Investing in Distressed Assets (DA)

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Course Outline

OVERVIEW

DISTRESSED means any situation where some additional factor(s) leads to the sale of an asset or the extension of credit, outside regular channels and/or at non-market rates.

WHEN DO THESE OCCUR? There are always individual instances of someone having to transact business at a time they would prefer not to. We can think of these as “micro” versions, and they go on all of the time irrespective of broader business and economic cycles. There are also “macro” versions which come along in groups as a function of some type of pressure impacting one or more industries (and maybe even entire economies).

SHOULD WE GET INVOLVED? Some people view DA transactions as taking advantage of people when they are in a pinch. Others take the position that a second-tier market beats no market at all, and that those looking/needing to do a deal would rather have a sub-optimal option than to be shut out altogether. Like any other business, the ethics of the matter probably come down to the intentions and actions of the participants involved.

A FEW EXAMPLES. Foreclosures, Factored Receivables and Tax Liens (oh, my…). More in-depth “Rogue’s Gallery” to follow later.

CONCEPTUAL ISSUES

RULES OF ENGAGEMENT. DA investing doesn’t have a separate rulebook. It’s the same rulebook with a few additional chapters. DA investing is not based on “instead of” it’s based on “in addition to.”

WELCOME TO THE TWILIGHT ZONE, in which we try to answer the burning question, “How on earth could this have happened?” Making sense of what we see when we look at a DA deal. Attempting to determine if we’ve just found the proverbial too-good-to-be-true, a piece of junk that no one else wants and neither should we, or something in between (HINT: Blunt instrument analysis and generalities are not your friends)

WHAT WE THINK WE KNOW. Reconciling what the book tells us about investing with what we see in real life. The problem with the risk/reward lens.

ASSET VALUATION and other impossible pursuits

<u>WHY IT REALLY IS DIFFERENT</u>

THE SECRET LIVES OF DISTRESSED SELLERS. “We’re not having our rathers on this trip”

YOU WANT TO KNOW WHAT!?!? Data and the lack thereof.

ALL BUYERS ARE EQUAL, BUT SOME ARE MORE EQUAL. Deals have different values to different types of players.

<u>GETTING IN AND GETTING OUT</u>

RISK AND REWARD? How about Work and Reward? Closing the loop on how we convince ourselves that it might actually be a deal worth doing (even though conventional wisdom says it probably shouldn’t be).

JUMPING IN. Deal flow: where and how much. Which fear is driving your actions? Maxim: you make your money when you buy.

EXIT STRATEGIES. Metamorphosis without the cocoon: the buyer becomes the seller. What price? What terms? The acceptable-return school of thought vs the what-it’s-worth gang. Practical considerations (once you’ve tired of all the theory stuff).

<u>THE MARKET: PLAYERS AND DEALS</u>

TIRE KICKERS AND TROPHY HUNTERS. A gloss on your fellow investors, circa 2010.

SURVEY OF THE LANDSCAPE. Touring the Rogue’s Gallery. War Stories.

Appendix A

Rogue's Gallery of Common Distressed Assets

Although a distressed situation could conceivably apply to most any asset or financing situation, there are certain ones which by their very nature are generally regarded as distressed. This Appendix provides a list of some of the more common ones, along with a brief description.

Foreclosed Real Estate – Perhaps the most ubiquitous example of this broad class of assets, these are properties which had a mortgage where the borrower defaulted and the lender is now the owner. Usually involving a bank, these are referred to in the industry as "REO's" after the requirement under the regulations that banks reclassify these assets out of their loan portfolios into the balance sheet category "Real Estate Owned." Banks are meant to be lending institutions, not property holders. So they have to break this out to a separate line item so that outsiders will have a gauge of their effectiveness in underwriting loans and keeping them current. Suffice it to say that bankers hate REOs. Since they don't want them, they are motivated sellers; which means you have a shot at being a discounted buyer.

Discounted Debt – Banks dislike REOs so much in fact, that from time to time they sell the loan before it ever goes bad. This might be due to a belief that default is more likely than they are comfortable with, or it might just be a case of feeling "over concentrated" in a given type of debt or a specific geographical region. Bankers pay attention to diversification too, as do their regulators. So whether in answer to a finding from their examiners, or to avoid such a finding in the first place, banks are often willing to let someone else become the owner of a loan. Banks have to carry reserves on their books for all of their outstanding loans to borrowers, as a hedge against the possibility of default. These reserves are effectively a partial charge-off against the balance of each loan. Since the charge-off has already impacted their income they are often willing to walk away at a price that is less than 100 cents on the dollar (i.e. if the discount equals the reserve, there's no additional income statement impact for selling at less than par). When the debt is finally repaid though, the borrower is still on the hook for the full amount.

Over-Collateralized Loans – Sometimes a borrower is asset rich and cash poor. When this happens, they might be willing to pledge an asset that is more valuable than what would normally be required for debt of a given level. For instance, they might put up $5M worth of farmland to secure $1M in cash. The mismatch might, for instance, be due to concerns over the ability of the farmland to produce enough income to service the debt in a timely manner (since cash flow is one of the considerations a lender usually has to make; not just collateral). In such a case, the lender has virtually no risk in the deal because the "asset coverage" is so great. Deals of this type are not necessarily high yielders, but they can be extremely safe. These are also referred to as "low LTV" loans (LTV is an abbreviation for "loan to value," the ratio of the former over the later; in this case 1-to-5 or 20%).

Factored Receivables – Sometimes an operating business sells goods or services to a reliable customer, but has to wait a long time to get paid. In the meantime, that company still has to pay its workers, keep the lights turned on, service its debt, buy inventory and so forth. Cash needs of this type are referred to as working capital, and one of the oldest ways to finance working capital is to "sell" the right to collect from the customer, to someone who can wait to be paid. A typical deal might have the factor (the party that buys the receivable, which in this case is our distressed asset) giving the company $98 for every $100 worth of invoices. The factor makes his money by receiving the full $100 from the customer (who may not even be a party to the factoring transaction). To continue the example, let's say it takes an average of 45 days to collect. Our factor can "recycle" the $98 eight or nine times over the course of the year, picking up 2 additional dollars each time. By the time the year ends, he's received $16 to $18 for letting someone else use his $98; a return approaching 20%.

Discounted "Annuities" – Annuities are often identified with contracts written by insurance companies, but under their broadest definition the term really just refers to any stream of payments over time. Such streams can come from any source: royalty payments, structured settlements from lawsuits, even lottery winnings. Sometimes the owners of such streams of income want cash in hand. So they sell them in exchange for a lump sum. The amount offered by the purchaser can be used to calculate a rate of return (and in fact, usually what happens is that a desired rate of return is used to back into a sales price). The greater the need for the lump sum payment, the more likely the buyer will get a high return. (This type of transaction is what's referred to as a "discounted cash flow." Although this format doesn't lend itself to in depth discussion, DCFs are an important class of transactions that you might want to invest some time learning about, if you are not familiar with them. Most any college-level finance textbook should be able to provide you with comprehensive information.)

Municipal Tax Liens – Local governments rely on property tax collections to fund most of their budget (sheriff's dept, road crews, schools, etc). Since collection is so important, people who fail to pay such taxes face a harsh penalty: they stand to lose their property. But just as banks aren't really in the business of foreclosing on loans, neither are local tax offices much interested in seizing and selling property. So in about half the states, there are laws on the books that allow the government to effectively sell their right to collect to someone who is willing to put up the operating money needed today (sounds a bit like the offspring of factoring and discounted debt, no?). The collection right is conveyed by a financial instrument, often known as a Tax Lien Certificate, or similar; and in most places they are sold at an annual sale at the courthouse on every property that was delinquent for the last collection period. The rates on tax certificates are usually fairly high to reflect the punitive nature of tax delinquency (the delinquent property owner pays the interest, not the county), despite the fact that as investments go, they are usually extremely safe. Since the government is selling its rights to the lien holder, the lien holder generally has a superior claim on the property, even if there's a mortgage on it. If the property owner doesn't pay (both the lien balance, and the accrued interest) in a stipulated period of time, they run the risk of losing the entire property to the lien holder. The area of the law dealing with these is fairly arcane, and in the states where the biggest opportunities exist, large institutional buyers pick up a lot of the best deals. But in smaller jurisdictions or on properties where the locals know something the out-of-towners don't, there are always opportunities.

Tax Deeds – These are similar to tax liens, but they represent an interest in the property that is closer to full ownership. People who buy tax deeds (in most states) actually enter the chain of title, and though the delinquent owner may still have a few rights to redeem, he is getting very close to losing the property forever. These deals are much harder to do in bulk – as there are fewer of them, and each property usually has its own unique story – so there is not as much institutional involvement in this market. But the fewer number also means that you will probably have to flip more rocks and be patient for the good ones, versus being able to have lots of these going at one time. However, when they work, the investor usually walks away with a multiple of what was invested.

Liquidated Inventory – This is something that you probably shouldn't consider unless you have access to the necessary infrastructure. But if you do, you can take advantage of the fact that large commercial concerns are forever making ordering errors (buying too much of x) and discontinuing product lines while there is still inventory out in the market place. Also in the mix is the incidence of cosmetic damage during shipping and handling (even if only the carton). Large corporations routinely dump out of truck loads of these types of goods, often for just a few pennies on the dollar. To the extent that they are worth something to someone, you might be able to buy low enough that even a small markup yields a big return on capital. Again, this one isn't for everyone; but it's included to highlight the fact that distressed situations don't just occur with real estate and financial instruments, they occur with physical goods too.

Vacation Property – Especially during times of economic downturn, there are often very good deals to be had in the vacation property sphere. The reason is just as you would surmise. When people get in a pinch they are more likely to let the extras take the hit than they are to risk their main residence. Beach condos and mountain cabins (not to mention boats…) often end up first in line for the chopping block. There are usually two types of buyers: those who plan to use the property for their own enjoyment and see no reason to pay full price when discounts are available; as well as financial buyers looking to tap into a source of rental income, and/or ride the price back up when the economy recovers.

Bridges – Hey mister, I've got a bridge I'd like to sell ya. Just kidding…