LOOKING AT HEDGE FUNDS

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In a context where companies continue to look for new resources to facilitate the improvement of their financial liquidity due to the health crisis, hedge funds can be an "opportune" solution for all parties. We talked with Sixto de la Calle, of counsel in the Corporate and M&A area and

head of Eversheds Sutherland Nicea's Private Equity practice in Spain about this issue, about debt funds as an alternative to bank financing and their particularities. We also asked him about which are, in his opinion, the most active investment funds at the moment.

To begin with and as there are many definitions, although none of them "universally" accepted, describe to us what hedge funds are to you and how they differ from the so-called "opportunistic" funds and what their main characteristics are, as well as their advantages and disadvantages.

Probably it will be easier if we start by distinguishing between traditional private equity funds from those with a more opportunistic approach. And then, we will try to distinguish them from hedge funds. The situation created as a result of the pandemic paves the way for those willing to fish in troubled waters. Private equity is not an exception. Differences between traditional industrial private equity houses and those with a more opportunistic approach become more acute these days. Traditional private equity funds are typically engaged in investing in companies by acquiring a significant or controlling stake with the aim of improving the company through management changes, streamlining operations, or expansions, with the eventual goal of selling the company for a profit, either privately or through an initial public offering in a stock offering.

These private equity houses are navigating uncertain times. COVID-19 is hitting hard private equity. General Partners (i.e. the managers of the private equity funds) are today, literally, in the struggle of maintaining their portfolio companies alive. The task ahead of them is enormous and requires titanic efforts that, on many occasions, will not be satisfactorily rewarded as a good number of portfolio companies will inevitably perish. Business Plans are in the process of being amended, so are the financing agreements entered into with the private equities and financial institutions, managers need to adjust strategies constantly, and each investment needs to be reconsidered with new eyes. And despite all efforts, it will be difficult that under these circumstances these equity houses meet the very high investment return commitments promised to their Limited Partners (i.e. investors such as pension funds, insurance companies or family offices) within the agreed life term of the fund (i.e. typically ranging between four and seven years). Needless to say, that today the current

environment does not ease investing. And this is not only because of the managers struggle with their own portfolios but mainly because it is hard for them to accurately evaluate investment opportunities being surrounded with such levels of uncertainty. In other words, sometimes General Partners are unable to conclude whether an investment opportunity really fits with the investment criteria agreed with the Limited Partners. However, these very same circumstances pave the way for other sorts of opportunistic private equities to flourish. The focus of some private equity houses is precisely distress and special situations, and there is no doubt that there will be opportunities for them in the short term, particularly in the context of distress situations and insolvency proceedings. Finally, hedge funds are alternative investments that use pooled funds and employ a variety of strategies to earn returns to their investors. They are opportunistic by nature (as to some extent the private equity houses with a distressed angle), although the approach is different. The aim of a hedge fund is to provide the highest investment returns possible as quickly as possible. To achieve this goal, hedge fund investments are primarily in high liquid assets, enabling the fund to take profits quickly on one investment and then shift funds into another investment that is more immediately promising. Hedge funds could invest in anything and everything (e.g. bonds, commodity futures, derivatives, currencies) that offers high potential returns in a short period of time. There are some important differences between hedge funds and private equity. In terms of control, hedge funds have a lower level of influence over the management of assets, as the investment strategy does not rely on the improvement of a company results through the management (which requires some time to crystallize), provide debt that will be returned in the long term (trusting, therefore, in the company's ability to perform as a going concern) or the turn-around of a company (in the case of special situations private equity funds), but on the ability to take advantage of specific investment opportunities that can generate positive returns within a shorter span of time. Therefore, they are considered riskier in comparison to private equity funds.

The banks took on the first major impact caused by the COVID-19 on businesses; government measures also helped at the time. Now that the summer is over and the impact of the pandemic is still being felt, some businesses are planning to resort to debt funds, while the funds are demanding hybrid debt instruments. What is your reading of the situation?

Absolutely, my feeling is that the industrial fabric is somewhat comfortably numb as a number of companies have benefited from the government aid. But at the end of the day, although very positive, these measures have a transitory impact on companies which, sooner or later, will have to face their destiny with their own resources, very damaged as a result of the pandemic. Debt funds will be an oxygen balloon for many of these companies.

Indeed, some private equity funds are basically focused on providing financing to big corporations and mid-market companies as an alternative to bank financing.

Today, not only big corporations but also mid-market companies (i.e. we may typically place as mid-market companies those having an EBITDA ranging between Euro 2.5 to 8 Mio) have access to debt funds. Debt funds are sector agnostic and could potentially invest in any sort of company with some very few exceptions which are typically related to real estate development, alcohol, tobacco or betting.

What requirements must a company meet to be able to access this type of funds? For example, are companies with an undergoing restructuring process the most attractive for these funds?

We have seen numerous examples of large corporations, but what about SMEs or more medium-sized companies, can they also have access to these funds? As the investment criteria of the debt fund does not rely on the acquisition of a company's stake, there is no need for them to depend so much on company valuations (as it is for an industrial private equity), but on the ability of a company to repay the debt and provide sufficient guarantees as collateral of the financing granted. This is the

main requirement for a company to have access to these debt funds. Today, there are good big and mid-market industrial companies with historically robust balance sheets that, circumstantially, will have no access to additional bank financing in the short term because of the pandemic and, particularly, once the ICO funds exhaust. Many of these companies will certainly look towards these debt funds that have proliferated in Spain in recent years.

The typology of these debt funds is very wide, and there may be some blurred lines between what the natural investment opportunity of a debt fund and a special situations fund may be. Probably, the main difference relies on the historic financial stability of the target company. Pure debt funds would be keener to provide financing to companies with predictable returns and solid balance sheets while may feel reluctant to invest in companies which, for instance, may have experienced a sudden and significant drop of EBITDA in a very short period of time. In turn, it is precisely in these circumstances where a special situations fund may find itself in its element. Investment strategies of special situations funds are also very wide; they could potentially provide debt, acquire equity (e.g. a production unit within an insolvency proceeding) or provide hybrid debt instruments with the aim of converting debt provided into equity. It is true that the financing of a private equity debt fund may be more expensive compare to that provided by a financial institution, but it is also true that the risks assumed by the debt fund are usually higher. As a general rule, if a company seeks financing apart from traditional banks is because the company is somewhat navigating a distressing process and that inevitably has an impact on price. As it happens with the traditional private equity, General Partners of debt funds assume very high return undertakings vis-à-vis their LPs (with annual target returns ranging from 6% to 15%), being the nature of the LPs (i.e. the investors of the debt fund), in essence, the same as those of the private equity. However, it is true that not only opportunity and price play a role in the equation.

There are other important considerations that may lean the scale in favour of debt funds despite the price. Sometimes debt funds have the ability to provide certain degrees of flexibility that a bank is unable to provide today. For example, debt funds count with a wide range of debt instruments and are probably more likely to offer amortization schemes that suit better in a particular situation. It is not uncommon that debt funds propose a mezzanine financing (subordinated to the senior debt) in the form of bond that is fully payable on the maturity date (bullet). Likewise, a debt fund may possibly propose a client one-tranche bullet financing with interests fix rates ranging from 6 to 9 per cent) with a balloon payment on the maturity date (i.e. final amortization being higher than ordinary amortizations). Another element that may be relevant to elect a debt fund instead of a bank is speed. Debt funds structures are simpler, lees bureaucratized and are designed to take decisions in a very short lapse of time. Sometimes timing is a key element.

What funds lead this type of investment product in your opinion and what is, in your view, the key to their success? We would like you to tell us about some success stories of this type of funds, whether or not you at Eversheds have been involved.

Very recently, in the pre-COVID era, we have been lucky to take part in a number of investments by industrial private equity houses in Spanish companies. Among the more relevant ones was the transaction by which Three Hills Capital Partners invested €45 million in the multinational transport software and consulting company Goal Systems. Goal Systems incorporated an experienced partner into the company that not only provided the necessary financial support to develop the agreed business plan, accelerate growth and the conclusion of selective strategic acquisitions but also is helping today the company itself and the founding partners through these very uncertain times. One of the particularities of the transaction consisted of the investment scheme, as it was structured as a hybrid investment between equity and debt. This sort of structures encourages the injection of liquidity into a company through debt instruments, to undertake growth in an organic or inorganic way, combining the investment with the acquisition of a certain level of equity, but without

pretending to reach majorities. From special situations angle, we see Elliot, Avenue Capital and Sherpa Capital rather active. In our experience, they have the ability to identify and evaluate investment opportunities in a very pragmatic way while being straightforward with the target owners. Regarding pure debt funds, we have seen Incus Capital, Alantra, Ares and Starz very active.

Interview by Desiré Vidal

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