

AN FTI CONSULTING REPORT – PUBLISHED JANUARY 2023

2023 Special Situations Investor Survey

A Review of 2022 and Look Ahead to 2023



Introduction

We are delighted to present the findings from the second FTI Consulting Special Situations Investor Survey and share our own thoughts on distressed deal activity for the year ahead. The survey, which was conducted in December 2022, aggregates the views of UK-based investors focused primarily on alternative investments in the lower to upper mid-market with a typical equity cheque size ranging from £10 million to £100 million per transaction.

Key themes from this year's survey:

- The majority of investors (65%) saw an increase in special situations investment opportunities in 2022, with this pickup in activity coming through in the second half of the year.
- Despite this increase, the number of transactions completed was below expectations, with the quality and/or size of the opportunities commonly cited as the reasons for not pursuing or closing deals.
- The most active sectors in 2022 were retail (22%), consumer goods (19%), automotive (13%) and industrials (10%). Investors expect this theme to continue in 2023 given the specific challenges faced by these industries.
- 80% of respondents expect to deploy more capital in 2023 compared to 2022, given their expectation that both the quality and quantum of special situations investment opportunities will improve.
- Compared to accelerated M&A (“AMA”) opportunities, the corporate carve-out market was a more fruitful hunting ground for special situations investors in 2022. The expected rise in AMA processes this year suggests this trend could reverse in 2023.

“Given the headwinds facing UK corporates, I think we are heading for a period of increased activity in the special situations M&A market that will cover (1) company rescues where a transaction needs to be delivered ahead of a pending liquidity event (2) large corporates seeking to exit non-core divisions, and (3) sale processes conducted to benchmark value to support a financial restructuring. Whilst I don’t think it will be the tsunami of mandates that some have previously predicted, I believe special situations M&A will be a trend for the coming years and turnaround investors will play a vital role.

I hope you find the report insightful and would like to thank the significant number of investors who responded to the survey.”

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2022 in Review

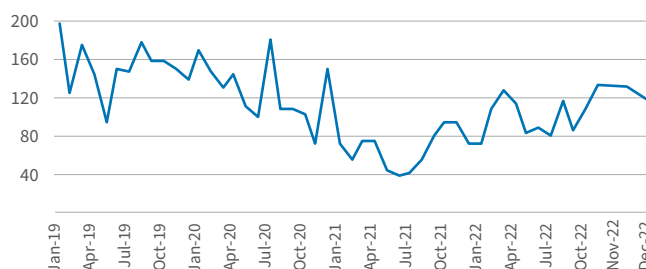
Despite a gradual pickup in Special Situations M&A (SSM&A) activity in the second half of 2022 and some notable transactions throughout the year, the wave of opportunities that had been predicted to come to market since the onset of the pandemic is still yet to materialise.

A key takeaway from our inaugural Special Situations Investor Survey from 12 months ago was that almost 90% of respondents expected SSM&A activity to increase over the course of 2022. The reasons given for the expected increase in activity were (1) 2021 being a soft comparator as it was a quiet SSM&A market and (2) the challenges faced by UK corporates primarily, disrupted supply chains, the unwind of government support measures, inflationary pressures, and record levels of corporate and government debt.

Whilst the 90% were correct in that 2022 would present multiple challenges to UK companies, few if indeed any respondents would have predicted what was to follow, including:

- Russia's invasion of Ukraine and the knock-on effects, including skyrocketing energy costs and wide ranging sanctions;
- three UK prime ministers in two months;
- a mini-budget that damaged investor sentiment towards the UK, plunged the GBP to a low of 1.035 against the USD⁽¹⁾ and spooked the gilt yield markets to the point where the Bank of England intervened to prevent a market meltdown;
- private and public workers across the UK stepping up pressure over pay rises with co-ordinated strikes across a range of industries (417,000 days of work were lost in October 2022 alone⁽²⁾); and
- the bank rate increasing from 0.25% in December 2021 to 3.5% in December 2022 across eight separate rate rises.⁽³⁾

Figure 1 - Number of Administrations by Month⁽⁴⁾



As the financial shockwaves of these events started to be felt by UK corporates, restructuring activity picked up, and the number of companies entering administration began an upward trend from August 2022, albeit notably still c.30% lower compared to the same period in 2019.⁽⁴⁾

With the volume of administrations being a fair proxy for SSM&A activity, this rising trend supports the results of our survey. 65% of investors reported that the total quantum of opportunities in 2022 was higher than in 2021, with 71% of these respondents seeing an increase in the latter stages of 2022.

Whilst special situations investors were encouraged by an increase in activity, a number of opportunities brought to market (particularly for those investors with limited appetite for retail) were deemed either too small and/or past the point at which a successful turnaround could be achieved. This is reinforced by analysis of the investment activity of 45 turnaround funds, which shows a 30% decline in the number of transactions completed in 2022 compared with 2021.⁽⁵⁾

2023 Outlook

The number and quality of special situations investment opportunities brought to market in 2023 is expected to improve as companies grapple with a slowing economy and stronger macro headwinds causing restructuring activity to increase.

2023 is forecast to be even more challenging for companies given a worrying mix of high inflation, unprecedented energy prices and declining disposable income and consumer confidence, along with continued supply chain disruption and staffing shortages.

1 INFLATION – PEAKED

Consumer Price Index is expected to have peaked at 11.1% in Q4 2022 and is forecast to decline to 10.2% in Q1 2023 before falling to 2.5% by Q1 2024. Had it not been for the Government's Energy Price Guarantee, CPI would have peaked at 13.6% in Q1 2023.

10.2%

2023 Q1 inflation forecast⁽⁶⁾

2 RHDI – SUSTAINED DRAG INTO 2024

Real household disposable income is forecast to fall by 4.3% in 2022-2023, which would be the largest drop since ONS records began. A further fall of 2.8% is forecast for 2023-2024 which would be the second largest drop.

-7.1%

Decline in RHDI across 2022-2023 and 2023-2024⁽⁶⁾

3 REAL GDP – OFFICIAL RECESSION INCOMING

Gross Domestic Product ("GDP") declined by 0.2% in Q3 2022 but is likely to have remained steady in Q4 2022. However, GDP is then forecast to fall by 1.4% in 2023 before returning to growth of 1.3% in 2024.

-1.4%

Real GDP decline in 2023 as the UK navigates a lengthy recession⁽⁶⁾

4 BAD DEBTS – RISING AND RISING

In October 2022 Credit Suisse estimated that UK banks may have to write off £47 billion of bad loans from 2023 to 2025 as the economic outlook darkens. This is a £6 billion increase on their worst case estimate made in 2022.

£47bn

Potential level of bad debt write-offs for UK bank in 2023-2025⁽⁷⁾

These factors, combined with higher interest costs and tighter credit markets, will also make it more difficult for a company to refinance existing debt or raise new capital. As one investor commented *"with so much secured debt flooding the SME market during Covid-19, the biggest challenge will be finding headroom in businesses' balance sheets to support further lending."* In situations where funding is required but not forthcoming from new or existing shareholders and lenders, a sale of the business is likely to be the next best alternative.

In line with the vast majority of respondents to our survey, we expect 2023 to bring a continuation of the upward trend in restructuring activity that we saw at the back end of 2022. This should result in the increase in larger and higher quality investment opportunities

that special situation funds have been waiting for. With mainstream private equity also sitting on a record amount of dry powder and a slowdown in that market, it will be interesting to see how they approach capital deployment in 2023 and whether some move into special situations territory given this outlook.

This uptick in activity will also present "cash long" and less risk averse corporates with the opportunity to drive future growth via acquisitions by removing competitors, increasing market share, entering new products or territories and targeting synergies. Overseas investors and corporates with non-sterling-denominated capital may also view the UK as more attractive given the relatively weak GBP.

Survey Results: Looking Back

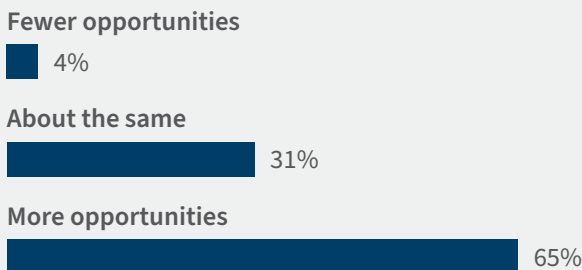
Whilst investors witnessed an uplift in activity in the second half of 2022, most of this activity was related to lower mid-market (or below) opportunities or less attractive sectors with turnaround stories that investors found difficult to underwrite.



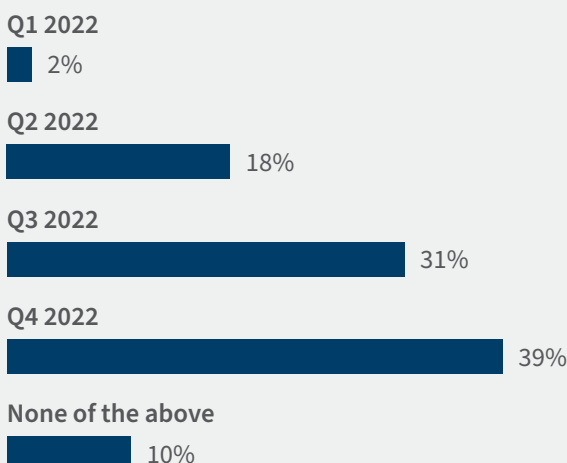
2022 Activity Gauge

65% of survey respondents witnessed higher levels of SSM&A opportunities in 2022 compared to 2021, with 70% indicating this came through in the second half of the year, which is consistent with the trajectory of the negative economic trends experienced by the UK over the same period. However, the quality of these new investment opportunities compared with pricing expectations was the most commonly cited reason by investors for not pursuing or closing transactions.

How does the volume of special situations investment opportunities seen in the UK in 2022 compare with 2021?



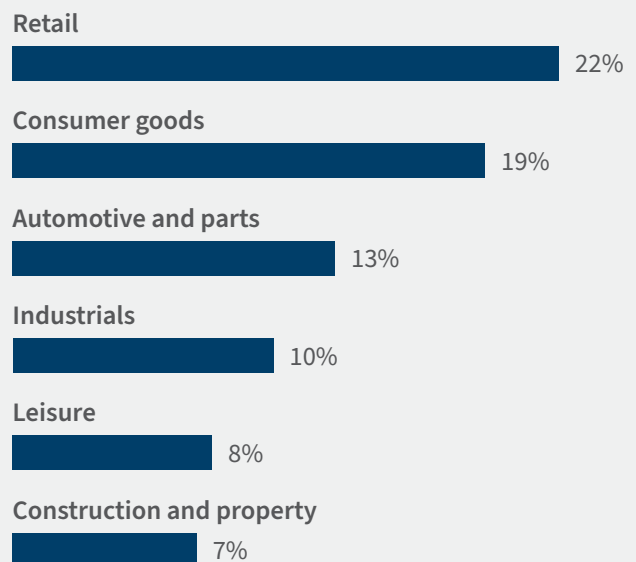
When did you see increased levels of special situations M&A activity in the UK in 2022?



Sector Hotspots

Last year's survey correctly identified what would be the top six sectors in terms of SSM&A activity in 2022. The retail sector, which tends to be of limited interest to a majority of turnaround investors, presented the most opportunities in the year. Interestingly, a number of these situations involved pure-play online retailers, suggesting this channel may not be the panacea for the sector as many had predicted.

How does the volume of special situations investment opportunities seen in the UK in 2022 compare with 2021?



Note: Graph showing top 6 sectors only

The most active sectors were those that were impacted more acutely by inflationary pressures, a weaker GBP and supply chain disruption. Unsurprisingly these sectors also experienced the largest increase in insolvencies over the course of 2022.⁽⁸⁾

Survey Results: Looking Ahead

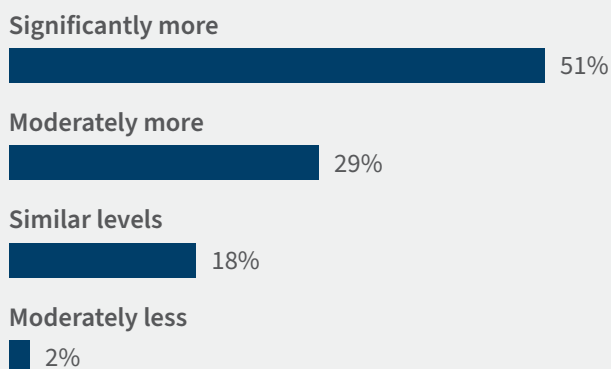
Looking ahead, special situations investors expect to deploy significantly more capital this year and predict a continuation of the sector themes experienced in 2022. In the succinct words of one turnaround investor, *“the levels of debt, cost increases and flat sales should make it an interesting year.”*



2023 Predictions

Despite there being an increase in investment opportunities in 2022, the level of capital deployed was still modest as investors chose to hold fire for better quality and/or larger businesses to come to market. Investors anticipate this will happen in 2023, with 80% of respondents expecting to deploy significantly (51%) or moderately (29%) more capital this year.

Do you expect to deploy more capital in 2023 than in 2022?



Almost half of those investors expecting to deploy significantly more capital have a healthy war chest of between £100m and £250m, the majority of which (64%) typically target transactions below £15m, and the remainder between £15m to £50m. Interestingly, those expecting to deploy moderately more capital have the least amount of dry powder of the sample, implying additional fundraising may be required to capitalise on the more lucrative SSM&A opportunities that may arise in 2023.

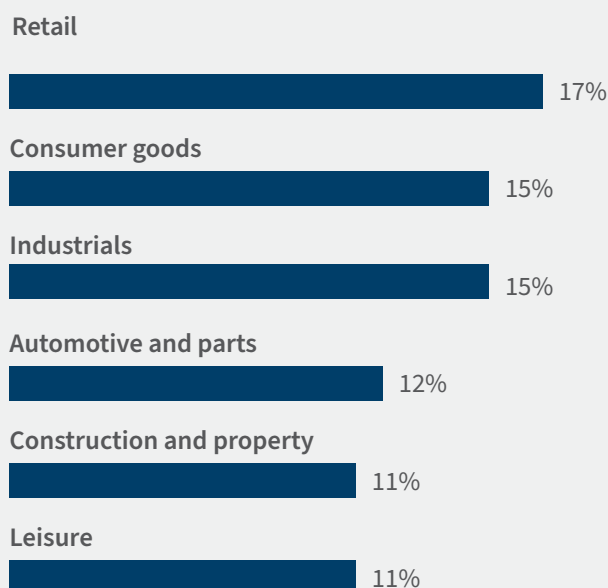


Sector Hotspots

Given the range of different challenges facing UK corporates, investors do not see any sector being immune from stress. However, the common view is that activity will be concentrated in the six sectors that presented the most special situations investment opportunities in 2022.

Industrials, which is a very broad category, is expected to experience the highest jump in activity compared to last year, as businesses in this sector tend to be energy intensive, are facing inflationary pressure on other input costs and typically have a limited ability to pass through cost increases to their end customers.

Which sector(s) do you expect to see increased special situations opportunities in 2023?



Note: Graph showing top 6 sectors only

Survey Results: Looking Ahead (cont'd)

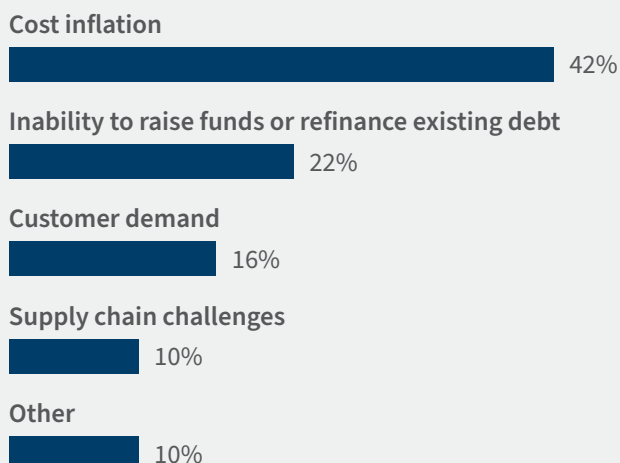
In line with last year’s survey, our special situations investor network believes that an inability of companies to raise capital or refinance existing debt will be the main driver of investment opportunities in 2023.



Situational Dynamics

42% of investors surveyed identified cost inflation as the most likely contributor to SSM&A activity in 2023. The number of respondents citing this is likely to have been even higher had our survey been conducted following the release of the full details of the Energy Bill Discount Scheme.⁽¹⁰⁾ This new scheme commences in April 2023 but doesn’t provide the level of support that many businesses were hoping for.

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?



22% of investors believe an inability to refinance debt or raise new capital will be the main driver of SSM&A activity in 2023, with many companies leveraged at multiples well above what could be secured in the current market given their trading performance and unencumbered asset base. Tighter credit markets and higher interest rates will also make servicing debt or refinancing existing leverage without a partial equity pay down difficult.

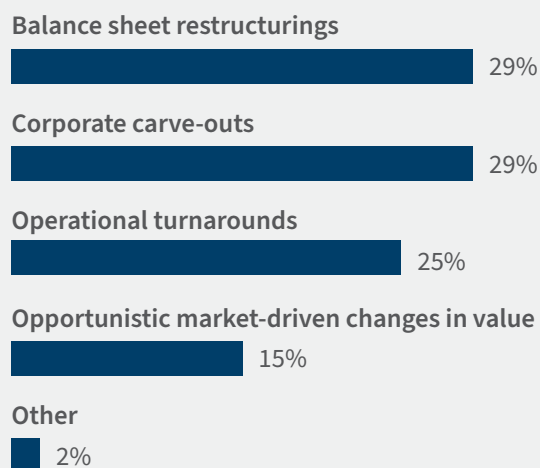


Investor Preferences

Whilst special situations investors have a significant amount of flexibility when it comes to sectors, they will usually have a mandate to focus on opportunities aligned to the nature of the turnaround or deal structure required.

In this respect, the survey indicates that investors continue to focus on corporate carve-outs and balance sheet restructurings together with operational turnarounds.

Which type(s) of special situation investing opportunities are you prioritising in the UK?



Separately, there is an expectation that some mainstream funds will look at special situation opportunities as a way of deploying more capital. We consider it more likely they will focus on corporate carve-outs, operational turnarounds and opportunistic market-driven changes rather than balance sheet restructurings, given the typical aversion to acquiring a business via an insolvency mechanism.

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.



Non-core exits

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



Accelerated funding solutions

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



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 Markets Insider, September 2022: <https://markets.businessinsider.com/news/currencies/pound-dollar-tax-cuts-inflation-recession-stagflation-interest-rates-hikes-2022-9>
- ² Sky News, January 2023: <https://news.sky.com/story/more-than-a-million-work-days-lost-to-strike-action-in-2022-12775946#>
- ³ Reuters, December 2022: <https://www.reuters.com/world/uk/view-bank-england-delivers-8th-final-rate-hike-2022-12-15/>
- ⁴ Gov.uk, November 2022: <https://www.gov.uk/government/statistics/monthly-insolvency-statistics-november-2022>
- ⁵ Office for Budget Responsibility, November 2022: <https://obr.uk/box/the-outlook-for-household-income-and-consumption/>
- ⁶ Bank of England, December 2022: <https://www.bankofengland.co.uk/financial-stability-report/2022/december-2022#:~:text=In%20aggregate%2C%20UK%20businesses%20are,the%20Covid%20pandemic%20have%20abated>
- ⁷ Telegraph, November 2022: <https://www.telegraph.co.uk/business/2022/11/09/ftse-100-markets-live-news-us-economy-meta-twitter/>
- ⁸ Cork Gully, December 2022: <https://corkgully.com/uk-insolvency-rate-forecast-2023/>
- ⁹ Intralinks, January 2023: <https://www.intralinks.com/insights/publication/2023-global-ma-dealmakers-sentiment-report>
- ¹⁰ ICAEW, January 2023: [https://www.icaew.com/insights/viewpoints-on-the-news/2023/jan-2023/energy-bills-discount-scheme-details-and-eligibility#:~:text=The%20Energy%20Bills%20Discount%20Scheme%20\(EBDS\)%20will%20come%20into%20force,all%20eligible%20non%2Ddomestic%20customers.](https://www.icaew.com/insights/viewpoints-on-the-news/2023/jan-2023/energy-bills-discount-scheme-details-and-eligibility#:~:text=The%20Energy%20Bills%20Discount%20Scheme%20(EBDS)%20will%20come%20into%20force,all%20eligible%20non%2Ddomestic%20customers.)