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Hedge Fund Activism in Distressed Situations

For distressed debt investors, the debt markets have in recent times been characterised by surprisingly resilient conditions despite Brexit uncertainty and the mounting case for interest rate rises. The consensus is that these are still fairly healthy times for borrowers, with the state of the markets permitting them to issue cheap debt and refinance large amounts at low yields – at least for the time being... but there are clouds gathering on the horizon....

Banks across the globe continue to offload non performing/high risk debt. Deloitte reported recently that the loan sale market is the most active it has been for years with Blackstone, Cerberus, Bain and Goldman Sachs lately being amongst the biggest buyers of distressed and non-performing debt across Europe, Asia and Latin America.

The challenging global economic climate and the prospect of tightening monetary policy leading to an increase in credit spreads gives rise to some interesting investment opportunities for managers of activist hedge funds, focus funds and other investment vehicles seeking out targets for value-enhancing investment strategies.

Whereas previously activist opportunities were principally bank driven, increasing complexity in credit markets and non-bank corporate financing structures has opened the market to hedge funds and private equity firms.

While shareholder activism continues to grow in prevalence and significance in the UK and Europe, there is also an increasing appetite for hedge fund activism in distressed and restructuring situations where value can be unlocked.

In a potentially deleveraged environment, there will inevitably be investor appetite for strategies that can generate alpha without the use of leverage.

As history suggests, activist strategies have the potential to perform well following credit cycle corrections, primarily because of the value creation potential of the activist’s specific skill-set. From a corporate perspective, activist hedge funds can be important economic actors in challenging economic climates.

Strategy is key

Most commonly considered a component of the broad event driven category, an activist investor generally attempts to enhance a company’s value by restructuring its operations, capital structure and/or implementing strategic initiatives in response to perceived underperformance of a company. This may involve taking an active role in the restructuring of the
companies in which they invest, providing advice to management, participation in creditors’ committees or by facilitating shareholder action.

Activist hedge fund strategies include taking distressed value or undervalued positions, event driven/special situation strategies predicated on a significant corporate event or the accumulation of a significant position in a company's equity, whereby managers will seek to improve shareholder value over a defined time-period.

Activist hedge funds tend to target companies that are typically "value" firms, with low market value relative to book value. Relatively few targeted companies are large-cap firms, which is not surprising given the comparatively high cost of amassing a meaningful stake in such a target. Targets tend to exhibit high institutional ownership and trading liquidity.

In this vein, activist hedge funds usually take a value-oriented, “hands on” approach, using diligent analysis of corporate fundamentals to find value – often with an activist strategy already in mind. And those firms with the most “firepower” are not afraid to go up against some of the biggest names. Elliott Advisors, in particular, has taken on Samsung and Hitachi, two of the biggest conglomerates in Asia, and has famously challenged the government of Argentina in a ten year-long legal battle over the nation's debt default.

**Activist tactics in distressed situations**

The most common way hedge funds become actively involved in a distressed firm is to purchase existing debt securities – the 'fulcrum securities' – essentially being the most senior security that will be “impaired” (will not achieve full recovery) and therefore most likely to be converted into equity in the restructured debtor. Investors holding a fulcrum position tend to have a greater role in the negotiation process and the formation of restructuring plans as the fulcrum investment is often at the centre of a debt for equity swap or an insolvency proceeding.

Another common method to achieve a fulcrum position is to inject new capital into the distressed firm. Admittedly supportive monetary policy and benign interest rates has meant that financially distressed debtors have found it easier to find capital sources of late. But even in the current climate, distressed debtholders still represent a source of liquidity for those companies and investors continue to position themselves to take advantage of this need. Moreover, the loans or capital injections are often sweetened by warrants or conversion rights, vesting hedge funds with a significant equity stake in the target company.

Finally, a distressed investor may accumulate debt and, insofar as it is permitted in the credit documentation and applicable law, then credit bid the value of that debt in a sale of the company or its assets. A key advantage with credit bidding from a hedge fund’s perspective is that it often cools any competitive bidding process for the company, thereby giving the activist investor an advantage compared to other creditors.

**Extracting Value vs Creating Value**

The universe of hedge funds focusing on restructuring companies (whether public or private) has been steadily growing. This is either through a dedicated restructuring strategy or via a special situations investment within an event-driven/distressed hedge fund. The majority of equity based hedge fund strategies look to extract market value from positions taken whereas activist hedge fund managers, by contrast, look to take longer term positions with a view to creating corporate value from within. This often involves the activist fund taking complex illiquid positions at below their intrinsic value and through active operational, financial and legal restructuring creating additional corporate value in that position.
Activism is the new normal

Over recent times, hedge fund activism has developed from a relatively incidental strategy among distressed investors to one of the most attractive strategies for managers of alternative investment funds armed with the funds and expertise needed to support their campaigns. Similarly, the market is also seeing many more hedge funds which would never call themselves activists trying the strategy when in a position where they think they can find and create value.

Hedge fund activism can therefore be viewed as a new middle ground between internal monitoring by large shareholders and external monitoring by corporate raiders. And the benefit from hedge fund activism goes beyond improved performance and share price at the actual target companies. For the presence of these hedge funds and their potential for intervention exert a disciplinary pressure on the management of public firms to make shareholder value a priority.

Previously, debtors responded to activist pressure using the same tactics employed to repel a hostile takeover bid – reluctance to directly engage, implementation of a poison pill or ignoring the activist altogether.

Although best practice has evolved significantly over the last few years and companies pursue these dated defence strategies at their peril, activists still need to be prepared for a hostile response from debtors that feel under threat and to be both resistant and adaptable in the face of initial defiance.

In these cases, it is vital that legal advice delivered to activist institutions is clear, pragmatic and able to be provided with the full range of options in mind.
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Overview

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