PHOENIX
MANAGEMENT SERVICES

Investing in Distressed Opportunities After COVID-19

Patrick Bellot, Director

With sectors of the economy beginning to open, there are more questions than answers on what the new economic "normal" will be. The lingering commercial impacts of COVID-19 may require businesses to restructure for survival. Opportunistic investors may find value in these special situations. On ACG Philadelphia's May 28th webinar, "Investing in Distressed Opportunities," **Mark Karbiner of Phoenix Management Services** and **David Lorry of Versa Capital Management** provided commentary on the landscape of distressed investing post-COVID.

We haven't seen the tsunami of distressed deal flow in the middle market, yet.

There have been large-cap bankruptcy filings in the recent wake of COVID-19 including J.Crew, Gold's Gym, JC Penny, and Hertz. However, we have not seen this trickle down to the middle market yet in a meaningful way.

- M&A deals that have closed since February were already far along into diligence prior to the impacts of COVID. The industries with the most deal flow since February have been somewhat insulated from the downside risks of demand contraction due to COVID-19. These industries include education technology, food manufacturing, specialty manufacturing, and certain pockets within healthcare. Many more deals have been paused indefinitely due to the uncertainty caused by COVID-19 and specifically valuation changes with renegotiation.
- New deals coming to market now are largely companies that are not investible in the traditional sense. Either they were severely distressed prior to COVID-19 or they are in industries that are too volatile to invest in right now, e.g., travel, retail, restaurants, oil and gas.
- To date, lenders have been supportive of portfolio companies that have experienced demand shocks due to COVID-19. Companies have been granted 60 to 90-day forbearance agreements from their senior secured lenders with reduced covenants in an appreciably more flexible approach, as compared to traditional norms. Some lenders are also modifying borrowing base structures to provide incremental liquidity to borrowers.
- PPP funding has provided a temporary lifeline for many middle-market companies trying to keep the lights on for another 8 weeks. However, a large portion of companies will require additional capital to fund operating losses until demand recovers.

- While PPP funding and lender cooperation have undoubtedly been helpful in the short term, it may have only delayed the inevitable closure of many businesses that will experience long term contractions in demand through the end of 2020 and possibly beyond.

Distressed investors are cautiously trying to find value in the downturn.

It is especially difficult for investors to value distressed assets in the current environment because the shape and timeline of the economic recovery are so uncertain. Even still, special situation investors are relying on proven strategies to maximize value in the acquisition of distressed assets.

- There are two broad categories of distress that companies face: structural and cyclical. ***Structural distress*** refers to challenges that are company specific. Examples of structure distress may include failed acquisitions, poor leadership, negative working capital, over-levered balance sheets, or unprofitable business lines. ***Cyclical distress*** refers to broader economic stressors including debt bubbles, industry downturns, and, more recently, global pandemics. Cyclical stress, like COVID-19, requires investors to correctly time the market recovery and the degree of recovery.
- Distressed deals may be done both in-court or out-of-court. In court restructuring provides the buyer with the protections of the U.S. Bankruptcy Code but the process requires substantial professional fees and administrative costs.
- Uncertainty around PPP payback may cause some risk and exposure for buyers. However, given PPP loans are unsecured, over-levered companies still struggling may use bankruptcy to flush out/ reduce the leverage, including PPP loans, burdening the capital stack.
- Special-situation investors must decide how to allocate their capital for a distressed business: paying a value for the assets or earnings of the business, funding a process in-court or out-of-court, or funding the operational turnaround of the business. Investors will need to balance these competing demands on their capital to obtain control of the business and ensure it has the best chance of recovery in the future. However, quantifying the value of the assets and the capital necessary to fund a turnaround has become increasingly difficult with the uncertainty of future demand in a post-COVID economy.
- Investors may find value in businesses that are being controlled by an involuntary owner. Involuntary owners are creditors or preferred shareholders that have taken control of a business due to a deterioration of the Company’s circumstances. Certain involuntary owners, like regulated lenders, may not be organized or equipped to run the day-to-day operations of a business, increasing the likelihood they are willing to accept a lower valuation in consideration for a transaction.

It is still too early to tell what the recovery will look like, but it seems likely that distressed deal flow will continue to increase in the back half of the year.

- It is unclear whether there will be a second, third, or fourth wave of COVID-19 infections once the economy reopens in a meaningful way.
- Valuation will continue to be a hurdle for deals to be completed in the near-term since projecting revenue with any level of certainty will be a challenge. Investors will be reluctant to pay full price for businesses that are experiencing a meaningful revenue contraction due to COVID-19.
- Lenders and sponsors will not be able to support everyone forever. They will need to pick winners and losers in their portfolios as PPP funding runs out and companies require another injections of capital. The Companies who do not receive support will need to avail themselves to restructuring processes at appropriate valuations or face permanent closures.
- Distressed investors will be challenged to find situations where the company is early enough in its distress that there is still enough runway to turn the business around.

The COVID-19 crisis will continue to expose those businesses that had operational issues and over-levered balance sheets coming into 2020. However, many more businesses that were healthy prior to COVID-19 will also suffer. In both cases, prolonged impacts of COVID-19 through the end of 2020 will put pressure on owners and capital providers to restructure businesses. There will be opportunities for distressed investors to unlock substantial value in this market if they can thread the needle on deal structure, valuation, and the timing and extent of the recovery.