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Three Ways to Benefit from COVID-Induced Distress

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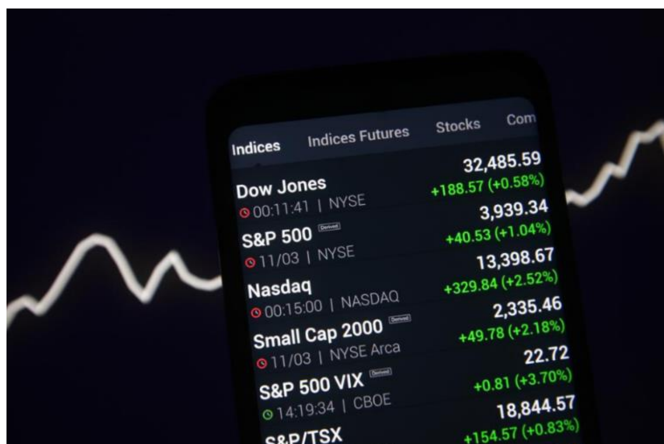
Recent financial headlines have touted several stories outlining how the amount of distressed debt has dropped precipitously, from $1 TN last March to under $100 BN today. That news might lead some investors to conclude that opportunities in distressed securities investing have dried up. However, while buying distressed debt for pennies on the dollar can be a winning strategy, there are numerous other attractive opportunities for investors in distressed companies before, during, and even after bankruptcy.



One such lesser-known strategy is to short sell the common stock of a company heading into trouble. In most cases, shareholders of firms that take a trip through bankruptcy court receive little or no recovery. Examples of this can be seen in several recent high-profile cases, like Chesapeake Energy, Whiting Petroleum, and Ultra Petroleum. While not without risk and definitely not for retail investors, short selling stocks of companies facing bankruptcy can provide potentially attractive event-driven returns.

Later, at the height of the company's distress and while it is operating under court supervision, the more typical distressed investment strategy is to purchase distressed debt. Purchasing the fulcrum debt security, which is the one most likely to be equitized, often presents the best risk/reward opportunity at that stage.

Another less well-known strategy is to buy stock issued by firms that were previously distressed but made it through a restructuring or are otherwise just recovering. Investors who don't understand that bankruptcy doesn't have to be the end of a good firm tend to be skittish about this strategy. Moreover, there are structural reasons why certain institutional investors tend to avoid such "post-distress" stocks temporarily. But this is where a diligent investor employing specialized analysis may find outstanding arbitrage opportunities. Success with post-distress stocks requires an ability to look forward and predict how the market will eventually feel about the firm a few years from now, after the distress fades away in the rearview mirror.

Besides the obvious benefit of being able to reduce excessive balance sheet debt via restructuring, several other factors sometimes go unnoticed among post-distress companies. One to consider is that firms in distress often generate large net operating losses ("NOLs") which, in turn, can create tax losses that may be carried forward. In analyzing two similar companies, one with NOLs and another without, the one with NOLs will be more valuable since they can shield it from future income taxes. General Motors, which reorganized in 2009, still has large NOLs which help increase its after-tax cash flow. Similarly, Pacific Gas & Electric,

which restructured in 2020, also has large NOLs. Both of these post-distress firms still look attractive on an after-tax cash flow basis versus their peers. Going forward, many more firms emerging from the COVID crisis will have large NOLs that can benefit their post-distress shareholders.

Last year, there were a record number of companies in distress due to COVID. But even before the pandemic, there was considerable distress in certain sectors like energy and retail. The energy space just got worse as oil prices briefly plummeted below zero. Similarly, the retail store industry got worse as COVID forced more shoppers online and away from stores. However, the pandemic also drove numerous other industries to a standstill and therefore many more companies found themselves in dire straits. But, since the darkest days of last Spring there's been a pretty big snapback thanks to all the governmental support—low interest rates and even "free money" in the form of loans and grants.

That assistance impacted the total amount of distressed debt outstanding, but the effect wasn't always direct. For instance, Boeing was already in trouble due to its 747 Max grounding, new order cancellations, and customers seeking refunds. Then, COVID hit and virtually shut down all air travel. Many of Boeing's distressed airline customers thus applied for relief under the CARES Act, but Boeing opted out to avoid issuing equity to the government. Instead, it issued new bonds after the Fed committed to all sorts of extraordinary measures including junk bond purchases. Of course, the situation was different for each distressed firm as was the solution. Some got out of distress because they borrowed from the government while others, like Boeing, succeeded in getting private financing after the government announced relief measures. Some just rebounded as the economy improved and customers started spending again.

Now, as the global economy continues to recover from COVID, it may seem like distressed investment opportunities have disappeared. However, that isn't true because nimble distressed securities investors can do well throughout a cycle, not just when defaults are high. As default rates drop and distressed debt supply diminishes, there are often great returns to be made from investing in post-distress stocks as the cloud of distress fades and they eventually get reaccepted by the marketplace over time.