SPECIAL PURPOSE

In December, *Real Deals* gathered key participants from the special situations community to discuss dealflow, management team fatigue and LP appetite. Against a backdrop of multiple headwinds facing UK businesses, 2024 looks set to be an especially interesting year for this space

Photography by **Phil Bourne**

AT THE TABLE

Jatinder Bains
Partner, Macfarlanes

Zeina Bain
Managing partner, Sullivan Street

Thomas Boszko
Partner, Alchemy Partners

Alex Cadwallader
Director and head of south and offshore, Leonard Curtis

Tom Callaghan
Director, Endless

Tristan Nagler
Partner, Aurelius

Ari Stavropoulos
Partner, Ridgeway Capital

Moderated by
Alice Murray
Editorial director, Real Deals

Given the macro conditions and the multiple headwinds facing businesses, will 2024 be the year of the turnaround?

Tristan Nagler: The last five to 10 years have threatened to be the year of the turnaround and yet it never quite arrived. Overall, 2023 has been a very hard year to get deals done and therefore I am probably more optimistic about 2024. Inversely, I think the M&A market might come back a little bit in 2024, meaning there could be more liquidity and not such a strong year for turnarounds. It feels like everyone's been waiting but it hasn't quite come. There are always lenders who will provide a little bit more help. There are always management teams who are creative and find new solutions. And there are always investors around to provide support.

Tom Callaghan: It feels like there could be a lot of opportunities for us. However, some are also saying it's going to be a good year for more mainstream M&A when interest rates flatten and there's more certainty. But then you've got a UK and US election next year, which will also be on people's minds, and further uncertainty around where things are going to be from a political standpoint. But that could also bring dealflow because a lot of business owners may take a view from a tax perspective that now is a good time to crystallise value.

Zeina Bain: There's a dichotomy between what we are seeing at the smaller end of the market in terms of businesses starting to get into stress and distress as the cost of interest, and the ability to pass on inflation and payment strains are catching up with them and what we are seeing at the macro level in terms of consumer behaviour.

The term 'turnaround' needn't be just about distress; it is the pivot or operational changes to continue to improve businesses and create value at a time when they are facing multiple pressures. Difficult times can allow you to take a contrarian view and use the context to push profitability, consolidate market position, or do acquisitions, so that you emerge as a stronger business after the storm.

Alex Cadwallader: The number of insolvencies is increasing across the board and that's set to continue in 2024. The number of enquiries has started to ramp up in the last three months. Also, if you look at the number of winding-up petitions being issued, there's been a significant rise as well with HMRC being the most active petitioner. In terms of sectors, unsurprisingly, construction is the one with the highest percentage of petitions being issued. This has had a knock-on effect on any sector linked to construction, which is also starting to see a lot of pain. In addition, real estate, both commercial and residential, is suffering and causing pain for lenders and investors, both being squeezed and not necessarily having the level of equity in these projects that they were expecting previously.

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Jatinder Bains: We're already experiencing busier times and receiving lots of calls. And if you look at the government statistics, we've had the highest number of liquidations and administrations since Q2 2011. A lot of that is in the SME space, which a lot of special opportunities investors are less interested in. That could be a warning of what may be coming in larger businesses. They obviously have greater financial strength to be able to withstand the pressures faced in recent years, including higher inflation, higher interest rate costs and supply chain issues. But ultimately they have a finite amount of resources and so what happens to SMEs is likely to eventually hit larger businesses in due course, and that may well be this year.

Thomas Boszko: It's very hard to call the economic conditions but it certainly feels like we're busier. We feel very optimistic about the opportunity that's coming towards us. One of the big drivers is that, structurally, there are a lot of businesses out there with too much debt. Whether the economy improves or deteriorates, what isn't going to change dramatically is the fact that debt has transitioned from 10 years of basically being free to costing something. And, if you look at a lot of private equity funds, they're staffed by, in the main, people who don't remember a period before debt was free. A lot of deals have been done at 12x Ebitda, which mathematically means around 8x Ebitda of debt. Today, businesses can only support 5x to 5.5x Ebitda leverage, which means no one will ever pay a 12x Ebitda multiple for it.

I think there will be bifurcation among assets – there will be those whose backers want to hold on and are willing to put the money into refinance, and others where the sponsors will need to hand over the keys because they simply can't support everything. We're seeing the first of those deals now and I think during the next three years there will be a wave of restructuring activity to structurally reset the balance sheet of businesses that are over-leveraged.

With a new deal you can reinvigorate management; there's a new incentive scheme or a reset to the business plan. Management teams do need supplementing, refreshing and support in these tough times

Zeina Bain, Sullivan Street

Ari Stavropoulos: I think there should be a lot more opportunities out there. Some businesses are struggling and their balance sheets still haven't recovered from Covid, debt finance is more limited and expensive, and VC funding has dried up. For us, we're seeing a lot of failed capital raises and M&A processes. That's where a lot of the opportunities are coming from at the moment; where they've been unable to sell or raise due to valuation expectations being too high and are coming to us. The need becomes urgent when they realise they're about to run out of cash and there is a desire to do a deal at more realistic valuations. We still need to be highly selective, however, as a lot of those businesses maybe shouldn't have survived Covid or aren't geared to the future.

What are the key sources of deals for special situation investing at the moment? Are there any deal types or sectors that are especially prominent?

Bain: We see several sources of activity. One is corporates doing carve-outs because of management or capex bandwidth and a focus on portfolio consolidation. The second is founders looking at possible adverse changes in the tax regime and seeking to sell out now or needing help with the transition and taking their business to the next level. Thirdly, there are more stressed and distressed assets in the market, and then we see opportunities from certain processes falling through as trade buyers pull out, either because of cold feet or having to concentrate on their own trading.

Callaghan: We're seeing a fair few carve-outs, which is a good source of dealflow because there is a real need for a transaction; maybe the parent has

What happens to SMEs is likely to eventually hit larger businesses in due course, and that may well be in the next year

Jatinder Bains, Macfarlanes

announced to the markets that it is going to divest that division so there is a high likelihood of a transaction. We're also seeing a fair bit of distressed assets coming through, but mainly in retail. However, they're often coming too late – obviously, we've seen Wilko this year and Wiggle is in administration at the moment. Businesses exposed directly to consumer spending are hard turnarounds to execute; there aren't many levers you can pull when customers aren't spending money. The other notable source is where debt funds have taken the keys and are potentially looking for a solution as they're not necessarily set up to cope with these assets as portfolio companies.

Cadwallader: There have been a myriad of different types of investors and lenders in the last five years who are relatively new to this space and don't have the expertise or the desire to deal with a proper turnaround situation. How likely are they going to be to spend six months onsite with their team trying to turn a business round, as opposed to some of the turnaround investors around the table who really know how to do this? So you are seeing some of these more vanilla PE houses thinking, 'I'd rather crystallise my loss and just move on'. Yes, it might hit the bottom line initially but then they can focus their time and efforts on really converting their more successful investments. So this is where we have seen a material uptick in dealflow.

Boszko: One strategy we focus on is what we call distressed asset aggregation, particularly in the hospitality sector. Looking at individual hotels or individual pubs, which are feeling the storm much more than some of the bigger businesses because they're generally less profitable and less professionally operated. Our investment strategy is to invest in these businesses and aggregate them. That, for us, is a very durable 10- to 15-year play.

Is buying a business out of administration a good source of deals?

Bains: For many years, the market has enjoyed a lot of liquidity and cheap money. And then during Covid we had a few years of free money and liquidity. You've got a lot of businesses out there that arguably just shouldn't exist but have been able to keep going with the benefit of that funding. By the time they reach formal insolvency now, our clients tell us that there isn't a huge amount that they as a potential investor can actually do as things are too far gone. So a lot of those perceived opportunities aren't as good as they might seem.

Stavropoulos: If the business is in administration it's often too late, with the situation already impacting employees, customers and suppliers. For us, it's part of the restructuring process. If the business is taken through a pre-pack that's fine as a cleansing process, but it's got to be planned and well managed. That's the final step after you have planned and structured how the business survives. When you're acquiring the business on the other side, you need to be executing the recovery plan immediately – the initial days and weeks are crucial. Whereas if you're coming in at the point of administration, it's unlikely it's an opportunity you're going to get comfortable with. Too much can go wrong if it's not a managed process.

Cadwallader: Invariably, the administration is part of the solution. So, a private equity firm would have identified a business they are interested in and then part of their strategy may well be to put subsidiaries or the whole business through an administration. None of these funds are sitting there waiting to read about a company going into administration. Wilko is a good example of this; by the time it fell into administration it was probably too late and too challenging to turn that round.

Boszko: We're always very focused on the team we're backing, so for us, buying something out of administration can work if it is done via an existing portfolio company. We know the team and they know the assets, so we can move very quickly. You can talk about buying things out of administration and securing a big discount to price for the risk, but it's hard to know exactly how much risk you're taking without a good team you already trust.

There have been a few mentions of fatigued management teams being a key factor in troubled assets at the moment. How do you discern management teams that are too far gone, or those that can be re-energised with a deal?

Bain: On the one hand, management teams are battle-weary because of all the different pressures they've faced recently. That means you need that broader bench strength to face all the different types of headwinds currently at play. It's been as hard a time to manage a business as it has ever been. On the other hand, you have management teams that are tired in the context of pre-existing deals, where teams aren't getting the payouts they expected because processes have been delayed or have fallen over. These are two separate issues but with a new deal you can reinvigorate management; there's a new incentive scheme or a reset to the business plan. Management teams do need supplementing, refreshing and support in these tough times.

Dealing with that churn and recruitment challenge means the role of HR is significantly elevated. If you're dealing with more cost headwinds or inflation, the finance function has to come to the fore as a business partner and help you tackle that. The increased need for more data to inform decision-making puts more onus on the digital team. Everybody's got to be on it. With so many pressures facing businesses, you have to be much more rigorous about all the functions in your central team than you used to be.

Nagler: I think you can spot the management teams who are tired. We tend to do a lot of corporate carve-outs. In those deals, the management teams have often waited quite a long time, feeling that they are a non-core business within a larger group. It doesn't take a lot for them to spot that; they've been making requests for capital allocation, making requests for time with senior-level people – for one-on-one engagement – and they've been squeezed off the agenda. That is quite tiring and demoralising. Eventually, the business is put up for sale, which is briefly invigorating. But they know it's a long way to getting a deal done. And then there's a long way after the deal is done to get the business to fire again. So we do tend to meet management teams who are quite beleaguered but are then jumping for joy at the idea of establishing themselves outside of the parent group. And it's an amazing career opportunity for many. So there is an element of reenergising but it's important to remember that in the current climate, a huge number of people are demoralised and worn out. It's a very difficult

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Thomas Boszko, Alchemy Partners

environment economically and politically.

Boszko: There's certainly a potential issue for those management teams who were in a buyout and thought they were going to sell in 2019 and make a lot of money. Then Covid happened, rates moved and the business devalued, the loan notes have gobbled up all the equity value. Management has then been in it for five years longer than they thought and they're not getting paid anything like they thought they would. Those additional few years have been really tough and now they probably have to go again – so you can see how motivation issues might arise! It's also the case that the chief executive who established a good track record of growing a business in a good time isn't necessarily the right person to work through all the difficult stuff in a bad time.

Bains: In many situations where the keys have been handed over by a sponsor to, for example, a secured lender, managers have ended up in the mode of working towards debt recovery for that lender and reducing the debt burden on the balance sheet. Running a business for cash, as opposed to for growth, from a management team perspective may well be less exciting. That can be really demotivating, particularly if that ownership change comes after a lengthy restructuring process where they will have had to make a lot of tough decisions and navigate around the demands of competing stakeholders. And so having been beaten up during the restructuring process, they end up in a mode where they're operating on a more conservative basis without the opportunity to do some of the more exciting things they might be keen on. In some of the situations I've seen, it does mean that a business ends up being in the doldrums, so that's where there might be a better prospect upon a further change of ownership with a special opportunities investor coming in and re-energising the business.

Callaghan: When you're carving out a business from a PLC, I think the management team is actually quite excited. They're excited to have the shackles set free, have capital invested in them and have the opportunity to think about M&A, capital investment and turbocharging growth.

Where you've got genuinely tired management teams is if they've been so burdened with the multiple challenges of Covid, dealing with Brexit and then Trussonomics last year. Couple that with managing a leveraged balance sheet and the day-to-day operations, and it can be extremely challenging. That's where maybe a business needs a reset in terms of the management team.

Cadwallader: That's always a difficult judgement call. Often, it's the team below the founders that you really need to focus on and see if you can incentivise them. We are seeing a fair bit of director fatigue; it's been a challenging environment for business and there's not a definite light at the end of the tunnel yet.

Stavropoulos: These teams do need a lot of support at the moment. With those who are struggling, it can be hard to tell whether they're struggling because they're worn out or if they just have had too many challenges but with support can be remotivated and effective going forward. You need to go in and spend some time with them, take the pressure off them with funding and remove some of the non-operational issues, and see how they perform. It's not something you can always work out beforehand but it's something to be conscious of. For some, you can get them motivated once a few issues have been resolved. And it's not that easy to find good replacements at the moment – it can be a long search. So you want to give the existing management team a good go first if you think you have identified potential there.

Given the more challenging economic environment, and the gap between seller and buyer valuation expectations, how important is deal craft right now? And are there new tools in the kit coming through?

Boszko: One of the key issues in the market at the moment is there's a big bid-offer spread. Asset owners are anchored to a historical value of their assets and the buyers don't agree with that. For our asset aggregation strategy, if you need to start that by buying a platform, you're going to have a difficult conversation with the seller about the net worth and then you're caught in a bit of a stalemate. So we've been playing around with a sidecar structure where you can invest alongside an existing business without having to buy into the business itself. And therefore without having to dilute the ownership or accept a depressed valuation or massive change in governance. Through the partnership, you can go and acquire assets and sell the whole entity together. That's an innovation we've come up with for this particular market to bridge the bid-offer spread and to allow us to exploit opportunities.

Bain: Deal craft for me, at the moment, is coming in the form of bridging valuation gaps, particularly as certain sellers are still looking at the past in terms of multiples and to the future in terms of earnings, yet still trying to execute a deal today. With that, it's about coming up with creative solutions for how you bridge that gap, whether it's through earn-outs, rollover of shareholdings, or vendor loan notes.

Given today's uncertainty and greater risks, securing lower valuations gives you a lot more latitude for error. Being able to take that conviction view or seeing through some of the market headwinds means you need to correct for that and therefore just be more disciplined on price. Up to this point, that's been harder to apply because of the lower interest environment. Certain assets are traded at certain multiples in the context of the amount of leverage but that's no longer there. It's a new world in that regard. Today, the right reference point of valuation in this new world is really hard to call. You're having to look out five years and think about what the exit multiple will be, but the last five years is not the right reference point so you go back to focusing on fundamental value and the actual performance of the asset.

Bains: There certainly are new tools available, particularly off the back of changes brought about by the Corporate Insolvency and Governance Act that passed in 2020. When formulating transactions, we are seeing a greater and more creative use of mechanisms like restructuring plans. We can see how, in comparison with Company Voluntary Arrangements (CVAs), they can enable a business to do something more aggressive with, for example, landlord creditor claims. The problem with a CVA has always been that you need to propose something that gets enough votes from unsecured creditors, including landlords, so you end up arguably not being radical enough in a restructure. When it comes to a restructuring plan, because you can give effect to a cross-class cramdown, then, so long as you have the support of senior secured creditors, you could do something more radical. The problem, however, is it can be a very expensive process. And if you are looking to push the envelope when it comes to landlords,

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Alex Cadwallader, Leonard Curtis

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Businesses exposed directly to consumer spending are hard turnarounds to execute; there aren't many levers you can pull when customers aren't spending money

Tom Callaghan, Endless

they will naturally push back because they're already unhappy with how they've been treated in recent years. So a business going through that sort of process needs to have the financial resources to be able to get to the end and, therefore, it's not appropriate for every situation. Arguably, in the lower and midmarkets, the old-fashioned pre-pack may well be where one ends up in terms of deal craft.

Cadwallader: The one thing the UK restructuring and investment market cannot be criticised for is not having a diverse and ever-expanding set of formal and informal processes and investment structures. Whether that is restructuring plans, M&A insurance products or new types of funding, we are pretty good at finding solutions to allow deals to take place. The key solution is often one that allows the buyer and seller to get comfortable on valuation. And as highlighted already, expectations based on the market three years ago won't help bridge that gap. We also see that having an adviser with sector expertise can assist greatly.

Nagler: We've always gone into these processes with an open mind. We look at the information, try and solve it ourselves, go to the banks to get financing support, and look at our own resources and offerings. If a gap emerges and financing is short, we often ask the seller to help out. Often, after a lot of disagreement, we can end up with an outcome where the vendor has provided a loan instrument to bridge the gap. A notable change I've seen in the last 12 months is vendors proactively offering this sort of instrument. Before we've gone to the financing banks, and before we get to our final investment committee, sellers are offering solutions to get the deal done. And that's a remarkable transformation from having had to fight like mad to get such a level of support at the end of the process, to getting something offered up right upfront. That's a real transformation.

Callaghan: Sellers and sell-side advisers are being more open and flexible. If you were looking at buying a business two years ago, you had to do it in two weeks otherwise someone else would come in. Now, there's a lot more flexibility in terms of structuring and timing.

How important are advisers when doing deals in the current environment, and has their role changed at all?

Bains: What's come to the fore is the importance of relationships. If you need to move quickly, then working with professional advisers who understand the drivers and the key concerns of any special situations investor will be critical. Furthermore, because we act for so many different stakeholders across the spectrum – M&A sponsors, boards of directors, secured lenders and insolvency practitioners – we enjoy seeing things from different perspectives and helping to solve problems collaboratively. I do think that sort of collaborative approach can be important to ensure that deals get done at the speeds that are sometimes needed.

Cadwallader: Crucial in my view. Having a good adviser on the other side of the table is a massive tick in the box. One of the key skills of an adviser is to understand their client and their needs. Advising one of the investors around this table as opposed to a small family office who has never invested directly into a UK trading entity before are two very different things. Secured lenders also have very different workout teams now. Ultimately, you need to have the relationship to make that assessment to bring the most suitable contribution to the table. As we mentioned earlier, the advisers can also assist in ensuring their client is not being unrealistic in their expectations and is fully aware of the possible implications of taking a certain stance. In this climate, engaging advisers is anything but a box-ticking exercise.

Bain: There is a need for greater handholding and expert insights from advisers at the moment. I also think there is a level of sell-side advisers working harder to get deals done through more pragmatism and cooperation. You are solving problems together to get transactions over the line as they are taking twice as long as expected.

Nagler: For me, advisers can be the difference between a deal happening and not happening. In this climate, you need help to get to a positive outcome. You need collaborative approaches and you need empathetic advisers. Sometimes they need to speak to their clients to help

Special situations in this environment is operationally hands-on investing. It is the answer to high inflation and high interest rates

Tristan Nagler, Aurelius

them understand the reality of the situation we're in.

Callaghan: It feels like it's a more mutual relationship because things are hard at the moment. Everyone is realistic and trying to get a deal done because they're incentivised to get a transaction over the line. So I think there's more alignment of interests than there potentially has been before.

Boszko: Some do a good job of it, some less so, and the smarter advisers realise that this isn't 2019; nobody's going to believe it if you say it's a highly competitive process. Buyers have retrenched slightly to what they know and what they like, so processes, by definition, are narrower. And the good advisers are tailoring their processes to that; everything has to be more tailored otherwise it's not credible. Also, in more difficult environments you're more likely to work with people you know and trust.

ESG has been a key focus for the industry for several years now, but given the more challenging economic environment, is it still a priority?

Boszko: It is still very high on the agenda; it's the right thing to do. What's interesting today is that it is one of the few things that is uniform across the portfolio. We ask all of our CEOs to carry out certain ESG reporting metrics and to hit ESG targets, which means you can look across the portfolio and see who is doing a good job and who isn't. Who hasn't bothered or who is late in reporting, or who is on top of it and thinking about it? It's quite a good benchmark.

Callaghan: Private equity has a massive part to play in the ESG agenda. It's very difficult to buy an ESG-perfect business and I don't think one exists. Therefore, our role is to transform these businesses and make them better from an ESG perspective. Things like oil and gas are never going to be perfect overnight but they need capital, it needs investment to diversify those businesses away into other renewable sectors. There are a lot of jobs moving out of these sectors and there's a role for us to play in developing new skillsets.

Nagler: We recently acquired The Body Shop; we were very much attracted to its strong heritage and purpose-driven operation. It's very rare to find such a special business. I can't think of a business more emblematic of social purpose and it's a real privilege to be involved in its next phase of development. Many businesses lose their way a little bit, particularly those that change hands several times. We're thrilled to have the opportunity to take it out of the corporate veil and for it to be standalone again and give it a chance to recapture its pride and that which made it special. Its ethical stance gives it a huge advantage; it was such a trailblazer before ESG was even coined.

Stavropoulos: ESG is essentially good business sense and is in line with our and our investors' values in general. To create and realise value in the future, good ESG behaviours need to be pursued as part of the investment strategy. A lot of positive ESG practices are inherent in business plans nowadays – we are much further on than we were five years ago when it was a much newer concept. For us, it's also a useful lens to assess management decision-making and it can act as a red flag sometimes. You can always improve ESG policies and compliance in investee companies, but if policies are just being resisted or ignored by management, in the face of strong commercial imperatives, that can be reflective of a management's decision-making more generally. It often prompts us to ask what else might they not be doing properly.

Bain: I believe we're past peak ESG-related valuation froth where certain deal valuations were driven more by the need to fulfil the criterion rather than a reflection of business quality. I think there has been an unintended consequence from the focus on ESG – it has meant funds were often walking past the burning building rather than putting out the fire. ESG is fundamentally good business practice, it's an indicator of business quality and an effective culture, and will have a positive value impact. However, it is those businesses that are more ESG problematic that often hold the key or indeed the ability to invest in or innovate and develop the transition. Private equity is best equipped to tackle this given our longer-term perspective, drive for results and impactful stewardship.

To create and realise value in the future, good ESG behaviours need to be pursued as part of the investment strategy. A lot of positive ESG practices are inherent in business plans nowadays

Ari Stavropoulos, Ridgeway Capital

In an incredibly challenging fundraising market, special situations appears to be one of the few bright spots. Are you seeing strong LP appetite and are investors looking for anything in particular?

Nagler: The category is very attractive and that's because special situations in this environment is operationally hands-on investing. It is the answer to high inflation and high interest rates. You have to be proactive and make sure that businesses grow their revenue faster than their costs are rising. It's no surprise that LP appetite is warm towards the special-sits players. But we've got to be productive and a bit contrarian. We've got to take views on things, find conviction, get things done and then put the effort in.

Boszko: We are currently out fundraising and we're seeing a lot of appetite from investors for value. It's a big shift from two years ago when LPs were talking about how well their tech portfolios were performing! Today, sophisticated LPs see the same opportunities we do and are expecting very strong vintages for the next couple of years. But it is a tough fundraising environment. LPs really care about track record and also the ability to be a flexible investor, because in special situations that means durability across the cycle.

Callaghan: Yes, they're looking for a demonstrable track record in terms of cashflow back from funds. DPI is the metric everyone is talking about at the moment. It's also a case of sticking to your strategy, sticking to what you're good at and focusing on your strengths and delivering returns.

Bain: During the last 20 years, there's been a shift in terms of risk-reward trade-offs. A benign environment and low interest rates meant the market drifted towards lower returns for lower perceived risk and I think investors were often underpricing risk. What's happened now, as risk has become more apparent – whether it is geopolitical uncertainty or performance or micro challenges – LPs should need the better return to compensate for that heightened level of uncertainty around outcomes. So there is that greater demand for deep value and higher returns in response to the greater risk assumed.