Under Pressure:

Investors May Have to Dig for Distressed Deals

BY KATHRYN MULLIGAN

When President Donald Trump picked Wilbur Ross to run the Department of Commerce, he reinforced the new administration's pro-business reputation. The choice of Ross, a turnaround investor who built his fortune betting on struggling companies, sent a positive signal to both Wall Street and Main Street, which stand to benefit from the financial deregulation and tax reform promised by Trump.

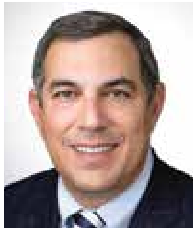
But for Ross' distressed investor counterparts in the middle market, a stronger economy means fewer opportunities. In the absence of broad conditions pushing companies to the brink, these investors are honing in on specific drivers of distress and industries undergoing rapid change.

The U.S. economy is showing signs of strength, including employment growth, low interest rates and ample capital. For investors like private equity firm Blue Wolf Capital Partners, that climate doesn't spur the financial and operational turmoil that can push new industries into financial distress.

"You have an environment where companies are more likely to be growing and profitable than shrinking and unprofitable," says Michael Ranson, a partner at Blue Wolf, which focuses on special situations in North America, including distressed and turnaround investments.

That can be a challenge for investors in distressed assets, who target struggling companies or market inefficiencies using strategies that include purchasing the debt of a troubled business, investing in an embattled company in hopes of turning it around or targeting so-called special situations—a catch-all term that describes businesses under pressure for any number of reasons.

Mansour Bassem



J. Scott Victor

THE TRUMP EFFECT

Over the past few years, the pace of distressed and turnaround investing has slowed. The number of middle-market distressed debt deals fell to 73 in 2016 from 127 two years earlier, according to data provider PitchBook.

Those conditions aren't likely to change anytime soon. Trump has promised to dismantle many of the regulations instituted over the past eight years, notably the Dodd-Frank Act, the sweeping financial reform legislation that placed new restrictions on capital providers. With less regulation, banks will be able to lend more freely, in some cases propping up companies that might otherwise fall into distress.

Interest rate increases expected during Trump's first term are touted as a headwind to growth, yet many professionals like J. Scott Victor, founding partner and managing director of investment bank SSG Capital Advisors, don't expect rates in the next few years to reach a point where they will impact middle-market distressed activity in a meaningful way.

"The higher the interest rate, the more distressed there's going to be, yes. But no one knows how high those interest rates are going to go, and I don't predict they're going to go that high," says Victor, who is also immediate past chairman of the Turnaround Management Association.

NOT ALL MARKET SEGMENTS ARE CREATED EQUAL, AND FUNDS INVESTING IN SMALLER COMPANIES MAY FACE MORE OPPORTUNITIES AND LESS COMPETITION THAN THOSE CHASING BIGGER DEALS.

Interest rate hikes present a heightened threat to companies carrying heavy debt loads, but Blue Wolf's Ranson doesn't think middle-market companies are particularly vulnerable.

"I don't sense that companies are systematically way overleveraged. I think that there's a lot of debt capital out there, but we've seen the (middle-market) lending community behave in a way that seems to be pretty responsible," he says.

ONE MAN'S TRASH...

The economic outlook doesn't suggest widespread business failure, but opportunities still exist for investors in distressed assets. Not all market segments are created equal, and funds investing in smaller companies may encounter more prospects and less competition than those chasing bigger deals.

Lower middle-market companies tend to be more susceptible than their larger counterparts to strains like the loss of a big customer, a quality issue at a manufacturing facility or a management mistake. Such events can create an opening for an investor to provide financing or operational support.

A struggling lower middle-market company also may have fewer suitors. Strategic acquirers, large private equity special situations funds, and credit and hedge funds compete aggressively to invest in businesses generating $500 million in revenue or more. Fewer funds target the lower middle market, where private equity firm Resilience Capital Partners has focused since its founding in 2001. The firm's co-CEO, Bassem Mansour, says this segment is typically less attractive to strategic buyers or falls under the radar of large private equity firms.

As investors in distressed companies look for their next deal, private equity portfolios are a good place to start. Sales of portfolio companies to other private equity firms have grown as an overall share of the market, according to PitchBook. In fact, secondary buyouts made up more than half of middle-market private-equity-backed exits in the third quarter of 2016. Once a fund reaches maturity, a firm is under pressure to sell its holdings, regardless of performance; even before then, it may offload a business early to rid itself of an underperforming asset, which might appeal to a private equity firm oriented toward distressed assets.

Corporate entities present another source of deal flow in the form of carve-outs. As large

companies—both public and private—grow, they often find that some assets no longer align with their core strategy or drive revenue. These non-core business units can appeal to investors with a different perspective.

"We can carve those assets out, create an independent company with its own identity, invest capital behind it, bring strategic and management resources if necessary, and give it an opportunity to improve, recover and grow from there," says Mansour, who expects this trend to continue.

INDUSTRIES UNDER SIEGE

Even in a growing economy, individual industries experience pressures that force companies into distress. In the view of Thomas Kim, managing director of consultancy R2 Advisors, an economy in flux drives distressed deal flow by creating winners and losers, even as the overall business climate improves.

"The best-run companies are going to enjoy the lift," Kim says. "But the worst performers are going to quickly be left behind. Those are the businesses that will get restructured or sold because they can't keep up."

Industries like oil and gas, metals and mining, retail and health care have presented distressed opportunities for the past several years, and that activity is expected to continue.

Trump and the Republicans have introduced legislation to upend the Affordable Care Act, creating uncertainty for health care businesses. The ACA's future is unclear, but the impact of any legislative changes will be felt alongside a host of other factors, like downward pressure on reimbursement rates, rising costs and consolidation in the health care industry, says Warren Feder, a partner with investment bank Carl Marks Advisors and member of ACG New York. Feder expects those combined forces to continue creating work for firms that work on distressed deals.

Although the price of oil has risen since its sharp decline in 2014, deal flow is likely to increase now that the industry is less volatile. When prices were dropping, many investors were "wary about trying to catch a falling knife," Feder says, whereas today, the industry has largely adapted to the lower price environment.

"Oddly enough, I think the rise in oil prices to above $50 and a certain amount of stabilization

Warren Feder

Thomas Kim

Michael Ranson

creates an environment and a dynamic that's actually more favorable for investors, and we may see more transactions," he adds.

In retail, high-profile Chapter 11 bankruptcy filings by brands like American Apparel, Pacific Sunwear and Aeropostale have highlighted the challenges facing the sector. A major retail shipper, EZ Worldwide Express, filed for bankruptcy in mid-January. Heavy debt loads, reduced spending on apparel and changing consumer tastes have weighed on traditional retailers, as has the impact of e-commerce.

The trend toward online shopping shows no sign of slowing. Kim emphasizes the impact this will have across the entire industry, hurting not only retailers slow to adapt to online platforms, but suppliers and real estate owners. "It's just going to be a pretty big shift in one segment in the economy that's going to ripple through," he says.

LPS HEDGE THEIR BETS

Limited partners have continued to commit capital to funds with distressed asset strategies, despite strong macroeconomic indicators. In 2016, distressed debt funds raised more than $16.8 billion, an increase from $12.1 billion in 2015, according to PitchBook.

Resilience's Mansour sees an appetite for distressed funds among LPs, whose managers recognize the impact investors can have in transforming a troubled company.

"Generally speaking, people view our business as intuitive and positive, and I'd anticipate there will continue to be funds raised in the space," he says.

The enthusiasm for distressed investing could become tempered for some limited partners, however, as they try to time their investments with the next economic downturn. The growth environment expected under the Trump administration may extend the business cycle, leading some LPs to adjust where they put their dollars and to choose funds more selectively.

"Some of them might be willing to back funds thinking that two or three years from now maybe the economy softens and the natural business cycle creates opportunities, but I've got to imagine that because the economy is pretty healthy, LPs aren't just throwing money at these strategies right now," Ranson says. //

Kathryn Mulligan is a former editor with *Middle Market Growth* and a contributor to the magazine.

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