Distressed investors look to 2019

The U.S. economy is unpredictable — but health care restructurings are a given

PLUS: A GLIMPSE OF DISTRESSED INVESTING IN FRANCE, GERMANY, INDIA AND THE UK
Distressed investors look to 2019
What is most certain about the U.S. economy going into 2019 is uncertainty. Where will the stock market land as we move through the early months of the new year?

Will relatively low unemployment figures hold? Will the U.S.-China tariff issue resolve or escalate? Will interest rates remain where they are to keep the economy moving, or rise to calm fears of its overheating?

All these elements were discussed at the annual International Restructuring Conference held in November in New York City. Hosts were Grant Thornton and the McDermott Will & Emery law firm. Panelists from the U.S. kicked off the presentations, which were followed by talks about France, Germany, India and the UK.

The consensus among U.S. representatives was that although U.S. bankruptcy activity remains at its lowest level in several years — on pace to be just above 5,000 filings at the end of 2018, compared with about 13,000 back in 2009 — opportunities in distressed investing are still out there in health care, oil and gas, and retail and restaurants, among others. And now there’s a new investment structure through the federal Opportunity Zone program.

Watch interest rates, bonds, CLOs, more

Interest rates are a key concern looking at 2019, said Ryan Maupin, a principal with Grant Thornton’s Strategic Solutions practice. Maupin led a U.S. panel titled “The next bankruptcy wave in the U.S.”

A fear is that the Federal Reserve will raise interest rates too fast, which would have an adverse effect on U.S. businesses, he said. “The question then lies in how much they can ease rates if they do need to do that in future years.”

Tariffs remain another worry. Some economists are predicting 25% tariffs involving roughly $517 billion of Chinese imports for 2019, which would affect a significant amount of companies and consumers.

Another area to watch is the stock market, which lost roughly $5 trillion in value in October 2018, with $2 trillion of that in the United States. Despite recent volatility, the overall market selloff in October represents investors coming to terms with overpriced assets and uncertainty around U.S. trade policy, Maupin said.

Junk bond pricing is yet another item to watch, Maupin said: “There’s talk about how alarming the triple-B bond market is right now, how much that’s grown in such a little time.” Triple-Bs now exceed by 50% the entire investment-grade market at the peak of the investment boom in 2007.

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On top of all this is the activity around collateral loan obligations (CLOs). “The CLO market is very, very hot right now, with some staggering stats,” said Maupin. “In 2014 a record of about $127 billion came into the market in the U.S. alone. Currently we’re at about $99 billion.” Also worthy of attention are exchange-traded funds, which are similarly close to record levels.

“In addition to record levels of debt that we have right now,” Maupin said, “you have record levels of covenant-lite deals. Something like 70% or 80% of the debt that’s outstanding right now is in cov-lite.”

“I would say to anybody looking at distressed investing opportunities, if you don’t know how CLOs work, you should definitely start learning.”

Ryan Maupin, Principal, Strategic Solutions, Grant Thornton LLP

Oil and gas may continue to see activity

Many companies that took advantage of Chapter 11 bankruptcy filings in 2015 and 2016 may be heading back there, Maupin said. “Several disappointing earnings reports came out during a time in which oil was near the $66 to $70 per barrel band. Some companies that exited Chapter 11 did so at high leverage multiples. Some companies that didn’t take advantage of Chapter 11 are now competing with companies that did take the opportunity to restructure and are doing so with not-so-competitive capital structures. I wouldn’t be surprised to see some additional filings as well as a few Chapter 22s in the oil and gas space.”

Maupin cited other areas to watch — power utilities with lots of leveraged debt, coal companies, dry bulk shipping and tankers, cable and noncable media, and retail and restaurants. Retail and restaurants are not the same, he said, “but both have a lot of broken concepts.”
Meet the new funds
A relative newcomer to the investment market are Qualified Opportunity Funds (QOFs), which already show signs of becoming hot investment tools, said Steve Carter, Grant Thornton managing director with oversight of the state and local tax credits incentives practice.

Opportunity Zones were established as part of the Tax Cuts and Jobs Act of 2017 as a way for private investors to defer and abate long-term capital gains tax by investing in Qualified Opportunity Zones (QOZs), or low-income neighborhoods. The zones are within or contiguous to low-income areas as reflected in U.S. Census Bureau data, designated by state governors and approved by the U.S. Treasury Department. Initial guidance about implementing the program has been released by Treasury with further clarification coming soon.

What is known about the funds
The funds work in several ways:

- An investor can effectively defer and eliminate a portion of the capital gains tax by investing the capital gains in a QOF.
- The QOF must acquire QOZ assets with the capital gains proceeds received from its investors.
- If the QOF holds the QOZ assets for a period of five to seven years, a portion of the original capital gains will be forgiven.
- Capital gains taxes will be due at the time the QOZ property is sold or on Dec. 31, 2026, whichever occurs earlier.
- Most significantly, should the QOZ assets be held by the QOF for 10 years, future capital gains taxes associated with the QOF assets will be forgiven.

Opportunity funds must be a corporation or partnership for income tax purposes. Critical is a 90% rule, said Carter, which dictates “if you’re going to create a QOF, by rule 90% of your assets have to be in QOZ property. Failure to meet this requirement will result in significant penalties going forward.” It may be possible to reduce the 90% rule to as low as 63% through legal entity planning and structuring.

Should the QOF purchase an existing building within a QOZ, the rules dictate that the facility be “substantially improved,” Carter said. “The IRS doesn’t want to see people just acquiring buildings within QOZ areas and getting this long-term gains tax deferral without improving the property.” For the most part, this improvement must be completed within 30 months and be equal to what the fund paid for the asset initially. For example, if a fund pays $1 million for a property, it has 30 months to invest that same amount in improvements.

Carter said he gets calls several times a week from fund managers, private equity investors, high-wealth individuals, real estate investment trusts (REITs) and large-scale developers asking about the program. “We’re seeing a lot of movement.”

Qualified Opportunity Funds present an interesting opportunity for strategic investors. An example would be a steel mill in South Carolina that goes through bankruptcy. The facility is found to fall within an Opportunity Zone. A distressed investor purchases it for a greatly reduced price, using its own funds or a fund set up with other investors’ unrealized capital gains, and begins rebuilding the business, assuming the project meets all the other tests in a tax-advantaged way. This allows the investor to defer and lessen capital gains tax while contributing to growth in a disadvantaged area.

A STRATEGIC INVESTMENT

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Health care: Distressed opportunities keep coming

Whether the next round of restructuring and bankruptcy is a wave or a ripple, “within the health care provider space, the tide is coming in,” said Scott Davis, Grant Thornton’s Corporate Advisory & Restructuring partner and Strategic Solutions leader. The health care industry, particularly providers, has been distressed for years, he said, for a whole variety of reasons including the following:

- High fragmentation. Health care’s delivery network is highly fragmented, with more than 5,000 acute-care hospitals in the United States, almost half of which are unaffiliated. Like no other business, health care lacks scale, which negatively affects costs and revenue.

- The high cost of labor. The single largest component of cost for health care providers is compensation and benefits. Hospitals, for example, typically incur compensation-related costs at or above 50% of net patient service revenue. There is also a shortage of nurses, doctors and technicians that will continue to create upward pressure on wages.

- The high cost of evolving IT and medical-treatment technology.

- High fixed costs, especially real estate.

- Rigorous regulations.

- Little or no control over pricing. For example, Medicare and Medicaid programs dictate what providers receive, and for the most part, so do insurance companies. Even though providers can arguably set prices for those who do not have health care coverage, the uninsured often cannot and do not pay.

- Little ability to negotiate pricing with suppliers. For everything from drugs to medical devices to linens and food, providers negotiate with people who typically have more power than they do.
**A history of spiraling costs**

For 48 of the past 49 years health care costs have continued to escalate at a higher rate than the Consumer Price Index or any other economic inflator indexes, said Davis. The United States pays more for health care than any other country, with spending projected to represent 20% of the U.S. gross domestic product within a decade. Total spending is estimated to reach the staggering sum of $5.6 trillion by 2026. These statistics and increasing criticism of the present system as unsustainable have combined to make health care a political football. Providers are the easiest target.

**A breakdown of competitors**

Nontraditional players such as pharmacies and more recently retail chains, along with stand-alone urgent-care and MRI facilities, have squeezed providers like hospitals, taking away patients and revenue and contributing to excess capacity, said Davis.

Nathan Coco, a partner in the restructuring insolvency practice at McDermott Will & Emery law firm, confirmed that assessment. “These nontraditional providers put together deals that allow them access to the market in direct competition with legacy hospital providers.” This encroachment creates enormous stress, he said.

Another big stressor is a growing pool of uninsured and underinsured patients. Although Obamacare brought the uninsured number down, that number went up again in 2017 with new restrictions and could easily rise more. People with high-deductible plans typically have to pay the first $3,000 to $5,000 of their care. “Those patients are effectively uninsured if you are the provider, because they may not be able to pay you,” Davis said.

It’s not surprising that the number of health care provider bankruptcies has tripled in the past few years while Chapter 11 filings generally have gone down. Said Davis: “In 2018, we flagged about 15 to 20 large and small health care provider bankruptcy filings, making health care the ‘growth sector’ within restructuring practices.”

“If you think back 20 years, when MRIs and CT scans first became a diagnostic tool, you had to go to the hospital. Now you can get a CT scan or an MRI practically in the neighborhood drugstore.”

*Scott Davis, Leader, Strategic Solutions Practice, Grant Thornton LLP*
Changing transactions and players
Coco elaborated on the issue: “One thing we’ve noticed in connection with M&A and consolidation within the sector is that the variety of transactions, and the nature of transactions and players, have changed over the past decade,” he said. “Activity has moved from rural hospitals, single sites or smaller systems to megamergers even among nondistressed healthy systems.” To achieve greater scale and improve the platform, large not-for-profit systems are merging not within the same market but within regional or separate markets.

These moves are opportunistic but also defensive, Coco said. “If you’re not trying to consolidate and secure a place in the market, it’s going to be tough sledding in the coming years.”

Continuing care retirement communities (CCRCs) present another area of change, redefining the way people fund their health care in their senior years, said Davis. The model typically involves a significant up-front payment, with an independent living arrangement that progresses to assisted living and ends with memory care or a traditional skilled nursing facility.

CCRCs have also seen upheaval, especially because the industry is tied to real estate. People going into CCRCs often need to sell their homes to fund that up-front payment. After the housing downturn in 2007–2008, a lot of those CCRCs went through restructuring, said Davis. “I wouldn’t be surprised if there were hundreds of those that got restructured out of court.”

There’s been less restructuring activity since residential real estate prices improved, Davis said. “But there’s still an awful lot of restructuring going on in the traditional senior living space, both skilled nursing facilities and other long-term-care facilities.”

“As restructuring professionals, we’re sort of like roaming negative economic indicators who gravitate toward whatever sector is taking it on the chin. It might be oil and gas. It might be retail. But the one constant has always been health care. It’s always been distressed, and it’s always going to be distressed.”

Nathan Coco, Partner, Restructuring Insolvency Practice, McDermott Will & Emery

Added Coco: “From a marketing standpoint, these projects often reduce the price for the units in order to get people in the units, but because they’ve reduced the pricing, they’re constantly behind, and they’re never able to achieve the level of revenue necessary to actually perform the way that the investors expected them to.”

A decade or more ago REITs became major players in the skilled nursing space. Yet many REITs are shedding those assets. Said Coco: “A real estate play mixed with a health care play — which is what a senior living project is — involves a lot of execution risk. A lot of things can go wrong.”
The realities today
Because it’s so difficult to restructure a health care provider that’s in distress, said Coco, “we’re seeing that most of these bankruptcy filings end up being a liquidation — either an orderly sale or a bankruptcy free fall.”

Often these facilities simply close. “And closing a hospital is almost as expensive, cumbersome and difficult as it is to operate it,” Coco said. Such closures can be devastating in rural areas where people don’t have other viable access to care.

“Health care is a complicated business,” Davis concluded. “And for the foreseeable future, those complications are not going to get better.”

WHAT’S HAPPENING NOW IN U.S. RESTRUCTURING
A lot of nontraditional investors have come into the distressed space over the past few years, said Nathan Coco, a partner at McDermott, Will & Emery law firm. These include, he said, “old school casino operators partaking in Section 363 sales, family offices putting up portfolio companies through pretty complex Chapter 11 restructurings, and retailers filing for bankruptcy and taking advantage of the statutory cap on lease-rejection damages.

“And the timeline in bankruptcy filings has become condensed primarily because a lot of restructurings are fully baked, whether through a prepackage or a free fall; regardless, you’re seeing DIP [debtor-in-possession] loans lined up going into bankruptcy.” Also in line, said Coco, are stalking horse bidders with a credit bid sizable enough to effectively preclude other bidders.

“I think this means that private equity funds, family offices and traditional debtors are looking for ways to make the bankruptcy process much more efficient, with fewer professional fees. And that’s something to pay attention to.”
A glimpse at distressed investing in France, Germany, India and the UK
When it comes to distressed investing, every country has its own rules and characteristics. Representatives from France, Germany, India and the UK shared a taste of their own country’s particularities at November’s International Restructuring Conference in New York City.

**France**

France presents a different investing market generally from other European countries or the United States, said Timothée Gagnepain, head of the Restructuring practice at the Paris office of the law firm McDermott Will & Emery. He was joined in his presentation by Clotilde Delemazure, head of the Grant Thornton International Ltd Restructuring practice in Paris.

A key takeaway: The French market has improved for foreign investors in distressed properties, yet anyone contemplating an investment should have an adviser who understands the ins and outs of the French investment system — specifically, the country’s legal structure, which is very protective of corporations and employees.

Said Gagnepain: “The market is different, the legal system is different, and you need a good reading [of the market] before you invest. You need a good assessment of a company’s value and assets to be able to mitigate the risks and make sure you have the yield you’re expecting over a set period of time.”

Delemazure explained that most insolvency proceedings in France stem from a company’s having no cash to pay debts that are due. France has a cash, not a balance sheet, system.
Gagnepain added: “Usually the French banks that lend money to companies do not have the same interests as the foreign investors. Foreign investors try to get their money back. French banks — they’re also commercial banks — are trying to keep their clients alive.”

The market for foreign investments in France changed in 2005 with the country’s sauvegarde (safeguard) law, inspired by the U.S. Chapter 11 bankruptcy law. Gagnepain said, “For the past 10 years, we have had more U.S. investments and foreign investments in France.” Still, he said, the distressed market has not been well defined, and investors worry about how they will get money back in the event of an insolvency.

To relieve such concerns, the legal system has created tools for use in investment in distressed companies. One such instrument, a fiducie (a trust), allows a company to transfer assets, rights or security interests into a trust that manages the assets for beneficiaries — so that lenders to distressed companies can get their assets back in cases of insolvency.

“Once you have accepted the idea that the legal system is different and the risk is different, and you understand you have to think differently, then you have a lot of opportunities in France,” said Gagnepain. “French banks do not have the DNA for distressed investments. They are usually asking shareholders to put money back in the company.

“The French market is full of uncertainty, but in these uncertainties lie opportunities.”

Germany

Germany’s economy is in good shape, with low unemployment and all-time-low insolvencies. At the same time, business is mindful of weak economies in places like Greece, Italy and Spain, and pays close attention to market shifts and uncertainties in Europe and in the United States, its biggest single-country market for exports.

So said Stefan Eggers, senior manager, HANSE Consulting in alliance with Warth & Klein Grant Thornton. He was joined in the discussion by Uwe Goetker, partner, McDermott Will & Emery, and Christian Heuermann, senior manager, HANSE.

Germany, the geographic size of New Jersey but with a population the size of California’s, has the largest economic market in Europe, with 40% of its gross domestic product in exports. Within its borders are about 32,000 mostly midmarket companies that have revenue of €50 million (almost US $57 million) or more per year; 12,000 of its companies are privately run (many family owned), and 45% of those have revenue of €50 million or more. An investment opportunity lies within this private-company market, as a big chunk of these companies have no succession planning, i.e., no one wants to take over, said Eggers. Many of these companies also have an international presence.
Another area to watch is potentially overpriced real estate, said Goetker, created when investors moved from stocks to real estate when the economy crashed in 2007-2008. The German fashion and retail industry, too, is changing and under stress, as is the food and beverage industry. Germany has five big food retail chains that control 75% of the food market, and most are family run — again presenting potential opportunities.

In terms of the automotive industry, suppliers are the ones to watch, Goetker said, as they have not been able to get sufficient funds, equity or cash on the balance sheets to be well-prepared for another downturn.

A major influencer in restructurings is what Goetker described this way: “In Germany, we have the sword of Damocles, which is the insolvency filing obligation. Once you run into illiquidity, you’re not able to pay your debts when due, or you become overindebted, which can be quite early, you have to file for insolvency. If you don’t do so, as a manager you face severe liabilities, including criminal liabilities, not only for management, but also for everybody helping.” This includes creditors; they may be held liable at a later stage or have to face “voidability” of contracts.

In light of this insolvency filing obligation, and the potential risks to all stakeholders, investors usually need a restructuring “expert opinion” regarding the business’s potential to be restructured, said Goetker. Those experts analyze the business, put that analysis into a report, and demonstrate measures to “cure the issues” and make the company profitable again. They specify measures required for refinancing, which is another burden. “The good news is, everybody knows what’s going on and you can discuss valuations, cast doubt and see upside potential,” said Goetker. “You also avoid legal risks.”

Despite overall positive prospects in Germany right now, Goetker and other panelists believe the economy is fragile, and they expect a downturn within the next two years, which will result in a wave of restructurings. “To be a first mover,” he said, “you should do your homework and prepare early to be ready for opportunities in the German and European markets.”
“The government is very proactive and wants to make sure that we get this right. India has taken bold steps to move up in its ranking as a place where it’s easy to do business.”

Ashish Chhawchharia, Partner and Head of Restructuring, Grant Thornton India

India

India’s restructuring regime is only about 18 months old, said Ashish Chhawchharia, partner and head of Restructuring at Grant Thornton India. Grant Thornton India Partner Sid Nigam joined him to discuss the market in the country.

The Insolvency and Bankruptcy Code (IBC) of India was created by the government that took power in 2014. The intention was to begin cleaning up a system rife with nonperforming loans, stressed assets amounting to about US $125 billion in the economy, and 60,000 bankruptcy cases that have been pending in the courts. Each case has taken more than four years to adjudicate and has resulted in a recovery rate of only about 25 cents on the dollar — compared with about 71 cents on the dollar within countries of the Organisation for Economic Co-operation and Development. The recovery process itself has involved an elaborate, multilayered judicial framework of multiple agencies, junior courts, senior courts and the Reserve Bank of India, which controls the country’s central banking system.

The IBC represents landmark reform in the corporate and economic law of India. Simply stated, it provides a "commercial solution to a commercial problem with a lighter touch of the judiciary, by letting the creditors decide how to deal with a situation," said Nigam, "it provides more certainty and a time-bound process." The new insolvency law prescribes 180 days for resolution, with a 90-day extension if a majority of lenders agree. It has very strong penalties for fraudulent asset diversion — when sponsors or promoters divert funds from a company and thereby cause it to become stressed.

In another change, said Chhawchharia, the "government lowered its ranking in the waterfall." Basically, this means that the government is not the first to take its share after a resolution, but instead ranks itself as fourth in line.

A reflection of the newness of the law is that since its imposition, there have been more than 25 amendments to the code or its regulations. Many items remain to be worked out, such as cross-border and group insolvencies.

“But that’s very good,” said Chhawchharia. “It shows the government is very proactive and wants to make sure that we get this right.” India has taken bold steps, he said, to move up in its ranking as a place where it’s easy to do business.
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The UK

A panelist discussing the distressed market in the UK began with a blunt joke that encompassed Brexit and other uncertainties the nation faces: “The UK is still part of Europe for the moment,” said Andrew Charters, director, Restructuring and Insolvency, Grant Thornton UK LLP. He was joined in his discussion by Alicia Videon, partner, McDermott Will & Emery.

Following up the comment, Charters cited a recent survey on business confidence by the Institute of Chartered Accountants of England, which pointed to business confidence in the UK being the lowest since 2009. “That’s quite a stark statistic,” said Charters. “When I look back at what we’ve been doing in the restructuring community, it feels like we’ve been busier in 2018, and busier on domestic, UK-focused deals rather than working across Europe like we had been doing previously.”

Like other countries, the UK sees the retail sector struggling, and a lot of retail restructurings have really hit landlords, said Charters. They’ve had to reduce rents or take back properties, making them concerned about the value of their assets. Some of the big listed real estate businesses are trading at a discount on the London Stock Exchange, he said.

Construction is another area that has gone through some high-profile restructurings and even liquidation. Financial services is another area to watch. When regulators took action to prevent a repeat of the 2008 recession, larger banks in particular pulled out of certain sectors, Charters said. That gap has been filled by alternative lenders, particularly high-cost, short-term and payday lenders. These lenders now have many “conduct” and other claims being filed against them.

In addition, a whole host of new banks entered the market before the crisis, buying market share and portfolios that now need new capital. “They were backed by sensible shareholders who are in it for the long term and are willing to keep providing capital at the moment, but if losses continue, that’s an area to watch,” Charters noted.

“Like other countries, the UK sees the retail sector struggling, and a lot of retail restructurings have really hit landlords.”

Andrew Charters, Director, Restructuring and Insolvency, Grant Thornton UK LLP
The UK also has private sector health care in addition to the National Health Service. The health care sector generally is facing staffing issues — finding, training and retaining staff with the right skill sets. In turn, the staffing issue has created operational issues.

Videon talked broadly about the UK market, saying all the unknowns around a Brexit deal have stirred a pot of unpredictability. At the same time, the Bank of England has cited leveraged lending as a possible cause of instability. Especially of concern is the role of nonbank lenders in the leveraged loan market and how they would react in a slowdown.

Pay attention to get it right
Opportunities in distressed investing continue to develop across the globe. Taking advantage of them requires a country-by-country education.
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