Special situations and distressed debt

Private Markets

1 A story: the salvage crew

- A salvage crew is paid for one event
- Not for a calm sea or a rising market
- Special situations: capital that salvages
- The return comes from the event being resolved

IN THE LESSON

- Picture a salvage crew.
- A ship runs aground, and the owner cannot wait.
- The crew is paid not because the sea is calm, or because ships in general are rising in price.
- It is paid because of one particular event, and because it can handle a messy job that most people cannot.
- Special situations investing is salvage for capital.
- Maya Osei at Larkspur Capital looks for companies and assets caught in a specific event, such as a restructuring or a forced sale, and asks what the situation will be worth once it is resolved.
- The event is the source of the return, and the direction of the market is not.

2 A menu of events

- Distressed debt and restructurings
- Rescue or bridge financing
- Spin-offs and forced asset sales
- Litigation finance
- Changes in regulation

IN THE LESSON

- What kinds of event does Maya look for?
- Here is the menu.
- Distressed debt and restructurings come first: a company cannot pay its lenders, and its debts are being reshaped.
- Rescue or bridge financing is new money lent to a company in a hurry, on strict terms.
- A spin off is a business split away from its parent, often ignored by both sets of owners.
- A forced asset sale happens when a seller must raise cash, whatever the price.
- Litigation finance pays for a lawsuit and takes a share of any award.
- And a change in regulation can strand some owners and reward others.
- Each is a different event, with its own catalyst.

3 Five features

- Event-driven: a catalyst releases the value
- Idiosyncratic: little tied to market direction
- Legally complex: courts, contracts, creditors
- Flexible capital: any layer of the structure
- More supply when credit stress rises

IN THE LESSON

- Now the features that these situations share.
- First, they are event driven.
- A catalyst, such as a court ruling or a completed sale, releases the value.
- Second, they are idiosyncratic, which means specific to one situation.
- The result depends little on market beta, the part of a return that simply follows the market up or down.
- Third, they are legally complex, with courts, contracts and many creditors involved.
- Fourth, they need flexible capital, able to invest anywhere in the capital structure, meaning the layers of funding such as loans, bonds and shares.
- Fifth, the supply of opportunities rises when credit is under stress, so the best chances come after trouble begins.

4 The same recovery, arriving later

Chart: Yearly return (IRR, %) vs Years to resolution (1 to 5)

- Buy 50, receive 75
- 50% in 1 year
- 14.5% in 3 years
- 8.4% in 5 years

IN THE LESSON

- Here is the risk that surprises people most.
- The horizontal axis is the years until the situation is resolved, from one to five.
- The vertical axis is the yearly return, the internal rate of return.
- Larkspur buys a claim for fifty and will be paid seventy five, however long it takes.
- Start on the left.
- If the money arrives in one year, the return is fifty per cent.
- Now follow the curve down.
- At three years the yearly return is fourteen point five per cent, and at five years it is only eight point four.
- The payment never changed.
- Only the date moved, and the steepest fall comes in the first extra years.

5 Example 1: delay and costs

Claim bought at 50; 75 expected

Multiple	75 ÷ 50	**1.50×**
Resolved in one year	1.5 − 1	**50.0%**
Resolved in two years	1.5^(1/2) − 1	**22.5%**
Resolved in three years	1.5^(1/3) − 1	**14.5%**
Three years, costs of 5	(70 ÷ 50)^(1/3) − 1	**11.9%**

IN THE LESSON

- Let us do the arithmetic for Larkspur's claim on Brennick Marine, a shipping services company in trouble.
- The fund pays fifty and expects seventy five, a multiple of one point five times.
- If the money arrives in one year, the return is fifty per cent.
- If it takes two years, take the square root of one point five and subtract one, which gives twenty two point five per cent.
- At three years, the cube root gives fourteen point five.
- Now add legal and advisory costs of five, paid at the end.
- Cash received falls to seventy, and the yearly return to eleven point nine per cent.
- The forecast recovery was right every time.
- The return still shrank.

6 The risks of special situations

- Legal and process risk: courts set the pace
- Catalyst timing: delay cuts the yearly return
- Valuation and recovery: estimates may be wrong
- Illiquid and concentrated: few holdings, hard exits
- Reputation: hard tactics can damage the firm

IN THE LESSON

- So the risks.
- The first is legal and process risk: courts, creditors and regulators set the pace, and Maya does not.
- The second is the timing of the catalyst, which we have just seen.
- A delay cuts the yearly return even when the recovery is as forecast.
- Third, valuations and recoveries are uncertain, because the business may be worth less than the advisers say.
- Fourth, these positions are illiquid and concentrated, so a few holdings carry the result and exits are hard.
- Fifth, there is reputational exposure.
- Aggressive tactics against a troubled company, its workers or its other creditors can damage a firm's name, and that matters when it raises its next fund.

7 A story: the bakery that went bust

- Bakery goes bust: many claims, one pot of money
- Distressed debt: deep discount, very wide spread
- Default is likely, or has already happened
- The price is a bet on how much comes back

IN THE LESSON

- Imagine a bakery goes bust.
- The flour supplier, the bank that paid for the ovens and the landlord all want to be paid, but there is only so much money.
- There are rules about who goes first.
- Distressed debt investing is buying those claims, at a price that reflects how little may come back.
- Debt is called distressed when it trades at a deep discount to its face value, with a very wide spread over a safe government bond, because default is likely or has already happened.
- The price stops being a view on interest payments.
- It becomes a bet on how much of the face value will actually be recovered.

8 What distress looks like in a price

Illustrative bonds, price per 100 of face value

Bond	Extra yield
Healthy, price 98	2%
Stressed, price 82	7%
Distressed, price 40	18%

IN THE LESSON

- Look at three invented bonds, priced per hundred of face value.
- The face value is what the issuer promised to repay.
- A healthy bond trades at ninety eight and pays two per cent a year more than a safe government bond.
- That extra yield is the spread.
- A stressed bond trades at eighty two and its spread is seven per cent.
- A distressed bond trades at forty, and its spread is eighteen per cent.
- See the pattern: as the price falls, the spread widens, because lenders demand more for the risk.
- At forty, the market is saying that default is likely.
- Then the question changes from whether interest will be paid to how much will be recovered.

9 Routes for a troubled issuer

Out of court

Waiver or amend and extend →
Exchange offer →
Asset sale or rescue capital

In court

File for reorganisation →
Rescue loan, super-priority →
Reorganise or liquidate

IN THE LESSON

- A troubled company has options, and they fall into two groups.
- The top row happens out of court.
- The company can ask for a waiver, which forgives a broken promise, or amend and extend, which pushes the repayment date later.
- It can offer an exchange, swapping old debt for new terms.
- Or it can sell assets or raise rescue capital.
- If those fail, follow the bottom row.
- The company files for court supervised reorganisation.
- To keep trading it borrows a rescue loan, called debtor in possession financing, and the court gives that loan super priority, so it is repaid ahead of the old debt.
- The business then either reorganises or is liquidated.

10 Out-of-court routes defined

Four ways to avoid court

Route	What it does
Waiver	Forgives a breach
Amend and extend	Pushes out maturity
Exchange offer	Swaps for new terms
Rescue capital	New money in

IN THE LESSON

- Here are the out of court routes in a line each.
- A waiver forgives a breach, such as a missed financial test, so lenders cannot demand repayment at once.
- Amend and extend pushes the maturity out and may change the pricing.
- An exchange offer swaps existing bonds for new ones on new terms, often with less face value or a lower rank.
- Rescue capital is new money, usually from lenders who insist on being repaid first.
- These routes are quicker and cheaper than court, but they need most creditors to agree, and a few holdouts can block a deal.
- When agreement fails, court is the fallback.

11 Three approaches, one rule

- Buy cheap debt and wait for recovery
- Active, non-control: sit on the creditor committee
- Loan-to-own: claims convert into control
- Recoveries follow absolute priority
- Key question: which class is the fulcrum?

IN THE LESSON

- How do investors act?
- There are three approaches.
- The simplest is to buy cheap debt and wait for recovery, taking whatever the process delivers.
- The second is an active, non control role.
- The investor sits on the creditor committee, the group that negotiates with the company, and shapes the plan without seeking to own the business.
- The third is loan to own.
- The investor buys claims that will be converted into control of the reorganised equity.
- All three follow one rule.
- Recoveries follow absolute priority: each class is paid in full before the next receives anything.
- So the key question is which class is the fulcrum, and we answer it now.

12 Example 2: find the fulcrum

Value 330. Claims in priority: 30, 180, 140, 90

Claims against value	30 + 180 + 140 + 90	**440 vs 330**
Left after rescue loan	330 − 30	**300**
Left after first lien	300 − 180	**120**
Second lien recovery	120 ÷ 140	**85.7%**
Unsecured notes recovery	nothing left	**0%**

IN THE LESSON

- Brennick Marine files for reorganisation.
- Advisers value it as a going concern at three hundred and thirty.
- The claims, in order of priority, are the rescue loan of thirty, first lien debt of one hundred and eighty, second lien debt of one hundred and forty, and unsecured notes of ninety.
- A lien is a claim secured on the company's assets.
- The claims add up to four hundred and forty, more than the value.
- Pay the rescue loan: three hundred left.
- Pay the first lien in full: one hundred and twenty left.
- The second lien is owed one hundred and forty and gets one hundred and twenty, which is eighty five point seven per cent.
- The unsecured notes get nothing.
- The second lien is the fulcrum security.

13 Who gets paid in Brennick Marine

Recovery (% of claim)

Rescue loan	**100%**
First lien	**100%**
Second lien	**85.7%**
Unsecured	**0%**

Fulcrum: the second lien

IN THE LESSON

- Here is that waterfall as a picture.
- The vertical axis is the recovery, as a percentage of what each class is owed.
- The first two bars are the rescue loan and the first lien, and both reach one hundred per cent.
- They are paid in full.
- The third bar is the second lien at eighty five point seven per cent.
- This is where the money runs out, so this class is the fulcrum, the most senior class that value does not fully cover.
- The last bar is the unsecured notes, at nothing.
- Notice that if the company's value rose or fell, the fulcrum could move up or down the stack with it.

14 Example 3: which claim to buy

Prices per 100 of face value

First lien at 96	pays 100	**1.04×**
Unsecured notes at 8	pays 0	**0.00×**
Second lien at 55	pays 85.7	**1.56×**
Verdict	the fulcrum; loan-to-own	**Second lien**

IN THE LESSON

- Now put prices on the classes.
- First lien debt trades at ninety six per hundred.
- It will be repaid at one hundred, a multiple of only one point zero four.
- Safe, but little upside.
- The unsecured notes trade at eight.
- They look cheap, but they recover nothing, so the multiple is zero.
- The second lien trades at fifty five and recovers eighty five point seven, a multiple of one point five six.
- It is the fulcrum, and it will probably be paid in the new equity.
- That is why Larkspur, if it wants control of the reorganised company, would buy this class.
- The trap is misjudging the fulcrum.
- Buy above it and the upside is small.
- Buy below it and you can lose everything.

15 Mistakes to avoid so far

- Judging the recovery and forgetting the date
- Treating special situations as a market bet
- Buying a fully covered class: no upside
- Buying below the fulcrum: wiped out
- Forgetting the rescue loan ranks first

IN THE LESSON

- Let us collect the mistakes so far.
- One: judging a deal by the size of the recovery and forgetting the date, when a delay can crush the yearly return.
- Two: treating special situations as a bet on the market, when the return comes from the event.
- Three: buying a class that is fully covered, such as the first lien, and finding there is no upside.
- Four: buying a class below the fulcrum, which can be wiped out whatever its price.
- And five: forgetting that the rescue loan ranks first, so the value left for everyone else is smaller than it looks.
- All five come from skipping the waterfall.

16 From forced seller to return

The seller

Capital rules or redemptions →
Forced to sell fast → Few bidders in time

The buyer

Complex documents →
Price set by negotiation → Paid for complexity

IN THE LESSON

- Think of a moving sale.
- A family must leave by Friday, so the sofa goes for far less than it is worth.
- Is the sofa bad, or is the seller in a hurry?
- That is the puzzle of this section.
- Read the top row first.
- A bank must meet capital rules, or a fund faces withdrawals, so it must sell quickly, and few buyers can act inside the window.
- Now the bottom row.
- The assets are complex, so the price is negotiated privately instead of set by a market.
- The buyer is paid a premium for handling the complexity and for accepting illiquidity.
- None of that depends on markets rising, which is the attraction.

17 Typical dislocation deals

- Portfolios of non-performing loans from banks
- Structured credit; orphaned and non-core assets
- GP-led secondaries and NAV loans
- Structured preferred equity

IN THE LESSON

- What do these deals look like in practice?
- The first is a portfolio of non performing loans, which are loans where the borrower has stopped paying, sold by a bank that needs to shrink its balance sheet.
- The second is structured credit, loans pooled and sliced into tranches, and orphaned or non core assets, which a parent no longer wants.
- Third come G P led secondaries, where a fund manager arranges the sale of fund holdings to new investors, and N A V loans, which lend against the net asset value of a fund.
- Last, structured preferred equity, a flexible layer of capital that sits between debt and ordinary shares and is tailored to a need.

18 What these deals share

- Complex documents and many stakeholders
- A short window to act
- Illiquid, with a price set by negotiation
- Return from complexity and liquidity premia
- Not from market direction

IN THE LESSON

- These deals have five traits in common.
- The documentation is complex, often running to hundreds of pages.
- There are many stakeholders, each with a different interest.
- The window to act is short, sometimes only a few weeks.
- The assets are illiquid, and there is no screen price.
- So the price is set by negotiation.
- Because of that, the return does not come from market direction.
- It comes from the complexity premium and the liquidity premium, and from the buyer's ability to structure a deal that the seller cannot do alone.
- Maya often says that her firm earns its return by being the buyer who can say yes quickly and carefully, and who reads the small print.

19 Example 4: the same discount, two answers

Face 400, price 30%, servicing 8%, three years

Price paid	30% × 400	**120**
Technical: net collected	48% × 400 × 0.92	**176.6**
Technical: yearly return	(176.6 ÷ 120)^(1/3) − 1	**13.8%**
Fundamental: net collected	36% × 400 × 0.92	**132.5**
Fundamental: yearly return	(132.5 ÷ 120)^(1/3) − 1	**3.4%**

IN THE LESSON

- Here is the puzzle in numbers.
- A bank offers Larkspur a portfolio of non performing loans with face value of four hundred, at thirty per cent of face.
- Larkspur pays one hundred and twenty.
- Servicing costs take eight per cent of collections.
- If the discount is purely the bank's forced selling, Larkspur expects to collect forty eight per cent of face over three years.
- After costs that is one hundred and seventy six point six, and a yearly return of thirteen point eight per cent.
- But if the borrowers have genuinely weakened, collections are only thirty six per cent of face.
- After costs that is one hundred and thirty two point five, and the yearly return is three point four per cent.
- Same price, very different deal.

20 Cheap for a reason?

Yearly return (%)

Technical case	**13.8%**
Fundamental case	**3.4%**
Fund target	**10%**

Same price, same discount

IN THE LESSON

- Here are those two answers as bars.
- The vertical axis is the yearly return, in per cent.
- The first bar is the technical case, where the price is low only because the bank must sell.
- It earns thirteen point eight per cent.
- The second bar is the fundamental case, where the borrowers have really weakened.
- It earns three point four.
- The third bar is Larkspur's target of ten per cent a year, which is our fund's hurdle for this kind of deal.
- The first case clears the target comfortably and the second falls far short, yet both start from the same price and the same discount.
- The discount alone cannot tell the two cases apart.

21 The trap: cheap for a reason

- Ask who is selling and why they must
- Technical: the seller's need drives the price
- Fundamental: the asset really is weaker
- Check that borrowers still pay and security is complete
- Underwrite the weaker case before bidding

IN THE LESSON

- The exam trap here is simple.
- An asset may be cheap for a reason.
- A good buyer separates technical selling pressure, where the price is low because the seller has to sell, from genuine deterioration, where the price is low because the asset is worse.
- Maya does this by asking who is selling and why they must.
- She tests whether borrowers still pay, and she checks the documents, because missing security can cut recovery.
- And she underwrites the weaker case before she bids.
- If the deal only works in the technical case, she knows she is relying on a hope.
- The seller's hurry can create a bargain, but it never guarantees one.

22 A story: surveying the flooded house

- Legal map first: who ranks where, under which law
- Business viability: can it earn again?
- Liquidity runway: how long does the cash last?
- People: management and other creditors' incentives

IN THE LESSON

- Suppose you are offered a flooded house at half price.
- A careful buyer does not simply admire the discount.
- First she reads the deeds, to see who owns what and who holds the mortgage.
- Then she checks whether the walls will dry.
- Then how much cash she has to cover repairs.
- Then who else is involved, such as neighbours and insurers.
- Maya Osei does the same for a distressed company, in this order: the legal map, then the viability of the business, then the liquidity runway, which is how long the cash lasts, and then the incentives of management and rival creditors.
- Only after that does she put a value on the claim.

23 From investigation to price

Investigation

Legal map → Business viability → Cash runway

Valuation

Going concern or sale value → Waterfall by scenario → Weight, compare to price

IN THE LESSON

- Here is the whole process in two rows.
- The top row is the investigation.
- The legal map comes first, because the law decides who is paid before whom.
- Next is business viability, and then the cash runway.
- The bottom row is the valuation.
- Maya first values the business as a going concern, using discounted cash flow or multiples of earnings, and also by what it would fetch if sold off, the liquidation value.
- Then she runs the recovery waterfall for each scenario, paying claims by priority.
- Last she weights the scenarios by probability and compares the weighted recovery with the price, over a realistic timeline.

24 The legal map

What each item tells Maya

Legal item	It tells you
Capital structure	Who ranks where
Intercreditor agreements	Who can block
Covenants and security	What is pledged
Insolvency regime	How courts act

IN THE LESSON

- Let us look inside the legal map.
- Four items matter most.
- The capital structure lists every claim and its rank.
- Intercreditor agreements are the contracts between lenders, and they say who can block a deal, who can enforce, and how proceeds are shared.
- Covenants and security say which promises have been broken and which assets are pledged to which lender.
- And the insolvency regime of the relevant country decides how a court treats each class, how long it takes, and whether the company can keep trading.
- Two companies with identical numbers can have very different recoveries if their laws differ.
- That is why legal advice is part of the valuation, not an extra.

25 Recovery, expected recovery and return

Recovery = min(claim, value left) ÷ claim
Expected recovery = Σ probability × recovery − legal costs
Yearly return = (expected recovery ÷ price)^(1/years) − 1

Value left	What this class can be paid
Probability	From the diligence
Legal costs	Paid out of recovery
Years	Time to cash in hand

IN THE LESSON

- Three small formulas do the work.
- The first is the recovery of a class.
- It is the smaller of the claim and the value left for that class, divided by the claim.
- If value is short, the class gets less than it is owed.
- The second is expected recovery.
- Multiply the recovery in each scenario by the probability of that scenario, add them up, and subtract the legal costs.
- The third is the yearly return.
- Divide the expected net recovery by the price paid, raise the result to one over the number of years, and subtract one.
- Probabilities come from the diligence.
- Legal costs and years are the terms that people most often forget.

26 Example 5: price the second lien

Second lien claim 140; price 55; two years; target 15%

Reorganise: probability 65%	(330 − 30 − 180) ÷ 140	**85.7%**
Liquidate: probability 35%	(250 − 30 − 180) ÷ 140	**28.6%**
Weighted recovery	0.65 × 85.7 + 0.35 × 28.6	**65.7**
After legal costs of 3	65.7 − 3	**62.7**
Yearly return at price 55	(62.7 ÷ 55)^(1/2) − 1	**6.8%**

IN THE LESSON

- Now Maya prices the second lien.
- Scenario one is reorganisation, with a value of three hundred and thirty.
- Three hundred and thirty less thirty less one hundred and eighty, over the claim of one hundred and forty, gives a recovery of eighty five point seven.
- Scenario two is liquidation, with a value of two hundred and fifty.
- After the same two claims, two hundred and fifty less thirty less one hundred and eighty, over one hundred and forty, gives a recovery of twenty eight point six.
- She gives reorganisation a probability of sixty five per cent and liquidation thirty five.
- The weighted recovery is sixty five point seven.
- Legal costs of three leave sixty two point seven, received in two years.
- At a price of fifty five, the yearly return is only six point eight per cent.
- That is far below the fifteen per cent Larkspur wants.

27 What price clears the target?

Chart: Yearly return (%) vs Price per 100 of face (40 to 62)

- Target 15%
- Pay up to 47.4
- Offer at 55: 6.8%

IN THE LESSON

- So what price would work?
- This picture shows the yearly return against the price paid.
- The horizontal axis is the price per hundred of face value, from forty to sixty two.
- The vertical axis is the yearly return.
- Larkspur keeps the expected recovery and the timing fixed.
- Follow the curve: the cheaper the claim, the higher the return.
- The flat line is the fifteen per cent target.
- The curve crosses it at a price of about forty seven point four, which is the most Larkspur should pay.
- At fifty five, the price in the offer, the return is six point eight per cent, well under the line.
- Maya should negotiate or walk away.

28 Example 6: costs and delay bite

Second lien at 55; recovery 65.7 before costs

As planned	2 years, costs of 3	**6.8%**
No legal costs	65.7 ÷ 55, 2 years	**9.3%**
Delay to four years	62.7 ÷ 55, 4 years	**3.3%**
Price for 15% in 2 years	62.7 ÷ 1.15^2	**47.4**

IN THE LESSON

- Finally, the trap in this section: ignoring legal costs and delay.
- Keep Maya's second lien at fifty five.
- Start with the plan, two years and costs of three, which gave six point eight per cent.
- Now remove the costs altogether.
- The recovery is sixty five point seven, and the return rises to nine point three per cent, so the costs take a real bite.
- Next keep the costs but let the case run to four years.
- The yearly return falls to three point three per cent, though the recovery has not changed.
- Last, the price that would deliver fifteen per cent in two years is sixty two point seven divided by one point one five squared, about forty seven point four.
- So costs and delay both cut directly into the price you can safely pay.

29 Strategies from steadier to equity-like

- Direct lending
- Senior rescue lending
- Secured distressed claims
- Control distressed
- Litigation finance

IN THE LESSON

- Now to the allocation question.
- Place the strategies on one line.
- On the left are the steadier, contractual returns.
- Direct lending, ordinary private loans paying interest, sits far left.
- Next is senior rescue lending, new money that ranks first and is repaid by contract.
- Secured distressed claims are in the middle: they have collateral behind them, but their recovery depends on the process.
- Moving right, control distressed positions behave like equity, because the investor owns the reorganised company and the value is a gain, not a coupon.
- At the far right is litigation finance, where the payoff depends on a court outcome.
- Targets rise along the line, and so does the spread of possible results.

30 Special situations against direct lending

Special situations compared with direct lending

Feature	Special situations
Target return	Higher
Current income	Lower
Capital gains and timing	Lumpy
Best vintages	After stress

IN THE LESSON

- Compare special situations with direct lending in general.
- Special situations target a higher return, which compensates for the extra risk.
- But they pay less current income, because the investor is waiting for an event.
- Most of the return comes from capital gains, and those arrive in lumps at uncertain dates.
- The opportunity set is countercyclical: it grows when credit is under stress, so the best vintages, the years in which a fund starts investing, tend to follow downturns.
- Direct lending is the opposite.
- It pays steady income through the cycle, and its best years are the calm ones.
- They are partners in a portfolio, not substitutes for each other.

31 Example 7: a sleeve for Fenmoor

Need 6% income. Lending 8%; special 14% (3% income)

Return, 85/15 mix	0.85 × 8 + 0.15 × 14	**8.9%**
Income, 85/15 mix	0.85 × 8 + 0.15 × 3	**7.25%**
Gains, 85/15 mix	8.9 − 7.25	**1.65%**
Income, 50/50 mix	0.5 × 8 + 0.5 × 3	**5.5%**
Verdict	the 50/50 mix fails the 6% need	**Keep 15%**

IN THE LESSON

- Now a decision.
- Fenmoor Pension Plan has a private credit sleeve that must produce at least six per cent a year in income.
- Direct lending targets eight per cent, all of it income.
- Special situations target fourteen per cent, but only three per cent arrives as income.
- Consider a mix of eighty five per cent lending and fifteen per cent special situations.
- The return is eight point nine per cent.
- The income is seven point two five, comfortably above the need.
- The remaining one point six five comes from gains.
- Now try half and half.
- The income drops to five point five, which is below six.
- The plan could not pay its bills from that mix, so the sleeve must stay small.

32 Propose and defend

- Propose: about 15% of the private credit sleeve
- Defend: income stays above the 6% the plan needs
- Defend: gains add 0.9 points and follow another cycle
- Risk: lumpy, late gains; needs patience and skill
- Not a yield product: the payoff is event-driven

IN THE LESSON

- Here is how Maya would put the recommendation to Fenmoor's trustees.
- Propose a modest sleeve, about fifteen per cent of private credit, with capital held ready for periods of stress.
- Defend it with the numbers: income stays above the six per cent the plan needs, and the gains add nine tenths of a point of return, and a different cycle from steady credit.
- Then name what could go wrong.
- The gains are lumpy and late, so the plan needs patience.
- Results depend on specialist skill.
- The trap is to treat special situations as a yield product, a higher paying cousin of direct lending.
- Their payoff is driven by events, not by coupons.

33 Recap: the lesson in five lines

- Event-driven: delay cuts the yearly return
- Fulcrum: first class value does not cover
- Forced sellers: technical or genuine weakness?
- Legal map, scenarios, costs, years
- Modest sleeve that complements steady lending

IN THE LESSON

- Let us pull the lesson together.
- First, special situations are event driven and idiosyncratic, and delay is a risk of its own: the same recovery, paid later, gives a lower yearly return.
- Second, distressed debt trades at a deep discount, troubled issuers use waivers, exchanges, rescue capital or court, and the fulcrum is the first class that value does not fully cover.
- Third, forced sellers create complex deals, and the buyer must tell technical selling from genuine weakness.
- Fourth, diligence starts with the legal map, then weighs scenario recoveries and subtracts costs.
- Fifth, the sleeve is modest and opportunistic, and complements steady lending.

34 Try three quick questions

1. Buy at 40, receive 50 after three years. Yearly return?
   Answer: (50 ÷ 40)^(1/3) − 1 = 7.7%.
2. Value 250; claims 20, 150, 100 in order. Fulcrum and recovery?
   Answer: Junior class: (250 − 20 − 150) ÷ 100 = 80%.
3. Recoveries 90 or 30, equally likely; costs 4; price 50; two years. Yearly return?
   Answer: Net recovery 56; (56 ÷ 50)^(1/2) − 1 = 5.8%.

IN THE LESSON

- Now try three quick questions yourself.
- Pause after each one.
- Question one.
- A claim is bought at forty and fifty is received after three years.
- What is the yearly return?
- Fifty over forty, cube rooted, less one, gives a yearly return of seven point seven per cent.
- Question two.
- Value is two hundred and fifty.
- The rescue loan is twenty, the senior debt one hundred and fifty, and the junior debt one hundred.
- Which class is the fulcrum, and what does it recover?
- After the first two classes, eighty is left against one hundred owed, so the junior class recovers eighty per cent and is the fulcrum.
- Question three.
- Recoveries of ninety and thirty are equally likely, costs are four, the price is fifty and the time is two years.
- Net of costs the recovery is fifty six, and the yearly return is five point eight per cent, which is thin for the risk taken.