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Distressed investors feel no distress

Financial crisis creates opportunities for special situations funds

THE DEBT SIDE OF THE CAPITAL structure offers a handy alternative to the equity side traditionally targeted by mainstream private equity firms, as an investment destination. Internationally, many commentators are talking of a new age of distressed/special situations investing, where leading firms in the space step forward to assume the mantle hitherto worn by the top buyout firms. Even in Asia Pacific, where overall economies have suffered least from the global crisis, market opportunity remains strong, proponents argue. Whether NPLs, single credits, distressed real estate, financial restructurings or other approaches, the portfolio of distressed products presents interesting and thought-provoking comparisons – and challenges – to private equity.

Benjamin Fanger

Distress approaches

As indicated above, not all distress players invest in the same spaces. There is a spread of asset types comparable to the growth capital and control approaches seen in private equity, with corresponding skill sets for each. Furthermore, these perform differently to both public equities and private equity-related approaches, and can usefully offset both.

Howard Marks, Chairman of leading distress firm Oaktree Capital Partners, indicates the range, and potential, of his firm's investment choices. "The opportunity in the areas we're interested in – distressed debt, distress for control, and other forms of unlevered value investing – has been attractively anti-cyclical over the last several years."

Benjamin Fanger, Co-Founder & Managing Director at Shoreline Capital Management, enumerates his firm's own strategies. "We specialize in Chinese NPLs, distressed real estate, restructuring of single credits, and special situations financing."

However, Asia Pacific distress tends to lean towards the bank loan market, as most corporate and other debt in Asia is still originated by banks. Senior secured bank loans are therefore frequently the base currency of Asian debt investing, with public bonds also strongly favored, though Asia's public bond market is also still maturing, with high-yield debt comprising roughly 10-15% of its total size. Real estate and other hard assets tied to debt also often come into the Asian debt investor's focus. Other more sophisticated debt investment classes, such as structured credit products, have yet to make significant inroads in Asia.

Jean-Louis Lelogeais, Partner at Strategic Value Partners, illustrates one strategy, known in some cases as 'loan to own' or 'distressed for control': "One of our private equity pools of capital is focused on distressed for control. One of the primary avenue to take control of companies is by accumulating enough debt (51% or more or at least 33% which is veto control) and through a debt for equity restructuring own the company and not only create value in the financial restructuring but also drive the operational turnaround."

In other jurisdictions, this approach has resulted in distressed investors becoming owners and managers of assets as diverse as any seen in private equity or infrastructure investment, as when Bluebay Value Recovery Fund became part-owner of the UK's Eggborough Power Station earlier this year, or when Octavian Advisors moved into sporting goods manufacturer Head NV. However, applications of this strategy have been fewer in Asia, at least to date.

> "This has been a great time for a contrarian discipline."
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> – Howard Marks

Prospects and competitive dynamics

The distressed investment universe remains a substantial pool for potential players.

"We estimate there's about $3.7 trillion of outstanding leveraged loans and junk bonds primarily between the US and Europe" says Lelogeais. And some more committed debt investors have been able to benefit from growing LP interest, better competitive dynamics, and an expanding target asset base.

As awareness of distress began to sink into the financial community, fundraising began in advance of the supply of new distressed assets, according to Marks, coordinating nicely with the economic cycle. "The imminence of distress permitted substantial fundraising in 2007, and when the distress arrived in late 2008, investment opportunities approached once-in-a-lifetime levels," he affirms. "This has been a great time for a contrarian discipline."

Some distressed investors of the pre-crisis era, notably certain types of hedge fund, found their own business models under pressure during 2008, and in some cases had to retrench. Rob Petty, Managing Partner at Clearwater Capital Partners, foresees: "consolidation of investors or simply the decline in investment teams and dollars dedicated to the business. Specifically, those firms funded on balance sheets or through shorter-term structures that migrated into

Not every distressed transaction is handled through the courts, but the legal environment is very important.

all dimensions of the private equity business have left."

Lelogeais also sees the competitive environment shifting substantially in favor of the more durable and committed distressed investors. "A number of players who you would have expected to have been able to deploy capital in distressed are either no longer in business or in the penalty box," he notes. "The global financial crisis has really pummeled a number of the players."

As markets corrected during the evolving crisis, so more and more cheap distressed debt became available. Lelogeais reports "pricing of distressed debt drifting down and going off the cliff post Lehman." In his view, "all this sets the stage for a pretty extraordinary opportunity for distress." And he sees the aftermath of leveraged buyout transactions as one especially fertile hunting ground for prospective debt investors. "You've got close to 30-40% cumulative default rates across the whole universe of buyouts that were done over the past couple of years."

"You're looking in distress at the opportunity of a lifetime."

– Jean-Louis Lelogeais

Asia in the distressed perspective

As befits a region where most economies are anything but stressed or distressed, Asia Pacific has hitherto ranked fairly low on the target list of distressed investors – for various reasons, from macro to regulatory. Not least among the factors is the overall lower level of corporate indebtedness, and of private equity-related leveraged deals, in Asia. "All regions suffered in 2008, but the generally lower use of leverage in Asia meant that the pain was proportionately less," Marks says.

Legal norms are one of the principal components in this preference, coupled with reasonably-sized target asset pools. Some Western-standard jurisdictions, such as Singapore and Hong Kong, can offer the first, but not the second. As a result, "when you look at Asia from a distressed investor perspective, there are really only two countries that we are comfortable doing business which are Japan and Australia," Lelogeais affirms.

Legal and enforcement regimes impact most distressed strategies far more directly than private equity investment approaches. Although both investment disciplines are affected by legal regimes, in distressed investing, the courts and the judicial procedure can be an actual part of the investment process.

"If you bought the debt, and you're senior in the capital structure, you want to have the law in place to protect your creditor rights," Lelogeais notes. "If you start to look at Indonesia or Thailand, it's a very different place to do business."

This summer's outcome with FerroChina Ltd, following the refusal of the indebted PRC steelmaker to repay its loans, has apparently given distressed investors some new-found comfort in China's 2007 bankruptcy law, at least. Creditors, including Citi, Credit Suisse Group, private equity firm CLSA Capital Partners and Citadel Investment Group, were able to recover up to 60% of their initial loans and investments after a $468.5 million sale of assets to China Minmetals Corp. Here, foreign investors received equal treatment with domestic investors, at least in secured classes of credit. Significantly, Asia Aluminum Holdings, a far less positive outcome for debt investors, was wound up in a Hong Kong court, not a PRC jurisdiction.

China deal flow may have choked off somewhat thanks to the PRC government's stimulus packages, but the actual drivers of disposals in the first place may have altered the availability of NPLs, believes Fanger. "NPLs in China are sold in large part as a result of pressure from the government to clean up the banks' balance sheets. As the government's policies have shifted towards pumping more money into the economy and originating a lot of new loans, their focus has shifted."

Fanger also sees potential for company financing in China. "There are SMEs and some property developers that have a strong base of assets and are otherwise good companies. It's just that for refinancings or other cash needs, they need some near-term cash that banks are not providing to their space. In those situations, firms with experience structuring and collecting debt in China have opportunities for originating or restructuring high-yield financings."

Ultimately, however, Asian distressed debt investing does impose stiff requirements on firms who wish to prosecute it seriously. These include a good sourcing and origination network, investment analysis capabilities, and relevant – and Asia-specific – accounting and legal skills. The last two items underline one factor that will allow Asian distressed investors to keep their market lead for many years to come – there are simply too few experienced professionals in the space to date to allow fast expansion of the discipline.

Rob Petty

Conclusions

Although the above analysis is not wholly favorable to Asia, some seasoned debt investors do insist on the importance of the region's debt market as a fundamental platform for its strong economic growth – and a solid source of distressed/special situations opportunities in the longer term. These investors have emphasized that in Asia, as elsewhere, the crisis will create debt investing opportunities – not to the same degree as in current Western markets, perhaps, but with the added attraction of benefiting from the region's macroeconomic growth, as markets and valuations recover.

"You're looking in distress at the opportunity of a lifetime," Lelogeais believes. "When you look at all the numbers together, it really makes things look much bigger than the distressed opportunity in the last cycle, which is the blowout of the tech bubble in 2002."

"The opportunity set has changed, and in the distressed space this is particularly true; as cycles run their course, there may be one opportunity set one year and another the next," adds Fanger. "In inefficient markets, there is always something to be doing, though the particular type of asset or investment might change each year."