Private equity distressed debt and restructuring market investor survey

Survey devised and conducted by PEI Media and Probitas Partners

Analysis by Kelly DePonte and Nicole Warren, Probitas Partners

For any established market, understanding the attitudes and perceptions of institutional investors who devote capital to the sector plays a crucial role in determining fund manager strategies and in fundraising success. This survey identifies emerging trends and the shifting investor attitudes that have been brought about as a result of a dramatic global recession and a nascent market recovery. Conducted in February 2010, this survey collected responses from over 100 investors representing institutions such as fund of funds, public and corporate pensions, family offices, insurance companies, banks and consultants/advisers.

Respondent profile

The profile of respondents, determined by the first series of questions, provides a context for the subsequent findings of the survey.

As detailed in Figure 1, no single type of institution dominated the survey, with responses widely distributed across investor types. Fund of funds managers represented the largest group of respondents with 22 percent of the total, with family offices and public pensions following close behind with 15 percent and 14 percent, respectively.

As far as geographic distribution, over 60 percent of respondents were from the US, which has the most developed bankruptcy law regarding restructurings and a wide variety of

Figure 1: **Profile of respondents**

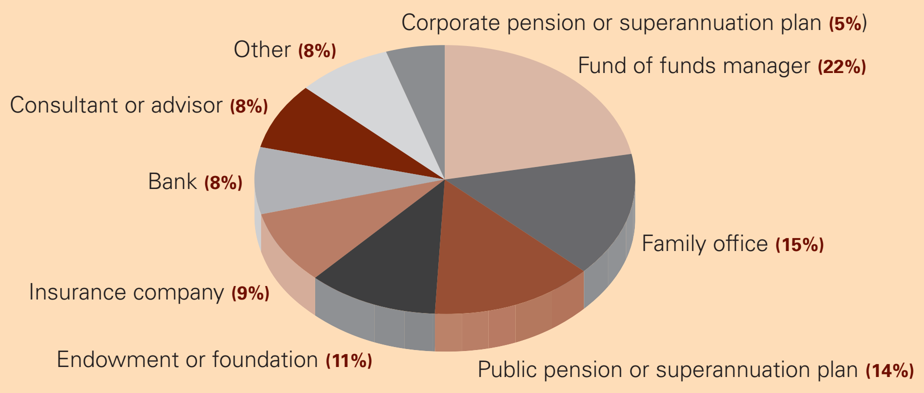


Figure 2: **Respondents' firm headquarters**

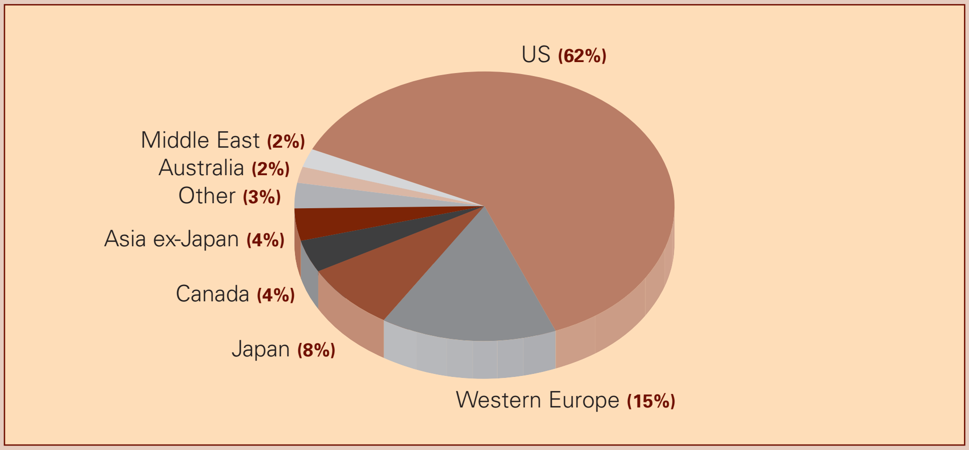
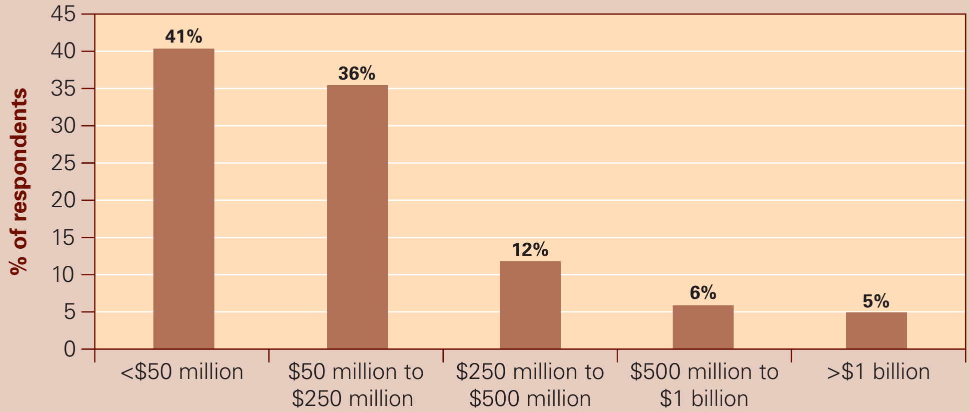


Figure 3: **2010 targeted allocations across all private equity areas (in US$)**



established distressed debt and restructuring funds. As demonstrated in Figure 2, there is a wide distribution of interest in the sector globally, though no geographic sector approaches the US in depth.

Allocations to private equity are forecast to be down in 2010 compared to other surveys of institutional investors that Probitas Partners has conducted in the past as many institutional investors continue to struggle with portfolio issues. Over three-quarters of this survey's respondents are planning private equity allocations of $250 million or less, with the majority of that group intending to spend no more than $50 million. Although not detailed in Figure 3, over 80 percent of endowments, whose private equity portfolio struggles have been widely publicised since the onset of the global recession, have reported that their allocations to private equity will be less than $50 million in 2010.

Performance expectations

The next series of questions examines investor interest in and performance expectations for the four major types of distressed debt and restructuring funds. These are defined as:

- Distressed debt trading funds, which are focused on short-term movements in the value of bonds of companies in financial distress. The positions are held for a relatively short period of time;
- Distressed debt for control funds, which are focused on either controlling the restructuring of a company by controlling the fulcrum debt security in a potential bankruptcy or insolvency process, or on taking equity control of a company through a debt-for-equity exchange;
- Distressed debt hedge funds, which are most often focused on trading and are subject to liquidity constraints in building their portfolios due to the redemption provisions in their structure; and
- Restructuring funds, which purchase companies in financial distress utilising equity instead of debt.

Although certain fund managers pursue a mix of these strategies, in this survey each strategy is examined on an individual basis for analytical purposes. The bulk of these funds focus on corporate debt or corporate acquisitions, although a few distressed debt funds also purchase asset-backed securities or loan pools.

Figures 4, 5 and 6 in combination present an interesting pattern. Institutional investors in private equity strongly prefer distressed debt for control and restructuring funds, a preference driven by their anticipation that these funds will generate significantly higher internal rates of returns (IRRs) and return multiples than either distressed debt trading funds or distressed debt hedge funds. For example, 58 percent of respondents expected that both top quartile distressed debt for control and restructuring funds would generate net IRRs greater than 20 percent, while just over 20 percent of respondents felt that distressed debt trading or distressed debt hedge funds could achieve those sorts of returns.

Figure 4: **Interest in 2010 vintage distressed debt and restructuring funds**

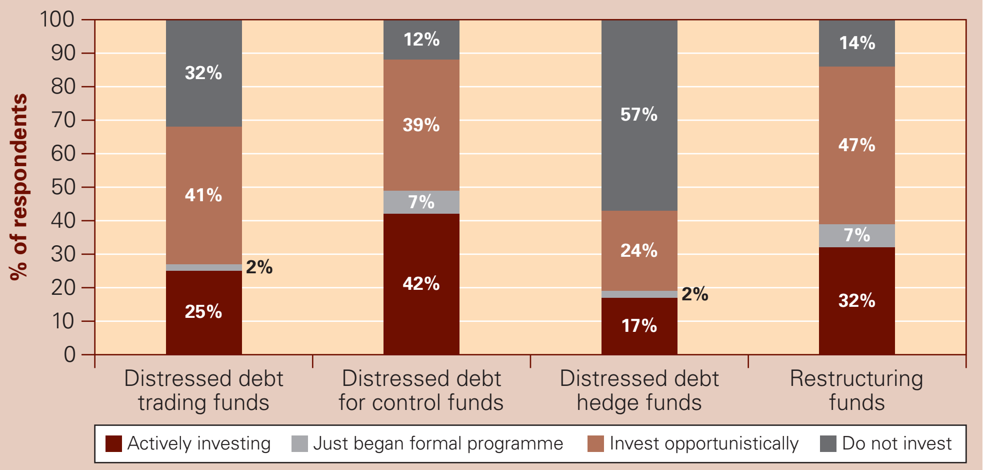


Figure 5: **Expected net IRRs for top quartile 2010 vintage distressed debt and restructuring funds**

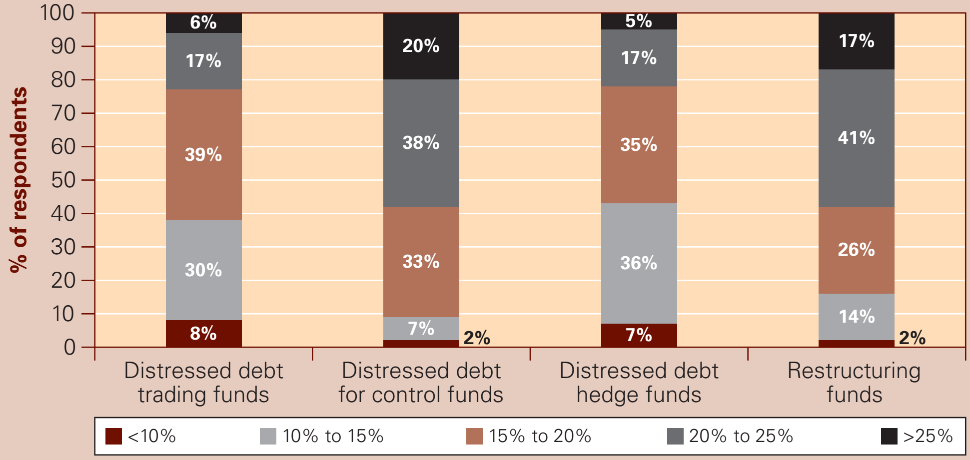
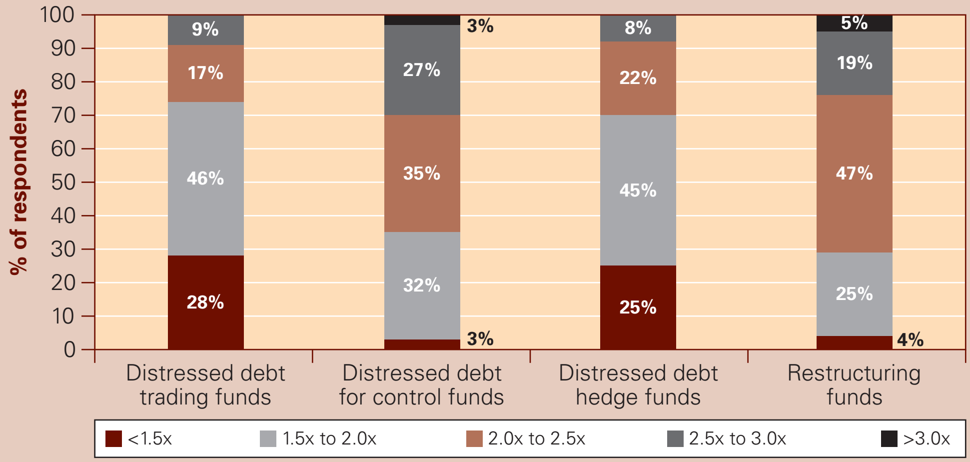


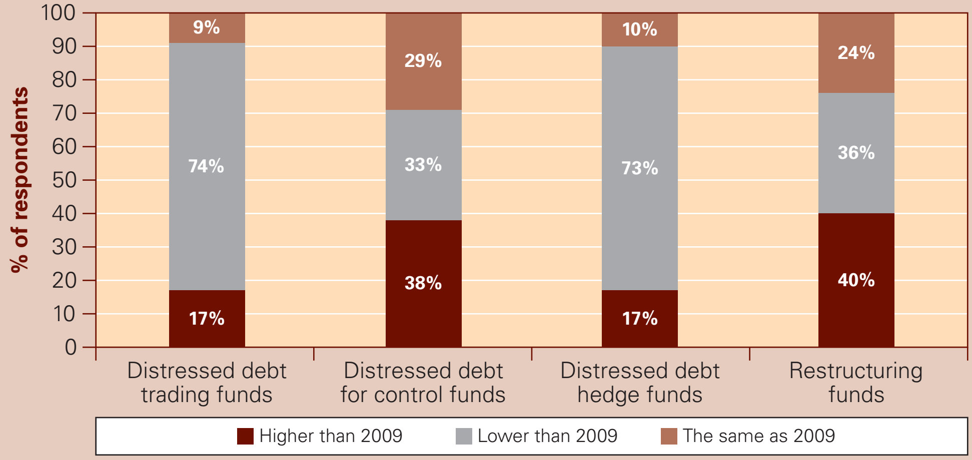
Figure 6: **Expected net multiples for top quartile 2010 vintage distressed debt and restructuring funds**



Though trading-focused funds and hedge funds have very similar return expectations, a much higher percentage of respondents said that they do not invest in distressed debt hedge funds. Of course, the survey was targeted at private equity specialists, many of whom do not consider hedge funds within their investment remit. (Hedge funds were included in this analysis as a potential substitute to private equity vehicles in this strategy.)

Figure 7 looks at performance expectations in a slightly different light, by comparing expected 2010 vintage funds performance relative to 2009 vintage funds. Respondents clearly felt that distressed debt trading and distressed debt hedge

Figure 7: **Overall expected returns for top quartile 2010 vintage distressed debt and restructuring funds**



funds would fare worse in 2010 than in 2009, while their expectations for distressed debt for control funds and restructuring funds were much more evenly split, but with a small plurality in both cases feeling that returns would be better for the 2010 vintage. This reflects a feeling that the distressed market, at least as far as private equity strategies are concerned, may have hit bottom, but that the longer-term strategies implied in control and restructuring funds still have some room to play out and create value.

Geographic markets and sectors

In the series of questions that follow, respondents were asked to identify those geographic regions and industry sectors they find most attractive for top quartile distressed debt and restructuring funds, as well as which private equity sectors they have identified as key areas of interest in 2010.

As far as geography is concerned, the US, as a developed market with well-established bankruptcy laws, is the clear favourite. Further emphasising that dominance, although not detailed in Figure 8, even among non-US respondents it is the region of choice. Aside from the US, Europe was the only other region garnering any notable interest, with Asia trailing significantly.

Industry preferences are examined in Figure 9. For each of the distressed debt strategies analysed here, nearly 70 percent of respondents are most interested in pursuing funds that are broadly diversified across industries and are not focused on specific industry bets. These findings are consistent for all geographies and investor types. Real estate was the only other industry sector amassing interest across each of the distressed strategies, accounting for 5 to 11 percent of respondents. For distressed debt for control funds and restructuring funds a small percentage of respondents show an interest in the industrial sector, while for

Figure 8: **Geographic preferences for top quartile 2010 vintage distressed debt and restructuring funds**

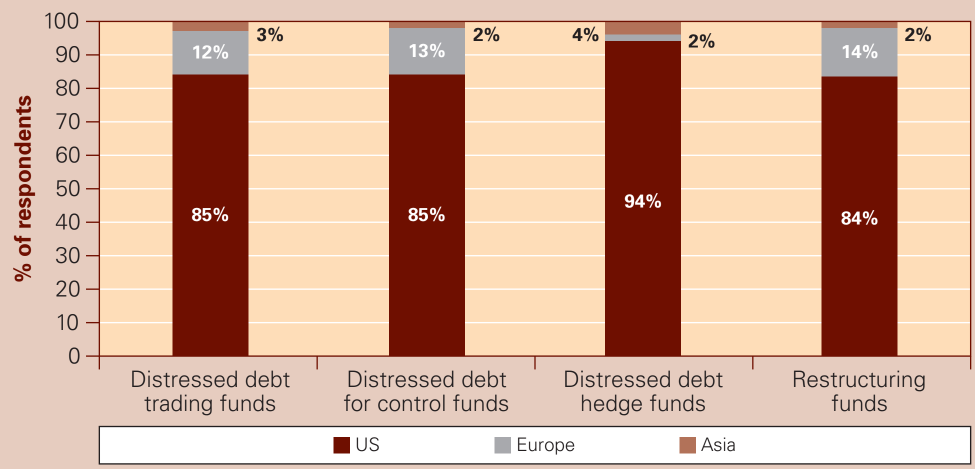
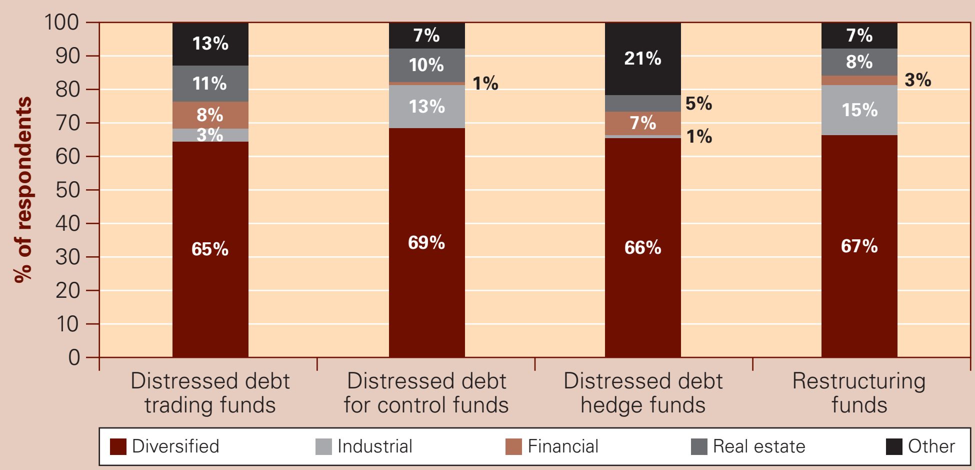


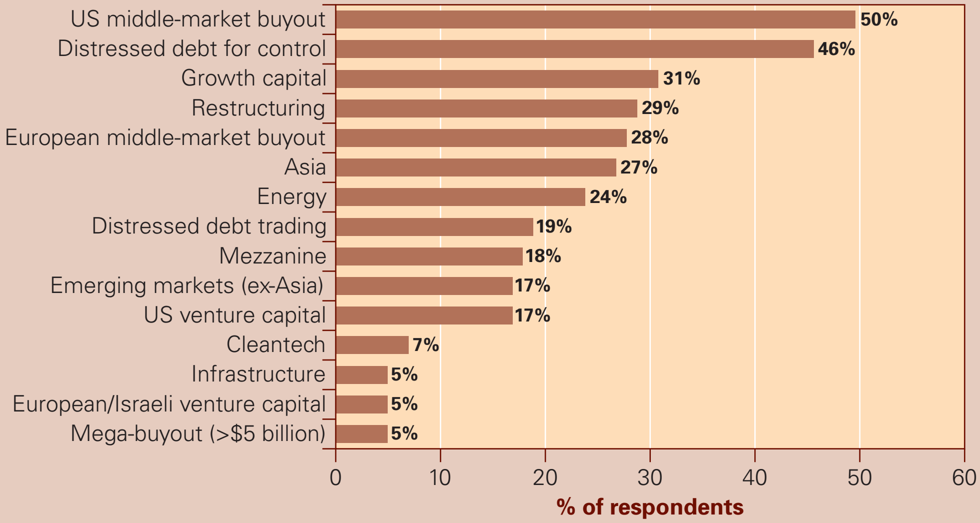
Figure 9: **Industry preferences for top quartile 2010 vintage distressed debt and restructuring funds**



distressed debt trading funds and distressed debt hedge funds a slight interest in the financial sector is reported. Respondents were also asked about their interest in the automotive, retail, media/telecom/technology, transportation and utility sectors, but responses were so small for these that their results were bundled into the general 'other' category.

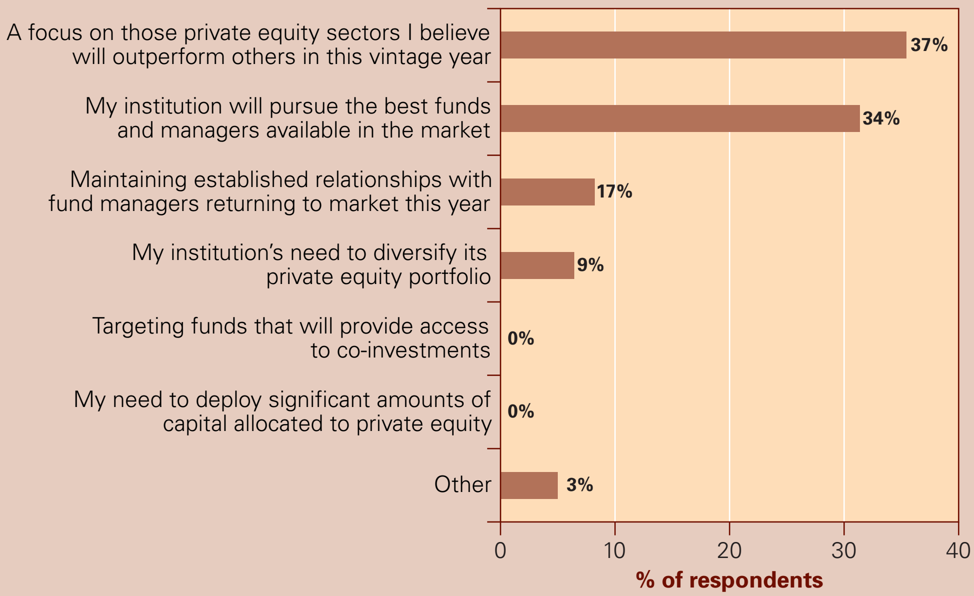
Next, respondents were asked about which private equity sectors they plan to focus on in 2010; those findings are detailed in Figure 10. With 50 percent of the total, US middle-market buyouts are the leading sector of interest followed closely by distressed debt for control funds with 46 percent. Restructuring funds are also a leading sector of

Figure 10: **Key sectors of interest in 2010***



* Respondents chose all categories that applied.

Figure 11: **Drivers of sector focus in 2010***



* Respondents chose all categories that applied.

interest, ranking fourth overall, while distressed debt trading funds place only eighth. Interest in the mega-buyout sector, which in the past several years has consistently been a key sector of interest among institutional investors, has fallen to last place, garnering interest from a mere 5 percent of respondents.

For North American, European and Asian respondents, there is an overwhelming preference for home markets. Although not detailed in Figure 10, 60 percent of North American respondents are most interested in US middle-market buyouts, nearly 70 percent of European respondents are most interested in European middle-market buyouts and 71 percent of Asian respondents are focused on funds targeting Asia. US middle-market buyouts remain a top choice, however, for both European and Asian respondents, ranking second among both groups. Distressed debt for control funds scored strongly with all respondents as well.

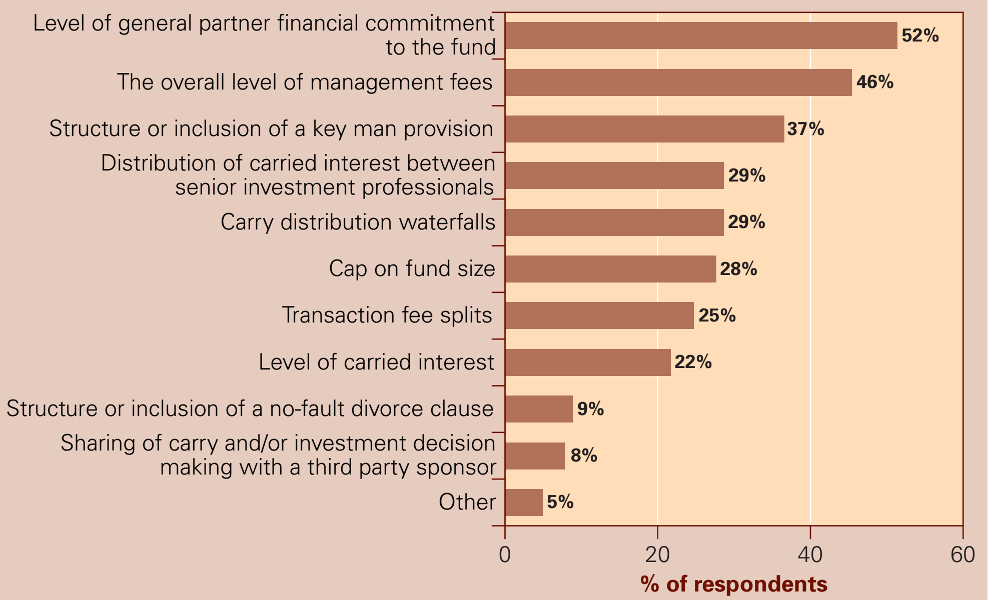
Respondents were next asked what factors drive their sector investment focus. The top two drivers, a focus on the private equity sectors believed to outperform others in 2010 and the pursuit of the very best funds and managers available in the market, account for over 70 percent of the total responses, as detailed in Figure 11. Extensive due diligence and market research by investors will be the key to identifying the best managers and sectors. The key factors driving investment decisions in 2010 have little to do with the amount of capital to be deployed or co-investment opportunities and everything to do with generating the best possible returns.

Structural issues and key terms

With the next series of questions respondents are given the opportunity to address those key issues that surround fund structure, key terms, fees and carried interest.

The principal concern for investors at this point, in all sectors of private equity, is alignment of interest between fund managers and investors. As detailed in Figure 12, the two

Figure 12: **Issues regarding terms of fund structure***



* Respondents chose no more than three categories.

leading issues in the survey, the level of general partner financial commitment to the fund and the overall level of management fees, are two aspects of this single issue of alignment. Investors are frustrated at racking up losses over the last 18 months with fund managers who they do not believe 'have enough skin in the game' and who have generated in many cases large amounts of profit driven solely through fees rather than capital gains. These results are similar to other survey results for private equity done recently and are not particularly focused on the distressed debt and restructuring sectors.

As a major concern for investors, as observed in the previous chart, respondents were next asked what they expect management fees and carry to be for top quartile 2010

Figure 13: **Expected management fees for top quartile 2010 vintage distressed debt and restructuring funds**

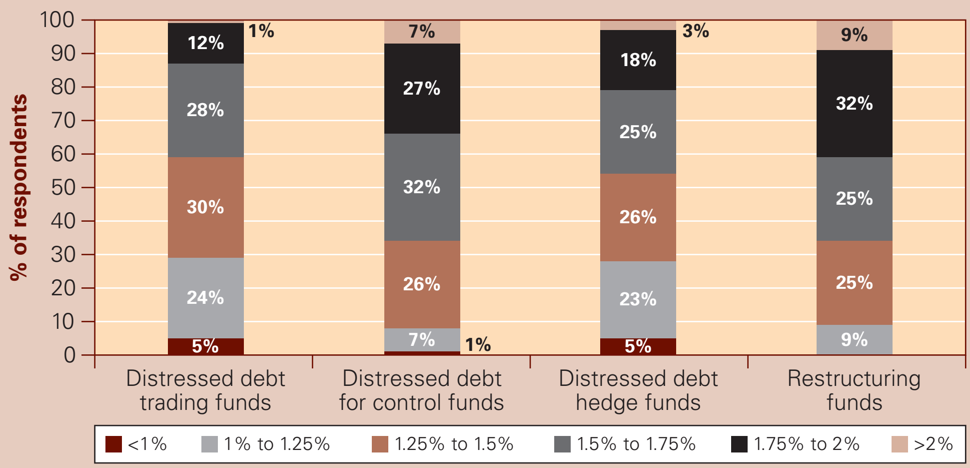
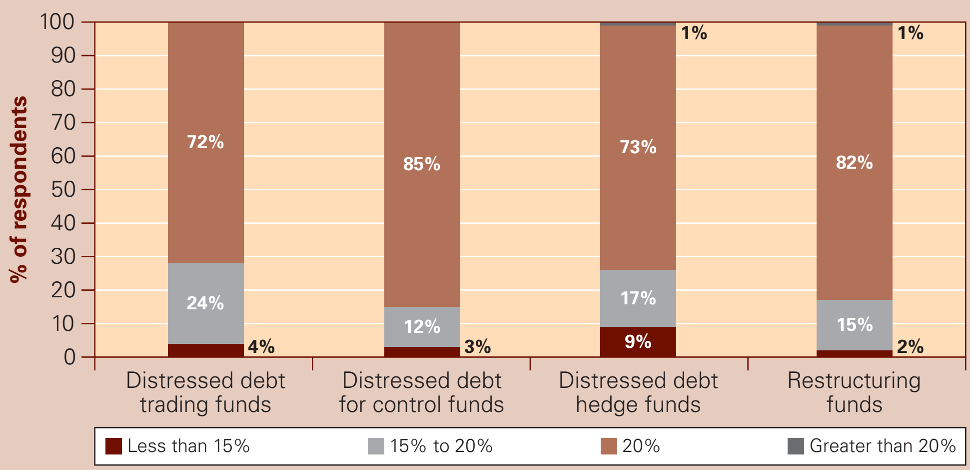


Figure 14: **Expected carried interest for top quartile 2010 vintage distressed debt and restructuring funds**

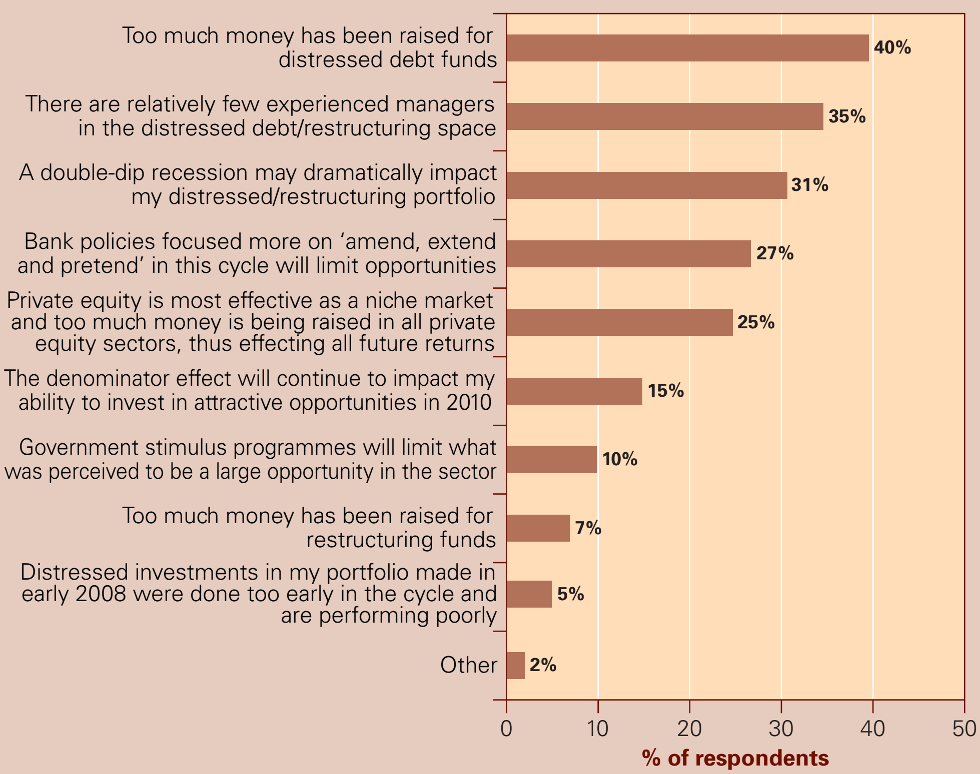


vintage distressed debt and restructuring funds. In a similar pattern to what we found earlier, respondents are willing to pay more in fees and carry to invest in strategies that they believe will generate higher net returns, with distressed debt for control and restructuring funds being the favoured sectors (as detailed in Figures 13 and 14). Though the vast majority of investors expect a 20 percent carry for all funds in these sectors, there are still noticeable differences between the sectors. Expectations on management fees are much more diverse, but still heavily favour control and restructuring funds.

Investor fears and concerns

The final question of the survey asked respondents to identify their two greatest fears regarding the distressed debt and restructuring markets; those findings are detailed in Figure 15. Respondents are most fearful that too much money has been raised for distressed debt funds; that the sector is lacking experienced managers; of the possibility of a double-dip recession; and that bank policies will limit opportunities. These fears rank highest across all geographies and investor types with the exception of endowments. Endowments are most fearful that the denominator effect will continue to impact their ability to invest in 2010 and as a result many have looked to the secondary

Figure 15: **Greatest fears regarding the distressed debt and restructuring market currently***



* Respondents chose no more than two categories.

market to help alleviate this issue as well as to resolve other issues plaguing their private equity portfolios.

In 2009, fundraising for the sector declined significantly in large part because of the fears that rank high on this table. Investors bet heavily on the sector in 2007 and 2008, a period that saw more managers come to market that lacked a deep background in the sector or were plagued with significant problems in their current portfolios caused by investing before the market dropped precipitously. Though still interested in the sector, investors are taking heed of their fears and are becoming more cautious.

Summary

Over the last four years, more institutional investors have turned to the distressed debt and restructuring sector both as an attractive investment opportunity and as a hedge against problems in their core portfolios. That interest, however, does not broadly cover all areas of distressed investing. Investors globally are most interested in what they perceive as the higher-return sectors of distressed debt for control and restructuring funds, and they are willing to pay more in management fees to access top quartile managers in these sectors.

They also fear that in this particular cycle the returns may not be as large as expected – that too much money has been raised, that managers with the necessary experience are in short supply and that a double-dip recession (or the lack of one) may dramatically impact ongoing returns. Even with these fears, however, distressed debt and restructuring investing has moved from a small niche within private equity to a major sector of interest, and one that is becoming increasingly global. □

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