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Distress investing: Crime scene investigation

The ultimate murder weapon is almost always leverage and financial sponsors the main culprits

IN THE underbelly of private markets lies the main culprit behind corporate failures: defective capital structuring.

Frequently the result of human failings, the widespread overcapitalisation of startups and quasi-universal overleveraging of buyouts have led to a deep-seated zombification of private markets.

With interest rates remaining at or near 20-year highs, ballooning interest expenses will continue to cause cash-flow incontinence. A whole new landscape for private capital fund managers and their portfolios could shape out.

Thames Water's sewage treatment works in west London. In cases where debt-ridden companies provide vital services, governments usually have to step in, as the UK authorities are expected to do in a potential renationalisation of Thames Water. PHOTO: REUTERS

Forensics in private markets

In a segment of the economy notorious for its opacity, distressed scenarios are particularly poorly analysed. Modern investigative techniques applied by turnaround consultants and court-appointed administrators rarely gather sufficient proof of corporate responsibility. This is surprising because Locard's exchange principle regarding forensic evidence applies to most instances of mismanagement.

While market disruption can be deemed a natural cause of death, especially among startups, no such justification can be used to describe the putrefaction of debt-bloated buyouts.

Naturally, failure is part of private markets' DNA. About one in six leveraged buyouts (LBOs) fails to deliver its financial sponsors' hurdle rates, and seasoned venture capitalists (VCs) know that seven out of 10 startups they back will lose money. But these are averages over the economic cycle. In a recession, more than half of LBO exits could be bankruptcies or insolvencies as happened in 2009, according to data compiled by the United Kingdom's Centre for Management Buyout Research at that time. And most dotcoms ran out of money or went through a forced sale process during the 2000-2005 market correction.

Live, die, repeat

Some sectors of the economy regularly go through turmoil. The mattress industry, for instance, has long been subject to periodic crashes.

In the wake of the global financial crisis (GFC), UK private equity (PE) firm Candover lost control of Hilding Anders when this mattress maker buckled under its debt burden. Following a complex refinancing, KKR Credit diluted Candover's equity stake before eventually acquiring the business. Partly due to the Covid-19 pandemic, KKR still holds Hilding Anders in its books eight years later.

Other examples of botched buyouts in the sector abound. Last year, Advent-backed Serta Simmons Bedding filed for Chapter 11. It wasn't a first for Simmons, which had gone bust during the GFC and was then bailed out by credit specialist Ares Management.

What is odd about fund managers' passion for the bedding industry is that, even without leverage, it is a corporate graveyard. Years of quantitative easing encouraged VCs to back mattress startups, granting them the right to sell products at a loss. The practice pushed Mattress Firm, the sector's largest brick-and-mortar retailer in the United States, out of business.

E-commerce platforms were no disrupters. They simply peddled their wares through online channels. Eventually, they went ex-growth. In the United States, online specialist Casper Sleep's abysmal post-IPO trading led to it being taken private in late 2021, 18 months after listing, at half the price of its first-day close. The European equivalent is called Eve Sleep. It was rescued from administration in 2022 after its market capitalisation dived 95 per cent in the five years following its IPO.

The notion that consumers would get into the habit of changing mattresses ever more often was misconceived. Mattresses are typically replaced every eight to 12 years. At the peak of the cycle, consumers renew them more frequently, but when budgets are stretched, they wait much longer.

Anatomy of a fall

Case studies of cyclical sectors are instructive because the Covid pandemic turned many opportunist deal doers into special-situation investors and corporate undertakers. Even acyclical industries, however, can suffer from PE fund managers' slapdash practices.

In recent years, the case of Thames Water, the United Kingdom's main water and sewerage utility teetering on the verge of bankruptcy, demonstrated the impact that many years of debt-fuelled dividend recaps and chronic underinvestment can have not only on water quality and delivery, but also on the viability of a business operating in an industry considered resilient.

A similar homicidal scenario occurred 15 years ago at TXU, also known as Energy Future, Texas's largest power generator that was taken off the stock exchange by KKR, TPG, and Goldman Sachs during the credit bubble before filing for Chapter 11 in 2014. The autopsy of TXU's corpse revealed that the cause of death was not due to natural causes, such as infrastructure obsolescence, but rather to excessive leverage when shale gas discoveries brought energy prices to all-time lows.

If the cause of death was not accidental, lucki-