

# WS+B HEDGE, ALTERNATIVE & PRIVATE EQUITY FUNDS

NEWS AND UPDATES FROM WS+B'S HEDGE AND PRIVATE EQUITY FUNDS SERVICES TEAM

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## Investing in Distressed Debt

Gone are the days when a fund manager looked solely for opportunities in companies that have filed for bankruptcy protection, and sought to pick up a bargain in a 363 sale. With the advent of more complex entity structures, and the expanding universe of private equity funds, lenders looking for the doors and an overall lousy worldwide economy fund manager have capitalized on the opportunities. There are now funds whose focus is exclusively in distressed situations. The market has evolved to where the funds focus on geographic or country specific issues.

Investing in distressed debt and/or equity is not for the faint of heart, it is the ultimate buy low and sell high, with some strategies earning nick names like "loan to own". Understanding the opportunity is critical prior to investing with the troubled entity.

Distressed opportunities come in many flavors, including equity, preferred and common, as well as debt positions at all levels with the distressed entity. Inherent in the evaluation of the opportunity is taking advantage of a situation where debt or equity holders are looking for an exit, or simply are no longer in a position to finance the business model. Fund managers are uniquely positioned to bring tools to bear to reorganize the company with the patience to implement a strategy and bring it to fruition.

In order for a fund manager to take advantage of the situation deep probing due diligence is critical not only of the entity, but of the industry within which it operates, the customer base and economic trends. So with Ouija board in hand, attempting to evaluate an opportunity using traditional models will "miss the boat" in uncovering the value of an opportunity where others have overlooked them.

The due diligence starts with the company, attempting to uncover the true reason(s) as to why the company has gotten in this position. Is it a natural disaster, a law suit, did it expand too quickly? Did it take on ancillary lines of business that took resources from its core business, or is it the age old story of bad management?

### Key steps to take when performing due diligence:

- Get behind the numbers to understand the layers of debt and equity, the rights and likely recovery of each party in a worst case scenario.
- Evaluate operating assets, liquidity, and cash burn as well as the historical performance of the various business lines and their prospects moving forward.
- Identify undisclosed or off balance sheet liabilities (a critical component of the due diligence).

Commercial and operational due diligence is also vital to understanding the opportunity. Understanding employee, customer and vendor relationships is critical to establishing a reorganization plan. Then there is the acid test, which raises the question: if the business is allowed to fail would anyone care?

Naturally once the issues have been addressed, the ultimate question is can the business be returned to profitability within a sufficient timeframe, given the price, at an appropriate return to the investors.

There is no perfect analysis in this arena; opportunities require quick and decisive action. Having a trained and knowledgeable due diligence team is indispensable.



If you have any questions please contact Ken DeGraw, Team Leader of our Hedge and Private Equity Funds Services Team:

Ken DeGraw, CPA, CFE, CFP<sup>®</sup>, CRFA<sup>®</sup>  
Team Leader  
908.526.6363 ext. 3310  
kdegrow@withum.com

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