ROUNDTABLE

PROBLEM SOLVING

Rising inflation, climbing interest rates, geopolitical conflict and high energy costs have put businesses and economies on the back foot. Against this challenging macro-economic backdrop, *Real Deals* sat down with a panel of managers and advisers to unpack what this all means for the special situations community, and how developments over the last year are influencing strategies and deal flow.

Photography by **Phil Bourne**

AT THE TABLE

Jat Bains *Macfarlanes*

Michael Loizou *Ridgeway Capital*

Thomas Boszko *Alchemy Partners*

Rudi Pattni *Zetland Capital Partners*

Alex Cadwallader *Leonard Curtis*

Will Southgate *Rutland Partners*

Moderated by
Nicholas Neveling
Real Deals

The special situations community is a broad church. What does it mean to you and how you invest?

Thomas Boszko: Special situations can mean different things to different people. For most firms, the strategy emerged from secondary debt trading and a bit of restructuring, and over time a number of those managers migrated into primary debt.

For us at Alchemy, however, special situations encompasses anything that is a little bit unusual and doesn't fit traditional pockets of capital. It can be a debt or equity deal, but it will almost always be complex, not intermediated properly, probably initially too small for the mainstream. Fundamentally, special situations is about investing at a discount because of these factors.

Michael Loizou: We look at complex situations – deals that mainstream private equity wouldn't do because they are not straightforward or too small. The focus is on deploying our capital and expertise to solve a problem and get a business to a stage where the next owner can take it to the next level. We come in where there is stress, distress and underperformance and then affect a turnaround to create long-term value. Our turnarounds are therefore potential deals for the mainstream. Our background is in restructuring, so we are very much set up as a classic turnaround and growth operation.

Will Southgate: Our investment proposition is slightly different because we are not typically looking

at stressed or distressed situations. For us, it's about finding fundamentally good businesses that are looking for a more hands-on investor. They need someone supportive to partner with them as they go through some sort of change in their business. For example, that could involve helping an owner to transition control to a newly established management team to facilitate an exit from the business or helping with a capex program to transform the operations of the business.

We are looking at situations where we can add value beyond just providing capital. If you look at our portfolio, there is quite a range of businesses at different stages, but in each case, we can articulate where we are adding value and we see that as the reason we secured the deal.

Rudi Pattni: We look at distress, but we cover a wide range of other situations too. We will do corporate carve-outs of non-core divisions, back family-owned businesses that are capital constrained or acquire debt from banks that are trying to offload loans. We like anything that is off the beaten track where there is complexity, and there is an opportunity to deliver operational change and create value.

For us, special situations is a broad opportunity set and we cover these various sources of deal flow across three areas. One is traded credit, the second covers asset-backed situations where we have a team of real estate experts and, finally, we cover corporate turnarounds and transformations.

Jat Bains

Jat Bains: As we have heard from the managers at the table, the definition of special situations is very broad. The best way I can describe it is funds who are able to apply their creativity to offer bespoke solutions to difficult problems that an off-the-peg product from a mainstream institution just can't solve.

It is about being able to do deals in all sorts of different ways. That could be corporate carve-outs or investing in secondary debt markets then converting from that position to ownership via a restructuring. It could also include an acquisition of a business out of an insolvency process. Ultimately, it's about finding the right solution for the circumstances, and not being constrained by a one-size-fits-all approach.

Alex Cadwallader: To echo what people have already said, special situations covers anything that doesn't fit the norm. The market has become very sophisticated and there is a broad cluster of players providing different types of capital.

Where we come in is helping companies, lenders and business owners that have started to veer slightly off track find the right partner to work with. There is increasing demand for that. So many businesses just don't know what to do or where to go. We help them to understand what can and can't be done and support them through the process.

In addition, we recently have also been engaged by more traditional PE houses who wouldn't normally operate in this space as they spot various opportunities.

Given the types of deals you are all targeting, how does that inform cheque size and enterprise value for special situations managers?

Boszko: If you're thinking about special situations, it's primarily a mid-market opportunity set. There aren't a lot of mega-cap special situations, and there's a reason for that. Complex, difficult deals that would be off-putting to most when in a modest size, don't put people off when there's a vast amount of capital to be deployed, so the larger the deal the more likely it is to lean towards the mainstream.

We try to invest between £50m and £100m, but it is very hard to find good value situations where you can invest £50m or £100m on day one. We like situations that you can grow gradually into.

An example is a recent deal Alchemy did: we started with a cheque of £20m and grew it to £120m because the opportunity was there to continue to invest at a discount. But had we gone to write a cheque at £120m on day one, we'd have been in a full-blown mainstream auction. And that's not a special situation. When we wrote the £20m cheque there was no competition. We invested the following £100m through 26 bolt-ons and all of those were proprietary too.

Pattni: Zetland recently closed its second fund on €620m. We are looking to deploy somewhere between €10m and €60m per transaction and we can invest that by buying debt from lenders, providing debt to companies and buying companies with equity.

Like Alchemy, we like the mid-market. In the large-cap space, as soon as there is a hint of a deal it is all over the news wires, everyone knows about it. These processes take longer, there are often 10-20 lenders involved, a whole bunch of advisers and high costs. What this ultimately means is that it takes longer to get control and returns are lower. For us, being disciplined in the mid-market is a far better place to be, as we can find great off-market deals at attractive prices.

Southgate: Typically, we will be looking to invest equity cheques of between £15m to £50m, but there is a degree of flexibility to that if we find a situation that is an attractive fit for our investment strategy and operational capability.

Loizou: We have targeted the level below that, writing cheques in the £500,000 to £5m range. That was a deliberate move because there is a gap in the market at that smaller end and there is also not as much liquidity available for businesses of that size.

We have also found that there is much less distraction at the smaller end of the market, and we can get on

Thomas Boszko

Alex Cadwallader

with the operational and financial restructuring of the business by being able to focus on the operation and micro-managing the detail, rather than managing multiple stakeholders who may be dictating their own strategy as opposed to what the business actually needs.

In terms of enterprise value, like many things, it's in the eyes of the beholder but when a business is running out of cash, any value is largely contingent on the cash going rather than anything else.

Cadwallader: One of the interesting things we have observed is how corporates are actually morphing into pseudo-special-situations players. We have advised an increasing number of corporates who have seen an existing competitor in their market struggling and put in an offer to acquire the business with a view to executing a turnaround.

They will see that competitors are struggling and under-capitalised and then they will come to us to advise them on how to invest and restructure in the same way that a special situations firm would.

Loizou: Twenty years ago, you wouldn't have seen much trade buyer interest on deals where there was an element of underperformance or stress, but the landscape has changed. Trade buyers have become more sophisticated and understand the market. Even at the lower end of the spectrum, where we play, you can't assume that trade won't get there.

Pattni: An interesting development on the back of the point Alex outlined is that the increasing interest from SMEs in M&A is actually opening up more opportunities for us.

We have seen a number of ambitious family-owned businesses identify an attractive acquisition opportunity but need the capital to take advantage. They are not necessarily stressed or distressed, but they are capital constrained. They are looking for a partner with the deep pockets and expertise to support them through a deal and restructuring process. We have started to see more and more of these opportunities.

We have done a good job of outlining how the special situations community is different from the vanilla buyout market. As the macro-economic backdrop becomes more challenging, where does that leave managers with a special situations skillset?

Bains: The funnel of deals available to special situations investors is widening. In the last few years, businesses that have bumped up against covenants have been able to refinance their way out of difficulty. I'm not sure that is still an option now with rates being where they are. Businesses can't afford to cash pay interest above a certain level and there's a gap in the capital structure that will need to be met as a consequence of the reduction in the debt capacity of borrowers given higher rates.

I do think that will lead to deals where businesses are in difficulty. There's a potential opportunity to acquire the debt and do something more aggressive. Alternatively, some special situations firms could step in to plug a gap in the financial structure via a 'holdco PIK' type product. There is potentially also a competitive advantage for funds that can do this and are also able to offer a fixed-rate product in the market when there's so much uncertainty around interest rates.

Boszko: As Jat says, refinancing has been a 'get out' for businesses and lenders during the last 10 years. You've seen companies carrying massive leverage, trading poorly, hitting up against covenants, but able to refinance out of trouble in a matter of weeks. Not only that, but to do so at a lower cost! That dynamic has changed, which can only be good for the opportunity set for special situations investors.

If I look at what we do at Alchemy, we do credit, and we do control deals. On the credit side, I haven't seen the current level of dislocation in credit markets since the global financial crisis. The price of secondary debt has materially altered. Then on the control side, there are going to be fewer M&A processes, which plays to our capabilities because we like deals that are unstructured and not heavily intermediated. To date, the dislocation has been primarily driven by capital markets but we expect to see an impact on corporate profitability start to come through, which will drive restructuring opportunities for several years to come.

Southgate: I do sense that we now have an advantage over other investors in that you can't rely exclusively on leverage to generate returns anymore. You have to have that operational involvement and deliver more value than just a structure on the way in, which plays to our strengths.

Pattni: We also expect our pipeline to fill, but it is worth mentioning that we are still relatively early in the cycle. When the macro environment deteriorates, it impacts public markets and traded credits first and there is always a lag to private markets. You still see high price expectations from vendors, but credit is now drying up and profits are declining, so it will take a few months before the pressure really starts to build. Our expectation is that the most interesting opportunities are still to come to market. In this higher rate environment, one of the key triggers will be companies struggling to refinance maturing debt.

Loizou: My sense is that the approaching economic downturn is going to be a long haul. Having been in this space for 30 years, I am foreseeing certain characteristics of the 1990s recession as well as elements of the credit crunch. The full fallout from Covid is still to come due to widely available liquidity and/or creditor support or inaction; with the headwinds from inflation and rising interest rates, together with deteriorating market confidence, many more businesses will be exposed. I don't like to be pessimistic, but I do see challenging times ahead and this should be reflected in deal flow.

That said, I agree that there will be a lag before we see the volume of deal targets build, although this will accelerate with any further liquidity squeezes or more proactive stakeholder action.

As volume builds, the test remains to distinguish between those with solid business models where you can put money in with a good chance of making a good return, from those that would have never made it regardless.

Cadwallader: The restriction on creditor action through the pandemic and the fact that you could get some pretty chunky sums of cash into your business for two years through lockdowns basically shut down a number of deals that would normally have flowed through to the special situations ecosystem.

I agree that we haven't seen the full implications of the pandemic filter through. Then there are the current pressures building from interest rates and inflation. Put those two things together and we could easily see the number of opportunities for special situations houses double. Certainly, as an adviser, recent months have been some of the busiest we have had for a long, long time and I think we are only going to get busier.

What about the impact of the macro backdrop on your portfolios? What steps are you taking to create value in the portfolio when businesses are facing multiple headwinds?

Southgate: More than ever, the key thing is staying as close to the portfolio as you can and taking a granular approach to exactly what inflation, energy costs, supply chain issues and rising interest rates mean for portfolio company earnings and margins. You don't want to be hearing about stuff once a month at board meetings.

When things come up you want to be in a position to react quickly. It is also important not to forget about the upside. There will be opportunities to do bolt-ons and grow market share as competitors fall out of the market.

Finally, you have to be more thoughtful around exit plans. As has been mentioned, you are less likely to sell something through a traditional process. There has to be a much greater understanding of the end markets a company is operating in and what the strategic buyer options are, because they can come and go quickly.

Loizou: When it comes to the portfolio, the first area of focus is value preservation and that is all about the detail. We are very hands-on investors and look at things from the bottom up. So, when you are close to the detail, you see the opportunities and risks much earlier and you can be proactive and opportunistic.

Our current focus is more on looking at situations where we can invest now and create value in three to five years by doing the heavy lifting to increase that value through the holding period.

Pattni: The first thing for us is 'have you bought well?' - because if you bought badly then you are going to be in trouble no matter what steps you take post-deal. It all comes down to buying at good value.

On the operational side, we are focusing on all the things that we have been focused on through the last few years. We are hands-on investors and alongside the investment team we have an operational team. On the real estate side, for example, we have surveyors and architects. On the corporate side, we have turnaround managers and chief transformation officers. Having that expertise in-house really helps us to underwrite better, ensure we are protected on the downside and can focus on driving growth.

Boszko: Rudi makes an excellent point about buying well. This may sound a bit contrarian in an industry which likes to sell its value-creation credentials at an operating level, but the truth is that if you overpay on the way in, no amount of operating magic will make it a great deal. The first and critical step in value creation is buying well. If we can't capture some form of discount it's not for us.

Our focus is to bring capital to the right teams in difficult situations. When everything is getting squeezed, the businesses that do well are the ones that take advantage of that and consolidate their markets when the market is choppy.

Take Covid: 95% of management teams thought 'how do I weather this storm?'. But 5% asked how they could come out bigger, better and stronger. An example is a hotel group we had in the portfolio going into Covid. We went into lockdown with 10 sites. We came out with 31 sites and have already exited.

It is coming through strongly that investing well at entry is fundamental to creating value. Where do accelerated M&A processes fit into that? Will people around the table look at assets that are in accelerated M&A processes?

Southgate: We might take a look at something from time to time but never as a primary investment. Our focus is on spending time with the management team to understand the business and put a strategic plan in place to deliver value through the holding period. The timelines for accelerated M&A processes are so truncated that there just isn't the space to do that, so it is not something we would typically do.

That said, you do need to be able to move quickly in this market. It might not be an accelerated M&A, but there could be a liquidity issue on the horizon. With inflation and interest rates where they are, more quality businesses are going to need to do a transaction. We can move fast, but we do want at least a couple of weeks to sit with the team and really lay out a plan, understand the opportunity and build clarity around how we can help to deliver that.

Boszko: If you are an investor who has pursued an opportunity out of an accelerated M&A process during the last two years, there is a decent risk you acquired a pretty low-quality business. Unless it's a sector we already know very well, it's difficult for us to get excited about accelerated processes because you can't do thorough due diligence, yet they are probably the businesses that most require it!

Cadwallader: The time available for due diligence will come down to how far down the distressed spectrum a business is. The challenge in an accelerated auction is that it is hard to get the board to accept that a company is going to hit the wall, and that action has to be taken early.

As you move down the distress curve, the window for due diligence gets shorter and shorter. People can look at things quickly, and two weeks might be enough time for some buyers, but in reality, the pool of investors who are willing to write a cheque within two weeks of getting the phone call is very, very limited.

Bains: As Alex outlines, often the directors will have their head in the sand and will keep it there until they are forced to do a transaction.

If you have set up an off-market deal and there is no burning platform, why wouldn't you take as much time as you possibly can to make sure you are putting the right structure in place with the right planning?

But if you are in a situation where you are buying out of an accelerated M&A process or a pre-pack administration because things have been left very late, then it comes down to paying as little as possible as you don't have the time to look at the deal more carefully.

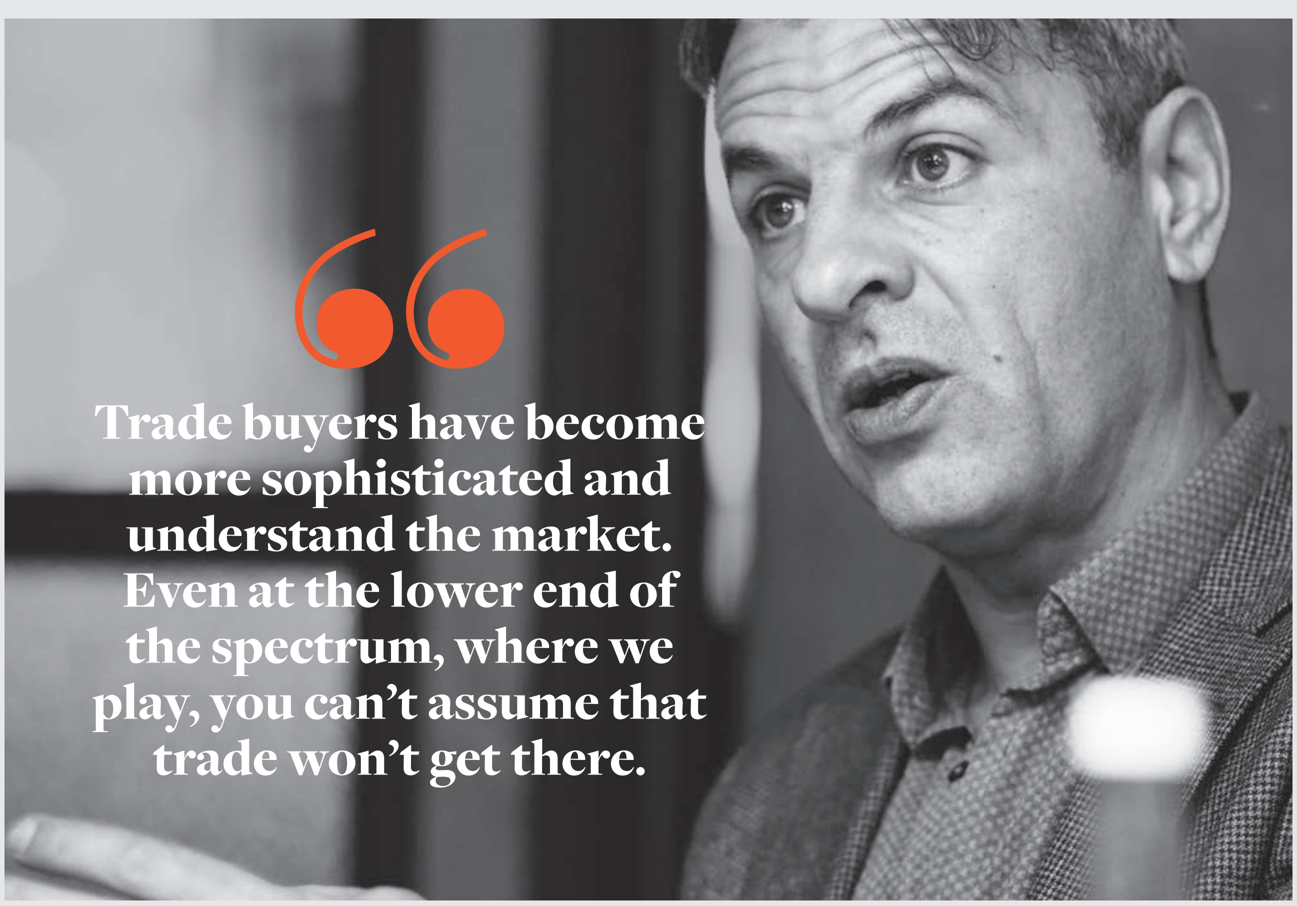
Pattni: We do look at accelerated M&A, but I have to say that the quality is often very low. These are businesses that have probably tried every option before they've gone to an accelerated M&A adviser. That might change and in a few months' time and you could see situations that are better, but typically you are dealing with companies that are going to run out of cash, haven't got much of a runway and are underperforming in a declining market. That is a lot of risk to be taking on.

Loizou: We will look at accelerated M&A processes, but it really only works when you are at the smaller end of the market. If we have to get six banks around the table and then five different sets of shareholders before we even start thinking about how to assess this business and lead a turnaround, it is impossible. If there are only a handful of stakeholders and we can get to understand the business, then it is possible. Ultimately, you're backing the people and the business, so it comes down to a judgment call and you've got to be in a position to make that call.

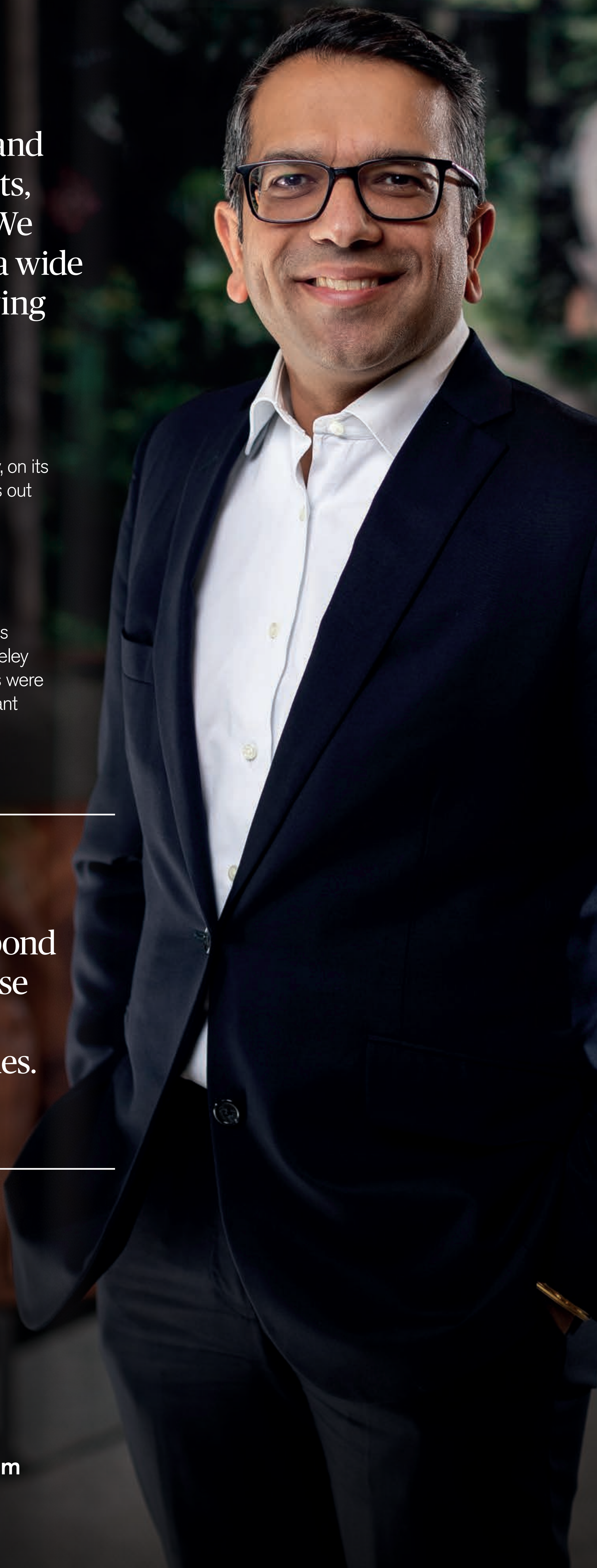
Looking at the investment process, how are special situations firms sourcing deals, conducting due diligence and manoeuvring to do deals outside of formal sales processes?

Bains: We have noticed a growing interest in buying assets after first acquiring the debt and are receiving instructions for these scenarios.

There is likely to be a pathway from acquisition of debt to ownership of an asset, but you do have to move very carefully to make sure that it is as certain as possible. Valuation is a key component. We have seen situations where debt has been acquired and the business has been pushed into administration with a view to facilitating an acquisition transaction. However, compliance with insolvency regulations then requires some form of market-testing process, and we've seen a bidder come out of left field to pay way more than the amount of the debt, which was bought out at a



Michael Loizou



discount. Your return comes back very quickly but what you haven't got is the business and the potential upside.

It may be surprising to some – other than lawyers – but you also find glitches in documents to be wary of. A personal favourite was one where we were advising on the company side where a couple of funds had bought up the debt and there was one lender who was looking to be more aggressive against our client in the way that I have just described. However, that lender hadn't quite clocked a particular nuance in the 'Majority Lender' definition where an instruction to enforce security required "over" 66.66% by value of lenders to give their approval. The other new lender in the syndicate didn't want to follow the same approach and held, to the penny, 33.33% of the debt. So, they had a block on any majority lender instruction to enforce security due to the use of the word "over", which turned out to be really, really important. Nothing happened for a year and a half due to the stalemate with the other lender, and the aggressive lender didn't get as good a deal as they had wanted.

Cadwallader: We have been advising on quite a few deals where buyers, often trading entities that aren't special situations investors, have gone to clearing banks, done an independent review on some loans, and said 'We think you are underwater. Here is 60% for your position.'

Six months later there is a bit of a process, they acquire the bit of the business that they like and make quite a nice return. There is opportunity there, but you have to be fully on top of the documentation and accept that you may miss out as there has to be an element of marketing and advertising if there is to be a sale, and someone else could come in.

Will Southgate

Southgate: There are a number of failed auction processes around and that is quite a rich pool of deals, particularly at this point in the cycle, as even when a process busts there is still a need for a transaction.

Once a deal has fallen out of a process, there is the space to spend time with the team, build a plan, and work out what we are actually getting behind. You can put the information memorandum to one side and build a proper plan that management actually believes in.

On the due diligence side, you can look at market trends and dynamics, but it is much more about the people you are backing. You are looking at how the team have dealt with the last three years. Is the team in that 5% that looked to take advantage of the situation rather than just batten down the hatches?

We also look closely at the processes within the business. Is the business set up properly? Are the processes suitable for managing a large organisation? Is there the ability to control the key areas of the business? A lack of controls and processes could prove to be an opportunity, but we need to identify the art of the possible upfront in order to assess the viability of the investment.

Boszko: When things are moving quickly, it is much more straightforward to assess the quality of the team if you know a sector.

We will invest in all industries, but we've done loads in financial services, hospitality and housebuilding; and it does help to sort the good from the bad when you know the sector.

On the process itself, we like bilaterals. One of the good things about a bilateral deal is that it allows lots of contact time with management. Bilateral deals exist because the vendor sees you as a good counterparty. They're prepared to invest the time and that gives you the time to get to know the team. And if you fall out with the team during the ups and downs of that process, then you probably shouldn't be backing them – that is some of the best diligence you can do.

Pattni: We see it as a broad opportunity set across sectors. We're seeing opportunities in three areas. One, we're seeing a lot of family-owned businesses coming through, because they lack deep pockets of capital, or they have a maturity coming up.

We are also seeing more carve-out opportunities. Larger conglomerates want to reduce debt and will look at selling non-core divisions to bring in cash and de-lever.

But I think the area that's most interesting concerns bank attitudes this time around.

In the last downturn, after the global financial crisis, most banks took the 'amend-and-extend' approach and they did it for a very long time. Now, the regulations around capital are much stricter, and banks are far better capitalised. That means banks have the ability to sell down their loans quicker and we expect that to create more deal flow.

Loizou: For us, regardless of how the opportunity comes to us, every deal comes down to the fundamentals of assessing cash, the people, any downside protection and the what-if scenarios, as well as robustly challenging the reason for the business to exist and how it compares to its peers.

We really get into the minutiae to assess where a business has been, where it is now and where we think it is going to go. In particular, if the first 12 months don't stack up then years two, three and four are going to be irrelevant, albeit with the understanding that often a turnaround may take a little longer and need a bit more cash than the base investment case.

Rudi Pattni