



## **Today's Distressed Buyer Could be Tomorrow's Forced Seller**

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As the threat of a recession looms and credit markets continue to tighten, the future looks increasingly promising for investors planning to take advantage of distressed and turnaround opportunities. Not surprisingly, the market has been awash with news of new funds gearing themselves up to take advantage of the large capital inflows expected to find its way into distressed investment strategies.

GLG Partners, PIMCO, Renaissance Investment Management, Pequot Capital Partners, PSource Capital and Goldman Sachs, are just a few names that have either launched or hinted at launching separate funds dedicated to distressed investing.

According to a survey carried out by Lipper Inc earlier in the year, out of 41 hedge fund managers managing some US\$227 billion, over 20% believe that distressed investing will top the league tables over the next 12 months. This figure is likely to be higher today given where we are in the credit cycle.

But as managers jump onto the distressed bandwagon to capitalise on its promise of strong inflows, investors need to ensure their assets are placed with the most able of managers. Even if a manager has a proven record in broader fixed income or equity investing, it does not necessarily translate into the required know-how for distressed investing.

Distressed investing throws up a number of challenges for the unprepared; it requires specific expertise including knowledge of bankruptcy law, negotiations and workouts, valuation of a broad range of securities, access to additional capital, and a strong network of contacts. A reputation for winning over management and experience in trading through crisis periods are also pre-requisites. The distressed investor's skill-set is further tested when the investment remit is extended beyond the home market and into new regions.

### **Profiting from Financial Innovation in a Global Environment**

The advent of globalisation means there are very few corporations today that operate solely as domestic entities. Many sizeable companies will have international assets and operations. Under such circumstances, global experience and perspective will significantly affect the success of a fund and prove critical in tackling the wave of restructurings the market is anticipating following the global liquidity freeze. However, there is still just a handful of managers that have the expertise and experience to deal with such far-reaching investment mandates.

Global mandates offer investors greater access to opportunities. Funds with a country or region-specific mandate would have been unable to take advantage of all the opportunities that were made available in recent years. The aftermath of the Asian crisis, the Russian default in 1998 and the Argentine moratorium in 2001, all provided a wealth of undervalued assets for the distressed investor to benefit from. Although buoyant economic conditions and the wide availability of credit during the last couple of years have reduced the scope for such strategies, the picture is once again changing, and possibly in a dramatic way.

The onset of new opportunities is great news for the strategy but in the interest of generating risk-adjusted returns, investors should seek out experienced managers with strong local contacts and on-the-ground investment teams. A good grasp of the local markets and their respective peculiarities will allow a fund to identify overlooked opportunities while remaining fully conversant with the associated risks.

But managing a global distressed opportunities mandate is not just about proficiency. In some instances managers are expected to produce novice responses to unprecedented problems, especially in the context of a legal framework. When Essar Steel, a large Indian company defaulted on its debt, Argo was not prepared to litigate in the local courts as it felt its rights might be difficult to enforce. Instead, Argo sued for repayment through the English courts – and won – in a landmark case which helped establish hedge funds as formidable players in the loan market<sup>1</sup>.

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<sup>1</sup> The Argo Fund Ltd v Essar Steel Ltd (2006) EWCA Civ 241.



Another issue investors have to contend with is the strategy's demand/supply disequilibrium, which is often accentuated when investment is concentrated in one region or market. While the supply of stressed assets has increased since the beginning of the year and with the present economic situation likely to fuel supply further, the absence of any meaningful defaults up until very recently means many investors have been playing a waiting game by sitting on cash or deploying capital to transactions that have either failed to result in a default or have taken too long to reach one. Planning successful entry and exit strategies is a manager skill often overlooked in the selection process.

Investors have to plan their entries early enough in order to benefit from any eventual default but not so early that they can't stomach the ride to the top. This is a skill requirement especially relevant to the current market where spreads have widened to levels that do not represent where we are in the default cycle. An experienced investor, however, will have the ability to time opportunities accurately and invest in stressed situations in lieu of distressed opportunities. This entails investing in companies that have sound underlying assets and cash flow potential but face reversible liquidity issues.

As the global credit crunch continues to develop and the space becomes increasingly saturated, investors will have to turn to smaller transactions in overlooked markets and rely on financial engineering to enhance returns. It will be interesting to see how the slew of newcomers will rise to such a challenge, especially when liquidity dries up in loans or bonds in complex structures and expert assessment of transaction documents is required.