An Overview of the Private Equity Distressed Debt and Restructuring Markets

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Distressed debt and restructuring investing is a small but growing sector of the private equity market, one with several unique characteristics:

- In a private equity market that is becoming increasingly global, it is one where local laws and regulations still have a significant impact. For many investment strategies, local bankruptcy laws and their practical application are tremendously important – though for global companies the question of which bankruptcy law applies is not always straightforward.
- Hedge funds are a significant competitor in the sector. Recently, hedge funds have begun to compete with private equity funds for transactions on a limited basis. In the Distressed Debt sector, however, hedge funds have been significant competitors for years, especially for funds pursuing Distressed Debt Trading strategies.
- Within the sector, fund managers pursue greatly divergent investment strategies. The investment strategies used by fund managers in the sector (described in further detail in the Investment Strategy sector below) are very different and require diverse skill sets to execute successfully.
- Investment opportunities in the sector are counter-cyclical to the general economy. Established private equity sectors such as buyouts, venture capital, and mezzanine investment are not totally dependent upon general economic cycles, but their returns are generally positively correlated to economic trends; a strong economy in general helps generate strong returns and a weak economy hurts returns. The reverse is true of Distressed Debt and Restructuring Funds, as a weak economy generates in general increased investment opportunities.

These factors make the sector complex, and this chapter is meant to provide a general overview of issues that are covered in depth in a number of the other chapters.

INVESTMENT STRATEGIES AND DEFINITIONS

Before covering how the market has developed, it would be useful to define the investment strategies that are prevalent in the market. It needs to be said that the "pure" strategies described below are useful for discussion purposes, but that many funds utilize hybrid strategies in some form of combination.

Distressed Debt Trading

At its simplest, Distressed Debt Trading involves purchasing debt obligations trading at a distressed level – for example at 40% of par value – in anticipation of reselling those securities over a relatively short period of time at a higher level, generating a trading profit. Distressed Debt traders are looking for investment opportunities in which they believe the debt obligations are fundamentally mispriced and will rebound in value. The holding period on an individual security is usually weeks, sometimes days, and the size of a particular position is not directly relevant. This is the most liquid of these investment strategies, and in part for that reason hedge funds are major players in this sector.

Distressed Debt: Active/Non-Control

Active/Non-Control strategies are substantially different from Trading strategies in that their goal is to accumulate significant positions in companies that are likely to go through, or are in, a bankruptcy restructuring process. The goal is to gain a position of influence in that restructuring process in which the value of securities – and indeed the nature of the end securities exchanged – is negotiated in bankruptcy in order to maximize returns. This complex process necessitates a longer holding period than in Trading, as well as larger, more concentrated portfolio positions.

Distressed Debt: Control
In this strategy, the fund manager builds a controlling position in the fulcrum distressed security in a bankruptcy proceeding in order to effectively buy control of the target company through the bankruptcy process, either alone or as part of a syndicate. With this strategy, the distressed debt position is in many respects the start of a much longer process, as after the fund manager wins control of the target he acts very much as a buyout fund manager would, controlling the company and turning it around in order to maximize profitability.

Restructuring or Turnaround
Restructuring or Turnaround funds target companies in distress but buy them utilizing equity, sometimes purchasing them before an expected bankruptcy and other times in the bankruptcy process. Their goal – much as it is for Distressed Debt: Control funds – is to get control of companies in distress cheaply and then restructure them. This strategy also requires detailed knowledge of local bankruptcy law in a similar manner to the distressed debt strategies.

Few funds follow any one of these strategies in a pure manner. For example, both Distressed Debt: Active/Non-Control and Distressed Debt: Control managers use smaller trading positions for reconnaissance purposes, sometimes building them up further into core positions and at other times liquidating the position in order to move on to another target. Even restructuring funds that normally do not deal in distressed debt have occasionally taken control positions through debt instead of equity.

In addition, a number of regular buyout funds will on occasion do turnaround transactions, at times in a syndicate with a Restructuring focused fund or at other times taking the lead themselves. This most often occurs when they have particular industry or country expertise (as was the case with Ripplewood and J.C. Flowers in the Shinsei Bank transaction in Japan) though in general buyout funds avoid restructuring transactions especially if the company is already in bankruptcy.

Lastly, though not private equity funds per se, there are also opportunistic real estate funds that are focused on distressed transactions, and several firms such as Cerberus and Lone Star got their start in this area before broadening their mandates into corporate investments as well. The dynamics of the distressed real estate market are somewhat similar to the private equity market, though the economic cycles and the types of assets are quite different.

THE ROLE OF BANKRUPTCY LAW

In most Distressed Debt and Restructuring funds, deep knowledge and experience in bankruptcy law and its processes are key to success. Though it can be argued that Distressed Debt Trading strategies may be driven more by market psychology and trading dynamics, in all the other strategies knowledge of the law and its practical workings is crucial. Also key is the fact that - as is discussed in other chapters of this book - the details of bankruptcy regulation can differ tremendously country by country. Success in one legal environment under a specific set of regulations does not set a template that can be automatically duplicated in another jurisdiction.

The starting point for any discussion of legal ramifications in Distressed Debt and Restructuring strategies is Chapter 11 of the U.S. bankruptcy code, adopted in 1978. This provision of the code for the first time put real stress on reorganizing a company so it could continue to operate instead of focusing on liquidating a company. The intention of the law was to both ease impacts on stakeholders like company employees and suppliers by having a revitalized if restructured company still in operation, and to provide debtors with at least the potential for a higher level of recuperation on defaulted securities than would be possible in a liquidation.

With real reorganization mechanisms in place, it began to be practical to try to take control of companies through the bankruptcy process. Liquidity preference (see the attached table) became not just relevant in the liquidation of a company but crucial in control of a restructuring. The "fulcrum security" in a restructuring would be the instrument likely to control the future of the company – with the size of overall potential losses determining which investment securities would be wiped out and which might be converted into common equity controlling the reorganized firm.

TABLE 1 – SIMPLIFIED PREFERENCE STRUCTURE

Secured Debt
Senior Debt
Subordinated Debt
Preferred Stock
Common Stock

For a number of years the U.S. stood alone with this approach to bankruptcy, but as these changes took hold other countries began to consider and then adopt this approach. However, the U.S. market is still the most advanced in this area, especially as regards tried and true processes and methods of applying the regulation. In addition, though a number of countries have adopted the general approach of allowing the restructuring of companies instead of forcing liquidation, specific law in each jurisdiction is different, for example, even within the European Union.

THE BEGINNINGS OF A MARKET: SUPPLY AS WELL AS STRUCTURE

Though a bankruptcy law favorable to restructuring as opposed to liquidation was a necessary first step in the creation of the Distressed Debt and Restructuring Market, the other key item necessary was a supply of transactions that were attractive and presented a critical mass of opportunities necessary to get investors to devote time and attention to the sector.

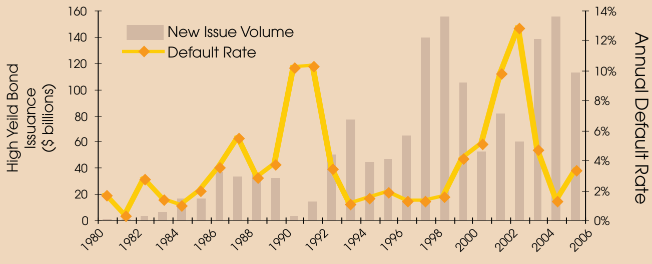
Until the 1980s, the supply of Distressed Debt was provided by "Fallen Angels" – debt instruments that had originally been issued by investment grade obligors whose credit standing and repayment ability had fallen. Though there was a constant supply of this type of paper as individual companies got into financial trouble in all sorts of economic environments, the supply was actually rather low – and a number of these Fallen Angels were so badly troubled that liquidation was still preferable to restructuring.

The 1980s, however, saw the creation of a new type of debt market – the high yield new issuance or "junk bond" market – in which highly levered companies issued non-investment grade paper with high coupon levels reflecting the increased financial risk inherent in their capital structures. Finance theory touted by Michael Milken of Drexel Burnham Lambert and others enticed investors to purchase these bonds on the basis that a diversified portfolio of high yield obligations was an attractive investment as the increased yield was attractive net of anticipated losses on defaults. Issuance of these bonds was also driven by another group on the rise – Leveraged Buyout Funds – that used these bonds to help buy targeted companies.

As noted in the chart below, the result was a surge in high yield bond issuance from nearly nothing in 1980 to $35 billion to $40 billion per annum by the end of that decade.

Though the analysis is basically correct and a portfolio of high yield bonds can be an attractive investment, in times of financial stress the debt of many more companies would go into default. Since these obligations were issued as below investment grade, they had a shorter distance to fall than Fallen Angels before they were in trouble. The default trends

CHART I – HIGH YIELD BOND ISSUANCE AND ANNUAL DEFAULT RATES



Source: Edward Altman, Stern School of Business, New York University

in the chart above also seem to show that a surge in high yield issuance in a strong economic market is followed by a surge in the default rate as the economy slows – providing more opportunities, of course, for distressed debt investors.

THE "HAPPY TIME"

When the economy began to turn down in 1989, the coincidence of supply and structure led to a "happy time" for investment managers who began to focus on the distressed debt and restructuring sector. The increase of high yield new issuance in the 1980s had created a number of fundamentally sound companies that had over-levered balance sheets. As the economy deteriorated and interest rates rose, these "good companies with bad balance sheets" became prime targets.

In addition, the Savings & Loan crisis that led to the formation of the Resolution Trust Corporation (RTC) broke at the same time, resulting in another group of distressed opportunities. During the 1980s U.S. Federal regulators loosened controls on S&Ls, allowing them to lend more aggressively both in broader areas of real estate than they had covered previously and in corporate loans. Unfortunately, their new lending capabilities were not matched by the ability to properly underwrite the new risks they were taking on. The results as the economy weakened were massive portfolios of both real estate and corporate distressed securities that the RTC was charged with restructuring or selling to the private sector.

As investment opportunities began to increase dramatically, investment managers began to coalesce around distressed debt and restructuring strategies. There were as yet no established fund vehicles concentrated on these strategies, but they began to form or make investments from related vehicles. Investment professionals from various backgrounds began to focus on the sector:

- High yield bond traders and investment bankers: Both high yield bond traders and investment bankers who had raised bonds for these companies were intimately familiar with these firms and their management, as well as with general credit analysis. They had a competitive advantage in understanding companies now burdened with distressed debt. In part because of this, many senior professionals in the Distressed Debt and Restructuring sectors worked for Drexel Burnham Lambert in the 1980s.
- Restructuring advisors: These firms act as consultants to companies in trouble. They had detailed knowledge of the bankruptcy process as well as expertise in turning companies around. A number of them began to invest in and seek to control companies instead of advising them, sometimes abandoning their advisory practice altogether.
- Buyout fund managers: Most buyout fund managers were reluctant to make investments in companies in bankruptcy or hovering on the edge, as the investment process is complex, time consuming, and heavily affected by legal issues with which they were unfamiliar. Other buyout managers perceived an opportunity to buy companies they wanted to own much more cheaply than would otherwise be possible, and were willing to spend the time to develop resources – such as bankruptcy expertise – necessary to effectively invest in the market.
- Event Driven hedge funds: From the very beginning, Event Driven hedge funds had a mandate that could cover Distressed Debt Trading strategies. Given their liquidity constraints, it was much more difficult for them to devote large amounts of capital to the various control strategies because those required a longer holding period. Over time, a number of hedge funds active in Distressed Debt Trading

created separate funds structured as private equity vehicles to give them greater flexibility in investing in control transactions.

- Bankruptcy attorneys: A number of bankruptcy attorneys also realized that although they did not have an investment background, their knowledge of the bankruptcy process made them valuable team members in private equity funds focused on the sector. Over time, the best of them became good investors in their own right, and not just legal specialists.

MARKET CYCLES AND GLOBALIZATION

The Happy Time, however, did not last forever. Though there are always companies going through financial distress for reasons specific to those individual firms, the volume of investment opportunities in distressed debt and restructuring fluctuates along with economic cycles. Returns generated by the first funds dedicated to investing in the sector attracted many new funds, increasing competition for transactions. At the same time, as noted in Chart 1, the mid-1990s in the United States were a period of strong economic growth and low default rates. As a result, even as competition increased, the supply of distressed transactions dwindled, making the investment environment in the U.S. much more difficult. (A summary listing of funds active in Distressed Debt and Restructuring investment is included in Appendix { } of this book, providing a glimpse of how the sector has grown over time.)

In 1997, however, the currency crisis that roiled Asia drew attention away from the U.S. and to other markets. (Table 2, A Brief Distressed Debt and Restructuring Timeline,

Table 2: A Brief Distressed Debt and Restructuring Timeline

1978	Chapter 11 of the U.S. Bankruptcy Code is adopted, creating an effective framework for restructuring companies in financial distress instead of liquidating them.
1978	Capital gains tax rate slashed from 49.5 percent to 28 percent; Labor Department clarifies that pension plans can invest in private equity, leading to increased interest in the overall sector.
1980	Total commitments raised for U.S. private equity: $600 million.
1980s	High yield bond market surges on a new issuance basis, with Michael Milken of Drexel Burnham Lambert a major force in the activity; much of the high yield new issuance activity is in support of Leveraged Buyouts.
1989-91	First spate of distressed debt and restructuring deals triggered by the junk bond boom of the 1980s.
1989	The Resolution Trust Corporation, formed by the U.S. Government to help restructure the Savings & Loan industry, creates additional distressed security opportunities.
1991	Total commitments raised for U.S. private equity: $7.7 billion.
1992	Cerberus Capital Management founded.
1997	Asian currency crisis creates many distressed debt and restructuring opportunities in Asia
1997	Oaktree Capital Management raises $1.25 billion for OCM Principal Opportunities Fund II and $1.5 billion for the OCM Opportunities Fund II, the largest such vehicles to date.
1997	Klesch Capital raises one of the first dedicated European restructuring funds in the United Kingdom.
2000	Total commitments raised for private equity: $155.2 billion in North America, €60.7 billion in Europe and $17.9 billion in Asia.
2000	Ripplewood and J.C. Flowers lead a consortium to purchase Long Term Credit Bank of Japan from the Japanese government and restructure it as Shinsei Bank in one of the highest profile turnarounds in Asia.
2002	The EU Regulation on Insolvency Proceedings is adopted, providing a framework for coordinating restructurings in the EU (with the exception of Denmark).
2003	Two local fund groups – Nordwind and Orlando – raise restructuring funds in Germany.
2004	Shinsei's IPO generates tremendous profits for the syndicate that funded the restructuring.
2006	Lone Star's Korean Exchange Bank transaction attracts various investigations by the Korean government upset by the high level of profitability in this public sector restructuring.
2006	Cerberus launches Cerberus Institutional Partners (Series Four) targeted at $6 billion with a $7.5 billion cap; at either level, it would be the largest Distressed Debt focused fund ever raised

provides some context to this and other issues.) It also highlighted the fact that not only do legal structures governing bankruptcy differ from country to country, but economic cycles do not act in lock step globally. The Distressed Debt and Restructuring market which had been born in the United States began to globalize significantly at this point, following opportunities where the economic circumstances and legal regulations would permit.

Japan and Korea particularly became significant targets for investment by U.S. headquartered funds. A number of very successful investments – such as Shinsei Bank in Japan (covered in a detailed case study in Chapter { }) and the Korean Exchange Bank – were executed, but with unexpected consequences. These high profile restructurings were so successful as investments that they attracted regulatory attention from local governments that felt that they been taken advantage of by foreign investors. In Japan, the result was a change in tax laws targeted at all private equity funds. In Korea, the result was a series of criminal investigations into Lone Star's Korea Exchange Bank investment, a situation that has not as yet been resolved.

Western Europe has also begun to attract attention. Though investment in European distressed situations had occurred on an ad hoc basis over the years (with American investors such as Oaktree, for example, taking long term positions in Eurotunnel bonds in the early 1990s), there has been much more focus on Distressed Debt and Restructuring investment in Europe over the last decade. Bankruptcy regulations have been changed in a number of EU countries to make restructuring companies easier, and in 2002 the EU implemented Insolvency Regulations that provide a framework for coordinating bankruptcy and restructuring processes for Pan-European firms. In addition, not only have U.S. firms been establishing funds focused on investing in Europe but local firms such as Alchemy, EQT, Orlando and Rutland also have created vehicles targeting opportunities in their home markets.

SUMMARY

In just over fifteen years, the Distressed Debt and Restructuring sector has developed from a concept to a substantial global investment market. For private equity and real estate investors, the counter-cyclical nature of the investment opportunity makes Distressed Debt and Restructuring funds an attractive risk diversifier as part of a portfolio, and more investors are making allocations to the sector. In anticipation of the next distressed cycle in the U.S. and Europe, a number of new funds are currently being raised, including the latest effort by Cerberus targeted at $6 billion – the largest fund ever to be raisied in the sector.

Importantly, in a number of countries, bankruptcy law has been changed to make company restructurings a more viable option than liquidation. These changes of course not only affect the investment environment for these strategies, but also directly impact the lives of various stakeholders in these companies undergoing financial stress, both positively and negatively. The next cycle of financial stress will continue to see changes in both law and investment strategy as fund managers and regulators adapt to new situations. ■

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