new ones seeming to pop up daily. And there is no sign that this will slow down in the coming years.

Investors are hungry for double digit returns. One of the biggest problems facing private equity funds and the industry, both distressed and healthy, is, now that they have raised the money, where and how quickly are they going to deploy it? Patience is generally nonexistent when the machine needs to feed. The pressure to raise capital is one thing; the pressure to deploy and garner desired returns is a more intense pressure. When you have raised your first fund you better make sure that the returns beat expectations. If you do, there will be

Executive Sounding Board Associates LLC

Management and Financial Consultants

Robert D. Katz, CTP, CPA, MBA is president of Executive Sounding Board Associates LLC. He can be contacted on +1 (215) 568 5788 or by email: rdkatz@esba.com.

a line of investors waiting. If you don't, the phone may not ring again.

Where will the opportunities come from?

Look to restructuring consultants. Since they work with companies in distress, and their networks target entities in distress as well as lenders, attorneys, auctioneers and appraisers that are all in that space, these professionals generally have their finger on the pulse of the market. They generally know who is busy, who is not, where the opportunities are coming from and where to focus limited resources.

Engage with attorneys who represent the 'workout lender' in large institutions. These individuals not only have the insight on which credits lenders want to exit from, but how quickly and what the bid and asking price are; that is, the discount that the lending institution is likely willing to take. In most cases, the 'discounted loan value' is a heavily guarded secret, so any insight can provide an investor with a huge advantage.

Find your niche. Whether you are Sun Capital or the Carlyle Group looking for the largest of large, or a 'home office' looking for smaller deals, there is a large supply. But make no mistake, it is going to take a lot of energy and invested time to find a quality opportunity.

Complete due diligence and close quickly to provide you with a leg up. Once a distressed investing firm knows that you can do this, it will move you up in the priority in terms of the number and usually the quality of the deals that you see. Rarely is anything as important as being able to close in an expeditious manner.

Ask one of your portfolio companies. Leaders within an industry who have longstanding relationships tend to know better than most who is struggling. Also, they probably know where the best value is and where immediate synergies can be realised and opportunities taken advantage of.

Bring on board the right talent. As an example, a business owner was approached by a distressed investing fund. His company had made a significant turnaround and the distressed fund wanted to use the business owner as the launch of the platform. The fund overpaid a bit for the foundation, but in the business owner they had purchased somebody who had grown up in the particular industry, had been through multiple cycles and was comfortable with all the ebbs and flows. The business owner had the ability to identify operating synergies, reduce overhead and improve efficiencies. He also had the ability based on his experience to identify targets. In addition to the business owner's operating prowess, in essence he had the ability to be the investment banker as well. In three years, the business owner and the distressed investing fund were able to more than double the size of the company from its initial investment.

Incentivise your people. When the market is this frothy you need someone who is going to go the extra mile – but make sure you have the right people. Too many people promise the world but fail to deliver, and that can potentially be a big mistake. Ask a candidate for their annual earnings statement, called a W-2 in the US. If they are not willing to show you this form, how can you be confident that they are telling you the truth, especially with such a large investment at risk? The right person will more than pay for themselves.

Make sure you have the right partners. And preach patience. The phrase 'manage expectations' is certainly overused, but in a red hot market like today's, it is very important to stay true to your game-plan and objectives and not chase returns just to get a deal done. The primary way to ensure this is to do some pre-funding due

Executive Sounding Board Associates LLC
Management and Financial Consultants

diligence. Make sure those providing the money have the same time horizon and same tolerance that you do. If the expectations are that you get more than one deal done in your first year, or that you will have completed a deal inside of six months, the odds are not in your favour. If that is the expectation, then you will start feeling pressure to put money out, when you might otherwise not.

The distressed investing segment and the entire private equity sector will stay on the forefront, worldwide, for 2015. There are plenty of opportunities. Investors need to be patient, focused and aggressive. Just remember that the likes of Carl Icahn, Wilbur Ross and others started with that first phone call, the first deal and those immortal words: Can you move quickly? Just remember to move smartly. Hopefully, looking in the right places for opportunities will help make 2015 a great year. ■