This year’s issue of Distressed Investing M&A sponsored by Schulte Roth & Zabel, in association with Mergermarket and Debtwire, examines the market for mergers and acquisitions for troubled assets in the US and abroad.

The current edition contains interviews with investment bankers, private equity practitioners and hedge fund managers. As distressed debt investors increasingly turn their eyes toward Europe, this report aims to gather insights on motivations and views on investing in the US and abroad.

Distressed M&A investors, who have previously mainly focused on distressed opportunities in the US, are now increasingly taking advantage of the historically low valuations of target firms in Europe. Also driving this trend is the fact that distressed prices in the US are going in the opposite direction — something that respondents in the report overwhelmingly agree upon. The improving economy and the more positive financing environment in the US are also pushing the amount of distressed assets down.

A majority of respondents claim that Europe will form part of their future distressed M&A investment strategies. An overwhelming number of them still cite troubles in the eurozone as a key consideration in their decision-making process. It appears that investors are very carefully treading European distressed waters.

By contrast, given that the US is viewed to be on the path to recovery, its economic health does not pose as much of a concern.

Evidently investors remain risk averse, and this shows in the factors they are looking out for and the strategies they employ. The lack of predictability in the companies they are investing in is considered a major deterrent by many. Additionally, the majority of the respondents are going for short-term investments for the quick turnaround, believing that they do not have the luxury of time when dealing with more troubled firms. They are also looking very closely at the operational risks that can easily hinder companies’ growth prospects.

The survey also examines specific issues affecting investments such as the US government’s role in reorganization sales and certain European regulatory issues. The myriad of topics covered by this edition is a reflection of the complex nature of distressed investing in a financial environment that generally remains challenged.

Methodology

In the third quarter of 2013, Schulte Roth & Zabel commissioned Mergermarket to interview investment bankers, private equity practitioners and hedge fund managers based in the US and Europe regarding their experience with distressed M&A activity and their expectations for the upcoming 12–24 months. All respondents are anonymous and results are presented in aggregate.
What do you expect will happen to the pricing of distressed assets and companies in the US over the next 12 months?

The majority of respondents expect distressed asset pricing to increase over the next 12 months. This year’s results show a stronger consensus than last year’s survey when the pool was split between respondents who were expecting an increase and those who anticipated no change in prices. An (albeit slowly) improving economy and financing environment are prominently cited. A US-based managing director explains: “Overall, the US is improving and debt levels are also coming down. So the level of distressed assets will also come down soon and that will trigger a price increase for the available distressed assets.”

What factors do you expect will have the greatest impact on the pricing of distressed assets and companies in the US over the next 12 months?

Interest rates will have the greatest influence on US distressed asset valuations, according to 68% of respondents. This is a marked change from last year when the availability of debt and the political climate were the top factors. Interest rates are remaining low atop the Federal Reserve’s decision to delay the tapering of its bond purchase program. Respondents say this has eased the situation for companies in distress and has forced potential buyers to raise offers.

“A steadily improving economy, coupled with a favorable financial environment, has resulted in a more limited range of distressed investment opportunities. Given the amount of money dedicated to this asset class, we expect prices to rise as a function of supply and demand.”

Adam C. Harris, Partner, Schulte Roth & Zabel
What do you expect will happen to the pricing of distressed assets and companies outside of the US over the next 12 months?

- Increase (56%)
- Decrease (48%)
- Remain the same (43%)
- Other (28%)

The market for distressed assets outside of the US is relatively unchanged. Respondents expectations are similarly split, as they were in last year’s survey, showing signs of stagnation in struggling economies. In the camp of respondents expecting prices to decrease, many express concerns surrounding the emerging markets and eurozone. One US-based private equity vice president explains: “The number of distressed assets is growing in Europe and Asia as the debt crises and emerging market slowdown have not improved.” Conversely, over a quarter of respondents expect pricing to remain unchanged primarily due to overall uncertainty. A UK-based investment banker says prices will increase because distressed companies are in a better position now than they were 12 months ago and notes a rising trend in valuations.

What factors do you expect will have the greatest impact on the pricing of distressed assets and companies outside of the US over the next 12 months?

- Availability of bank debt (56%)
- Interest rates (48%)
- Political climate (43%)
- Availability of other debt in capital markets (28%)

The political climate remains a top concern for 43% of respondents (56% last year), but debt availability and rising interest rates have emerged as the leading factors affecting distressed pricing outside of the US. While the factors are similar to those impacting US-based distressed investments, the results are not. UK banks are in a much weaker position compared to those in the US, respondents say. This factor limits the bargaining ability of distressed asset owners.

As one US-based private equity practitioner explains: “It will be difficult for the banks to sustain lending and provide debt unless the market improves. Soon interest rates will increase too, and this will greatly affect the pricing of distressed assets as companies will feel greater pressure to sell at lower prices.”
In which sector(s) do you expect to see the best opportunities for distressed M&A in the US?

Energy is the clear favorite to top distressed M&A in the US, according to a majority of respondents. The response is stronger in this edition of the survey, with 79% expecting the best opportunities in the US Energy sector (compared to 42% last year). Real Estate, Industrials and Chemicals, and Financial Services round out the most valuable industries to distressed investors.

The high volume of M&A activity in the Energy sector is a primary driver for many investors. Expectations for Energy asset returns are high and there is typically an abundance of cash-rich corporates seeking expansion that are ready to invest. “The exit process is much easier in Energy and Industrials,” a US-based private equity principal comments.

“The volume of distressed transactions in commercial real estate (CRE) will be enhanced over the next few years by the gap that will exist between the prolific amount of CRE mortgage loans that mature and the refinancing proceeds that borrowers will be able to obtain when these loans become due. Appraised values are still well below 2007/2008 levels and CRE mortgage loans are not at the loan-to-value ratio levels they were at five to six years ago.”

Jeffrey A. Lenobel, Partner, Schulte Roth & Zabel
In light of recent cases (e.g., Hawker Beechcraft), what do you expect to happen to US government’s (CFUIS) role in future 363 and reorganization sales?

The biggest deterrent to pursuing distressed assets is the lack of predictability in terms of investment scenarios, with 65% of respondents citing this factor. They do not consider the time and expenses needed in evaluating these investments as much of a hindrance to pursuing opportunities in the distressed sector.

The inability to compute asset values based on a definite event are currently impacting valuations. “Unpredictable scenarios should favor distressed investments, but they have now created a valuation gap that distressed investors are not comfortable with,” a Europe-based investment banker says.

“In addition to the impact on asset values, given the unpredictability of insolvency processes, competitive dynamics and post acquisition execution uncertainty, it is not surprising that distressed buyers focus on unpredictability — of course, as suggested, these uncertainties can create opportunities for the savvy buyer.”

David E. Rosewater, Partner, Schulte Roth & Zabel

A majority (52%) of respondents think that deals similar to Aerospace firm Hawker Beechcraft’s failed purchase by Chinese aircraft maker Superior Aviation Beijing Co. will not set a precedent in terms of the US Committee on Foreign Investment in the United States’ (CFIUS) role in reorganization sales.

The planned purchase fell through in October 2012, which resulted in Hawker emerging from bankruptcy by itself with significantly scaled-back operations. The deal’s collapse was reportedly due to complications with separating out Hawker’s commercial aircraft business from its defense and military unit, which would have been subject to CFIUS approval.

However, some respondents think that the government’s increased intervention will just further complicate things. “As the government intervention increases, the bankruptcy processes will not be the same and will be more complicated,” a Europe-based investment banker says.
Repeating last year’s results, balance sheet restructurings remain the top targets for those purchasing distressed companies, according to a majority 77% of respondents (stronger than last year’s 65%).

Balance sheet restructuring situations are popular for investors that have long- and short-term strategies. These opportunities will continue to increase as distressed companies seek to divest non-core assets to boost both strategic and financial flexibility. A private equity practitioner based in France explains: “These assets require less attention and little modification, while providing us with good returns.”

“Investing in balance sheet restructuring gives more hope for a turnaround and realizing better value when exiting,” says a European investment banker.

“The key to a successful balance sheet restructuring is an understanding of the needs and motivations of the various stakeholders in the capital structure, and at the company, in order to quickly identify and implement plans to insure both short-term stability to create the restructuring opportunity and long-term value creation, in each case in a manner that will be bought into by these critical stakeholders instead of leading to a destructive fight over available resources.”

David E. Rosewater, Partner, Schulte Roth & Zabel
What type of strategy do you employ for your targeted distressed assets and companies?

In last year’s survey results, 52% of respondents chose both short- and long-term strategies. This year tells a different story, as only 37% of respondents opt for long-term strategies. Increasing from the last survey, 79% of respondents are adopting short-term strategies while break-up distressed debt strategies have entered the mix, with a comparatively high percentage of respondents choosing this option.

Investors are clearly risk averse; the results show that many respondents do not want to commit to investments for the long haul. “Distressed and financially troubled companies have a host of significant risks and potential problems that are not typically found in the acquisition of a healthy, solvent company. Thus, in distressed investments, we do not have the leisure to make long-term investments,” says a hedge fund investor based in the US.

Investing for the short-term also offers a quick turnaround. As an Italy-based partner says: “We are splitting our investments accordingly in order to minimize risk and curtail losses to stay active in the market.” A US-based private equity executive adds: “Our goal is to invest for a short-term, as it gives immediate results and fulfills our pre-decided targets.”

“The increased focus on short-term strategies seems to signal a preference to invest in the more liquid names. However, in Europe in particular, liquid names are crowded and better opportunities may be found off the beaten track.”

Peter J.M. Declercq, Partner, Schulte Roth & Zabel
A majority 64% of respondents have not participated in club deals, which are distressed-for-control deals formed among a bigger group of investors. Of the 36% who have, there was a split of respondents between those that formed the group before and those that did so after the investment. Respondents who took part in these deals cite factors such as governance, understanding the capital structure, structuring the transaction as well as the internal requirements of various investors as the biggest hindrances to these transactions.

“Certain types of acquisitions, such as acquisitions of portfolios of distressed loans, are natural fits for club deals as the investors get the benefit of being able to take down larger portfolios and to agree upon a work out strategy during the course of portfolio due diligence. In our experience in these settings, while governance and structuring issues require attention, they are generally readily resolvable. Debt-for-equity swaps resulting in control of operating businesses may pose more difficult issues, as investors may have significantly different costs bases and return expectations, leading to complex negotiations over governance and exit rights.”

Stuart D. Freedman, Partner, Schulte Roth & Zabel
What level of interest do you have in distressed municipal debt in the US?

- **No interest**: 65%
- **Moderate interest**: 27%
- **Significant interest**: 8%

Investing in US distressed municipal debt is not very popular among the respondent pool as 65% of them say that they have no interest in these opportunities. Despite the majority’s refusal to engage in this type of investment, 27% express a moderate interest and 8% say they have a significant interest in these distressed assets.

A US-based hedge fund investor cites how hard it is to get out of these investments as the reason why he is not enthusiastic about buying this type of debt. He continues: “Investing in municipal debt is complicated and finding an exit is very difficult.”

“It is understandable that many investors are very cautious about investing in distressed municipal securities given the political nature of the process and the limited authority of bankruptcy judges in Chapter 9 cases. Nevertheless, while Detroit is an extreme case, the factors that led to its bankruptcy — underfunded pension plans, surging health care costs for an aging or retired work force, the funding of cash flow shortfalls through debt — are prevalent in state and local governments and more municipal restructurings are inevitable. As these cases proliferate, we anticipate that distressed investors will get increasingly accustomed to the process and will begin to more actively participate.”

*Stuart D. Freedman, Partner, Schulte Roth & Zabel*
Study findings

Which factor is most significant in evaluating a distressed municipal opportunity?

In looking at distressed municipal investments, the political nature of the process — as opposed to one being mainly based on economic considerations — is the biggest factor for the plurality (39%) of respondents. Bankruptcy also emerges as a major influence in investors' comfort levels when it comes to municipal distressed debt investments. Not only did the second highest percentage of respondents (27%) cite the priority of claims as their biggest concern, but 16% say that the limited powers of the bankruptcy judge and 13% note the limited precedent for Chapter 9 cases as forming a major part of their decision making. Only 5% of respondents name apprehensions about publicity as their main driver when they make this type of investment.

Which factor will have the biggest impact on your decisions to invest in distressed assets and companies?

Respondents chose operational risks as the biggest factor affecting their distressed investment choices in both the US and globally, similar to last year’s results. Regulatory constraints are more of an issue for non-US targets, with 23% of respondents choosing this as a factor in their investment decisions.

Last year, a majority (63%) of respondents chose operational risks as the factor with the largest influence on their decisions to invest.

Investors are mainly looking for targets with growth potential that operational risk can curtail. A US-based investment banker says: “Operational risk such as rising labor costs and low synergies will further lead companies to a downturn.”
Which current economic issue will have the biggest impact on your distressed M&A decision-making over the next 12 months?

- Eurozone crisis: 36%
- Growth slowdown in emerging markets: 16%
- Hyperinflation in emerging markets: 15%
- US monetary policy: 7%
- Chinese credit environment: 15%

Troubles in Europe are clearly still in the minds of many distressed investors. Similar to last year’s results, 36% of respondents (compared to 34% last year) cite the eurozone crisis as the leading economic issue that impacts their decisions when it comes to investing in distressed companies. However, a larger portion (39%) of respondents last year were concerned about US economic recovery. With the US economy viewed to be on the mend this year, only 15% of respondents are concerned about the US monetary policy in the current survey.

“The most significant macroeconomic issues affecting funds’ approach to distressed investing into Europe appear to be concern about when European interest rates will increase, and by how much and how quickly. Many European companies are still highly leveraged and so a hike in interest rates, which seems inevitable, would significantly affect their ability to service existing debt and ongoing ability to source working capital — let alone growth capital. Also of indirect concern seems to be the reduction in growth in, and therefore in demand from, Asia (especially China).”

Sonya Van de Graaff, Partner, Schulte Roth & Zabel
Distressed Investing M&A

Study findings

How important will Europe be to your distressed M&A investing strategy?

- Very important: 39%
- Moderately important: 21%
- Not important: 40%

Has the EU’s AIFMD “asset stripping rules” affected your distressed investment strategy in the EU?

- Yes: 32%
- No: 68%

Seeking opportunities in Europe plays a significant factor in investors’ distressed M&A strategies. An almost equally split portion of the respondents consider the region to be either very or moderately important in formulating their investment goals. “European assets are very attractive and their valuations are low for us to make new investments and diversify our investments,” a US-based investment banker says.

On the other hand, some say opportunities might be diminishing in the region. “The European market is at a standstill and the market does not offer a lot of distressed opportunities as European banks are not selling a lot of distressed assets. We would rather focus on other regions and make good use of those opportunities,” a Europe-based investment banker says.

”Despite the apparent reluctance of European banks to sell distressed assets into the secondary market, opportunities still exist and can provide significant returns for investors who are willing to dedicate the resources to identify the opportunities and who have the patience to realize on them.”

Adam C. Harris, Partner, Schulte Roth & Zabel

The European Union’s Alternative Investment Fund Managers Directive’s (AIFMD) “asset stripping rules” limits how much capital a general partner can get in the initial two years of ownership of an investment. Only 32% of distressed investors say that these rules will impact their investment strategy in the region.

A director in an investment bank in the US is in a wait-and-see mode. “We might scale back our investments if it proves to be worse. So far, we have not taken it seriously.”

The rules might create a problem for private equity firms in terms of data reporting. “The reporting obligations have created a significant challenge to our investment strategies and processes,” a Europe-based private equity practitioner says.
What are your expectations on the state of the EU over the next 12 months?

With Europe playing a key role in many distressed debt investors’ strategies, their expectations regarding the region will impact their future choices. The survey shows that respondents are almost split between those who are optimistic that conditions in Europe are going to improve and those who think they will simply remain the same.

“There is no doubt that the situation in Europe is improving. The debt crisis is slowly subsiding and there is no threat of a European Union break-up now,” a US-based investment banker says.

On the opposite side of the spectrum is the view that the debt crisis will deteriorate further. “It is very likely that the situation in the European Union will get worse. As the debt crisis worsens and new countries demand for bailout, soon the default threat will bring the European economy into recession again,” an investment banker in France says.

“The survey couldn’t show more clearly how much views on Europe differ. So there is uncertainty about Europe, uncertainty comes together with risk, shouldn’t that create opportunities?”

Peter J.M. Declercq, Partner, Schulte Roth & Zabel
Study findings

What impact has the ECB’s response to the Cypriot financial crisis in requiring converting consumer debt to capital affected the European distressed investing mentality?

The European Central Bank’s (ECB) response to the Cypriot financial crisis does not create a strong impetus to invest in distressed assets in the region. Forty-seven percent of respondents say the ECB’s decision to require the conversion of consumer debt into capital has no impact on their investment strategy.

A US investment banker views the effects of the ECB’s move as localized. “The European Central Bank’s response to the Cypriot financial crisis is only for Cyprus. It considers Cyprus’ financial and debt position and will not have the same impact for all the countries.”

“The ECB’s response to the Cypriot crisis surprisingly seems to have had little impact on investors’ appetite for exposure to European financial institution debt, at least in the non-fringe countries. This is perhaps because investors perceive Cyprus to be a contained and extreme situation which is unlikely to be repeated in the main European jurisdictions. Apart from those few worst affected, all seems to have been forgiven.”

Sonya Van de Graaff, Partner, Schulte Roth & Zabel
DISTRESSED INVESTING COMES IN ALL SHAPES AND SIZES

Representative distressed investing transactions include:

- **ICBC**
  - Broadcast Holdings, Inc.
  - Acquisition

- **Precision Partners**
  - Foreclosure on Equity Interests

- **Speymill**
  - Acquisition and Debt Restructuring

- **DRI Corporation**
  - Acquisition

- **Phoenix Technologies**
  - Debt Restructuring

- **WaMu**
  - Exit Financing

- **REAL MEX**
  - Acquisition

- **Chef Solutions**
  - Debt Financing

- **Local Insight Media**
  - Exit Financing

- **Deb**
  - Acquisition

- **Innkeepers USA**
  - Acquisition

- **Digital Domain**
  - Reorganization and Auction

- **Fiddler’s Creek**
  - Reorganization

- **Stormcat Energy Corporation**
  - Exit Financing

- **Orleans**
  - Reorganization

- **Angiotech**
  - Debt Financing

- **Brunschiwig & Fils**
  - Acquisition

- **Riviera Casino & Hotel**
  - Reorganization and Acquisition

- **Caritas**
  - Acquisition
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As one of the leading law firms serving the financial services industry on both sides of the Atlantic, SRZ has the experience and expertise to provide clients with comprehensive representation and advice in all manners of large and complex distressed situations across a wide range of industries and opportunities.

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