What is Distress Investing?

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Distress Investing vs. other forms of investing?

- Distress Investing is part of the broader discipline of Fundamental Finance, which encompasses:

  - Value Investing (passive investing in common stocks)
  - Control Investing (active investing in securities with a view of obtaining control or elements of control over the business).
  - Distress Investing (active or passive investing in credit instruments with a view of obtaining control, elements of control over the business, or with the view of participating in reorganizations or benefiting from credit enhancements)

What is Distress Investing?

- First: INVESTING
  - An investing operation is one which, after thorough analysis, both quantitative and qualitative, promises safety of principal and an adequate return. Operations not satisfying these conditions are speculative.
- Second: DISTRESS INVESTING
  - Involves the identification and purchase of credit instruments of companies experiencing financial distress at substantial discounts (30%) from their potential workout values.
  - This is a very broad definition, which I will narrow down once we talk about the different distress investing businesses.

What is financial distress?

- It is either the actual or perceived inability of a company to meet its financial obligations either soon or in the near-future.

What do we mean by "obligations"?

- From the accounting point of view they are the <u>company's liabilities</u>.
- From the point of view of those who lent or provided a service to the company they are their “claims” on the paying ability of the company.
- Company liabilities = third party claims

An aside on liabilities

- Definition of liability: legal obligations of the company that arise in the course of business operations. These obligations of the company or claims from third parties, must be settled.
  - Examples: accrued wages, taxes payable, payables, short-term debt, long-term debt, etc.

An aside on liabilities

- Definition of Debt: a legal obligation of the company to repay money that was borrowed from another party. Debt is a liability in that it arises in the course of business and must be settled, but it is a distinct liability.

- Not all liabilities are debt.

- Debt also represents a claim on the company's assets. Very important to think about claims in reorganizations.

Creditworthiness

- It is a relative concept. Relative to what? Relative to the amount of liabilities (obligations) that a company has.
- We think of creditworthiness in terms of an entity that is very creditworthy or not very creditworthy.
- Let me explain. A company is very creditworthy if the likelihood of it not paying its liabilities (obligations) is zero or almost zero. Notice that a company can be very creditworthy if it just does not have any liabilities or if it does, they are very small relative to its ability to pay.

The notion of solvency and how it affects the valuation of liabilities

- Definition of solvency:
  - A company is solvent if it can pay its bills as they come due (liquidity definition) and/or;
  - There is enough asset value to “cover” all of its liabilities adequately (the balance sheet definition)
- We shall deem a company “amply” solvent if both conditions are met without any reasonable doubt and under potentially large stresses.
- When a company is amply solvent, we shall value its liabilities at 100% of the claim they represent.

Solvency and valuation of liabilities

- Example:
  - If a company liabilities are $100 million, annual service of liabilities is $10 million, annual free cash flow (FCF) is $50 million and asset values are $1 billion, we shall value liabilities at 100% of claim or $100 million.
  - We can go over the same exercise with debt and conclude that for amply solvent companies, the value of its debt will be 100% of par value.
  - A simple way of thinking about this is if XYZ owes you $1,000 and XYZ is amply solvent, the value of your claim is $1,000 because you can extract $1,000 from XYZ. Notice that the valuation does not depend on XYZ willingness to pay, only on its ability to pay.

Why creditworthiness matter in investing operations?

- In value investing, we are passive buyers of common stocks of very creditworthy companies. Why?
- Because if the company were to become “insolvent”, the value of the assets may not cover all liabilities and that will render the common stock worthless.

Representing a business to understand distress

- We need to develop a simple framework for the understanding of distress and the valuation of a business.
- We are going to use the Balance Sheet as this simple representation.

Simple representation of a company

- The balance sheet is a static representation of:
  - What a business uses to execute its business (the assets).
  - How the use of such assets is financed (liabilities and equity).
  - Provides specific appraisals of value both for assets and liabilities. Quantitative aspect.

Simple representation of a company

- The balance sheet does not tell you anything about:
  - How the business works (business model);
  - Whether it is managed competently or not (quality of management);
  - Whether control groups are shareholder friendly or not (who controls the company);
  - Whether the company faces large amounts of off-balance sheet liabilities or not (safety);
  - No detailed description of the assets or liabilities (quality of resources)
  - These are the qualitative factors that also need to be thoroughly analyzed.

Simple representation of a company

- The previous qualitative factors can be as important and often are more important than the monetary appraisals on the balance sheet.

- We shall first focus on the quantitative aspect. Why? Because:
  - It is available to us for analysis in disclosures made by public companies as required by Securities Laws.
  - Provides a starting point for looking at the resources of the business.
  - Gives us some idea of "safety of the issuer"; i.e. its "creditworthiness".

Simple representation of a company

- Depending on how the values for assets and liabilities on the balance sheet are calculated, we have different representations of "reality":

  - GAAP or Accounting representation: when the the numbers are produced using GAAP rules. In the US, GAAP rules are used in the disclosure of financial information. So the financial information you find in 10K reports is prepared according to GAAP.

Simple representation of a company

- "Public Market" representation: If we use public market values for the "long-term debt" and "equity" components then:

- The public market value of the long-term debt (net of cash) and equity of a company represents the public market valuation of the enterprise, also known as Enterprise Value or EV.

- The important thing to remember is that EV is a "public market valuation" of the going-concern value of the assets of a company.

Example: Hertz Global Holdings

- Using the GAAP representation of Hertz Global Holdings, Inc. the “book” value of its assets on Dec 31, 2019 is? Is it solvent on an asset coverage basis?
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- Using the public market valuation, Hertz Global Holdings, Inc. Enterprise Value or EV on Dec 31, 2019 is? Is it solvent on an EV coverage basis?
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One simple rule

- When the market determined value of the assets is lower than the total liabilities of the company
- Start suspecting you may have potential financial distress…
- There are many qualifications, but you can use this rule to screen for potentially distressed situations.

Liquidation vs. reorganization values?

- If the main purpose of the assets is to produce income over time, neither their book value nor their liquidation value may be very useful values. Hertz case.
- Book values or "liquidation values" may be very distorted measures of their "reorganization" values.
- If you are going to reorganize a company, what you care about is "going concern value" or what EV tells you.

In passive or control investing in solvent companies we appraise the value of common stock by…

- Appraising the value of the assets
- Appraising the value of liabilities
- Subtracting the value of liabilities from the value of the assets to get our estimate of the value of equity.

$$V(\text{equity}) = V(\text{assets}) - V(\text{liabilities})$$

In Distress…

- We know V(Liabilities) is greater than V(Assets) which means, in general, Equity gets wiped out.
- So we invest in “liabilities” or “contractual claims” (debt, loans, etc.) NOT equity. Why? Equity is worthless.
- What are the steps:
  1. Identify the different investable claims. **Learn the Capitalization**
  2. Understand what their priority of payment will likely be relative to the other claims. **Learn to read indentures and credit agreements**
  3. Value the assets of the estate. **Learn to value assets**
  4. Based on the possible purchase prices for different claims, which ones stand to make the largest recovery. **Learn about the different risks in distress**