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2024 Special Situations Investor Survey

A Review of 2023 and Predictions for 2024

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Introduction

We are delighted to present the findings from this year's Special Situations Investor Survey and share our thoughts on distressed deal activity for the year ahead. The Survey, which was conducted in December 2023, aggregates the views of UK-based investors focused primarily on alternative investments in the mid-market. These investors have a typical equity cheque size ranging from £10m to £100m per transaction and target returns of between 15% to 30%.

The key themes from this year's Survey include:

- The vast majority of investors saw an increase in special situations opportunities in 2023, with the increase in activity spiking in Q3 before subsiding slightly in Q4. This trend correlates with the 27% increase in UK administrations in the 12 months leading up to December 2023.
- Despite this, and in line with 2022, the number of transactions completed fell below expectations, with low-quality, poorly constructed turnaround plans, and very accelerated timetables being the primary challenges cited by investors.
- Opportunities in sectors exposed to discretionary spending (consumer, retail, leisure and construction) were unsurprisingly higher, together with low margin industries (industrial, automotive and engineering) where supply chain and inflationary pressures continued to cause problems for operators.
- Special situation investors appear to have found fundraising in 2023 more challenging despite having a core focus on turnaround opportunities, suggesting that institutional investors may be reluctant to allocate significant capital to private equity in the current environment.
- Looking forward to 2024, more than 70% of respondents are not optimistic about the outlook for the UK economy.
- More than 80% of investors are expecting to deploy more or significantly more capital on special situation investments this year.

We have been involved in a broad range of situations across sectors including high end consumer, retail, telecommunications, real estate, business services and energy. The triggers in these situations have varied and include listed vehicles struggling to raise capital, sponsors turning off liquidity taps, and lenders looking to reduce their exposure.

In line with respondents, our activity levels certainly increased as we approached the end of 2023, and this has continued into early 2024. We would encourage you to reach out, whether to discuss the Survey results, catch-up generally or understand how we can support you with any exits or acquisitions you are considering.

2023 in Review

Reflecting on 2023, it feels like 'Groundhog Day' with the 2022 themes of elevated expectations, and higher volume but lower quality opportunities appearing to dominate the Survey results once again.

Mid-market special situations investors began 2023 with expectations of improved deal flow in terms of both quality and quantum compared to prior years. The economic backdrop supported these expectations with stubborn inflation, rising interest rates, high corporate leverage, low consumer confidence, challenging operating conditions and geopolitical tensions across Europe and the Middle East. For many, 2023 was supposed to be the year when "zombie" companies would finally face their day of reckoning. Based on our Survey results, this expectation partially transpired with approximately 77% of investors seeing an increase in distressed deal activity.

Critically, this did not translate into significantly more capital being deployed as the quality of opportunities being marketed was typically lacking as was the case in 2022. One investor noted *"The vast majority of opportunities seen during the year have been relatively low quality and not suitable to a financial investor."* Other frustrations raised by investors included:

- Processes being launched too late to preserve value.
- Management solutions often lacking and without a credible recovery plan.
- Conventional cash levers having already been pulled, thus limiting cost driven recovery initiatives.

Anecdotally, this meant that a number of accelerated M&A processes resulted in either connected party deals (e.g. to existing shareholders, lenders or management) or in no material transaction at all. Other opportunities were better suited to strategic acquirers who could account for significant synergies. For example, Frasers Group continued its buying spree, including its acquisition of Matches Fashion in December 2023 and further equity stake building in various listed retailers. Investors also commented that the total volume of opportunities was propped up by corporate carve-out activity, which continued to be strong in 2023 whereas "interesting 'AMA' opportunities were severely limited."

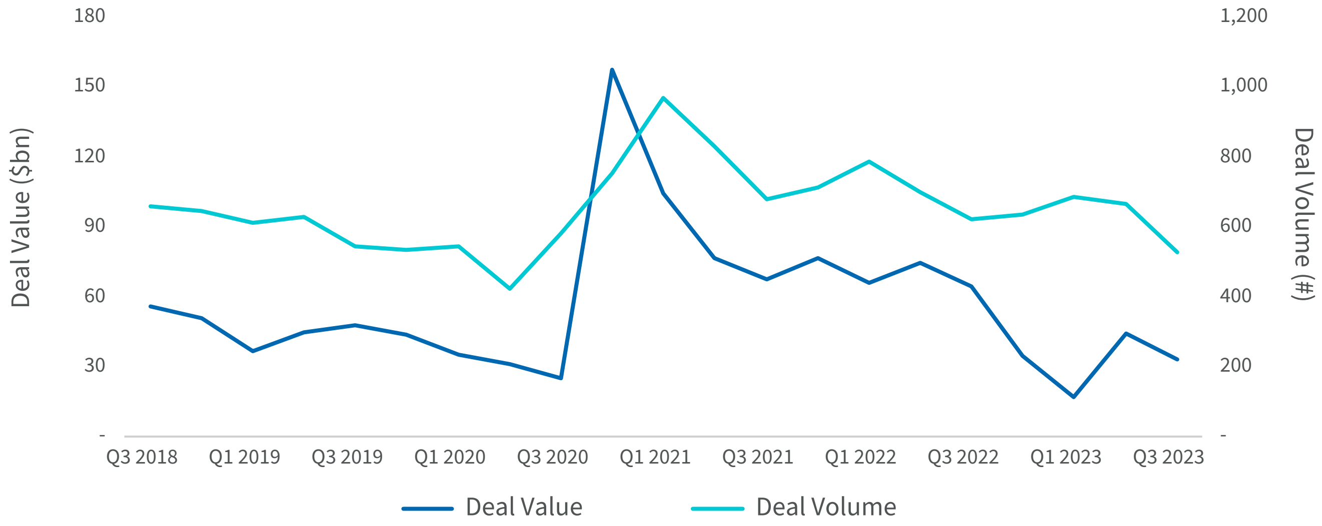
77% of investors saw an increase in distressed deal activity

During the year we also witnessed private credit funds taking ownership of distressed borrowers rather than forcing an accelerated sale to recover their lend. Whilst some of these processes involved non-consensual enforcements, many were a product of agreements between the lender and the sponsor which is reflective of the broader and symbiotic relationships between these stakeholders in the current market.

Disappointingly for turnaround investors and in contrast to previous downturns where leverage was typically held by high street banks, this approach meant many potentially higher quality investment opportunities were dealt with behind closed doors, with limited near term need for external special situations capital.

> *"Higher levels of carve-out activity was a key theme for businesses in 2023, as challenging assets were divested and core, profitable operations were prioritised."*
>
> – **Ben Hughes**, Senior Managing Director

Chart 1 – M&A Activity 2019 to 2023

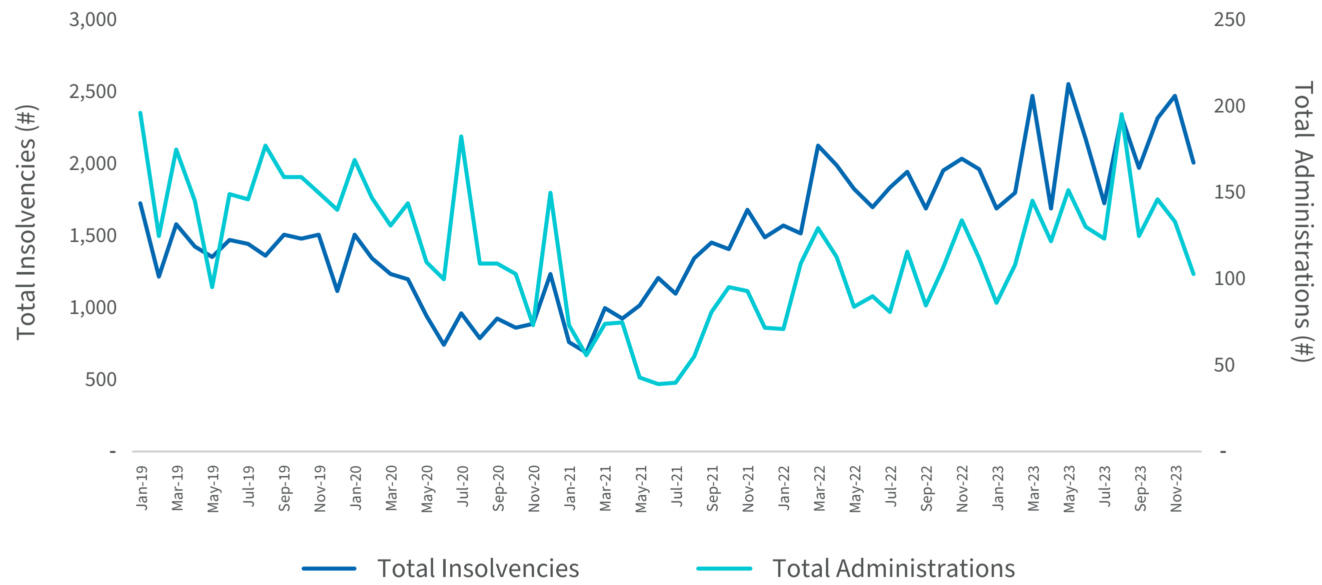


Source: https://mergers.whitecase.com/

Taking a step back to a macro perspective (see Chart 1), M&A activity in the UK followed global trends with deal activity in the 12 months to September 2023 down approximately 55% in value and around 11% in volume compared with the prior corresponding period. Low business confidence, tougher financing conditions and the surprising strength of the British pound, which had its best year against the US dollar since 2017, have been cited as contributing factors to this trend.

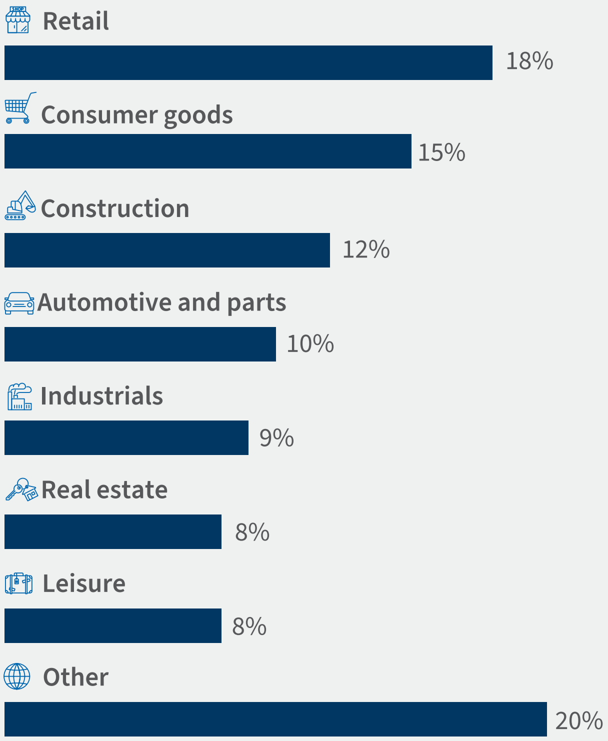
Conversely, UK insolvencies increased steadily over the 12 months to December 2023 at a rate of 14% compared with the prior corresponding period albeit with a notable 27% increase in administrations, which are more heavily correlated with delivering distressed deals whether to third or connected parties. This continued a theme seen in 2022 as decision-makers were forced to take decisive action following the withdrawal of COVID-19 support measures, along with the emergence of more challenging operating and financing conditions.

Chart 2 – Insolvency Statistics 2019 to 2023



Source: https://www.gov.uk/government/statistics/monthly-insolvency-statistics-november-2023

In which sector(s) did you see the most special situations opportunities in 2023?



Source: FTI Consulting 2024 Special Situations Investor Survey

Unsurprisingly, it was the sectors exposed to discretionary expenditure that suffered the most in 2023, with deal makers citing retail, consumer goods, leisure and construction as the most active in terms of opportunities. Industrial and automotive companies were also in the crosshairs as low margin businesses faced rising input costs with limited ability to pass these onto customers. Real estate saw an increase in activity too with commercial real estate materially impacted by changing working and living patterns and unsustainable financing structures based on out-of-date valuations.

Construction enters top 3 in 2023 for special situations opportunities, increasing 5% from 2022 to 2023

Investors have also been forced to reset return hurdles given the higher cost of capital, with the majority of surveyed investors citing that the rise in interest rates has resulted in either a moderate or significant increase in deal return hurdles. This has meant that at the same time that quality opportunities have been lacking, the return hurdles for many have simultaneously increased, resulting in an implied reduction in transactions completed.

The aforementioned economic challenges also contributed to a difficult fundraising environment for private equity in 2023, with the special situations community not immune. Survey respondents who attempted to raise funds in 2023 indicated that it was more difficult than prior years as institutional investors remain handcuffed from investing further in the asset class irrespective of the investment mandates of the relevant funds. As of September 2023, private equity firms raised approximately $509bn globally through 620 fund closings, which was only 46% of the prior year's total funds raised according to Prequin.[1]

> *"We have seen an increase in businesses coming to market but most were not suitable to turnaround investors as the least investible companies were typically the ones experiencing difficulty."*
>
> – **Callum Greig**, Managing Director

2024 Outlook

We expect further economic turbulence to create a platform for more special situation opportunities this year as flat gross domestic product ("GDP") growth, rising unemployment, numerous homeowners switching to variable rates and the increased (but hidden) tax burden offsetting falling inflation and limited interest rate movement.

Looking ahead to 2024, there appears to be an air of cautious optimism from investors in terms of the UK economy as inflation falls and central banks seem to have paused interest rate increases for the time being, with some forecasters even factoring in multiple decreases in the coming 12 months. However, this outlook may be overly optimistic:

— Inflation is expected to fall but should remain above the Bank of England's 2% target until late 2025. However, the experience of the UK and the biggest country in the EU, Germany, where the downward inflation trend reversed in the final month of 2023, is cause for some concern as evidenced by the market reaction to the UK data being released in January 2024.[2]

— Interest rates may have stabilised, but it is unclear when the Bank of England will begin reducing the rate from 5.25% which is the highest level since 2008.

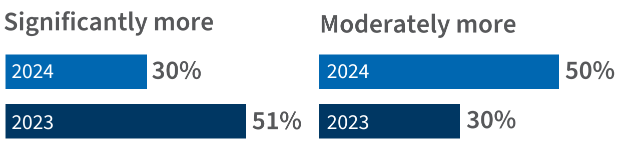
— UK GDP is expected to be flat in nominal terms and decline in real terms as the UK population experiences a significant fall in living standards.[3]

— Average mortgage costs are expected to continue to rise as homeowners roll-off fixed term mortgages, with a subsequent indirect impact on the UK rental market. It is unclear how economic forecasts are reflecting this significant reduction in consumer spending.[4]

— Unemployment forecasts suggest 4.6% of the labour force will be out of work by Q2 2025, with a significant increase in the number of large corporates announcing workforce reduction programmes late in 2023 and early in 2024.[5]

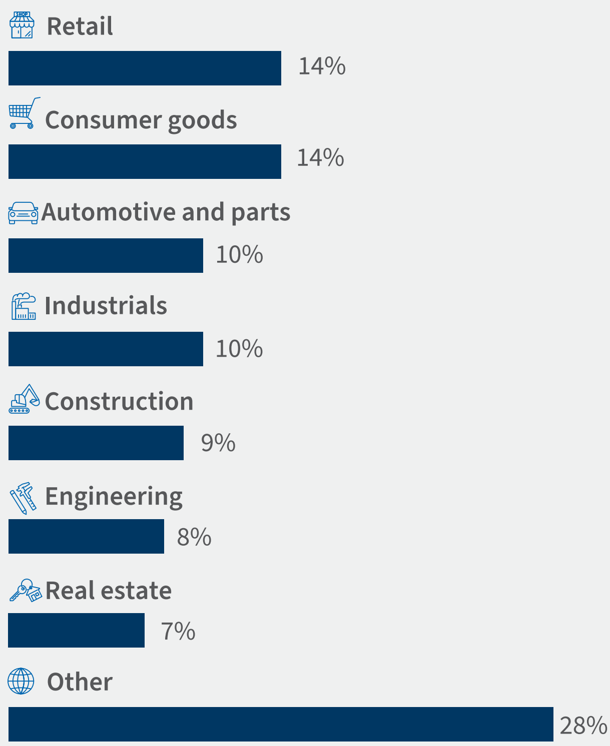
— Despite the national insurance reduction, the freezing of income tax thresholds will increase the tax burden on the UK economy to the highest levels since the mid-1900s.[6]

These concerns are re-enforced by special situations investors with more than 70% of respondents stating they are not optimistic about the UK economy in the near term. As a result, more than 80% of investors expect to deploy either moderately more (c.50%) or significantly more (c.30%) capital in the next 12 months.



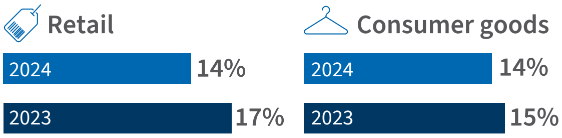
As shown below, investors expect the sector themes in 2024 to remain broadly unchanged as the existing areas of stress continue to negatively impact economic performance.

Which sector(s) do you expect to see increased special situations opportunities in 2024?



Source: FTI Consulting 2024 Special Situations Investor Survey

Despite a slight dip in expected special situations opportunities, **Retail and Consumer goods remain in the top 2 for a second year**



In terms of the causation behind the increased levels of distressed M&A activity, unsustainable debt servicing costs and failed refinancings accounted for more than 40% of Survey responses, followed by cost inflation and customer demand which respectively accounted for approximately 20% each. Whilst rates are broadly considered less likely to increase further, the combined impact of many sponsor-backed vehicles seeking to extend maturities ahead of an aspirational exit together with the expiry of often mandatory hedging arrangements on leveraged assets may lead to significant increases in capital structure-driven restructurings.

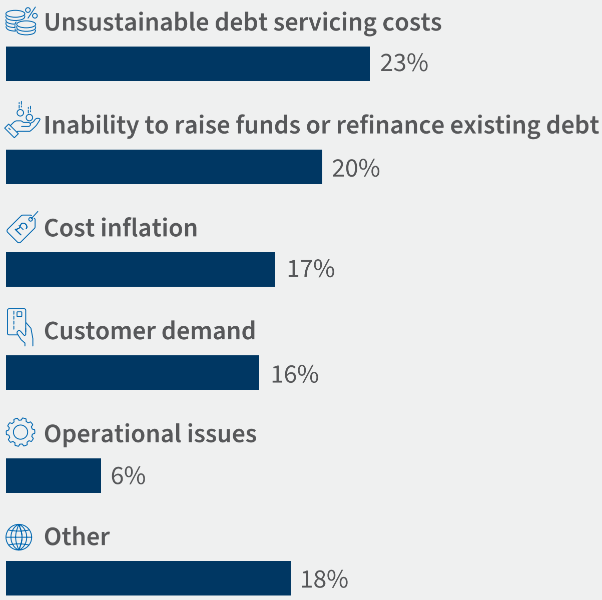
Other themes for the next 12 months identified in our Survey results include:

— Some mainstream funds, driven by investor pressure, will be forced to exit long held investments, most likely at subdued valuations.

— The trend of private credit providers taking ownership of distressed borrowers will continue.

We expect activity will increase steadily in 2024 as financing conditions remain tough, stakeholders become less supportive and a low growth economy drags on company performance. We also expect to see a rise in distressed activity for listed businesses, particularly small-cap companies, which will find it increasingly difficult to raise funding in the current environment and may require some form of insolvency process to transact given the additional complexities that come with trying to deliver solvent solutions quickly under the Takeover Code.

What factors will be more likely to contribute to the increased level of special situations investment opportunities in the sector(s) you've predicted to be most active?



Source: FTI Consulting Special Situations Investor Survey 2024

"We anticipate an increase in the volume of special situations opportunities as headwinds remain strong and sponsors are under more pressure to divest."

–**Ben Hughes**, Senior Managing Director

FTI Consulting’s Special Situations M&A Offering

We guide clients through challenging, complex and/or business critical issues, where specialist M&A expertise and advice is the key to delivering the optimal outcome.

Core Services

We provide the full suite of sell-side and buy-side M&A services for a range of clients across a broad array of sectors.

Accelerated M&A

Sale process with a truncated timetable due to a pending liquidity event or other precipitative factor such as unresolvable stakeholder conflict.

Accelerated funding solutions

Securing flexible capital for stressed or distressed corporates, where the funding requirement is more suited to special situation financiers.

Non-core exits

Sale process involving the exit of non-core divisions of large corporates or non-core investments sitting within private equity portfolios.

Strategic M&A support

Broad range of M&A support, including market mapping, sale process monitoring, retrospective sale process reviews, strategic option reviews and exit planning.

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Endnotes

1 WSJ: https://www.wsj.com/articles/private-equity-faces-gloomy-fundraising-forecast-for-2024-5951e96b

2 OBR – Chart 1.1: https://obr.uk/efo/economic-and-fiscal-outlook-november-2023/

3 ONS: https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/gdpmonthlyestimateuk/november2023

4 ONS: https://www.ons.gov.uk/peoplepopulationandcommunity/housing/articles/monthlymortgagerepaymentsup61foraveragesemidetachedhomeintheuk/2023-03-08 https://www.ons.gov.uk/economy/inflationandpriceindices/articles/costoflivinginsights/housing

5 OBR – Economic Outlook 1.10: https://obr.uk/efo/economic-and-fiscal-outlook-november-2023/

6 The Guardian: https://www.theguardian.com/politics/2023/oct/06/rishi-sunak-responsible-for-biggest-income-tax-rise-in-at-least-50-years