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US Distressed Investing: A Guide

Distressed US assets present unique investment opportunities for those willing to accept certain levels of risk and create value.

WHY INVEST IN DISTRESSED ASSETS?

The nature of a distressed asset is one whose intrinsic value is depressed because of either operational or financial distress. Distressed assets offer investors an opportunity to buy cheaply, with the potential for significant upside as the assets regain their value. Admittedly, investing in distressed assets requires a certain appetite for risk, which means that the pool of potential investors is usually smaller than for healthy investments. Potential pitfalls include (i) investors' general inexperience or lack of understanding in handling distressed assets, (ii) a different business or risk profile of the assets (and potential attendant regulatory pressure), and (iii) political or reputational risk of certain distressed investments. However, as a result of these risks, distressed investments present unique potential for opportunity for investors willing to accept certain levels of risk and create value. Put another way, investing in distressed assets can have significant upside for investors who are willing to take some risks on assets that require more active management or oversight than the average healthy investment.

ACTIVE VERSUS PASSIVE INVESTMENTS

Within the broad category of distressed investments lie investment options and asset classes catering to different types of investors with diverse capabilities and willingness to become involved in the management of the investment.

At one end of the spectrum investors are looking to be minimally involved in the management of the investment and are primarily interested in the return. These investors will generally rely on other parties in the capital stack to actively manage the asset or restructuring. For example, investors can buy distressed syndicated loans that need little to no active management of the underlying company but merely require the investor to determine when to buy and/or sell and have a high enough risk tolerance for the investment asset at issue.

At the other end of the spectrum are active investors whose goal is to purchase or take control of the underlying company or assets and either work with existing management or seek to replace existing management, in an effort to increase the performance of those assets and their return on investment. Thus, some investors employ a "loan to own" strategy, which involves buying up the debt of a company in order to effect remedies and ultimately convert their debt into a controlling ownership stake in the underlying company.

TYPES OF DISTRESSED INVESTMENTS – REAL ESTATE

There are various types of distressed investments available in the US, and in the current market, investors may soon have even more opportunities and options. In particular, there appear to be unique opportunities in the real estate sector, to either purchase existing non-performing loans including mortgage loans or mezzanine loans or to extend rescue financing to borrowers that are no longer able to obtain more traditional financing. Within the category of rescue financing, investors in the current market can opt for the following: (i) refinancing maturing loans in the current uncertain market (often at higher interest rates), (ii) financing new construction projects,

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(iii) financing strategic purchases of real estate parcels or existing buildings or (iv) financing the conversion of commercial office buildings to residential or mixed-use projects.

As a result of the recent market turmoil and increase in interest rates, there has been a marked increase in defaulting loans in the commercial real estate market. As governmental COVID assistance programs expire and tenants renegotiate commercial leases for better terms, less space or both, landlords will find themselves with fewer sources of funds with which to service their mortgage debt. According to a recent Fitch report[1], older office space at risk of obsolescence with upcoming tenant rollover is at high risk of mortgage default. In addition, buildings in this class will have more difficulty finding new tenants, who are migrating to newer, higher quality space. As a result, those borrowers will have difficulty in servicing their mortgage debt.

Approximately 75% of commercial mortgage debt is held by banks, government-sponsored enterprises ("GSEs") and as commercial mortgage-backed securities. As loans go into default, those lenders will either (i) foreclose on their mortgages and sell the underlying property (often at below-market prices) or (ii) sell the mortgages themselves as distressed assets. This will likely result in distressed investment opportunities.

In the case of buying distressed real estate assets at a foreclosure sale, investors have the opportunity to acquire those underperforming assets from lenders whose priority is recouping the amounts owed on their mortgages. This presents a potential cost savings on an asset that might otherwise sell at a higher price outside of the foreclosure context, leaving a purchaser with significant potential upside.

Investors looking to purchase distressed mortgages as financial instruments have the chance to step into the shoes of mortgage lenders and foreclose on the property following default or negotiate a consensual transfer of the underlying assets in exchange for a release of the debt. As the holder of the mortgage loan, the investor could either (i) "credit bid" (i.e., offer an extinguishment of all or part of its debt rather than cash) on the property to become its owner without an additional outlay of funds or (ii) sell the underlying assets for a price higher than the investor paid for the mortgage loan, thereby securing a more immediate return on investment.

The current market also presents an opportunity for rescue financing from lenders willing to take a risk, who can, as a result of the tenuous position of these borrowers, extract more investor-friendly provisions when making loans. Such provisions include (i) higher interest rates, (ii) prohibitions or penalties on prepayment (to preserve the steady flow of interest for a guaranteed period), (iii) additional payment-in-kind ("PIK") interest, (whereby borrowers can defer interest payments, which can be paid via the issuance of more securities rather than with cash), and (iv) preferred equity "kickers" from borrowers in exchange for investments.

Additional opportunities are also increasing in conversion of commercial office buildings to

multifamily housing. There are two notable trends in the current market: a shortage of multifamily housing and a surplus of commercial office space. The housing market is experiencing some of the highest rents in recent memory, while companies are rethinking their physical footprints with the advent of remote work accelerated by the COVID-19 pandemic. The result? Not enough housing, but vast amounts of downtown office space across American cities.

According to Jones Lang LaSalle ("JLL"), more than three-quarters of the office space in New York, San Francisco and Chicago is more than 30 years old, while office occupancy rates remain low in major cities. As more and more companies are institutionalizing remote work as part of corporate work policy, they are also downsizing office footprints and cutting their real estate costs. Accordingly, space that was previously allocated to commercial use may be a prime candidate for conversion into residential and multi-use space, i.e., adaptive reuse projects.

In addition, leases for approximately 243 million square feet of office space will have expired by the end of 2022. This represents roughly 11% of office space in the United States. Further, the volume of lease expirations is projected to exceed 200 million square feet for each of the next three years (2023-2025)[2]. As businesses reconsider how much office space to occupy, at least a portion of this square footage will remain vacant. As vacancy levels rise, the profitability of office buildings with increasing amounts of unleased space will decline. This presents a unique opportunity to repurpose that commercial space for a use that is in high demand, and to turn commercial space into residential space.

According to a report in RentCafe, adapting existing buildings into apartments, rather than building new multifamily housing, can be extremely cost-effective, with renovations that can cost up to 40% less than new construction for the same number of units. Adaptive reuse projects can help transform assets with declining value (i.e., old office space) into assets for which there is a high demand (i.e., centrally located housing in dense urban areas) at a lower cost than starting from scratch. Together, all of these factors make a compelling case for repurposing existing buildings for new types of use[3].

TYPES OF DISTRESSED INVESTMENTS – FINANCIAL INSTRUMENTS

Another avenue of distressed investing is the purchase of distressed financial instruments. These instruments can be cheap relative to their intrinsic value – fewer buyers (and better prices) for debt that is the subject of a forbearance or restructuring, the result of which is a larger upside than investing in healthy debt. Further, debt that is distressed may be misunderstood, but still have some value (e.g., debt issued by a declining company or business).

There can be significant advantages to investing in distressed debt. First, an investor may be able to influence the outcome of a company's equity without the burden of the regulation that comes with being an equity investor. This can be the case when a company's equity holders are "out of the money," obligating the company to work with its debt holders to come to an arrangement on how to move forward. In addition, there may be unseen benefits to buying a company's distressed debt, such as intellectual property assets or valuable litigation claims, that an investor can monetize. Owning distressed debt may also be an efficient way to end up as the equity owner of a company, either by extending new financing or cancelling indebtedness for a percentage of the ownership. Lastly, investing in distressed debt allows an investor to "try before you buy" – investors have the option of changing their minds and offloading the debt prior to a reorganization.

Distressed debt can be secured or unsecured. Examples of secured debt include: first lien loans, second lien loans, third lien loans, unitranche debt (which combines senior and subordinated debt), revolving loans, letters of credit, term loans and secured bonds. Examples of unsecured debt include vendor/trade payables, borrowed money (with no collateral) and bankruptcy rejection claims (the amount a debtor must pay a contract counterparty when rejecting a contract in bankruptcy).

There are certain considerations for investors looking at distressed debt. First, unsecured or under-secured obligations that are in default

generally accrue no interest – instead, they accrue a negative internal rate of return ("IRR") while the default exists. Second, recovery on distressed debt is capped at the full value of the financial instrument (i.e., at par), whereas there may be an unlimited upside for other types of investments. Lastly, distressed debt is usually issued by a company experiencing problems. Investors who make a bad bet on a company that cannot pay back what it owes face the possibility of a complete wipeout of their investments.

UNDERSTANDING RULES OF PRIORITY

Both in and out of bankruptcy, parties with monetary claims against a company must be paid back in a certain order. Outside of bankruptcy, this is determined by the contractual terms of a company's debt, with secured lenders holding the option to foreclose on their collateral in case of a default. In addition, lenders can contract among themselves to determine who gets paid first, using either an intercreditor or subordination agreement.

Once a company has filed for bankruptcy protection in the US, creditors must be paid according to the "Absolute Priority Rule". Also referred to a liquidation preference, this governs the order of payment among creditors and other financial stakeholders in the following order of priority:

- **Administrative Expenses**

These include certain taxes, wages, professional fees incurred during the bankruptcy proceeding, and claims of creditors for goods supplied within 20 days prior to the bankruptcy.

- **Secured Creditors**

- **Junior Lien Creditors**

These include second (or third) lien lenders.

- **General Unsecured Creditors**

These include creditors with no form of collateral, such as general suppliers.

- **Subordinated Creditors**

These include creditors that have agreed to be contractually subordinated to other creditors

- **Equity Holders**

The holders of a company's equity are the last to be paid the value of their shares in the company and are often wiped out in a bankruptcy.

DISTRESSED FINANCIAL INSTRUMENTS INVESTMENTS – TRADING BASICS

The most common instruments traded in the market are loans, bonds and credit default swaps. Other investments include trade claims (purchasing the right of a vendor to receive payment for goods or services) and vendor puts (issuing a contractual instrument that allow vendors to assign their rights to receive payment to the put seller upon a customer's bankruptcy in exchange for a premium to the put issuer). In each of these scenarios, the obligation being sold is a right to receive payment, whether on a loan, a bond, or a simple supplier arrangement. As a company's likelihood of payment decreases due to its distress, many creditors want to cut their losses and recoup the highest amount possible in the short term, rather than waiting to see how much their claims might be worth in bankruptcy. This is why distressed and discounted paper is quoted at "cents on the dollar," i.e., a percentage of their face value.

VALUATION METHODS

The most important consideration for an investor looking into distressed markets is the valuation of the company whose debt the investor might buy. As previously discussed, a creditor who owns a defaulted obligation is limited to recovery of the face value of the instrument. Accordingly, valuation is essential to determining the possible upside of an investment relative to how much the investor paid for it.

Investors use a variety of methods to determine valuation, which are as follows:

- *Trading multiples of comparable instruments.* A comparable trading multiple is a relative valuation used to assess a company's worth. This process involves finding a collection of similar / peer companies and deriving multiples based on their financials and market values to

assess how a potential investment measures up against other similar options in the market.

- *Transaction comparisons***.** This involves looking at recent transactions (last five years, depending on market conditions) for similar assets in similar markets to establish whether the deal terms fall within a range of reasonableness. This method is most often employed in real estate transactions and is rare in the corporate world.

- *Sum of the parts of a business.* This method is used when businesses have different multiples, often while divesting a company of certain under-performing aspects of its business. This method is intended to show value that a more holistic approach might overlook by evaluating the component parts of a company separately.

- *Discounted cash flow.* This valuation method estimates the value of an investment using its expected future cash flows. If the present value of future cash flows exceeds the current price of an investment, then it is unlikely an investor will make money on that investment. This method is better suited to long-term investments.

- *Liquidation value.* This method is used to estimate downside and should yield a number that is lower than the methods described above. A liquidation analysis models the distribution of a company's assets according to the order of priority of its creditors to see how much a particular class of obligation would receive in a liquidation of the company.

KEY RULES FOR DISTRESSED INVESTING

Know Your Downside Risk. Do a liquidation analysis of the target company you want to invest in. The best distressed investments are based on a strong liquidation value. If the liquidation value of the investment is not at least equal to the purchase price, you are more likely to lose money.

Due Diligence is Key. Due diligence considerations include (i) whether the company is over-leveraged, (ii) whether the company has bad management, (iii) whether there are commodity issues, (iv) whether the company is currently involved in litigation, and (v) what liabilities you would want to avoid as an investor. Evaluating these factors, and a company's prospects generally, are the keys to deciding whether there is enough likelihood that the value of the investment will increase over time.

Recognize that You May Need Help. When investing in a new type of asset or extending financing to a company in an unfamiliar industry, investors should be mindful of their own inexperience. Consider seeking out an advisor with expertise in the investment you are making, who can evaluate the diligence you receive during the investment process.

Understand the Mechanics. Most importantly, know what your obligations are, and be familiar with what happens in a worst-case scenario. Being prepared is the best way to monitor and protect your investment.

CONCLUSION

Distressed investments are not for everyone but present unique opportunities for investors willing to accept higher levels of risk in order to generate value and higher returns. We believe that the current market will generate significant opportunities to invest in distressed and stressed companies. Of course, as with any investment but, particularly with distressed investments, legal and financial diligence and structure are key. Chapman invites inquiries and questions on this topic and stands ready to advise on the legal aspects of distressed investing in the US. ■

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1 Fitch Ratings, November 29, 2022 (https://www.fitchratings.com/research/structured-finance/anticipated-recession-drives-2023-us-cmbs-delinquency-forecast-higher-29-11-2022)

2 Source: TheRealDeal April 12, 2022.

3 GlobeSt.com February 17, 2022.

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