For debt investors, the bad news is good news

By Tim O'Reiley
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For the obscure niche of investors who buy up distressed debt, the bad news continues to be the good news.

The economy has started to rebound, but too slowly to pull some struggling companies out of trouble. As a result, opportunities continue to crop up where lenders, particularly banks, will sell at steep discount loans in or close to default. The Palms, M Resort and Hooters Hotel are just three local examples in which distressed debt purchases led to ownership shake-ups.

"There is still a land rush ahead" for distressed debt investors, Gregory Segall, the CEO of Philadelphia-based Versa Capital Management, at said Thursday a Turnaround Management Association in Las Vegas Thursday. "I don't know if it will end in '12 or '13 or '14, but it hasn't gone away yet."

Michael Lipsky, senior portfolio manager of MatlinPatterson Capital Management in New York, added, "There are enough reasons to keep us busy so we don't have to wait for the next (down) economic cycle."

For example, managing director Christopher Alberta of Conway MacKenzie said restaurants will look especially good this year. They were battered by the recession but he foresees the trend reversing eventually.

Conway MacKenzie, based in the Detroit suburb of Birmingham, Mich., looks at chains and not mom and pop operations.

The conference follows a banner 2011 for distressed debt investing. Three years ago, problem loans traded at a one-third discount to face value as the financial system seemingly teetered on the edge of a major crash. Since then, businesses and their lenders increasingly have decided to quit fighting the tide.

"The biggest difference between '08 and now is two words: fear versus capitulation," Segall said. "We've been saying next year would be getting better for three years now." Instead, he added, the economic recovery has been "long, slow and flat," pushing banks and businesses to conclude that some loans are hopeless, opening the door for distressed debt sales. Versa Capital made only one investment in 2009-10, Segall said, but jumped on eight deals last year, all of them in capitulation situations.

Although not necessarily by name, distress debt investors are often depicted as the bad guys by Hollywood or on the political campaign trail because once they buy enough debt to take control of a company, layoffs, plant closures or total liquidations typically follow. Penn National Gaming, although not a distressed debt investor, used the same technique to take over the M Resort. The company paid $230.5 million for $860 million in loans on the property after default, then converted the debt to full ownership. As a result, developer Anthony Marnell III's undisclosed interest went down to zero.

Alan Carr, a managing director with Greenwich, Conn.-based Strategic Value Partners, said his company isn't always welcome when it asks for information about a company before buying distressed debt.

Not that the debt buyers are bothered much by their reputations.

Quite often, Segall acknowledged, they might restructure a company in a way that amounts to amputating an arm. Although critics would point out that investors started with whole bodies, Segall argued that radical surgery keeps patients out of the morgue.

"We are the ones who will try to keep a company going when no one else will," he said.

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