

Distress investing: Debt could magnify risks of market dislocations

In considering distressed opportunities, investors will need to discern whether companies are permanently impaired or can be turned around. BY SEBASTIEN CANDERLE

WITH recession expected in many economies, distressed situations will be an important source of deals for prospective investors. What will matter is whether the targets are permanently impaired or can be turned around.

Two real-life scenarios from the debt bubble of the early aughts and the ensuing credit crunch provide helpful guidance.

Cyclical volatility or dislocation

UK investment firm Candover bought hygienic products producer Ontex for one billion euros (\$1.4 billion), or 8.1 times earnings before interest, taxes, depreciation and amortisation (Ebitda), in 2002. The debt package, comprising senior and mezzanine loans, totalled six times earnings.

Despite strong economic growth, Ontex's Ebitda margin dropped from 17 per cent to 12 per cent within three years, due largely to rising oil prices. Oil is a key ingredient of the absorbent powder in Ontex's diapers.

The company could not pass the costs on to customers because their products are distributed by Walmart, Tesco, and other price setters with oligopolistic positions. Unable to ship directly to consumers, and as a private-label manufacturer without a dominant brand, Ontex is a price-taker.

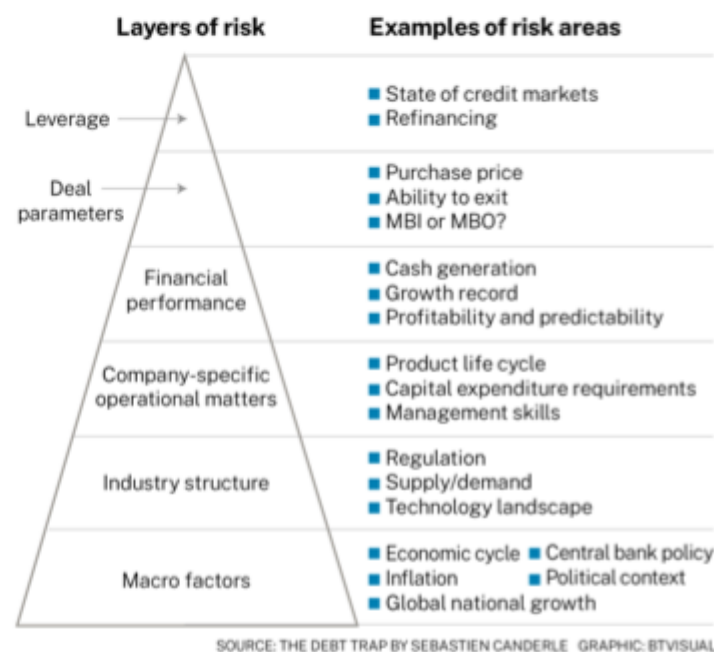
But this was not a new development. In the past, Ontex's profitability had slumped whenever oil prices spiked. Still, excessive leverage did not make Ontex a bad investment. Rather, its debt package had a rigid structure with a set repayment schedule and strict interest margins. Market cyclicality, however, demanded more agile lending terms.

When TPG and Goldman Sachs purchased Ontex from Candover in 2010, covenant-light – or cov-lite – loans had become plain-vanilla instruments that gave borrowers the flexibility to adapt to such economic dislocation. That was what Ontex needed. As crude oil prices rose more than 160 per cent between early 2016 and late 2018, its Ebitda margins slipped from 12.5 per cent to 10.2 per cent.

Structural change or disruption

But there is another kind of distress scenario where market shifts are more extensive. The private equity (PE) firm Terra Firma executed a leveraged buyout (LBO) of the sto-

Risks pyramid structure



ried record label EMI Music, valued at £4.2 billion (\$7 billion), in 2007.

Unlike Ontex's debt structure, EMI's featured all the tricks in the PE toolkit, including a gracious cov-lite package with unlimited rights to equity cures and abundant Ebitda adjustments. Yet the deal proved disastrous.

The Internet revolution had shaken up the recording industry and for years EMI had struggled to adapt. To turn the company's fortunes around, Terra Firma planned to raise capital in the bond markets and secure it against the recurring cash flows of EMI's music catalogues. It also hoped to restore margins by cutting the workforce, outsourcing some activities, renegotiating artist contracts, rationalising the property portfolio and shrinking expense accounts.

Terra Firma likewise had its eye on new revenue streams – concerts, online services, merchandising and artist management – and sought to onboard new tech talent to implement the digital transition.

Yet despite multiple equity cures, EMI's sole lender, Citigroup, took it over in 2011 and hastily sold it off piecemeal. EMI, it turned out, was not experiencing a brief dislocation but a permanent disruption.

Due to online piracy, US compact disc (CD) shipments collapsed by two-fifths between 1999 and 2007. In the fiscal quarter preceding the buyout, EMI CD sales had

fallen by 20 per cent. Paying over 18 times trailing Ebitda for such a business proved unwise.

Adding leverage to a business facing such severe challenges was not advisable. EMI's net debt-to-Ebitda ratio remained above eight throughout the LBO period. The turnaround strategy never improved profitability enough to keep up with the steepening debt commitments.

The risks pyramid

EMI's experience shows how significant execution risk does not mix well with leverage amid a major restructuring. Cost cuts, asset disposals, contract renegotiations, refinancing, securitisations, and other conventional strategic and operating tools are no match for disruptive innovation.

That is why dislocation cannot be confused with disruption. The former is temporary and cyclical – it is manageable, even when it is recurrent by nature. Disruption, by contrast, is permanent and structural; for many businesses, it is a terminal threat.

Whereas dislocation requires adaptation and can be tackled by progressively altering a firm's strategy, disruption calls for reinvention, in which case a firm must re-engineer its operations. In such a fundamental scenario, the extensive use of debt is a very bad idea.

The risks pyramid visualises



Markets are dynamic. Macroeconomic turbulence and sociodemographic transitions can transform value plays into distressed assets. PHOTO: PIXABAY

this dilemma. Leverage sits atop many other risk categories. Companies have little room for financial risk – that is, debt – when facing market, operational and strategic headwinds. Under the weight of so much uncertainty, additional leverage can crush any corporate borrower.

The great glut

The unprecedented monetary stimulus in the aftermath of the global financial crisis (GFC) and during the pandemic ought to provide fertile ground for distress investing in the years ahead. Excess capital is frequently misallocated and leads to wasteful and ill-advised investments. It can kill returns.

Debt-bloated buyouts and overcapitalised startups are plentiful. But thanks to capital accumulation – US\$12 trillion of assets, including US\$3 trillion in dry powder – private markets may take a long time to adjust.

Following its March 2000 peak, the Nasdaq did not hit bottom until October 2002, and many dotcoms were still reeling when the GFC broke out. Today's private market shake-out may entail a similarly extended wait. PE and venture capital (VC) firms would prefer to hold on to impaired assets and keep earning fees rather than acknowledge the true state of their portfolios. Yet with recent bank collapses, the bridge financing that startups need to postpone any down round may dry up.

With their avid use of leverage, financial sponsors can still manage downside risks by negotiating

looser loan agreements and massaging numbers. Too much debt, however, can leave borrowers in a zombie state and make it harder for distress investors to step in. They might have to wait it out like Citi did amid EMI's inescapable disintegration in the wake of the GFC.

Dealing with market fracture

The financialisation of the markets raises a broader question: Does the growing debt overhang represent temporary turbulence, or a more radical discontinuity of modern economies?

The cost of a stretched balance sheet varies. Businesses cut investments; credit downgrades drag down stock returns; corporate executives seek alternative employment. Workers become uncooperative; suppliers drive tougher payment terms; clients switch to more reliable service providers; lenders raise the cost of debt or cut off access to credit altogether.

Even if endemic overleverage does not lead to widespread economic destruction, dislocation-prone industries could eventually become more permanently impaired.

Today's elevated inflation, for instance, could be considered just a minor hurdle for Ontex: As oil prices rose from less than US\$20 per barrel in 2020 to more than US\$120 two years later, the company's Ebitda margins tumbled from 11.2 per cent in 2020 to 5.5 per cent last year. Leverage now exceeds six times earnings, as in the days of the Candover LBO 20 years ago, when the Ebitda margin stood at 17 per cent.

But the Covid-19 pandemic has provoked demographic instability that could have far deeper ramifications for companies such as Ontex, which serves both the young and the elderly by selling diapers and incontinence products. Excess mortality has jumped in Europe and the US. This trend may be short-lived, but it follows stalling life expectancy in the US, European Union, England and Wales. The benefits of improved sanitation and public health have, perhaps momentarily, reached their limits.

The pandemic also catalysed another demographic evolution. Rather than an anticipated Covid-19 baby boom, lockdowns may have contributed to a "baby bust". While post-Covid economic stimulus helped birth rates rebound to pre-pandemic levels, demographic challenges remain.

In struggling economies such as Japan, Spain and Italy, declining fertility rates have long been the norm. But if shifting birth rates and flatlining life expectancy become further entrenched, they would not represent mere dislocations, such as periodic oil price spikes, but more acute market fractures affecting long-term demand for hygienic products.

The ramifications would clearly extend far beyond any one company or sector. Therein lies the trouble with investing. Markets are dynamic. Macroeconomic turbulence and sociodemographic transitions can transform value plays into distressed assets.

The writer is a private capital adviser.