Private Equity Distressed Debt and Restructuring Market Survey

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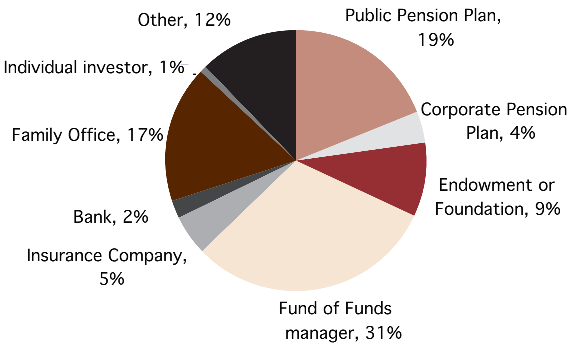
Investoraccess and Probitas Partners have conducted a survey of private equity limited partners and consultants in order to understand current institutional investor attitudes toward the distressed debt and restructuring sectors of the private equity market. Distressed Debt and Restructuring funds are a niche sector in private equity, and investor attitudes are in the process of changing as more investors consider the sector.

RESPONDENT PROFILE

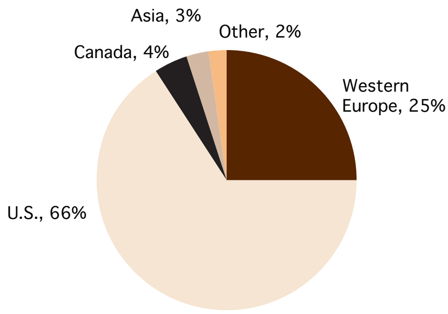
The survey was conducted in the late summer of 2006. There were 231 respondents to the survey from Insurance Companies, Banks, Family Offices, Public and Corporate Pension Plans, Endowments & Foundations, Fund of Funds Managers, and Individual Investors. Fund of Funds made up the largest group of respondents, representing 31 percent of the sample, followed by Public Pension Plans at 19 percent.

CHART 1: RESPONDENTS BY INSTITUTION TYPE



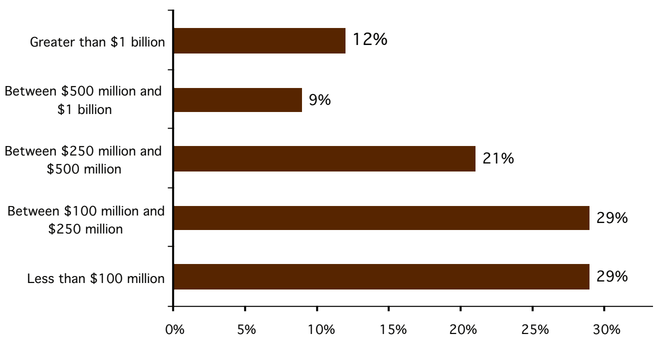
The geographic distribution of respondents largely matches the background of institutional investors with a slight overweighting to the U.S. As would be expected, institutional investors from North America and Western Europe predominated.

CHART 2: RESPONDENTS BY GEOGRAPHIC LOCATION



Respondents to the survey were diverse in their forecast allocations to private equity in 2006, with over 70 percent planning to invest $100 million or more during the year, and some 12 percent of the total planning to invest more than $1 billion.

CHART 3: 2006 ALLOCATIONS TO PRIVATE EQUITY



ATTITUDE TOWARD INVESTING IN DISTRESSED DEBT & RESTRUCTURING FUNDS

The next three questions in the survey were meant to determine investor attitudes towards the three major types of Distressed Debt and Restructuring funds:

• Distressed Debt Trading Focused Funds: These funds generate returns by buying distressed debt securities that they believe are undervalued and that will increase in value over a fairly short time. This is a strategy that is also pursued by a number of hedge funds.

• "Distressed Debt For Control" Funds: These funds look to generate returns by accumulating large distressed debt positions in specific companies that will allow them to accumulate a position of influence in bankruptcy proceedings or literally to take control of the company through converting the debt into controlling equity stakes in the restructured company.

• Restructuring Funds: These funds invest in companies in financial distress, but do so by investing new equity in companies in order to take control.

It should be noted that a number of fund managers pursue strategies that blend the three basic concepts, but for simplicity's sake these three "pure" strategies were focused on in the survey.

Key results from these questions:

• U.S. investors are the most active investors across all of the above fund types.

• A majority of investors has been actively investing in Distressed Debt Trading funds, Distressed Debt for Control funds and Restructuring funds for several years – though these results are skewed to a degree by the heavy number of U.S. respondents in the survey.

• Western European respondents are the least active investors in Distressed Debt Trading funds, while Canadian and Asian investors have the greatest proportion of new investors to the sector.

CHART 4: INVESTMENT IN DISTRESSED TRADING FUNDS

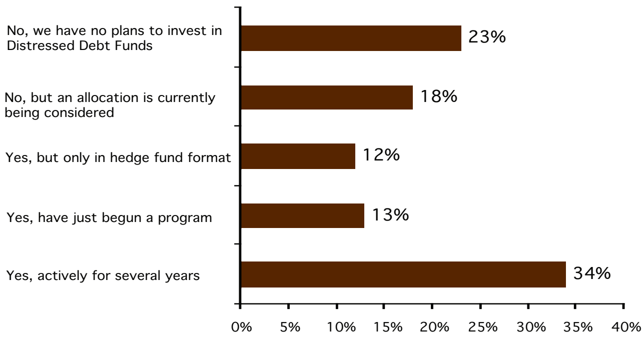


CHART 4B: INVESTMENT IN DISTRESSED TRADING FUNDS BY INSTITUTION TYPE

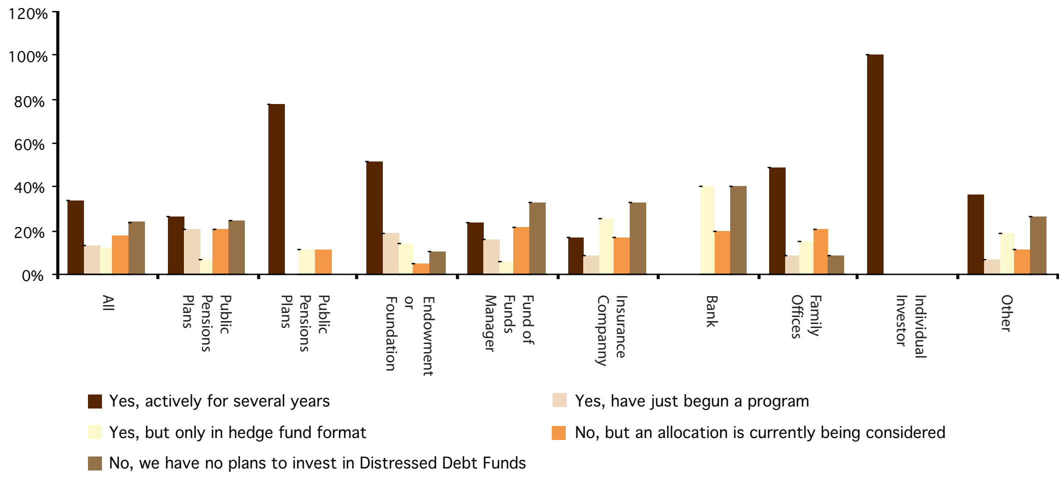
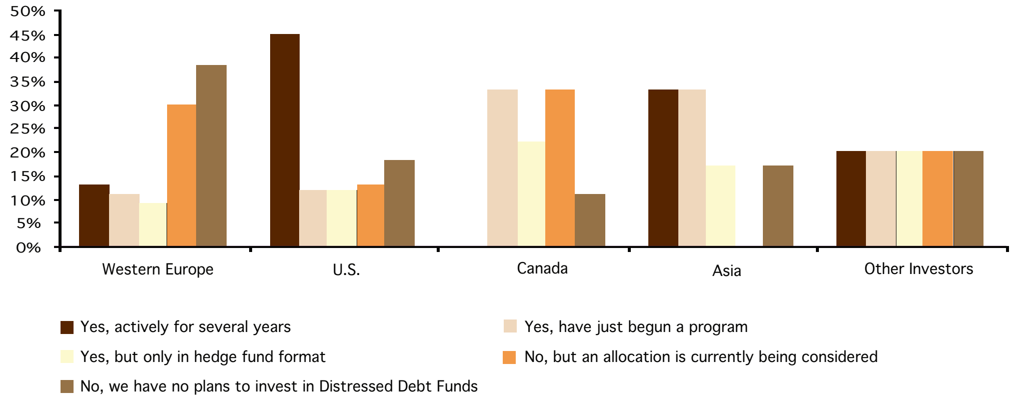


CHART 4C: INVESTMENT IN DISTRESSED TRADING FUNDS BY GEOGRAPHY



• Western Europeans are more likely to invest in Distressed Debt for Control and Restructuring funds than Distressed Trading funds.
• Corporate pension plans, endowments, and foundations are the most active investors in Distressed Debt Trading funds, Distressed Debt for Control funds and Restructuring funds; banks and insurance companies are consistently the more bearish.
• Fund of funds have a much more positive outlook on Distressed Debt for Control funds and Restructuring funds, with 70 percent and 73 percent of respondents respectively investing in those two sectors, compared with just 39 percent investing in Distressed Trading funds.

CHART 5: INVESTMENT IN DISTRESSED DEBT FOR CONTROL FUNDS

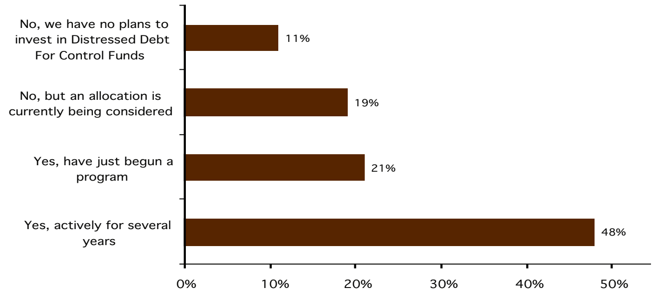


CHART 5B: INVESTMENT IN DISTRESSED DEBT FOR CONTROL FUNDS BY INSTITUTION TYPE

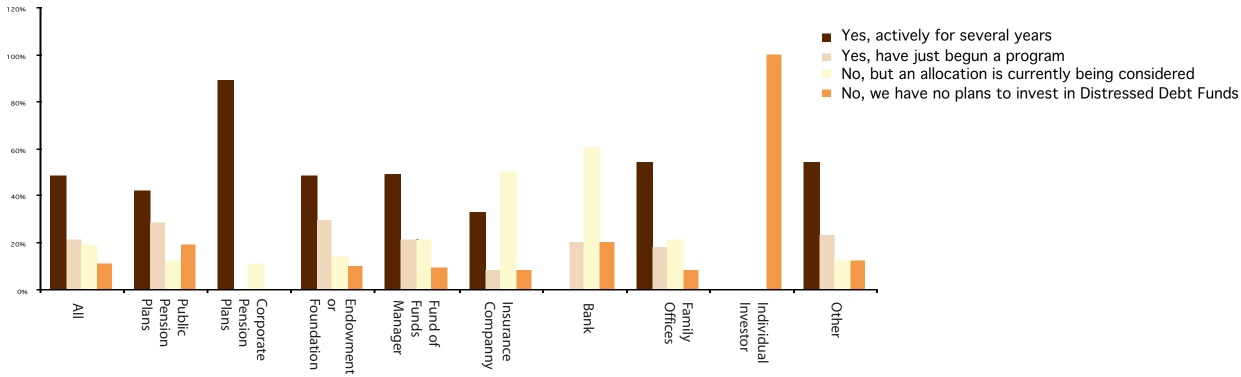


CHART 5C: INVESTMENT IN DISTRESSED DEBT FOR CONTROL FUNDS BY GEOGRAPHY

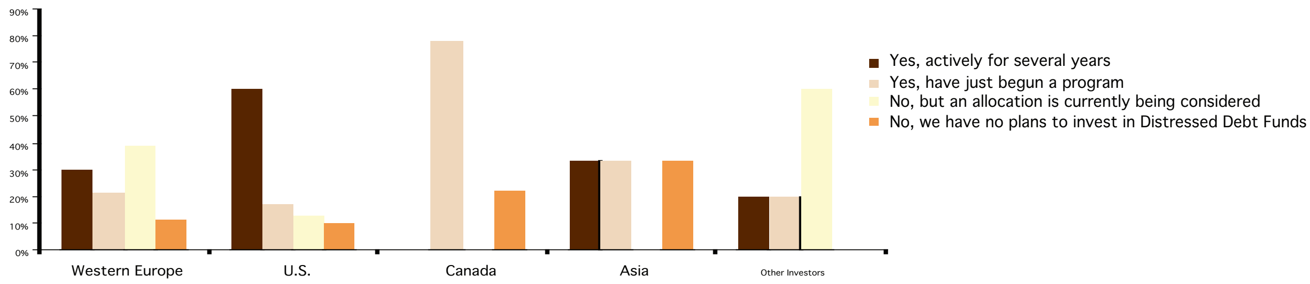


CHART 6A: INVESTMENT IN RESTRUCTURING FUNDS

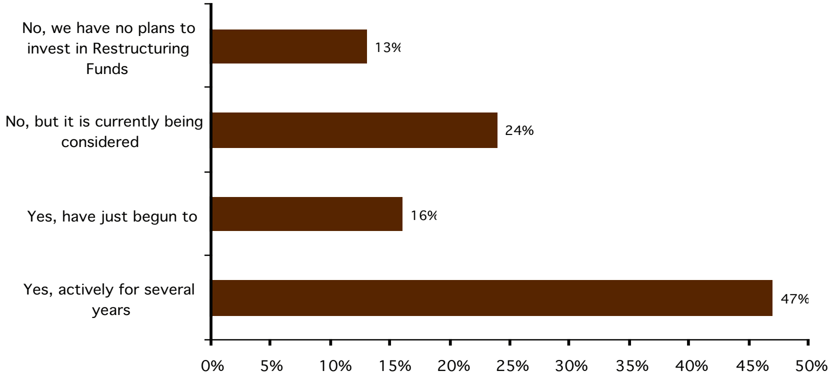


CHART 6B: INVESTMENT IN RESTRUCTURING FUNDS BY INSTITUTION TYPE

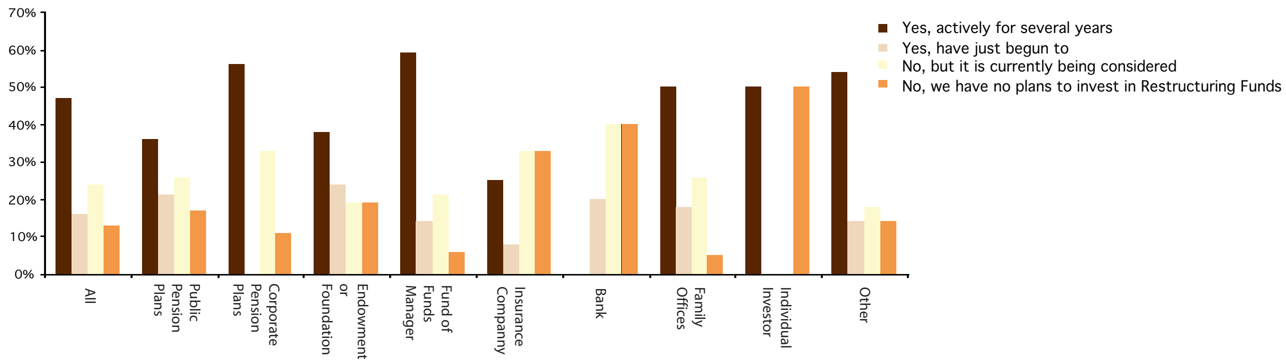
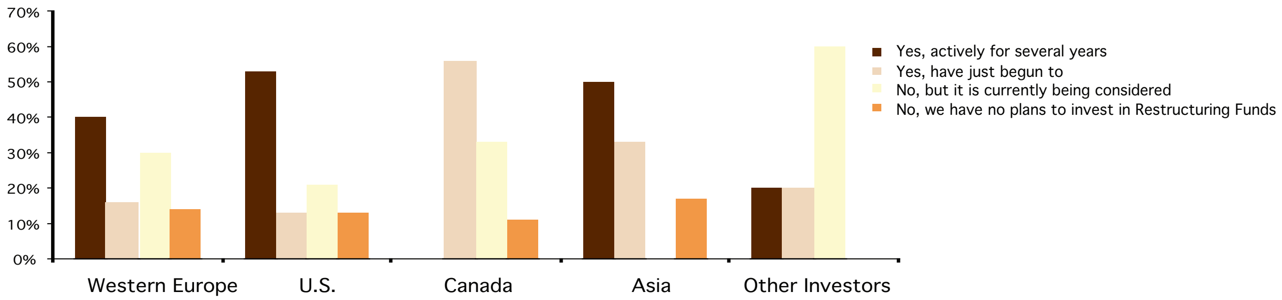


CHART 6C: INVESTMENT IN RESTRUCTURING FUNDS BY GEOGRAPHY



RETURN EXPECTATIONS FOR VINTAGE 2006 AND 2007 FUNDS

In the next set of questions we asked for a specific ranking of private equity sectors by expected returns for both the 2006 and 2007 vintages in order to see how investors' perceived Distressed Debt and Restructuring funds. Respondents were asked to choose up to three sectors where they expected the highest returns for each vintage year.

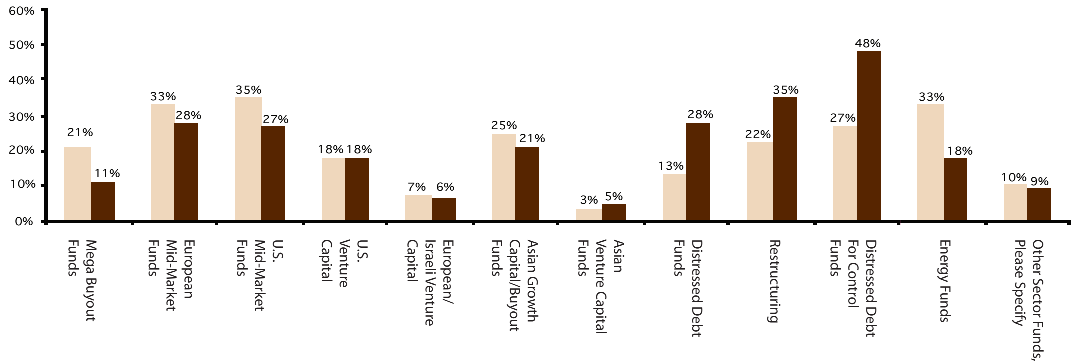
For vintage 2006 funds, the top ranking sector was U.S. Mid Market with 35 percent of participants expecting to find the best returns among these funds. European Mid Market funds and Energy funds were also ranked highly, both selected by 33 percent of respondents. Expected returns for vintage 2007 funds are highest for the distressed group of funds with Distressed Debt for Control funds selected by 48 percent of the sample, Restructuring funds by 35 percent and Distressed Debt Trading funds by 28 percent (tied actually at 28 percent with European Mid Market funds). The Distressed funds were the only private equity sectors that had a higher proportion of respondents expecting better performance for the Vintage 2007 than for Vintage 2006 funds. Consistent with investment activity, public pension plans, corporate pension plans, endowments and foundations, and fund of funds have the greatest expectations for distressed debt funds. It is also notable that the distressed investing strategies that require active involvement with portfolio companies – Distressed Debt for Control and Restructuring funds – were by investors forecast to perform better than Distressed Debt Trading funds. In addition, though Distressed Debt Trading funds performed well enough overall for a third place ranking for the 2007 Vintage, the only type of investor which actually chose them in their top three picks were family offices.

Interestingly, only 21 percent of respondents expect Vintage 2006 Mega Buyout funds to deliver the best returns and 11 percent Vintage 2007, despite, according to Buyouts, the nine Megafunds (defined as funds with commitments of $4 billion and above) that have already raised $42 billion in the U.S. in the first 9 months of this year.[1]

As illustrated in Chart 7b, a few patterns emerge across institution type with respect to return expectations for the proposed sectors. Endowments & Foundations have particularly high expectations for Asian Growth Capital / Buyouts funds which received the highest proportion of selection for both vintage 2006 and 2007 funds. This went against the trend for all other institution types which, with the exception of Family Offices, did not feature these Asian funds in

[1] *9 October, 2006, Buyouts, Fundraising Blasts Forward: $140B through 3Q*

CHART 7: EXPECTED BEST RETURNS FOR VINTAGE 2006 & 2007 FUNDS



their top three. There is a clear reduction in return expectation for Energy funds in 2007, falling out of top three for all institution types. Mega Buyouts appear in the top three for Public Pension Plans for vintage 2006 funds, and for Insurance companies for both vintage 2006 and 2007 funds, which may reflect the allocation needs and the practical co-investment desires and constraints of these investors,.

It appears that there is great variation between best return expectation for vintage 2006 and 2007 funds across institutions. Very few of the sectors remain in the top three across both years, even within an institutional grouping.

There appears to be an element of home bias in the survey. European Mid Market funds were in the top three for expected returns for Western European investors for both vintage 2006 and 2007 funds and likewise, U.S. Mid Market funds scored well with U.S. investors in both vintage years. Western European respondents also identified high expectations for Vintage 2006 Distressed Debt for Control funds which was a top three response versus fifth for U.S. investors.

MOST ATTRACTIVE GEOGRAPHIC MARKETS AND SECTORS FOR DISTRESSED DEBT OR RESTRUCTURING FUNDS

In this part of the survey, respondents were asked to select those geographic markets and sectors they felt were most attractive for Distressed Debt or Restructuring funds. Investors were asked to select up to two geographies and sectors.

Respondents felt the U.S. was far and away the most attractive market for Distressed Debt or Restructuring funds, selected by 80 percent of the sample. This is consistent with the U.S. being the most developed market with well established bankruptcy restructuring law, facilitating the operations of these distressed debt and restructuring vehicles. Markets with developing legal guidelines and perceived investing opportunities that attracted specific investor attention included the United Kingdom, Germany and Japan (and Other Europe in part helped along by developing common European Union legal guidelines). China attracted some attention though the practical aspects of how bankruptcy and restructuring work in that market are unsettled. Respondents selecting Other (2 percent) cited Canada as an attractive market place or that in fact no geographic markets were attractive. These trends were also robust when examined on the basis of respondents' geographic locations and institution type.

CHART 7B: TOP THREE SECTORS FOR EXPECTED BEST RETURNS FOR VINTAGE 2006 & 2007 FUNDS BY INSTITUTION TYPE

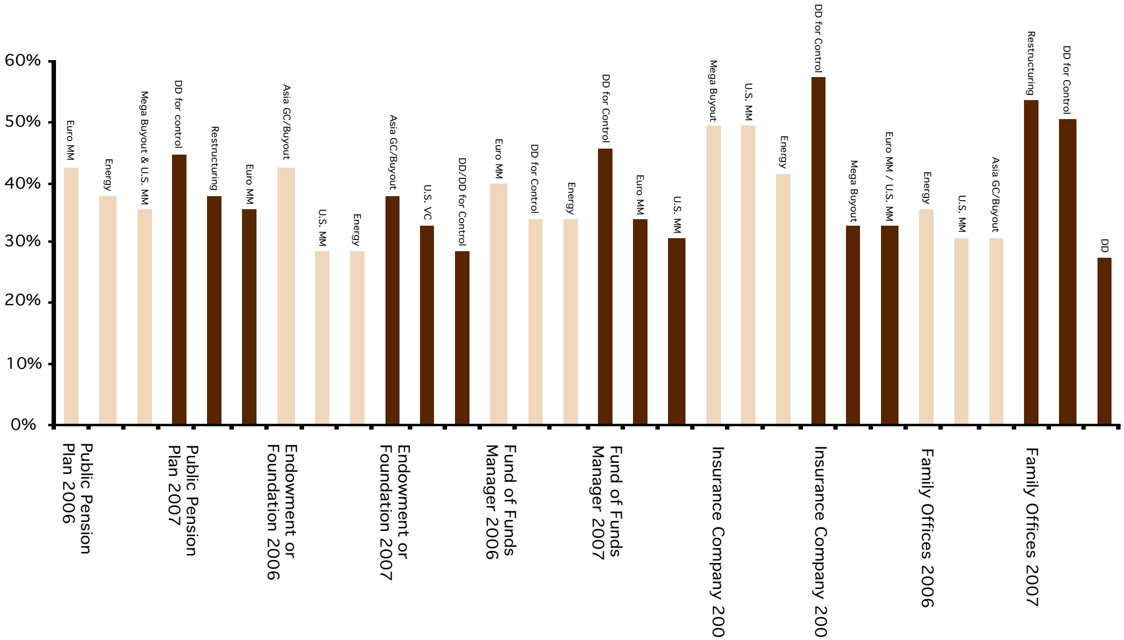


CHART 7C: TOP THREE SECTORS FOR EXPECTED BEST RETURNS FOR VINTAGE 2006 & 2007 FUNDS FOR WESTERN EUROPEAN & U.S RESPONDENTS

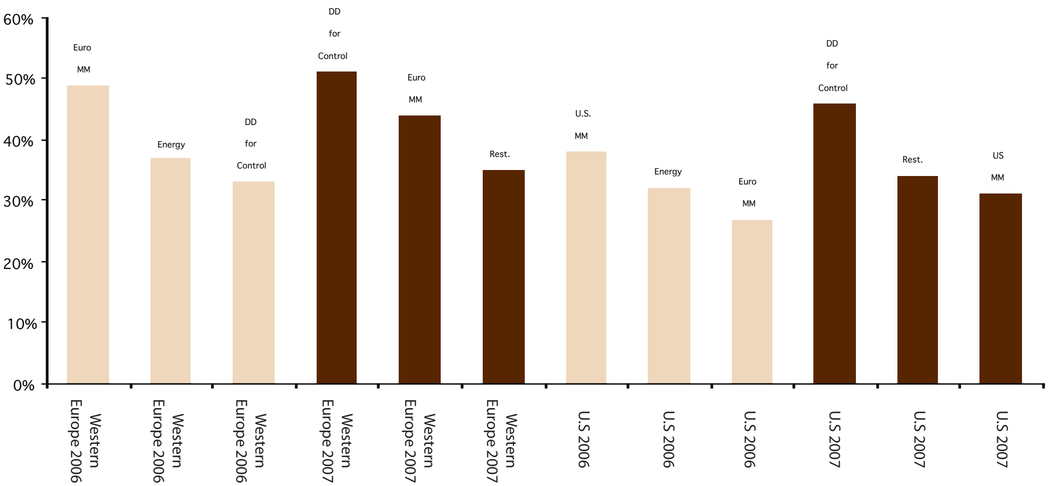


CHART 8: MOST ATTRACTIVE GEOGRAPHIC MARKETS FOR DISTRESSED DEBT OR RESTRUCTURING FUNDS

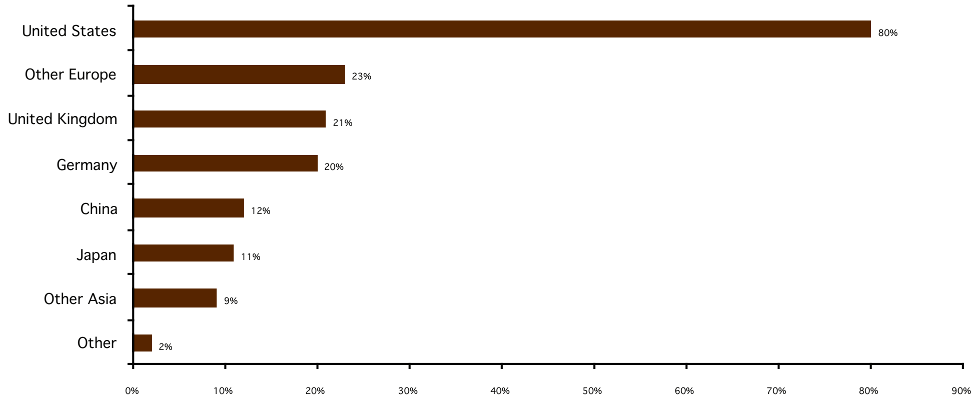
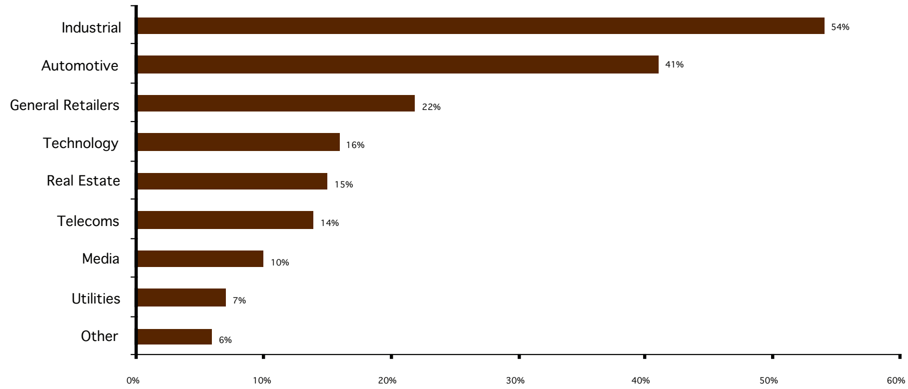


CHART 9: MOST ATTRACTIVE SECTORS FOR DISTRESSED DEBT OR RESTRUCTURING FUNDS

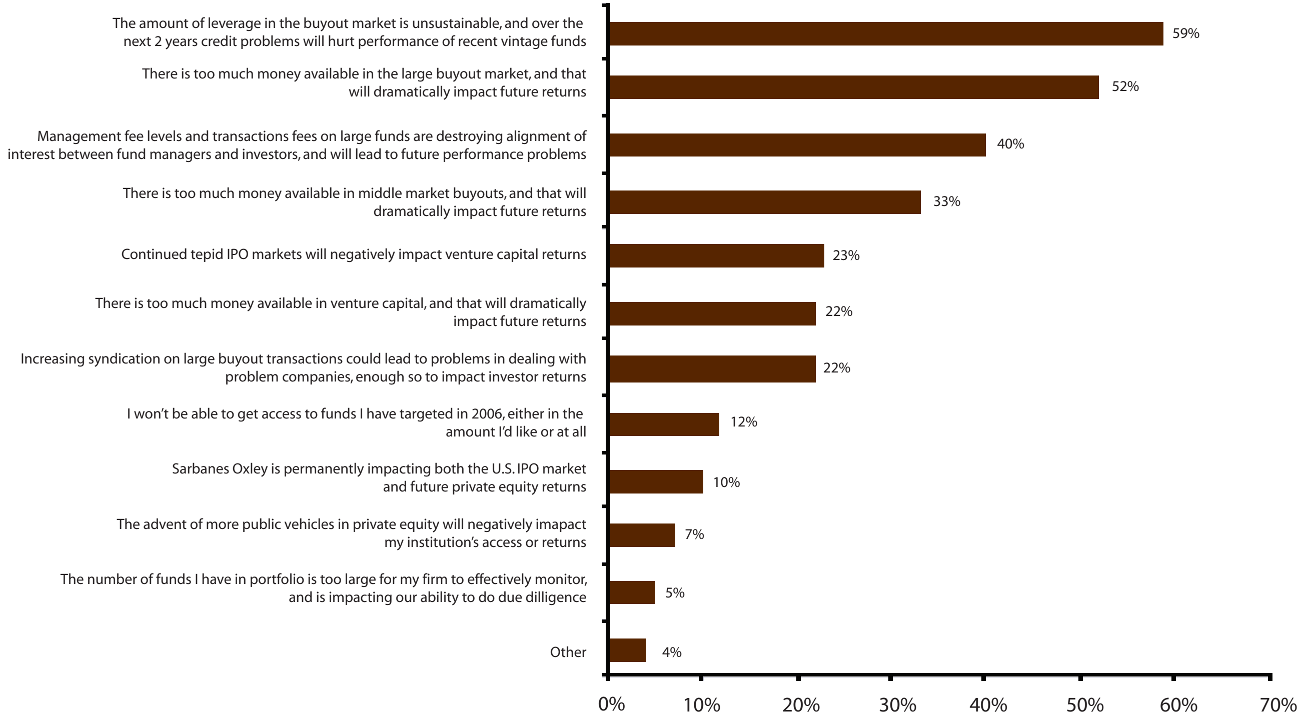


As far as industry sectors were concerned, the general industrial sector was clearly seen as the most attractive, selected by 54 percent of respondents. This sector is a broad category that has in common a high level of hard assets with a greater degree of residual value even in a "wind up" bankruptcy as opposed to a restructuring, thus providing investors a degree of downside protection. The general industrial sector was closely followed by the Automotive sector (41 percent), which is an area having substantial difficulties in the U.S. at the moment, providing opportunities for Distressed Debt and Restructuring funds. These observations are consistent among all institution types and across all geographic locations.

FEARS REGARDING PRIVATE EQUITY AND DISTRESSED DEBT/RESTRUCTURING SECTORS

The next part of the survey asked investors for their fears regarding private equity in general and the distressed debt/restructuring sectors in particular. Participants were asked to select their three current greatest fears regarding the private equity market and their greatest single fear regarding the distressed restructuring sector. These questions were intended to help understand what investors' major fears are and whether those fears may have any impact on their perception of Distressed Debt and Restructuring fund prospects.

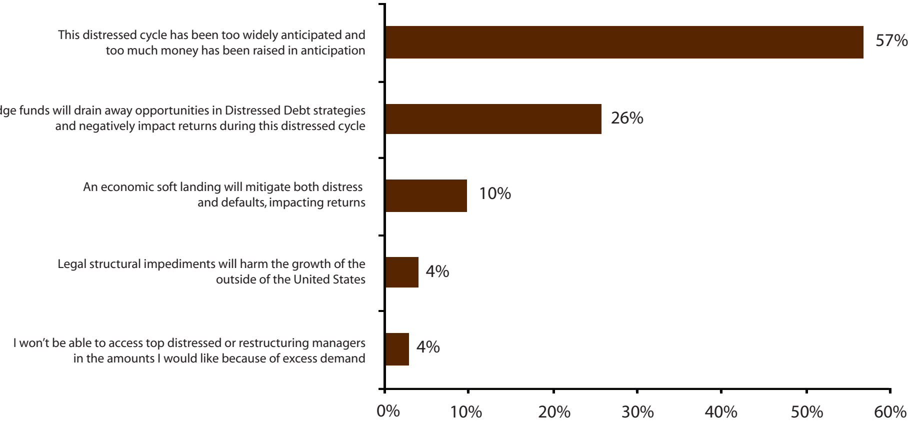
CHART 10: FEARS REGARDING PRIVATE EQUITY MARKET



Private Equity:

Fifty-nine percent of participants felt that the amount of leverage in the buyout market and its impending impact on recent vintage fund performance is their greatest current concern regarding private equity. This is consistent with the dominance of the Distressed Debt and Restructuring funds in the participant's selection of expected best returns for vintage 2007 funds. Investors are also concerned that there is too much money available in the large buyout market and that this will dramatically impact future returns (selected by 52 percent of the sample). This agrees with the absence of Mega Buyout funds in the top three expected best returns for both vintage 2006 and 2007 funds – though of course this is at odds with the recent fundraising success of Mega Buyout funds. A similar result is evident for Middle Market Buyout funds and corresponds to the fourth greatest concern investors have, that there is too much money available in middle market buyouts. Forty percent of participants were concerned that management fee levels and transaction fees on large funds are destroying alignment of interest between fund managers and investors, and will lead to future performance problems. This is another explanation for the lack of expectation for the performance of the Mega Buyout funds. These general trends are consistent across all institution types and geographic locations.

CHART 11: FEARS REGARDING THE DISTRESSED RESTRUCTURING SECTOR



Distressed Debt / Restructuring:

The greatest fear investors have regarding the distressed debt/restructuring sector is that this cycle has been too widely anticipated and too much money has been raised in anticipation. This is the most common concern among participants across all geographies and institution types (with the exception of the Individual Investors). A significant number of investors also are concerned that Hedge Funds will drain away opportunities in Distressed Debt strategies, which, given the liquidity restraints of most Hedge Funds, is more of a concern for Distressed Debt Trading strategies. However, the survey participants still felt that Vintage 2007 distressed and restructuring funds would provide the best returns, so these concerns don't appear to impair the perceived performance of these funds in a significant way.

SUMMARY

The diverse group of respondents to this survey, many of whom are experienced investors in the sector, have high return expectations for distressed debt and restructuring funds, specifically Vintage 2007 funds. Although their primary concern within this market segment is the fear that the distressed cycle has been too widely anticipated, high returns expectations for the distressed sector indicate that this concern is clearly overshadowed by their greatest fears regarding the private equity market as a whole:

(i) The potentially unsustainable amount of leverage in the buyout market

(ii) The oversupply of money in the large buyout market and its potential impact on future returns.

Thus it appears that concerns regarding the buyout market are driving increasing interest in the distressed sectors. How exactly this will play out in the fundraising market in 2007 – both for Distressed Debt and Restructuring funds, and Mega Buyout funds – is uncertain, as Mega Buyouts are still doing very well in the fundraising market. ■

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Kelly is the head of research and due diligence for Probitas Partners' alternative fund placement activities. Prior to joining Probitas Partners, Kelly was a Managing Director at Pacific Corporate Group, a leading provider of alternative investment advisory, management and consulting services to institutional clients, where he oversaw the partnership investment program. Before joining PCG, Kelly held various positions at First Interstate Bancorp in private equity, asset liability management and derivatives. He earned an MBA from The Anderson Graduate School of Management at UCLA, and a BA in Communications from Stanford University.

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Simone is responsible for the overall administration of Probitas Partners' office in London. Prior to joining Probitas Partners, Simone worked as a Research Analyst at the Securities Industry Research Centre of Asia-Pacific (SIRCA). Simone earned a Bachelor of Science and a Bachelor of Commerce from the University of Sydney and also completed a Masters in Finance at the University of New South Wales