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An Efficient Market Hedge: Distressed Assets

We have become converts to the distressed debt investment story while reading the entries made by analysts about distressed funds on a popular website. The story makes sense. Buy cheap debt, protected by assets, which could become the fulcrum security that converts into equity ownership of the re-emergent entity, or in a bull case, will appreciate in value.

Many fund managers try to market their long fixed income portfolios since it provides income in a downturn and acts as a safety haven, which is better than losses typically realized in equities. But, the returns are meager and does not provide significant alpha to investors. Why should an investor only make money in a bull market? Should a bear market be sustained for a few years, then the opportunity cost would be material. So aside from the negative carry trades like CDS, or short positions typically taken by investors, one should consider distressed debt, and in this case distressed company acquisitions. These are large investments not available to retail investors, but the concept is very attractive.

One item we thought of was buying assets that go up for sale when a company goes out of business. For example, we heard an acquaintance knew of somebody who put up commercial waffle irons for sale, since they were going out of business. These items go on sale for 70-80% off the full retail price. Being on the opposite of the fire sales provide lucrative opportunities. Engaging in a negotiation requires tact and smarts to get the seller to sell at a price that is desirable for me. We are reminded of a famous value investor who stepped out of the norm and placed his capital in acquiring deep sea oil rigs, when they ran out of favor. Eventually, the market turned and the rigs were more appealing, pulling in higher multiples.

Pawn shops have been receiving media attention lately since they are a perennial money maker. Although the façade is dingy and associated with a bad image, the asset protection covered by the collateral and the high interest rate markups attribute to handsome cash flow generation.

We think some of the industries such as shipping, mining which were red hot, but fell apart post -2008, will make a comeback in the next 5 years.