Principal protection in distressed asset investments

The corollary of the widespread assumption of safety and value in blue-chip investments has given distressed assets a reputation for being intolerably risky. The purpose of this article is not to say that the strengths of a blue-chip enterprise are not the envy of one that is distressed, but to explore how this perception is precisely what helps create outsized value in the distressed asset segment.

A single investment ideology, formalized by Graham and Dodd – better known as the mentors of the legendary investor Warren Buffet and fathers of value investing – has guided investment outperformance across the world and domains for little over a century. A simple tenet of the broader ideology is that in a place where price is what one pays and value is what they get, they would benefit in the long run by paying a price lower than the value of the asset – which, spoiler alert, is exactly what distressed asset investing is about.

An asset can become distressed due to multiple reasons – fiscal imprudence, promoter conflict, litigation, unprecedented market overturn, and more. The distress, in most cases, causes material impairment in the price of the asset without an irreversible damage to its intrinsic value. It is the mantra of a distressed asset investor to gauge the value of the asset in the absence of the ailment, recognize the path to nurse it back to health, purchase it at an acceptable discount, and sell it back in good health.

It is often argued that there is greater risk to principal in such investments. A prudent analysis dictates that this opinion is broadly based on sentiment and not analysis. It is fair to think that it requires active involvement and it is not suitable for all investors to get exposed to such investments without focussed, professional assistance. However, assets purchased at a reasonable discount from a conservative estimate of their intrinsic value – largely hinging on the realizable value of assets – inherently possess a greater margin-of-error than purchase of even exceptionally well businesses at prices greater than their intrinsic value – usually derived from assumptions for recurring income generation deep into the future.

By the numbers, any purchase if made at a discount, say 40%, from the market value of the real asset shall prove to be robustly safe. Even if the markets were to correct by 20%, a liquidation would still yield a $33\frac{1}{3}$ % return. This discount supplies the investor with inherent principal protection. Such opportunities, while a common occurrence in the public equity markets during Graham and Dodd's time are a rarity now and disproportionately present within the special situation domain. Focussing strongly on real-asset heavy enterprises within the segment, Great Value Capital's special situation fund aims to capture and deliver this value with ultimate downside protection to its investors.

History is full of glorious tales of riches birthed on the advent of foreclosures. Sam Zell went on to build an enviable real-estate empire with Equity Office Properties Trust, the largest office property company of USA in 2007 – sold to Blackstone for $ 38.7 Bn in the largest PE transaction of the time – by buying foreclosure real estate that had no takers. Blackstone's 1993 fund, raised and deployed in the recession of the first half of the decade has continued to be one of the most profitable funds. Great Value Group's resolution of Moser Baer through NCLT is a similar and one of the latest marquee transactions in North India.

Aakash Kataria
Investment Analyst