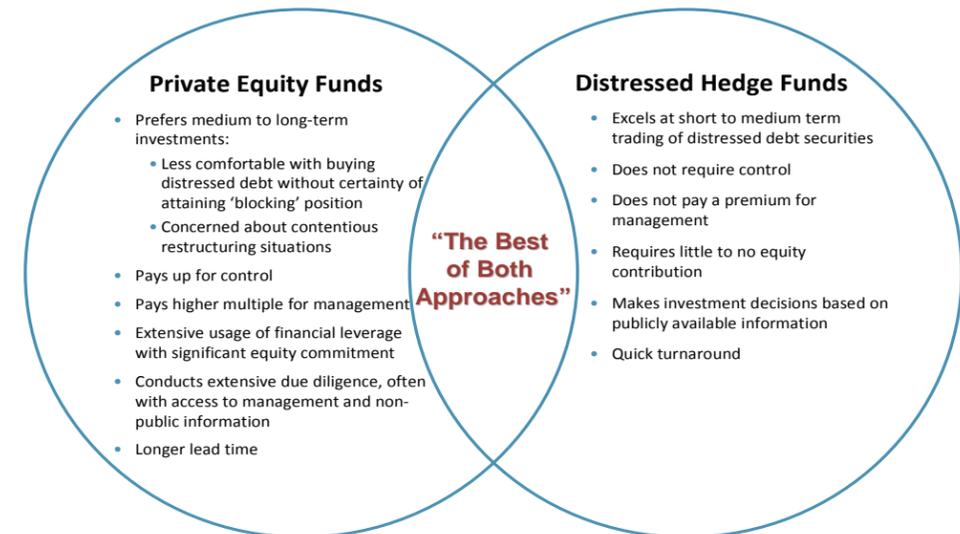


Investing in Distressed Debt

Sameer Jain
UBS
Harvard University, MIT

Private Equity and Distressed Hedge Funds



An Increasingly Popular Sub-Asset Class

Over the past 20 years, distressed debt investing has become increasingly popular. The distressed debt market has increased in size – private equity firms and hedge funds have become key players. There are around 170 U.S. based, and 20-30 Europe based credit managers who invest in distressed debt. They manage \$120-\$150 billion of private capital (hedge funds and private equity – often they overlap). These funds are generally engaged in the business of originating, underwriting, syndicating, acquiring and trading, debt securities and loans in corporate borrowers.

Distressed managers have wide latitude to trade across the capital structure. Such securities may include bonds, debentures, notes, mortgage or other asset-backed instruments, equipment lease and trust

certificates and commercial paper. They may also acquire positions in equity and equity-related securities, including preferred stock, convertible preferred stock, common stock and warrants. Very often securities in which distressed managers invest in may be publicly traded or privately placed. They may also purchase bank debt and trade claims or be invested in non-liquid securities or assets of distressed companies, which can frequently be purchased at a substantial discount to fundamental value.

We estimate that over the past few years, over \$50 to \$70 billion has been raised by dedicated distressed opportunity funds – the bulk of which was in 2008. At the end of 2010 around 38 funds were actively seeking around \$30-\$35 billion of private capital in the U.S. Consistent with investment activity, public and corporate pension plans, endowments and foundations, as well as fund of funds have been large

investors in the distressed sector. Many of these funds tend to have fairly broad mandates. They may trade in:

- Distressed and out of favor credits, including commercial and corporate loans and asset-backed securities,
- Residential sub-performing or non-performing loans and securities,
- Corporate and commercial loans, mezzanine loans and other investments in subordinate levels of the capital structure of issuers; such loans and investments may also include related warrants, options or other securities with equity characteristics,
- Publicly traded or privately negotiated equity securities (such as preferred stock, common stock and warrants) of stressed and distressed firms.

Opportunistic distressed debt is about making investments in situations in which companies are undergoing, or likely to undergo bankruptcies, or other extraordinary situations such as debt restructurings, reorganizations and liquidations outside of formal bankruptcy proceedings. Funds investing in distressed debt often become a major creditor of the underlying company through the purchase of low-priced bonds or other financial instruments. Similarly, they are, in many circumstances, able to exercise a certain degree of control in an underlying company through the acquisition of significantly discounted securities in order to enhance the value of such underlying company. In turn, during and after such underlying company's reorganization or restructuring, these funds are in a position to realize attractive gains through sales of restructured debt obligations, newly-issued securities and/or sale of its currently-held securities.

Traditional investors, who mainly seek to generate capital gains and investment returns through exposure to distressed debt investments, have been joined by strategic investors undertaking distressed M&A. The recent credit bubble with easy access to cheap credit and excessive debt leverage produced a robust seller's M&A market with seller-friendly M&A agreements and premium prices for target companies. These market conditions fueled the M&A market to historically lofty levels in terms of volume and number of transactions and peaked in Q3 '07. The credit crunch (which began in Q3 '07) and the global economic downturn have altered the M&A landscape dramatically and set the stage for distressed M&A. In 2008, volume of worldwide M&A activity decreased dramatically from 2007 levels. Highlighting the difficult deal making environment was a spike in the number of withdrawn M&A transactions, which hit an all-time record in 2008. Volume of financial sponsor-backed transactions reached its lowest level since 2003 and in the period following 2009 due to tightened credit markets (for lower and middle market deals), deal and negotiating leverage has shifted from sellers to buyers (with excess equity capital). Looking forward in the next few years ahead, unprecedented opportunities for distressed M&A transactions may exist provided sellers and buyers alike recognize that historical M&A "market" and deal structure models may require modification in light of the unprecedented economic climate.

As corporate, legal and capital structures have grown more complex, the level of expertise and differentiation in 'style' of investment has kept pace. There are a variety of investor groups participating in the overall distressed market, including hedge funds, banks, investment banks, broker / dealers, mutual funds, credit corporations and strategic investors. However, the private corporate, distressed-securities asset class is populated by just a dozen participants with capital of at least \$1 billion.

Market Conditions

Favorable Market Conditions in 2012

Until the onset of the credit crisis in 2007, the high yield markets were characterized by tightening spreads, low volatility, increasing leverage, reduced covenants, a growing collateralized debt obligations (CDO) market

and an abundance of liquidity available to provide rescue financing. Spreads widened, defaults and default expectations increased as high yield issuers faced a number of challenges, including substantially declining revenue due to severe economic weakness, a lack of available funding, slowing consumer demand and generally over-leveraged balance sheets. Furthermore, due to financial market de-leveraging, credit spreads were driven as much by technicals as by deteriorating fundamentals.

Defaults and credit problems increase during cyclical downturns. When default rates increase, such as they had in 2009, there are likely to be more defaulted bonds available for sale. Of course, the high yield and distressed investing landscape has since changed rapidly with the market recovery of 2010. However, the demand for this paper is relatively inelastic, since large institution buyers are restricted from investing in them; the space largely remains the preserve of hedge funds and private equity funds. This provides opportunities for distressed debt investors to acquire paper at cheaper prices. The success of such investment activities depends to a significant degree on the fund manager's ability to identify and exploit inefficiencies in the markets for a wide range of opportunistic investments; corporate loan originations including mezzanine loans and other investments in subordinate levels of the capital structure, other stressed, distressed and out of favor credits.

Supply of Distressed Investment Opportunities

Apart from occasional influxes from the investment grade and municipal bond markets, distressed investment opportunities typically include public and private high yield bonds, leveraged loans, second lien debt, mezzanine debt, convertible debt, trade claims, preferred stock and common equity of high yield companies that: (i) are likely to engage in a reorganization due to poor financial performance, (ii) are in a Chapter 11 or some other form of reorganization or (iii) have recently emerged from a reorganization proceeding.

The supply of distressed opportunities has traditionally been represented to the broader investment community as the recent history of, and near-term expectation for, defaulted high yield bonds. This thesis captures only a subset of the distressed marketplace and therefore greatly understates the true universe of opportunities available. Private placements, bank debt, second lien debt, mezzanine debt, other debt-like public and private securities, preferred stock and trade claims (collectively larger in size than the high yield market) are incremental to the high yield bond market. Furthermore, the life cycle of a distressed company, and therefore the investment opportunity, usually spans four to eight years, creating investment timing opportunities that substantially exceeds the initial default period.

Distressed Debt Opportunities are Counter Cyclical and Sticky

As economies deteriorate, default rates tend to rise. Yet, even after default rates stabilize and then decline, the outstanding volume of defaulted or otherwise distressed debt remains elevated for some time because work outs take time. Currently, even though default rates have declined to low levels, the cumulated number of defaulted securities over the past three years is considerable, suggesting that opportunities in distressed debt investing still abound.

Regulatory Conditions

The U.S. Insolvency Regime is supportive of distressed investors. Chapter 11 of the U.S. Bankruptcy Code is a law which was created to advance many goals, but in particular to (i) rehabilitate financially viable businesses, (ii) provide new capital including Debtor in Possession (DIP) loans to debtors; and, (iii) provide time and ability for the debtor company to reorganize its business.

The primary goals of the chapter 11 process are the rehabilitation of the debtor and the maximization of returns to all of the debtor's creditors. These dual goals guide a debtor's restructuring efforts and encourage the debtor to maximize the value of its bankruptcy estate through the financial and perhaps operational reorganization of its business. A debtor cannot always satisfy both goals, and in those instances, a liquidation of the debtor focusing solely on maximizing returns to creditors follows.

Importantly, Chapter 11 also provides very significant and important rights to creditors including the formation of Creditors Committees (and the hiring of advisers) to represent the interests of creditors, a formal plan process which requires affirmative acceptance by creditors and a requirement for equality of recovery among similarly situated creditors. It also requires maximization of business value, provides for proper distributions to creditors, as well as enhances transparency and disclosure on the business affairs of the debtor company to all creditors.

Chapter 11 provides relief, if agreed, from creditor claims for companies in financial distress. Large tax loss carry forwards, strict disclosure rules and clear debt restructuring rules further help in reorganizing distressed companies. In most other insolvency regimes, such as those of countries in Europe and Asia, there is no similar codified bankruptcy law – creditors often have significantly fewer legal rights along with non-timely information access. In Europe, bankruptcy is often intended to end rather than prolong the life of a company. In France, for instance, if a distressed company cannot find funding in 45 days, it is often forced to liquidate; there is no concept of Debtor in Possession (DIP) financing and companies can often take action without creditor support. Since insolvency law differs in other countries, some investors tend to prefer to invest in U.S. distressed situations.

The majority of corporate control transactions are conducted through the Chapter 11 bankruptcy process. This provides advantages to the buyer of distressed assets, for the bankruptcy process can potentially eliminate unfavorable contracts and other liabilities, which might otherwise limit the appeal of a transaction. Acquiring corporations, by utilizing the bankruptcy process to affect a relatively quick and inexpensive operational restructuring simultaneously with financial restructuring, are able to purchase valuable operating assets at attractive valuations. Additionally, the U.S. Bankruptcy Code allows an investor (strategic or otherwise) to purchase assets through several mechanisms, including a "Section 363 sale", which allows the purchaser to acquire specific assets free of any liens or liabilities, and without regard to creditor objections. Section 363 of the Bankruptcy Code provides a tool for distressed companies seeking to sell their assets and for buyers looking to purchase assets at potentially bargain prices.

Distressed Securities Characteristics

Distressed securities are "below investment grade" obligations of issuers in weak financial condition, experiencing poor operating results, having substantial capital needs or negative net worth. Such securities are therefore considered speculative. They often face special competitive or product obsolescence problems and may be involved in bankruptcy or other reorganization and liquidation proceedings. These securities are often risky investments although they may offer the potential for correspondingly high returns. Often, it is difficult to obtain information as to the true condition of such issuers. Such investments may also be adversely affected by laws relating to, among other things, fraudulent transfers and other voidable transfers or payments, lender liability and the bankruptcy court's power to disallow, reduce, subordinate or disenfranchise particular claims.

A distressed debt investor purchases the debt of a financially troubled company at a discount against the face value of the debt. The investor seeks to make a profit on its investment primarily by reselling the debt, through recoveries in the restructuring process or by converting the debt into an equity position in the reorganized

debtor. The traditional intuitive definition of "distress" often refers simply to a company with too much debt and insufficient cash flow to service the debt.

However, more broadly speaking, financial distress may result from one or more of the following causes:

- Excessive leverage due to a variety of causes.
- Declining profitability.
- Loss of competitive position.
- Changing business climate, whether in an industry, region or specific market.
- Regional or global economic disruptions, such as during the recent financial crisis.
- Lack of access to funding markets.
- Litigation or regulatory difficulties, including accounting improprieties, toxic torts or pollution control liabilities.

Trading in Loan-to-Own Securities

- Loan-to-own transactions typically involve a secured loan accompanied by equity stake and various rights associated with equity ownership (e.g., board representation, registration rights) but not voting control.
 - Does the transaction evidence investor's and borrower's intent that investor ultimately will be owner?
 - Were other creditors harmed by the transaction?
- Goal is to enable investor to exert influence but avoid "controlling shareholder" or insider claims
 - Recharacterization of investor's debt as equity.
- Documentation may contemplate subsequent chapter 11 or refinancing and provide investor significant rights in such circumstances.
 - Depends on nature of transaction and actions of parties.
 - Generally not permitted where debt is held by true third party.
- Potential issues with Loan-to-Own investments.
 - Avoidance actions based on payments received by or collateral given to investor.
- Discharge of fiduciary duties by board of directors or management.
 - Valuation - were other transactions sought and pursued?
- Equitable subordination of investor's debt.

Trading by making a Tender Offer

- Acquirer may purchase debt securities of a target, and a target may purchase its own debt securities, pursuant to privately negotiated transactions, open market purchases or a tender offer.
 - With care and planning, generally able to conduct a significant open market repurchase program and even substantial privately negotiated repurchases without triggering tender offer rules.
- No clear definition of a "tender offer," but courts have identified the following characteristics in determining whether an open market purchase or series of purchases constitutes a tender offer subject to the Securities Exchange Act.
 - Each negotiation independent of any other.
 - Each seller sophisticated
 - No attempt made to impose same terms on all sellers or to set any fixed deadline for responding
 - Limited percentage of the securities purchased
 - Limited advance public disclosure
- Active and widespread solicitation of public security holders
 - Compliance with anti-fraud and anti-manipulation restrictions requires that
- Solicitations for a substantial percentage of a class of securities
 - Acquirer may not purchase securities of a target (whether in privately negotiated transactions or pursuant to a tender offer) while in possession of material non-public information relating to such securities
- Offers made at a premium to market price
 - Company may not purchase its own securities while in possession of material non-public information relating to such securities
- Firm, rather than negotiated, terms
- Purchases contingent upon the acquisition of a fixed number of securities
- Offer open for a limited period of time
- Pressure from acquirer on security holders to sell their stock
- Public announcement of an intent to gain control of the target, followed by a rapid accumulation of securities

Meaningful opportunities in the distressed debt space tend to share one or more of the following characteristics (i) a capital structure and / or legal posture which suggests that any reorganization will be unusually contentious and protracted; (ii) obligations whose junior position in the capital structure suggest the possibility of total loss; (iii) dramatic events that place the entire enterprise value at risk; and (iv) complex problems with numerous critical variables and incomplete and / or unreliable information.

Left Tail Characteristics

Another point to note is the left tail characteristics of distressed investing. Distressed debt is characterized by heightened risk due to uncertainties surrounding businesses emerging from a bankruptcy process. In liquidation and other forms of corporate reorganization, there exists the risk that the reorganization either will be unsuccessful (due to, for example, failure to obtain requisite approvals), will be delayed (for example, until various liabilities, actual or contingent, have been satisfied) or will result in a distribution of cash or a new security the value of which will be less than the purchase price.

These risks can often be compounded by the illiquidity of distressed assets. Indeed, investors can face unexpectedly high bid-ask spreads when trying to liquidate distressed positions. Key risk measures such as the likelihood of insolvency, value at risk, and expected tail loss of bid-ask spreads tend to widen just when positions must be liquidated - thus triggering additional losses.

Liquidation

- Liquidation is a distressed firm's most drastic alternative, and it is usually pursued only when voluntary agreement and reorganization cannot be successfully implemented.
- In liquidation, the company's assets are sold and the proceeds are used to satisfy claims.
- The priority of satisfaction of claims is as follows:
 - Secured creditors
 - Bankruptcy administrative costs
 - Post petition bankruptcy expenses
 - Wages of workers owed
 - Employee benefit plan contributions owed
 - Unsecured customer deposits
 - Federal, state, and local taxes
 - Unfunded pension liabilities (Limit is 30% book value of preferred and common equity; the remainder becomes an unsecured claim)
 - Unsecured claims
 - Preferred stockholders (up to the par value of their stock)
 - Common shareholders

Value generation and distribution

The basic problem of a firm in distress is that the claims on the company by creditors, equity holders, suppliers and employees, are greater than the value of the firm. The other problem facing firms in distress is that they are running against time – as firms at this stage typically have negative cash flow. When a distressed firm looks at its situation, it usually has to decide between two courses of action (i) Liquidate or (ii) Restructure.

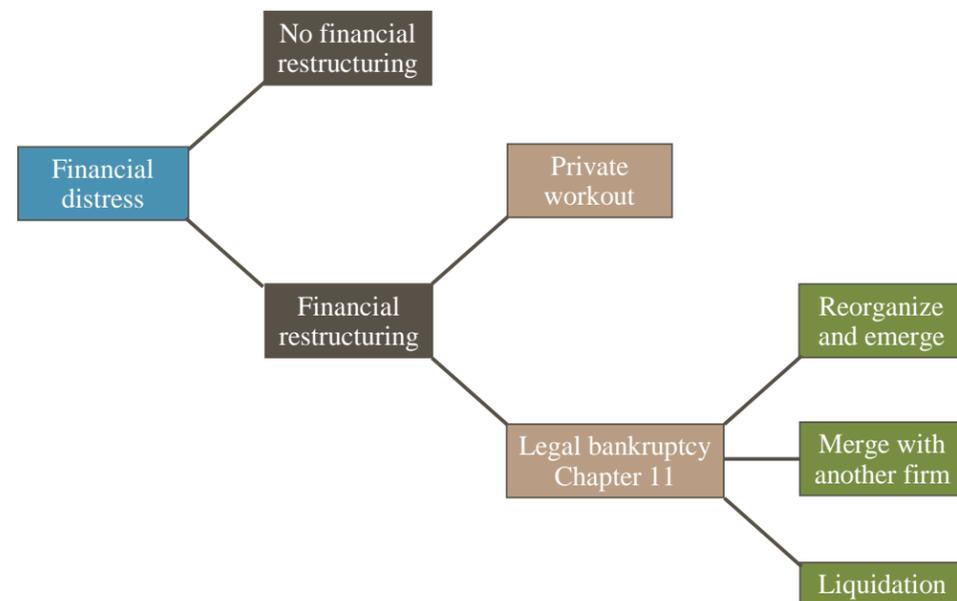
The decision is taken based on the value of the reorganized firm compared to the liquidation value. Reorganization may be achieved through financial reorganization, aimed at reducing the value of outstanding claims on the company, or through operational reorganization, aimed at increasing the value of the firm's assets. If the valuation for the restructured firm is greater than the liquidation value, then the firm should restructure so that the claimholders recover more out of their claims on the firm. If the ongoing concern value is less than the liquidation value, then the firm should be liquidated, as it is this course of action that will provides the greatest coverage to the claims of the claimholders - the liquidation or restructuring can be done inside or outside of bankruptcy court. Valuations, therefore, are strongly biased based on specific interests of the different claimholders and subject to fierce negotiation

The impact of financial distress on enterprise value is significantly different depending on whether a firm restructures in Chapter 11 or out of court. On average, claimholders recover 80 cents on the dollar when they restructure out of court, and around 51 cents on the dollar if they restructure in court. The difference is mainly because firms that go into Chapter 11 are typically much more in distress, for they have typically waited longer to address their problems. Naturally, business risks may be more significant in issuers that are embarking on a build-up or operating a turnaround strategy.

If the company liquidates under the supervision of the courts, then the amount which goes to each claimholder depends on the seniority of the claim they have. In this respect, the rule of 'Absolute Priority' plays an important role. According to this rule, all claims have different priorities, whereby each claim must be made complete before the claims with the next highest priority (seniority) can receive anything. Therefore, the highest priority claim could very well come out complete (receive 100% of claim) while the next lower priority might only receive a small fraction of claim, while the next lowest claim yet, may receive nothing.

If the value of the ongoing concern is greater than the liquidation value, then the difference between the two is

What Happens in Financial Distress?



Source: Karen H. Wruck, "Financial Distress: Reorganization and Organizational Efficiency," Journal of Financial Economics, 27 (1990), Figure 2.

Out of Court Transactions

Advantages

- Generally less time consuming than in-court, which can lead to reduced costs.
- Court approval not required and uncertainties associated with chapter 11 are avoided.
- Eliminates potential bankruptcy cross-defaults under debt instruments of non-debtor entities
- Reduces negative press and related effects on trade relationships that tend to be associated with a chapter 11 filing

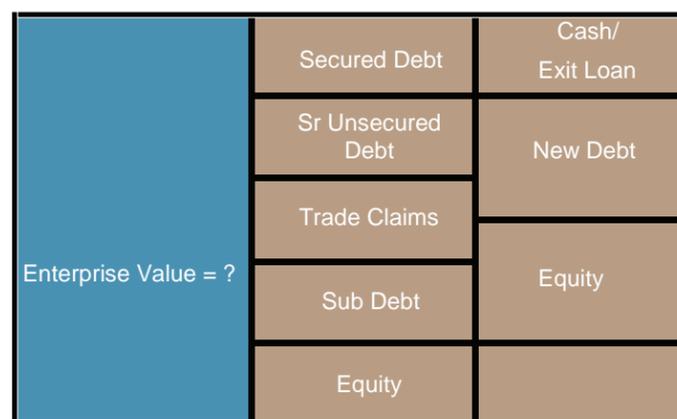
Disadvantages

- Increases risk of transaction failure or deterioration of business prior to closing.
- Negotiations are lengthy and complex at a time when the target likely has deteriorating liquidity.
- Third party approvals, consents or waivers may be required.
- Liens on assets and debt covenants.
- Requisite consents may be difficult to obtain due to divergent interests of multiple constituents.
- May require unanimous consent to amend key provisions.
- Fraudulent conveyance risk.
- Successor liability.
- Tax implications –inability to use net operating loss.
- Limited ability to restructure legacy employee liabilities.

negotiated amongst the different claimholders. The law is not clear on how this difference in value is distributed. The only rule is that each claimholder cannot receive less than they would have if the firm were liquidated. This invariably gives rise to lengthy negotiations and 'games' which claimholders play, whether they are in court or out of court. In out of court restructurings typically banks and senior creditors give up part of their claim to the benefit of junior creditors and equity holders.

Given these dynamics and the relatively high administrative and capital costs required for non performing assets, institutional lenders often end up selling their claims to specialized investors such as hedge funds and private equity firms. These investors are able to extract value out of distressed claims in a different way than, for example, a commercial bank can.

Distressed Investing Paradigm: How Much is There—Who Gets It—What Do They Get



Source: Tennenbaum Capital Partners, LLC

Determining Claim Status

General Rule:
All Claims equal unless:
Secured
Statutory Priority
Legally Subordinated
Structurally Subordinated



Source: Tennenbaum Capital Partners, LLC

Return Drivers

Investments in distressed securities are frequently undervalued by the marketplace, providing the prospect of greater appreciation in value than the securities of more financially stable companies. Market undervaluation in relation to fundamental value may be the result of several factors, including: (i) difficulties in conducting thorough financial analysis on a troubled company; (ii) the presence of complex legal difficulties or other business situations; and (iii) the general lack of reliable external sources of information, such as research reports or market quotations, on many companies. Market undervaluation can also occur as a result of market overreaction to geopolitical news, corporate accounting scandals and sector disfavor. Some distressed investors therefore primarily focus on companies experiencing operational difficulties, but with adequate historic revenues, which suggest a need for capital and management improvement, and on financially troubled or undervalued companies. They generally seek to create value by increasing a company's operational efficiency as opposed to relying on revenue growth or industry multiple expansions.

Distressed debt managers in effect create value through active management and deal sourcing:

Active Management: This type of value-add is usually achieved through (i) actively participating in restructuring and reorganization processes, through blocking positions, majority bondholder positions and creditors' committee memberships; (ii) serving on boards of directors to provide strategic direction to portfolio companies; (iii) capitalizing on their status as a significant debt holder or shareholder by establishing a relationship with management in order to guide the creation of a prudent business plan and to advise on and facilitate mergers and acquisitions ("M&A") and corporate finance activities; (iv) structuring add-on investments to assist portfolio company growth and enhance returns; and (v) leveraging negotiating skills to maximize value upon exit.

Bankruptcy

The rise in corporate bankruptcies that may occur and the pressure felt by companies not in bankruptcy to rid themselves of non-core assets are expected to result in an increase in private equity opportunities for investment in bankruptcy sales and corporate divestitures. Because management and operational problems typically accompany the financial difficulties experienced by such companies, investments in these companies are difficult to analyze.

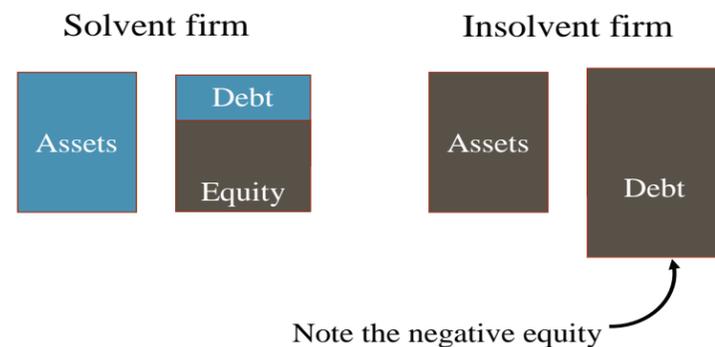
- Federal bankruptcy laws govern how companies go out of business or recover from crippling debt. A bankrupt company, the “debtor,” might use Chapter 11 of the Bankruptcy Code to reorganize its business and try to become profitable again. Management continues to run the day-to-day business operations but all significant business decisions must be approved by a bankruptcy court.
- Under Chapter 7, the company stops all operations and goes completely out of business. A trustee is appointed to liquidate (sell) the company’s assets and the money is used to pay off the debt, which may include debts to creditors and investors.
- The investors who take the least risk are paid first. For example, secured creditors take less risk because the credit that they extend is usually backed by collateral, such as a mortgage or other assets of the company. They know they will get paid first if the company declares bankruptcy.
- Bondholders have a greater potential for recovering their losses than stockholders, because bonds represent the debt of the company and the company has agreed to pay bondholders interest and to return their principal. Stockholders own the company, and take greater risk.

They could make more money if the company does well, but they could lose money if the company does poorly. The owners are last in line to be repaid if the company fails. Bankruptcy laws determine the order of payment.

- The bankruptcy court may determine that stockholders don’t get anything because the debtor is insolvent. (A debtor’s solvency is determined by the difference between the value of its assets and its liabilities.)
- Most publicly-held companies will file under Chapter 11 rather than Chapter 7 because they can still run their business and control the bankruptcy process. Chapter 11 provides a process for rehabilitating the company’s faltering business. Sometimes the company successfully works out a plan to return to profitability; sometimes, in the end, it liquidates. Under Chapter 11 reorganization, a company usually keeps doing business and its stock and bonds may continue to trade in securities markets.
- The U.S. Trustee, the bankruptcy arm of the Justice Department, will appoint one or more committees to represent the interests of creditors and stockholders in working with the company to develop a plan of reorganization to get out of debt. The plan must be accepted by the creditors, bondholders, and stockholders, and confirmed by the court. However, even if creditors or stockholders vote to reject the plan, the court can disregard the vote and still confirm the plan if it finds that the plan treats creditors and stockholders fairly.

Stock-Base Insolvency

Stock-base insolvency: the value of the firm’s assets is less than the value of the debt.



Source: Saeid Samiei, Portsmouth Business School

Deal Sourcing: Fund sponsors tend to have wide-ranging networks, composed of lower middle and middle market intermediaries, workout officers at national, regional and local banks, mezzanine and nonprime lenders, lawyers and accountants. The sources within this network do not, by and large, offer exclusivity. They do, however, ensure that a sponsor gets one of the first looks at transactions, and importantly, will likely give the sponsor a clear picture of the state of play. Good sponsors have the ability to (i) quickly make a go / no-go decisions; (ii) manage the transaction in a professional manner; and, (iii) close the transaction.

A sponsor’s investors too may offer an extensive deal network. Firms typically create an “advisory board” composed of high-profile individuals. Limited Partners and Advisory Board members can provide significant value in sourcing transactions as well. A number of deals also come as a result of previously “busted” deals, failed auctions and transactions suffering from deal fatigue. Often, it is exactly these sorts of transactions – ones that have legacy issues that are proving too hard for the traditional private equity investor to assess – that may offer the metrics to creating investment alpha.

When both middle-market and larger companies do not have large amounts of debt to purchase at a discount from face value, transactions can often be structured and priced to provide returns due to the urgency of distressed companies’ liquidity needs. These kinds of investments are structured in the form of private subordinated debt or private equity transactions in which hedge/ private equity fund managers would provide financing in the form of newly issued subordinated debt with attached warrants or stock options, newly issued convertible preferred stock or common stock. Privately negotiated transactions are also less cyclical than traditional secondary market distressed trading.

Privately negotiated transactions generally include the following: (i) the purchase of a distressed subsidiary needing an operating turnaround from a healthy parent; (ii) the purchase of a distressed subsidiary from a distressed parent; (iii) the purchase of a healthy subsidiary from a distressed parent; (iv) the purchase of an entire distressed parent or (v) the purchase of a company that a distressed investor can benefit from by improving operational focus even when the market generally does not view such company as operationally challenged or distressed.

Recently, many privately negotiated investment opportunities have been in the form of divisions or subsidiaries of larger companies that have been poorly managed, over-leveraged or not otherwise central to the operations of the parent company. Some opportunities have also occurred when the parent company itself is distressed while a division or subsidiary is healthy.

Investor Types

Types of Distressed Securities Managers

Demand for distressed investment opportunities comes from a variety of sectors, including (i) distressed private equity managers, (ii) dedicated distressed hedge funds, (iii) multi-strategy hedge funds, (iv) “cross-over” special situations, arbitrage and value funds, (v) investment banks’ proprietary capital, and (vi) “one-off” opportunistic fund managers.

There are many ways to participate in the distressed debt space. These include:

- Investing in relatively liquid short term trading strategies such as those favored by hedge funds.

- ii. Investing in longer term acquisitions such as purchasing undervalued debt securities from the secondary market and holding them until value restores.
- iii. Investing in relatively illiquid (often private equity type) fund vehicles; these funds acquire significant stake of loans (and equity) to control or influence a restructuring, make asset acquisition and disposition decisions or make operational execution decisions.

There are many strategies within distressed debt investing. These strategies include traditional passive buy-and-hold and arbitrage plays, direct lending to distressed companies, trades with active-control elements, foreign investing, emerging equity purchases, and debt and equity plays while the firms are going through reorganization in bankruptcy.

Stylistically distressed strategies can be divided into either Non Control /Trading oriented or Control oriented.

Trading Strategies

Non Control / Trading Oriented Investing

These managers invest in the senior levels of a company's capital structure. Through secured bank debt or senior notes, they assume a lower risk / reward profile by investing relatively late in the reorganization process or at times when credit risk can be minimized. They usually do not need or seek control. These managers are relatively passive in their investing style. Passive investing has a more opportunistic profile, often with substantial liquidity (except in private equity type fund vehicles). This liquidity affords an investor the ability to be nimble in entering and exiting passive investments, interestingly with very little a priori information. Occasionally, a passive investment may be a stepping stone to a control implementation approach, with the discovery of new information. Non control strategies derive returns from passively holding securities - where the value of securities is enhanced through negotiations during the bankruptcy process.

Types of securities traded include:

- Senior Secured Corporate Debt: Opportunities to purchase high quality, low leveraged companies, at low purchase prices.
- Stressed (but still performing) Corporate Debt: Opportunities to purchase debt of companies experiencing stress from industry, operational or liquidity challenges.
- Distressed Corporate Debt: Opportunities to purchase debt of companies with features that allow for upside potential in the event of a turnaround.

Often Trading oriented strategies are largely the preserve of hedge funds. These funds generate returns by buying undervalued debt where the investor purchases distressed debt and seeks to profit as the underlying company recovers and its debt appreciates. This approach hinges on the investor's ability to identify companies that are currently in financial distress, but look likely to recover in the near future. This strategy is predicated on a weak economy which usually leads to increased corporate default rates, thus creating opportunities for acquiring distressed debt cheap with a view to sell it when price appreciates. This approach is largely practiced by proprietary trading desks and hedge funds. Hedge funds tend to invest in both public and private securities, including leveraged loans, secured bank debt (first and second lien), subordinated bank debt, investment grade and high yield bonds, funded and unfunded bridge loans, convertible securities and a variety of distressed securities such as bankruptcy claims. Many managers employ a disciplined and value-oriented approach to

intensive credit research – they typically seek to purchase securities at a price which, when considered with the claims of other securities holders, allow them to acquire the underlying investment at an attractive valuation compared to private market, public market or merger comparables.

Control Investing

The strategy is to invest in the debt of undervalued companies with respect to enterprise value or liquidation value. These investments may be subsequently converted to equity interests through financial restructurings or reorganizations under the bankruptcy process. In other words these funds enter an investment with the intent of taking control of a company.

These managers are very active in their investing style. They have a higher risk / reward profile, accepting credit risk by investing in more junior securities and tend to take on activist approaches. Control oriented investing is largely practiced by private equity funds that generate returns by accumulating large distressed debt positions that allow them to acquire a position of control in bankruptcy proceedings – they make active operational and managerial interventions. Restructuring funds invest in financial distress companies, but they do so by investing new equity in companies in order to take control. They are, for the most part, equity investors and not debt investors. Control investments provide the flexibility to invest in all forms of debt and equity securities including: common stock, preferred stock, subordinated debt, senior debt, distressed debt, convertibles etc. They typically acquire positions in distressed issuers without regard to capital structure seniority, under circumstances in which material credit risk remains and few other distressed securities investors are willing to participate. They are thus often able to obtain control at a discount to fair value and to use such control to guide or arbitrage the reorganization process.

This strategy creates the potential to not only realize normalized valuations but also to capture a control premium upon exit. An active management approach often enables a fund to positively affect the value of securities meeting screening criteria. Active management requires a major time commitment by a fund's investment team and involves monitoring and analyzing the dynamics of each restructuring, interacting with a wide range of stakeholders with conflicting interests, participating on creditors' and shareholders' committees and judiciously enforcing legal rights. Successfully implementing a control strategy in reorganizations also requires the willingness to undertake measures to create value, including such things as (i) structuring, negotiating, sponsoring and implementing a complete plan of reorganization; (ii) assuming board control and / or through such board or other effective control appointing management either during or after the restructuring; and (iii) providing alternative sources of capital such as debtor-in-possession financings, plan funding and rights offerings.

Here an investor seeks to gain control of a company through a bankruptcy or reorganization process.

Typically, investors first become a major creditor of the target company by buying a company's bonds or senior bank debt at steeply discounted prices. Their status as creditor gives them the leverage needed to make or influence important decisions during the reorganization process. Subsequently, distressed debt firms exchange the debt obligations of a company in return for newly issued equity in the reorganized company, often at very attractive valuations. This is often utilized as a relatively inexpensive means of taking control of companies that have good assets, but are improperly capitalized. Often, they also participate in the workout process outside the bankruptcy process.

This approach attempts to accumulate deeply discounted securities and other obligations of distressed companies

as an initial step towards acquiring an influential or controlling interest, generally through a conversion of debt to equity. It strives to influence the reorganization process and the new capital structure. The strategy profits from revaluation of a distressed investment upon completion of restructuring, a return to normalized profitability as well, as mentioned earlier, realization of a control premium upon exit.

Often, these funds make initial toe-hold investments in a significant number of situations as a first step towards making core investments in certain companies. Occasionally, control may be acquired in a single transaction, but in some cases a fund may build increasing positions in stages. Very often the process of acquiring, restructuring, controlling and exiting certain core positions may require three to four years or even longer.

Control can be aimed at controlling (i) the target during and / or post-bankruptcy or (ii) a particular class of security. In the event of a control investment strategy, a thorough analysis of the company's capital structure determines what is known as the First Impaired Class or that senior-most tranche of claims wherein full satisfaction of amounts due cannot be satisfied in cash or market value. Such tranches have the highest voting authority in bankruptcy proceedings and therefore control the target's reorganization.

Ownership of the First Impaired Class becomes the most effective means of gaining control in the target company, and thus is, frequently the preferred strategy when ultimate control of the target post-bankruptcy is the goal. Value is created by actions such as the conversion of all, or a portion of debt holdings to other classes of debt or equity, the development of innovative structures for the repayment of interest and principal, injections

Reorganization

Traditional buy-out investment funds typically hesitate to make investments in companies requiring substantial turnarounds, including reorganizations subject to the complicated regulations of the bankruptcy process and involving the numerous constituencies that have to be satisfied before a Plan of Reorganization can move forward. Uncertainty about the ability ultimately to acquire a control position and, thus, the ability to select management and control the investment from the outset, can serve as a further deterrent to the participation of buy-out funds in such opportunities. Distressed investors however specialize in this form of investing.

- Committees of creditors and stockholders negotiate a plan with the company to relieve the company from repaying part of its debt so that the company can try to get back on its feet.
- The debtor does NOT need to be insolvent in order to file for chapter 11 protection
- Principal constituents
- Debtor (board of directors remains in control, subject to Bankruptcy Court oversight/approval)
- Debtor In Possession lender
- Secured creditors
- Official committees (unsecured creditors and sometimes equity holder committees)
- United States trustee
- Labor unions
- Filing chapter 11 automatically provides the debtor with the protections afforded under the Bankruptcy Code

- **Not entitled to adequate protection on unsecured portion of claim**

- Immediately upon the commencement of a chapter 11 case, third parties automatically are "stayed" or prohibited from taking any action to obtain possession of property of the estate.
- Automatic stay remains in effect throughout the bankruptcy proceeding
- Prohibits parties to contracts with bankruptcy default provisions from terminating those contracts
- Creditors holding liquidated, unliquidated, contingent or disputed claims against the debtor at the time it files its chapter 11 case hold "prepetition" claims; in contrast, creditors whose claims arise after the debtor files its chapter 11 case hold "post petition" claims.
- Debtor must pay post petition claims in full in cash in order to emerge from chapter 11
- In order to reorganize under chapter 11, the debtor must pay prepetition creditors at least as much as those creditors would be paid if the debtor liquidated its business under chapter 7
- Secured creditors entitled to adequate protection (likely to be significant (& potentially litigious) issue in cases with 2nd & 3rd lien debt)

of fresh capital and the issuance of new equity to existing or new shareholders. We now stress the importance of control and exit as a differentiator in investing.

There are a variety of means to control the reorganization process and, ultimately, a distressed debtor. Bankruptcy laws provide creditors with complex approval rights over restructurings that impair their claims. Generally, the U.S. Bankruptcy Code requires at a minimum, that each class of creditors receiving less than their claimed amount in a plan of reorganization (an "impaired class") cast a two-thirds vote in favor of that plan. This provision permits the holder of two-thirds of an impaired class (and similar supermajorities under the bankruptcy laws of most other countries) a great deal of negotiating leverage over the reorganization process. Similarly, a one-third position in an impaired class generally gives an investor a blocking position with the ability to veto a plan of reorganization. The investors controlling these percentages have a pivotal role in determining the allocation of value and the type of distributions to each class of creditors. Equity is frequently distributed to claimholders in reorganization. It is of critical importance that a control distressed investor be positioned to receive these distributions, which can confer outright or effective corporate control or substantial influence, of a corporation post-reorganization. There are generally no reporting requirements for the transfer of debt – such control of a corporation can often pass unnoticed during secondary market trading of securities. Hedge funds actively look for opportunities to obtain control of attractive distressed situations through secondary market purchases.

Securities and obligations of companies in financial distress tend to be excessively discounted in the marketplace because reorganizations are complex, resource intensive, tedious, contentious and uncertain. In the non-distressed marketplace, and in efficient markets, over-discounted debt or equity securities attract large corporations and institutional buyers seeking to make acquisitions at an attractive price. In inefficient markets these buyers are rationally reluctant to assume the risk of acquiring a distressed company without relying on the independent due diligence and transaction packaging of an outside investment bank. The resulting absence of well-capitalized investors leads to situations in which control positions, which sell at premiums in traditional markets, can be obtained at discounts to fair value.

The majority of the value creation from such transactions typically is achieved in the first two years – typically through a combination of operating improvements, restructuring resulting from the transaction (elimination or resolution of environmental liabilities for example) and an up-tick in exit multiples as the company moves from "distressed" to "going concern." Unless a compelling reason can be found, sponsors look to exit each investment soon after this.

Workouts

- A workout refers to a negotiated agreement between the debtors and their creditors outside the bankruptcy process.
- The debtor may try to extend the payment terms, which is called extension, or convince creditors to agree to accept a lesser amount than they are owed, which is called composition.
- A workout differs from a prepackaged bankruptcy in that in a workout the debtor either has already violated the terms of the debt agreements or is about to.
- In a workout, the debtor tries to convince creditors that they would be financially better off with the new terms of a workout agreement than with the terms of a formal bankruptcy.
- The main benefits of workouts are cost savings and flexibility. Participants in a workout are not burdened by the rules and regulations of Chapter 11 of the bankruptcy code. They are free to create their own rules as long as the parties agree to them

The availability of a range of possible exit strategies is a prerequisite to any prudent distressed securities investment. Exiting from a non-core position usually involves secondary market sales. In the case of a core position, however, the exit can be more complicated and may involve a negotiated transaction such as a merger, block sale, repurchase or refinancing. Active control managers create specialized exit strategies, which may include (i) the sale of all or part of a company to a strategic buyer; (ii) capturing cash flow from operations or liquidations; (iii) a roll-up into a larger entity; (iv) an initial public offering; (v) a recapitalization with existing management / owners; and / or (vi) the sale of post-reorganization securities back into the market.

The various negative catalytic events that coincide with all distressed companies and cause market discounts to true fundamental value, combined with the positive catalytic events that return pricing to appropriate levels, allow an investor to take advantage of a number of strategic entry and exit points. The holding period required to capture the rise in price to fundamental value is generally a function of the expected timing of certain events. As alluded earlier, control oriented investments are generally longer term (a few years) while passive investments are rarely long-term.

Specific exit strategies are based on the class of distressed securities or loans acquired and a matrix of restructuring scenarios. On a regular basis, an investor may choose to reassess the company's prospects as an independent ongoing entity and its current exit strategy in consideration of the value (i) of breaking up the enterprise into separate functional entities (disposing of some and retaining the balance), (ii) of selling the entire company, (iii) to be realized in a public market offering, (iv) of leveraging the company and distributing cash or (v) of selling a specific security or loan in the capital markets.

At such time that one of these disposition strategies appears feasible and likely to exceed target valuation, an investor may commence exit. This is usually done by way of a plan which may include engaging investment bankers, soliciting potential private buyers and structuring financings or other transactions. The timing of the transaction and the cyclical nature of the companies naturally are important considerations in selecting a particular exit plan.

Risk Factors & Mitigants in Distressed Investing

The recent crisis in the credit markets, resulting in contraction in the availability of credit accompanied by widespread insolvency, is unprecedented in recent times. Consequently, many of the risks that distressed funds will face operating in this environment are unusually difficult to predict.

Risks

Distressed securities' return is a combination of the risk premium from holding low-grade securities and the illiquidity premium from holding less liquid securities. The risk comes when underlying investments do not recover and the fund may lose part or even all of the money it invested in the underlying.

Moreover, many events within a bankruptcy case are adversarial and often beyond the control of the creditors. Typical risks – those that General Partners manage and not necessarily those that Limited Partners face - include company specific recovery risks, risks from a general widening of credit spreads, mark-to-market fluctuations and illiquidity. Other risks include plan risk execution risks, negotiation risks that can affect a creditor's ultimate recovery, escalating legal costs during the bankruptcy process as well as litigation from subordinated creditors that may impair senior claims; bankruptcy claims are amounts owed to creditors of companies in financial difficulty. They are illiquid and generally do not pay interest. Sometimes the debtor is never able to satisfy an obligation on the

bankruptcy claim. The markets in bankruptcy claims are also not generally regulated by securities laws or the SEC in the U.S. In addition, under certain circumstances, payments and distributions may be reclaimed if any such payment is later determined to have been a fraudulent conveyance or a preferential payment.

Further, below are additional risks and potential mitigants to consider when investing in distressed debt.

Headline / Reputation Risk

Many high profile institutions, given public scrutiny, attract criticism and acclaim for their investment decisions. This is despite the fact that they, as passive shareholders in commingled fund investment vehicles, have no control over how managers deploy capital. Given inadequate transparency, they may not even know what their managers hold in the first place, and certainly have no right to be consulted before a manager engages in a potential controversial strategy. Despite the lack of control, they are forced to spend substantial resources in managing their reputations, media coverage and relationships with their many stakeholders. They are therefore rightfully concerned with investing in strategies that have "reputation" risk.

Reputation Risk Mitigants:

- Invest with managers who practice active non control strategies, favor negotiated outcomes and avoid taking adversarial positions during deals.
- Invest with managers who work in consensual formal and ad hoc committees of investors.
- Make investments via a nominee where the beneficiary investor name is not disclosed.

Process Risk

Investments in distressed event-driven situations are characterized by complexity. Process risk is inherent in restructurings, for reorganization is a complex legal and financial process. It is important to identify and act on credit issues early. This provides opportunities to monetize portfolio holdings and improve the general investment risk profile.

Process Risk Mitigants:

- Invest with managers who work with financial advisors, legal experts, industry experts and who conduct in depth valuation analysis, including detailed liquidation analysis. During liquidation the aim is to realize as much value as possible from the sale of the security that has been offered as collateral for the loan. Transactions costs of this strategy may be significant; the cost of bankruptcy proceedings, as well as reduced proceeds from distressed sale. Such an exit strategy may nevertheless be attractive if the fund has entered the market during a recession and is exiting via liquidation during a strong upswing. The appreciation of the collateral during a cyclical upswing offers the chance of improving the recovery rate and therefore adding value for the fund's investors. Here the timing and selection skills of a trading specialist and the search skills of a broker are decisive.
- Invest with managers who understand and leverage the U.S. bankruptcy law which provides substantial creditor protection; historically debtors were able to drag out the process for many years; the Bankruptcy Code amendment of 2005 limits debtor exclusivity to 20 months.

Market Liquidity Risk:

These funds tend to invest in securities, loans or other assets for which only a limited liquid market exists. Interest rates, the price of securities and participation by other investors in the financial markets often affect the value

of securities purchased by distressed fund managers. Often they are subject to legal or other restrictions on transfer. The market prices for such assets tend to be volatile, and may fluctuate. Accordingly, these managers are sometimes not able to sell assets at what the fund may perceive to be the fair value of their assets in the event of a sale. Also the sale of illiquid assets and restricted securities often requires more time and results in higher brokerage charges or dealer discounts. This is why most funds investing in distressed credit tend to have long lockup structures.

Illiquidity Risk Mitigants:

- There is a robust over-the-counter market in distressed debt. Invest with managers who provide targeted segmented exposure to underlying relatively liquid asset types.
- Choose managers who prefer deals where situations and outcomes are not controlled by external single majority holder.
- Diversify distressed credit portfolio, both by security and industry to meet liquidity needs.
- Prefer managers who do mark to market valuations on a monthly basis, with pricing provided by third parties that better reflects supply / demand and takes into account illiquidity premium.

Conclusion

In the last few years a large and dynamic market for distressed debt has evolved. Numerous prospective buyers are competing in auctions for portfolios, baskets and single names. This means that sellers – despite the pressure they are under to sell – have the chance to achieve an attractive price. On the other hand, prospective buyers in inefficient middle market transactions have opportunities to acquire assets with significant upside at cheap prices.

Distressed investing has become main-stream. The investor base in distressed investing is considerably wider now than it was a decade ago in the face of a long-anticipated acceleration in corporate default rates and the return to more attractive risk-adjusted returns. It has also emerged as an important tool of corporate finance for middle market deals. Distressed M&A, by virtue of necessity and opportunistic capital, may yet continue to be an attractive proposition.

The economic and financial crisis has had a negative effect on the cost and availability of credit. This has further increased opportunities. The level of analytical sophistication, both financial and legal, necessary for successful investment in the space is unusually high, creating entry barriers for participants. Special situational investments are expected to be attractive segments for distressed investing.

To give feedback on this article and suggestions email AIAR@CAIA.org

Email the author at sameer.jain@ubs.com