1 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 that has come into sharper focus during the global recession. The sector is one with several unique characteristics:

- *In a private equity market that is becoming increasingly global, it is one where local laws and regulation 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.* Over the last several years, certain 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 section 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 debt are not totally dependent upon general economic cycles, but their returns are 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 increased investment opportunities.

These factors make the sector complex. 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 utilise 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 percent of par value – in anticipation of reselling those securities over a relatively short period of time at a higher level, thus 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 maximise 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 maximise profitability.

Restructuring or turnaround

Restructuring or turnaround funds target companies in distress but buy them utilising 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.

Asset-backed securities (ABS) and small loan pools

The strategies outlined previously are focused on purchases of the corporate debt of individual companies. Though rarer in the market, this cycle has seen an increase in 'busted' ABS structures and distressed small loan pools. In these types of transactions, the ability to underwrite and at times service collateral pools is key to success, and with ABS a detailed knowledge of the collateral structure is necessary as well.

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 as opposed to equity, and a limited number of funds deal in all types of distressed strategies within a single vehicle.

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 Holdings and JC Flowers in the Shinsei Bank transaction in Japan) though in general buyout funds avoid restructuring transactions especially if the company is already in bankruptcy.

During the latest distressed cycle, a few larger buyout funds have applied a new twist to the process by buying the distressed debt of portfolio companies where they control the equity in order to either influence a debt restructuring or maintain control in a potential bankruptcy filing. This tactic also raised concerns with a number of debt-holders, however, and was not widespread.

Lastly, though not usually classified as private equity funds there are also opportunistic real estate funds that are focused on distressed transactions. Several firms, such as Cerberus Capital Management and Lone Star Funds, 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 by 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 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 pertaining to distressed debt and restructuring strategies is chapter 11 of the US bankruptcy code, which was adopted in 1978. This provision of the code stressed for the first time the reorganisation of a company so it could continue to operate as opposed to focusing on liquidation. The intention of the law was both to ease impacts on stakeholders like company employees and suppliers by having a revitalised 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 if the company were liquidated.

With real reorganisation mechanisms in place, it began to be practical to try to take control of companies through the bankruptcy process. Liquidity preference (see Table 1.1) became not only relevant in the liquidation of a company but crucial in the 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 reorganised firm.

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

Table 1.1: **Simplified preference structure**

Simplified preference structure
Secured debt
Senior debt
Subordinated debt
Preferred stock
Common stock

The beginnings of a market: supply as well as structure

Though a bankruptcy law favourable 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 to get investors to devote time and attention to the sector.

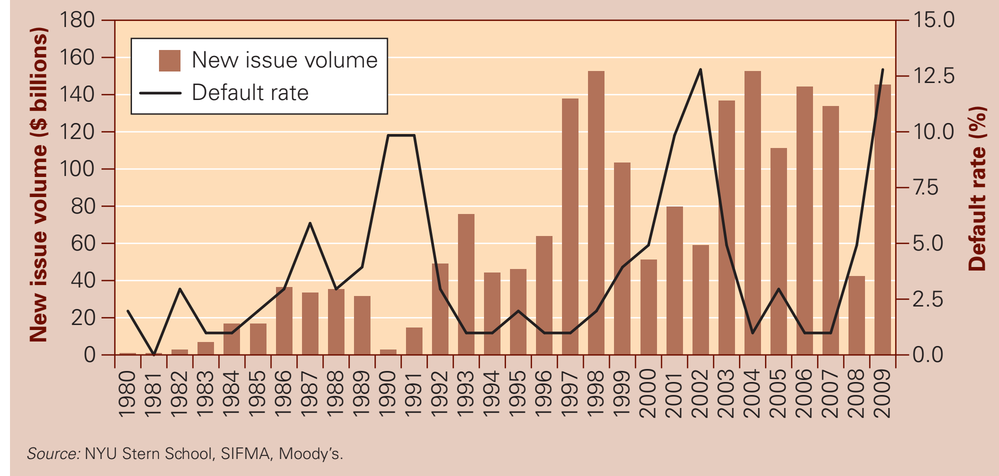
Until the 1980s, the supply of distressed debt was provided by 'fallen angels' – debt instruments that had originally been issued by investment grade obligors whose credit standing and repayment ability had fallen. Though there was a constant supply of this type of paper as individual companies got into financial trouble in all sorts of economic environments, the supply was actually rather low. Moreover, 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 often used these bonds to help buy targeted companies.

As noted in Figure 1.1, the result was a surge in high yield bond issuance from nearly zero in 1980 to roughly $40 billion by the end of that decade – an amount that would be easily eclipsed on an annual basis from the mid-1990s onward.

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 are likely to 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 in Figure 1.1 also seem to show that a surge in high yield issuance in a

Figure 1.1: **High yield bond issuance and annual default rate**



Source: NYU Stern School, SIFMA, Moody's.

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 and loan crisis (commonly referred to as the S&L 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, US 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 as well as in corporate loans. Unfortunately, their new lending capabilities were not matched by an ability to properly underwrite the new risks they were taking on. What resulted 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 dramatically increase, investment managers began to coalesce around distressed debt and restructuring strategies. At this time 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 advisers:* 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 are 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 various control strategies because those require 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 realised that though 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, not just legal specialists.

Market cycles and globalisation

The happy time, however, did not last forever. Though there are always companies going through financial distress for reasons specific to that individual firm, 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, thus increasing competition for transactions. At the same time, as noted in Figure 1.1, the mid-1990s in the US was 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 US much more difficult. (A summary listing of funds active in distressed debt and restructuring investment is included in Section IV of this book, which provides a glimpse of how the sector has grown over time.)

In 1997, however, the currency crisis that roiled Asia drew attention away from the US and to other markets. (Table 1.2, *A brief distressed debt and restructuring timeline*, 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 usually act in lockstep globally. The distressed debt and restructuring market which was originated in the US began to globalise significantly at this point, following opportunities where the economic circumstances and legal regulations would permit.

Table 1.2: **A brief distressed debt and restructuring timeline**

1978	Chapter 11 of the US 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; the US Department of Labor clarifies that pension plans can invest in private equity, leading to increased interest in the overall sector
1980	Total commitments raised for US 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 US government to help restructure the savings and loan industry creates additional distressed security opportunities
1991	Total commitments raised for US 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 UK
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 Holdings and JC 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 Capital and Orlando Management – raise restructuring funds in Germany
2004	Shinsei's IPO generates tremendous profits for the syndicate that funded the restructuring, though Shinsei later runs into difficulties
2006	Lone Star Funds' Korea Exchange Bank transaction attracts various investigations by the Korean government upset by the high level of profitability in this public sector restructuring
2007	Largest global recession since the Great Depression commences; fund managers anticipate a strong investment environment for distressed debt and restructuring funds

Table 1.2: **A brief distressed debt and restructuring timeline** *continued*

2008	Fundraising for distressed debt and restructuring funds hit a new high of $51.4 billion
2009	Cerberus turnaround of auto manufacturer Chrysler fails in a massive bankruptcy
2009	TPG Financial Partners decreases its fund size from $6 billion to first $4.5 billion, then $2.5 billion, as changing government regulation impacts the attractiveness of investing in distressed banks
2009	Default rate for high yield bonds hits 13 percent, a new high, though Moody's forecast for the rate for the end of 2010 falls to 3 percent

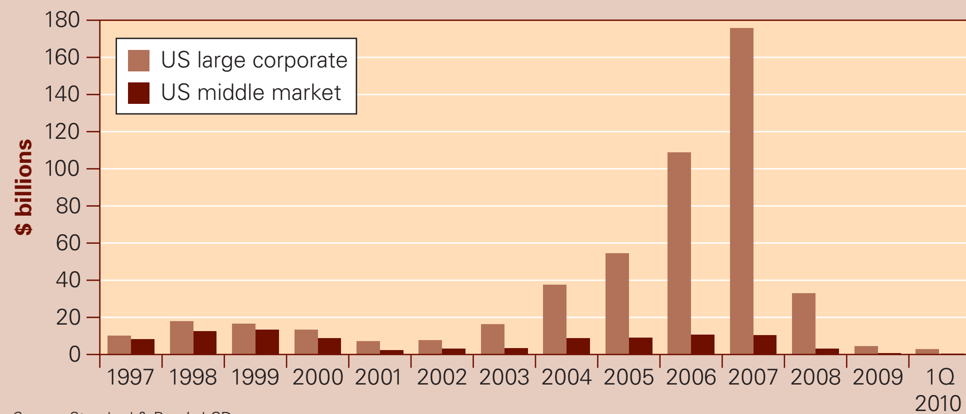
Japan and South Korea in particular became significant targets for investment by US-headquartered funds. A number of very successful investments – such as Shinsei Bank in Japan and Korea Exchange Bank (both covered in detailed case studies in Section III in this book) – were executed, but with unexpected consequences. Both of 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 South Korea, the result was a series of criminal investigations into Lone Star Funds' Korea Exchange Bank investment as well as actions by the Korean government to block the sale of KEB, a situation that has not as yet been resolved as of early 2010. (see case study on page 195)

Western Europe also began to attract the attention of fund managers and investors. Though investment in European distressed situations had occurred on an ad hoc basis over the years (with American investors such as Oaktree Capital Management, for example, taking long-term positions in Eurotunnel bonds in the early-1990s), there has been increased 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 US firms been establishing funds focused on investing in Europe but local firms such as EQT, Orlando Management and Rutland Partners have also created vehicles targeting opportunities in their home markets.

The mixed signals of the 'financial bubble'

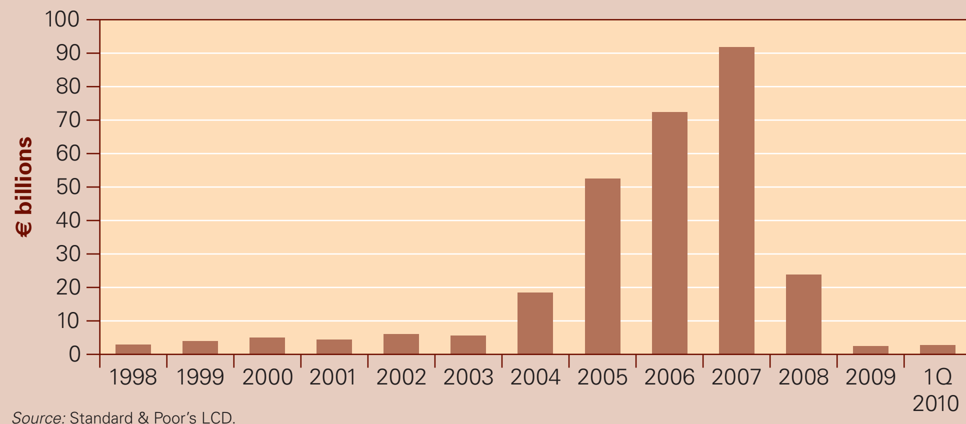
The latest market cycle has been named by some the 'financial bubble', whose bursting has led to the largest global recession since the Great Depression and a potentially huge opportunity for the distressed debt and restructuring sector. The cycle began with increasing liquidity in the market in 2003 and 2004, a trend noticeable in the high yield bond new issuance numbers in Figure 1.1, but even more dramatic in the rise of loans raised to back leveraged buyouts in the US and Europe, as detailed in Figures 1.2 and 1.3. The development of an active collateralised loan obligation and collateralised

Figure 1.2: **US corporate leveraged buyout loan volume**



Source: Standard & Poor's LCD.

Figure 1.3: **European leveraged buyout loans**



Source: Standard & Poor's LCD.

debt obligation market (CLOs and CDOs) led many large banks to act as originators, originating loans that would quickly be sold off their balance sheets to make way for the origination of more loans. Debt volumes surged significantly from historical averages as a result, with much of that activity going to support large transactions driven by the newly emerging mega-buyout funds targeting very large companies and detailed in Figure 1.2.

This surge in debt served as a signal to many investors that the top of a cycle was coming. As evident in Figure 1.4, which details the recent history of private equity distressed debt and restructuring funds, even before the high yield bond and leveraged buyout loan markets peaked in 2007, fundraising for this sector began to increase dramatically in anticipation of the turn of the market cycle. Every year from 2006 through 2008 a new fundraising record was set, with fundraising levels peaking in 2008 as the depth of the recession was becoming increasingly evident.

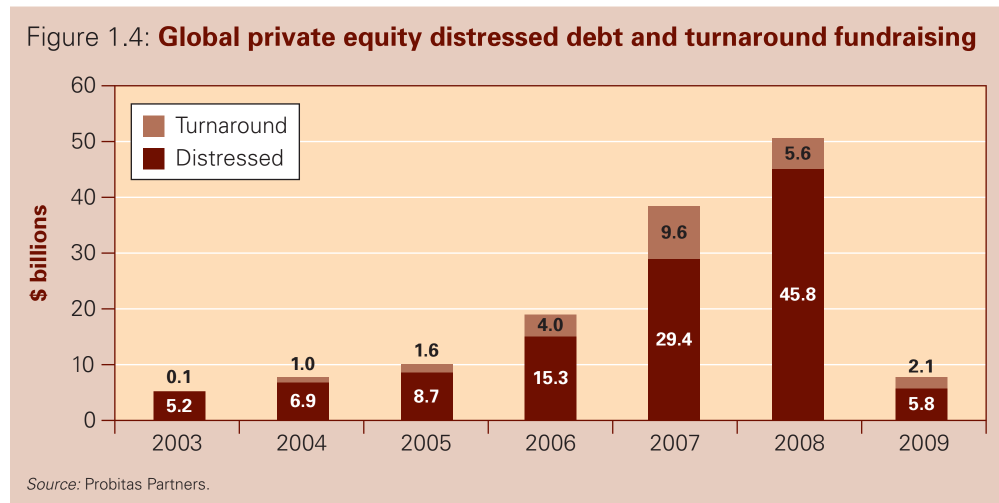


Figure 1.4: **Global private equity distressed debt and turnaround fundraising**

Source: Probitas Partners.

Most of the largest distressed debt and restructuring funds were raised during this period as summarised in Table 1.3. There are several things of note about these funds:

- *They are headquartered in the US:* Though a number of these funds invest globally, and several of these fund managers also have separate funds targeting Europe or Asia, all of these groups are headquartered in the US, the deepest and most developed market in the sector.
- *Two fund managers have multiple vehicles on the list:* Oaktree Capital Management and Lone Star Funds, both well established, were able to raise two very large vehicles within the same market cycle.
- *The list includes two specialist vehicles focused on the financial sector:* Most distressed debt and restructuring funds are generalists as far as industry is concerned, but at the beginning of this cycle opportunities in the financial sector were deemed to be so great that two very large funds, JC Flowers and TPG Financial Partners, were raised with this focus.

Table 1.3 also points out some of the mixed signals of this particular market cycle as we are part of the way through it. At this point it is not clear if this cycle while generate a 'happy time' of historic proportions for distressed debt and restructuring managers for several reasons:

- *The risks of investing heavily too early in a cycle:* Certain fund managers that raised funds early in the cycle invested heavily in late 2007 and early 2008, and were caught by surprise by the steep market declines triggered by the Lehman Brothers collapse in September of 2008. Sun Capital Partners, whose Fund V made the list, racked up a number of portfolio company bankruptcies over this period and in consultation with its investors ended up reducing the size of the fund from $6 billion to $5 billion in part as a result.
- *The impact of governmental policy and regulatory changes:* In reaction to the steep economic decline that became obvious in the fall of 2008, several governments globally instituted stimulus programmes to mitigate the fallout. These programmes had

Table 1.3: **10 largest distressed debt and turnaround funds raised to date**

Rank	Fund name	Firm name	Headquarters	Vintage or status	Amount ($ m)
1	OCM Opportunities Fund VIIB	Oaktree Capital Management	Los Angeles	2008	$10,900
2	Cerberus Institutional Partners (Series Four)	Cerberus Capital Management	New York	2006	$7,500
2	Lone Star Fund VI [1]	Lone Star Funds	Dallas	2007	$7,500
4	JC Flowers II	JC Flowers	New York	2006	$7,000
5	Avenue Special Situations Fund V	Avenue Capital Group	New York	2007	$6,000
5	Sun Capital Partners V [2]	Sun Capital Partners	Boca Raton, Florida	2007	$6,000
5	Texas Pacific Group Financial Partners [3]	TPG	San Francisco	2008	$6,000
8	CVI Global Value Fund	CarVal Investors	Minnetonka, Minnesota	2007	$5,750
9	MatlinPatterson Global Opportunities Fund III	MatlinPatterson Global Advisors	New York	2007	$5,000
9	Lone Star Fund V [1]	Lone Star Funds	Dallas	2005	$5,000
9	OCM Opportunities Fund VIII	Oaktree Capital Management	Los Angeles	In market	$5,000

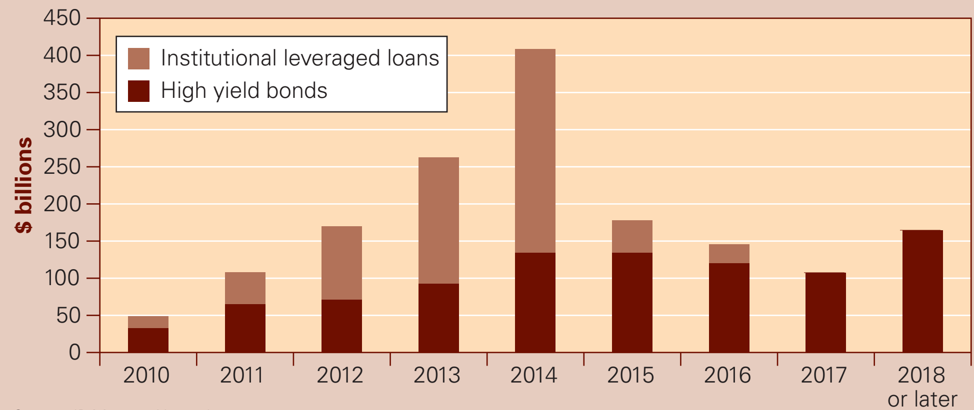
[1] Fund also invests in distressed real estate.
[2] Originally raised $6 billion, but by vote of the limited partners the fund size was reduced to $5 billion.
[3] Originally raised $6 billion, but commitments were unilaterally decreased by TPG to $4.5 billion due to doubts about the ability to deploy the larger fund due to changes in the bank rescue programme; fund was subsequently further reduced to $2.5 billion.

Source: Probitas Partners.

various impacts, but one of the most interesting initiatives were changes to banking regulations meant to prohibit private equity investors from generating perceived 'windfall' profits in buying distressed banks. In large part because of these changes, TPG unilaterally decided to decrease the size of its Financial Partners fund first from $6 billion to $4.5 billion, then even further to $2.5 billion.

- ***Amend, extend… and pretend:*** If there is a phrase that describes many debt-holders in this cycle, it is 'amend, extend… and pretend'. Given the massive problems hidden away on many lenders' balance sheets, there has been a much greater predilection to amend debt agreements and extend maturities in the hopes that things will get better in the future instead of moving things formally into default. Though there certainly has been a surge in defaults, they have not reached anywhere near the heights forecasted early in 2009.
- ***Covenant lite:*** Another issue specific to this cycle has been the issuance of covenant-lite debt during the 2005-07 period. Financial covenants in debt agreements are meant

Figure 1.5: **Maturity schedule of outstanding high yield debt**



Source: JP Morgan, November 2009.

to provide debt-holders with leverage to negotiate with debtors before the point where interest payments are missed. The combination of covenant-lite with payment-in-kind structures means that the usual restructuring mechanisms are simply not in place for debt structured in this fashion.

Though there is still fear of a double-dip recession (a fear growing recently along with the recent eurozone crisis), the markets have rebounded more quickly than expected from their March 2009 lows and high yield bond issuance actually soared in 2009 (though leveraged buyout loans remained low due to continued dislocation in the CLO and CDO markets). High yield bond defaults seemed to have peaked at the end of 2009 and current forecasts by Moody's have them declining significantly, to a 3 percent rate by the end of 2010. At the same time, fundraising for distressed debt and restructuring funds declined steeply in 2009 as a number of investors felt there was too much money targeting the sector.

In the face of these mixed signals, there is one other major factor that still presents risk and opportunity. Figure 1.5 summarises the 'wall' of refinancing from 2011 through 2014, much of that coming from a loan market that is still in disarray. A rapidly improving economy accompanied by increasing liquidity may yet prove effective with the wall, but a double-dip recession or slow growth may result in many companies scrambling to refinance.

Summary

Since the early-1990s, 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 thus more investors are making allocations to the sector. Importantly, in a number of countries bankruptcy law has been changed to make company restructurings a more viable option to liquidation. These changes of course not only effect 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.

This cycle has also shown, however, that accurately predicting how the market opportunity in any particular environment will play out is extremely difficult as changes to debt structures, shifts in government policy, differences in debt-holder perceptions and the sheer level of needed debt refinancings can significantly change how the game is played. □

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