Investing in special and distressed situations: strategies, opportunities, and risks. Comparison between jurisdictions of the US and Saudi Arabia

Paper

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March 2024

Table of Contents

Introduction

Assessing the nature and the extent of the distress

Strategies for value creation in a distressed asset context

Risks of investing in a distressed situation

Valuation of distressed firms

Distressed negotiations

The relevant legal environment and its implications for restructuring options: US vs Saudi Arabia

Conclusions

Bibliography

**Introduction**

In the wake of exponential growth in the leveraged finance sector and a notable uptick in bankruptcy proceedings, distressed assets have risen to prominence, garnering substantial investor interest. This trend underscores a shift in financial market dynamics, revealing a landscape rich in complexity and ripe with investment opportunities. In response, this paper offers an executive analysis of distress investing, aiming to deepen the understanding of its strategic impact, uncover hidden opportunities, and navigate its inherent challenges.

This paper seeks to examine the nuances of distress investing, providing an analysis of its aspects to enhance understanding of its impact, opportunities, and challenges. It begins by establishing a foundational comprehension of financial distress as a precursor to pinpointing distressed assets. The paper then provides actionable insights on how to identify and capitalize on undervalued opportunities within this space, offering a strategic lens through which to view potential investments. We proceed to address the risk profile of distress investing, emphasizing the need for astute risk management in the face of investment unpredictability and market volatility. The paper then addresses the complex issue of accurately valuing distressed companies, a task compounded by the unique circumstances of distress. It explores the tactical aspects of negotiation within distress scenarios, with an eye towards understanding how various stakeholders leverage their positions. To add a global perspective, it includes a comparative analysis, examining the distinct landscapes of the United States and Saudi Arabia.

**Assessing the nature and the extent of the distress**

Distressed asset investment offers diverse and complex opportunities, often linked to a company's cash flow problems and consequent failure to meet its financial commitments. Such challenges can emerge from both external and internal factors affecting a company's operations.

Externally, industry-specific crises, like a severe slump in oil prices, can severely impact firms in the related sectors. Broad economic declines, such as recessions, or extraordinary global incidents like the coronavirus pandemic, also have the potential to create widespread market distress.

Internally, a company might face difficulties due to specific events, such as the loss of a major client, which can significantly affect income. Other issues might include the inability to achieve expected benefits from mergers or acquisitions or widespread inefficiencies and profitability issues within the company’s management and operations.[[1]](#footnote-1)

The indicators of looming financial distress are varied, reflecting the multitude of potential underlying issues. They can be seen in worsening financial ratios, decreasing cash flows, and other subtle yet critical qualitative and quantitative signs. When these indicators emerge and continue to worsen, they warn of a company's impending difficulty in meeting its financial and operational commitments.

To thoroughly understand financial distress, one must adopt a dual analytical perspective. This involves a detailed assessment of the company's immediate financial health and a strategic analysis of its position in the industry. Effective recovery strategies are built by pinpointing and examining the primary contributors to distress, such as managerial shortcomings, strategic errors, or macroeconomic shocks.[[2]](#footnote-2)

Grasping the influence of various elements in a company's financial downturn is crucial. By understanding these factors, one can evaluate if the company's difficulties are deep-seated or if there is a chance to turn the situation around. Such insight is invaluable for investors in distressed assets, helping them formulate strategies that capitalize on high-return possibilities while mitigating risks. This detailed level of analysis is the cornerstone of effective distressed asset investing, aiming to balance profit potential with the judicious handling of inherent uncertainties.[[3]](#footnote-3)

Transparency in recognizing the root causes of financial distress is paramount. A candid and thorough acknowledgment of the factors leading to a company's difficulties is the first step toward recovery.[[4]](#footnote-4) This is because the strategic mitigation of information asymmetries lays the foundation for the development of robust and tailored solutions. This process of informed diagnosis and intervention is essential not only for restoring the company's operational health but also for rebuilding stakeholder confidence and attract new investors, securing the support necessary for a successful turnaround. Hence, it is the clarity of this acknowledgment that serves as the catalyst for effective and sustainable business recovery strategies.

**Strategies for value creation in a distressed asset context**

In the realm of distressed investing, the concept of the investment opportunity as a 'pie' serves as an apt metaphor for illustrating the enterprise's value and the distribution of its financial stakes. This 'pie' represents not just the current worth of the distressed firm, but also its latent potential for value augmentation. Through strategic investment methodologies, investors can fundamentally transform the size and shape of this 'pie,' aiming to enhance its overall value. Each investment strategy employed embodies a unique blend of risk and involvement, shaping the trajectory for potential returns. From surgical financial restructuring to operational overhauls, the approaches vary in their intensity and focus.[[5]](#footnote-5)

Some strategies can reflect an active control approach mirroring the efforts to expand the company's value. Through acquisition or control, those investors engage directly in enhancing the enterprise's value—be it through management overhaul, better asset utilization, or business model innovation. The risks and efforts are considerable, but the potential gains are in line with the lofty ambitions of corporate transformation and improved investment returns.

Next, some investors have an active/non-control strategy characterizing investors who, without seeking total control, aim to significantly sway the restructuring and revival efforts. They may not own the biggest portion of the 'pie', but they work to enrich its worth by taking strategic positions in the company's financial hierarchy. With skilled negotiation and a thorough comprehension of the business's assets and capital structure, they navigate the troubled waters, aiming to improve their stake in the envisioned enterprise.

Lastly, investors with passive investment style embody the principle that "patience is a virtue." Passive investors scout for undervalued market segments, secure them, and wait for market recalibration to address the undervaluation. Without partaking in the direct management or overhaul of the entity, they bank on the gradual appreciation of the asset's inherent worth. This method demands an acute sense for value and the resilience to endure market fluctuations.[[6]](#footnote-6)

A successful investor in the distressed space is distinguished by a strategic acumen for managing risk, an adeptness in appraising assets when transparency is limited, and a keen ability to engage in negotiations informed by a deep understanding of the company's financial intricacies. Investment approaches are meticulously tailored, considering the investor's profile and the unique risk landscape of each geography, which includes directorial responsibilities and market-specific regulations.

**Risks of investing in a distressed situation**

Investing in distressed assets entails specific risks, notably the potential to engage with assets that, while seemingly undervalued, are intrinsically compromised. These assets may be plagued with critical operational failures, excessive debt, or legal issues that prevent them from yielding expected returns. Another complex risk is intercreditor conflict, where creditors with different priorities and claims compete for the company's remaining assets. This can lead to extended legal conflicts and stall the restructuring efforts, further depleting the assets' value and diminishing returns for all creditors. Valuation risk is also a significant factor, as determining the true value of companies nearing insolvency is exceptionally challenging.[[7]](#footnote-7) The fluctuating nature of a distressed company's finances, alongside the often limited and unreliable data, can result in significant variances between the assessed and true values. This risk intensifies when liquidation is a possibility, potentially leading to asset sales at prices well below their actual worth. In such cases, the order of payout can result in minimal returns for certain investors, particularly those with unsecured or subordinate claims.

Additionally, distressed investors face market risks, like fluctuating interest rates or economic slumps, which can unpredictably alter the recovery outlook for distressed assets. Operational risks, such as the inability to improve the company's performance, and legal risks, including unfavorable judicial decisions or legislative changes in insolvency laws, are also significant concerns. The time-sensitive demands of distressed investing may necessitate swift decision-making, heightening the risk of mistakes.

Distressed investing, while potentially lucrative, requires rigorous risk management. Investors must engage in extensive due diligence, have a solid grasp of the legal context, and employ a hands-on method to manage the complex challenges encountered throughout the investment period.[[8]](#footnote-8)

**Valuation of distressed firms**

Appraising distressed companies is a complex and vital task that demands a nuanced grasp of the company's inherent value as well as market conditions. Investors embarking on this valuation must employ a variety of methods to fully understand the worth of the company, which may vary greatly from that of a financially sound firm.[[9]](#footnote-9)

Assessing the value of distressed companies requires a nuanced approach. Initially, this involves analyzing trading multiples of peer companies or comparable financial instruments, adjusting for risks and market conditions to ensure relevance. Moreover, insights into how the market values similar distressed assets can be gleaned from reviewing recent transactions, although unique attributes of each situation may limit direct comparability.[[10]](#footnote-10)

For businesses with diverse operations, a 'sum of the parts' valuation is advantageous, allowing for an independent estimation of each business unit's worth. The Discounted Cash Flow (DCF) approach, commonly used in valuations, must be applied with caution due to the inherent challenge of forecasting future cash flows under distress. Meanwhile, liquidation analysis provides a baseline for valuation, evaluating the potential returns from selling off assets and helping to measure the downside risk. Comprehensive due diligence is essential, looking into the company's debt, management, legal issues, and hidden liabilities. Recognizing the company's obligations and worst-case scenarios is also critical for safeguarding the investment.

Despite valuation methods represent commonly adopted methodology to price a potential investment, the bankruptcy context injects significant uncertainty into the process. Investors must adeptly combine these valuation techniques, balancing potential returns with the associated risks.[[11]](#footnote-11) In distressed situations, the predictive power of historical performance for future cash flows is greatly reduced. Distressed companies typically encounter specific, acute challenges that make prior performance trends unreliable for forecasting cash flows. Additionally, market prices for the company's financial claims, which could serve as valuation anchors, are often not available or trustworthy due to the company's troubled state. This absence of reliable market prices undermines traditional valuation methods that rely on such data.

The operating environment of a distressed company further complicates the valuation process.[[12]](#footnote-12)

The effectiveness of comparative valuation is diminished when firms within the same industry are distressed or have recently restructured, as this limits comparable data.

Furthermore, some creditors’ strategic actions can steer the valuation more by negotiation dynamics than by the firm's actual economic value.

This complexity calls for an agile and informed approach to valuation, underlining the necessity for expertise, innovation, and negotiation acumen to reach a fair valuation for all parties.[[13]](#footnote-13)

**Distressed negotiations**

Negotiating within the arena of distressed investing demands a profound understanding of the nuances involved and a sophisticated strategic approach to align the often-divergent interests of stakeholders. The cornerstone of such negotiations is conducting comprehensive due diligence, a step that cannot be overstated in its importance. It provides a critical understanding of the distressed entity's financial and operational conditions, shaping a negotiation strategy that can identify common ground and explore potential avenues for compromise.

In recent times, we've witnessed a shift towards more streamlined approaches, such as the adoption of pre-packaged bankruptcy plans[[14]](#footnote-14). These are agreements crafted and consented to by stakeholders before filing for bankruptcy, with the intent to expedite the reorganization process and curtail legal expenditures. Alongside, mediation has emerged as a preferred method to foster collaborative dialogues between stakeholders, aiming to circumvent adversarial and often protracted legal disputes[[15]](#footnote-15).

The evolution in deal structuring is also notable, with strategies such as 'loan-to-own'[[16]](#footnote-16) gaining prominence. These strategies concentrate on the operational turnaround of the distressed firm to sustain long-term value, rather than on immediate asset liquidation for short-term gains. Such approaches necessitate heightened transparency and consistent communication with all stakeholders, which need to be the norm rather than the exception. Stakeholders now expect regular updates, a practice that not only builds trust but also steers the process towards consensual solutions, rather than those imposed by court rulings.

In the complex realm of distressed negotiations, it is imperative for an investor to prioritize the process of identifying the interests diligently and continuously at play. A cursory examination of these interests can result in negotiations remaining on a superficial plane, potentially overlooking valuable options and untapped leverage. The consensus among expert negotiators is clear: a thorough understanding of the starting positions is essential for navigating towards improved outcomes[[17]](#footnote-17).

**The relevant legal environment and its implications for restructuring options: US vs Saudi Arabia**

Distressed investing in the United States contrasts sharply with that in Saudi Arabia, due to divergent legal systems, market development, and cultural views on financial distress, influencing the restructuring approaches and tactics available.

In the U.S., the process is guided by a predictable and tested legal framework, with the ‘Absolute Priority Rule’ creating a clear pecking order for creditor claims in bankruptcy. Supported by a strong capital market and a network of restructuring experts, the U.S. offers various strategies such as distressed debt, turnaround, and special situation investing. These are embedded in the financial system, with clear payment hierarchies and secured lenders' rights to seize collateral upon default.[[18]](#footnote-18)

The 1991 amendment to Rule 3001(e) regarding bankruptcy claims simplified the process of purchasing these claims, specifically targeting those not publicly traded. Judicial intervention in the trading of claims is limited to instances where objections are raised. Disclosure of the price or other transaction details of a claim is not mandatory.

In the United States, active investors represent the primary purchasers of bankruptcy claims. This activity results in a more concentrated ownership, especially for claims that allow holders to vote on the bankruptcy plan and hold the fulcrum security within the capital structure.[[19]](#footnote-19)

Moving to Saudi Arabia, the approach to distressed investing is evolving. Once hindered by a rigid legal system and cultural aversion to financial distress, the Kingdom has recently initiated reforms. New insolvency laws and security measures are aligning with global standards, reshaping restructuring into a strategic initiative rather than just damage control. This indicates a growing appreciation for the strategic aspects of distressed investing.

Saudi Arabia's nascent distressed debt market historically stems from legal and societal constraints. In the past, the absence of comprehensive insolvency laws led to prolonged enforcement actions for creditors, hindering the growth of specialized direct lending markets due to unpredictable outcomes.

Recent reforms in Saudi Arabia are moving towards a framework more akin to U.S. practices, slowly fostering a legal environment conducive to distressed investment strategies. Although both countries enforce a payment hierarchy for claims against a company, the U.S. has a well-defined system, while Saudi Arabia is still shaping its approach to creditor seniority.

Saudi Arabia's legal transformations, driven by economic diversification and market development, suggest a future with a more structured distressed investing framework. As reforms progress, the Kingdom may present more opportunities for distressed debt restructuring, moving closer to the established practices seen in mature markets like the U.S.[[20]](#footnote-20)

While Saudi Arabia has made strides in restructuring its debt trading landscape, certain challenges persist. Traders must be cautious, regarding licensing, responsibilities of appointed directors and other drivers without a track record yet.

Trading secured debt presents its own difficulties. Even if security's value may be diminished in distressed debt trading, its presence can be crucial, particularly for achieving a secured position in insolvency cases. For instance, Promissory Notes in Saudi Arabia must be enforced in their original form and are thus a critical type of credit support.

To summarize, while the U.S. features a dynamic market with active investor participation and established rights for claimants, Saudi Arabia is progressively cultivating its legal environment to attract strategic distressed investments. As Saudi Arabia continues to align with global standards and enhance its legal infrastructure, it stands on the brink of offering new opportunities in distressed debt restructuring, presenting a burgeoning landscape for investors who are attuned to the nuances of its evolving practices.

**Conclusions**

In summary, navigating the nuances of distressed investing requires a strong focus on risk management, an incisive approach to asset valuation amid opaque financials, and a negotiation stance rooted in comprehensive knowledge of the entity's value creation potential.

The comparison of distressed investing across the legal and developmental spectrums of the United States and Saudi Arabia underscores the significant influence of governance structures on investment strategy execution. The mature U.S. market offers a transparent and orderly environment, bolstered by the 'Absolute Priority Rule' and a suite of investment mechanisms, facilitating a predictable and secure landscape for investors. Meanwhile, Saudi Arabia stands at the threshold of transformative growth, with modern insolvency laws and shifting perceptions of financial distress signaling a move towards alignment with international standards, thereby unlocking new potentials in distressed investing.

The essence of successful distressed asset investment lies in the ability to pivot and implement strategies informed by these insights. The executive who leverages this knowledge will adeptly turn the intricacies of financial distress into avenues for lucrative investments. As we witness the ongoing maturation of markets, particularly in regions like Saudi Arabia, it is evident that adaptable and globally informed investment strategies are well-positioned to thrive.

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