


Distressed Debt Investment



Amid the current financial turmoil, as the value of most mainstream asset classes wither away, a few new investment opportunities have emerged and offer investors fresh hopes for decent returns. One of the most exciting opportunities considered by many institutional investors is distressed debt, a specialist asset class that kept a low profile during the previous period of economic prosperity. Data collected by Preqin, an independent research group, shows that a record amount (over \$80 bn) has been allocated by investors to private equity-style distressed debt funds since 2007. Established US distressed debt specialists, such as Oaktree, Avenue and Cerberus, have attracted the largest proportion of capital. A number of large buyout houses have also raised significant cash for this asset class as investment opportunities for leveraged buyout deals have dwindled. Despite showing an initial interest, most private equity mid-market players chose to focus on their core strengths and stayed away from setting up distressed debt funds.

The distressed debt market was initially formed in the US in the 1980s, following the adoption of Chapter 11 of the US bankruptcy code, which shifted the emphasis from liquidation to restructuring, and the creation of the high yield 'junk' bond market. Over time the market expanded globally as investment opportunities arose in other parts of the world. A salient feature of distressed debt as an asset class is its counter-cyclicality. As the economy deteriorates, falling consumer confidence erodes revenues and earnings, inhibiting businesses' ability to service their loans. Consequently the number of companies that breach their covenants or default on their loans inevitably increases. Companies with overly-leveraged balance sheets are particularly susceptible to default, even though they may be fundamentally sound. During the previous economic downturns, the so-called 'good companies with bad balance sheets' had provided valuable opportunities for distressed debt investors. Funds targeting these companies during the early 1990s and at the turn of the millennium were able to generate attractive returns for this reason.

The current economic downturn provides yet another window of opportunity in distressed debt investment. The difference with the previous two recessions is that now there may be a far greater supply of companies in distress. It is the first time in history that a slowdown in the economy has been felt globally. It is also the first time in the post-war era that a recession followed a financial crisis in the developed world; the full extent of its damage is still to be seen. As Stephen Kaplan, founder principal of Oaktree, put it: the current recession may see the greatest transfer of ownership from equity owners to creditors in history.

It is fair to say that a significant number of leveraged buyout deals were sponsored during the bygone era of cheap credit by private equity firms who perhaps had too much faith in the inflated valuations and were over-zealous in the use of debt. Senior debts of most large LBOs in Europe completed from 2005 to 2007 are reportedly trading at 40 to 80% of par value these days, with some already in default. Alchemy Partners, the leading distressed debt investor in the UK, envisages 50 to 75% of high yield bonds and leveraged loans in Europe to default in the next 4 to 5 years. Given that there are approximately \$1.2 trn of leveraged capital, BBB rated bonds, CDOs and CMBS outstanding in Europe, over \$600 bn worth of distressed investment opportunities will be available in Europe alone if Alchemy Partners is right. Yet, many traditional distressed debt players such as investment bank proprietary trading desks and hedge funds have ceased to invest in the market due to capital constraints. Therefore, despite the recent increase in fund raising, there is still a major imbalance between the supply of investment opportunities and the capital / knowledge base for exploring these opportunities.

A range of strategies are available for distressed debt investors to take advantage of the various investment opportunities. The primary strategies include (1) the short term trading strategy, often favoured by hedge funds given the liquidity that the strategy affords; (2) the long term secondary loans strategy, which involves purchasing undervalued debt securities from the secondary market and holding them for a period of time until the value restores to a desired level; and (3) the loan-to-own strategy, entailing building a significant stake of loans in the target company in an effort to control or influence a restructuring.

Jon Moulton, founder of Alchemy Partners, believes that loan-to-own is the essence of distressed investing. By buying debt at a discount and turning it into equity in a restructuring, the distressed debt investors may rejuvenate a business and preserve jobs whilst generating attractive returns for themselves. So far, however, distressed debt fund managers have been cautious in implementing the strategy fearing that, in some sectors and in debt prices, the worst is yet to come. The recent moves by Oaktree Capital to build up a stake in Countrywide's bonds in an effort to control or influence a restructuring is one of the few cases that investors are putting the strategy into practice. The strategy is not without its critics either. Some have referred to the followers of the strategy as ruthless vultures, who force companies into liquidation and reap huge gains from stripping their assets. It is true that in a small number of cases, a company may not be worth saving and asset sales are the only way for creditors to recover some value from the business. In reality, says Moulton, most companies are more valuable when kept as going concerns; it would make no economic sense for its debt owners to force them into liquidation.

Although the idea of turning troubled businesses around whilst generating equity-like returns may be tantalising, investing in distressed debt is extremely challenging. It requires a complex set of skills and involves high level inherent risks. Operating in the European market is particularly testing, given the heterogeneity in bankruptcy laws and other barriers such as business culture and language differences. A sound understanding of the local bankruptcy regulations and processes is especially important and not something one can develop overnight.

Investing in distressed debt at the present juncture is particularly difficult as economic conditions are still unsettled. Even sophisticated investors have struggled to grasp the current conditions and often hold very different perspectives. A large buyout group with considerable investment experience in distressed financial companies recently returned a quarter of a fund raised for this type of deals to its investors, following a major loss in its investment in a US bank. Yet, in the meantime, some of the firm's key competitors still appear to believe in the upside potential of investing in troubled financial institutions and are raising fresh funds for this strategy.

It is perhaps unlikely to see a surge in investment activity before the conditions become more settled. Indeed those who invested prematurely last year have hit the first bump in the road as debt prices fell still further subsequently. Those with no prior experience in the asset class will not find a smooth path. So far, we hear that the large buyout houses who delved into distressed debt have been experiencing drastically varying degree of success. It may be possible for these firms to build winning investment teams by bringing together external specialists in distressed debt and internal professionals with expertise in improving company performance. But this will take time. Investing in distressed debt is not for the faint-hearted. Whilst great gains may be achieved in the next few years, one should be aware of the bumps in the road.

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