

Distressed Private Equity: Is There an Attractive Investment Opportunity in the Emerging Markets?

The term “distressed” has become ubiquitous in light of a growing number of opportunities created by the dislocation in the credit markets. One limited partner (LP) active in distressed investing sums up the current landscape: “The model of good companies with bad balance sheets is quickly being replaced by great companies with terrible balance sheets.” The mounting number of companies falling into the latter category signals potentially unprecedented investment opportunities. Through September 2009, Standard and Poor’s reported 214 defaults globally year to date, a four-fold increase over September 2008, and comprising 34 emerging market companies.

The distressed market in the West is booming. According to data provider Prequin, distressed private equity funds raised approximately US\$92 billion in 2007 and 2008. The sheer volume of distressed companies in the West, along with overall perceptions of lower risk versus non-Western markets, have propelled many leading global distressed fund managers to focus entirely on U.S. and European deal flow, ignoring emerging economies altogether.

Despite expectations of a post-crisis flood of distressed entities in the emerging markets teetering on default or desperate to restructure, to date the opportunity set has not been sufficient to entice many distressed specialists to dedicate resources to developing countries. There is a growing consensus, however, that although the distressed activity in the West may be masking opportunities elsewhere, such opportunities do exist in a few select markets and will continue to grow. The fact that the large global distressed players are not active in these markets has created a significant opportunity for those few managers that have both the local knowledge and the specialized restructuring and legal expertise to act on these growing opportunities.

This article examines the state of play for distressed investing in emerging economies, with a focus on comparatively robust markets for the asset class in Asia and Central Europe. Additionally, this article highlights that if the handful of locally-focused fund managers with distressed expertise are able to raise capital in the current environment, they will be uniquely positioned to capitalize on both current and upcoming distressed opportunities in the emerging markets.

Exhibit 1: Distressed Investing Strategies

	Single Credits: Control		Single Credits: Non-control		Pools/Portfolios (NPLs)
	Passive Trading	Active Trading	Restructuring	Rescue/Turnaround	
Summary	Buy and sell securities that are fundamentally mispriced and will rebound without any direct involvement in the issuer’s operations	Accumulate distressed sizable (but minority) debt positions in entities and influence the process	Attain a controlling position in a financially distressed company and actively engage in the restructuring process	Attain a controlling position in a financially and operationally distressed company and work to repair the balance sheet and improve operations	Purchase packages of assets from banks or financial institutions and create workout agreements with individual borrowers
Skills Required	Trading, credit	Trading, credit, restructuring	Trading, credit, restructuring, legal	Trading, credit, restructuring, legal, operational	Legal; also need large teams and a local presence
Instruments	Primarily debt	Primarily debt	Debt or equity	Debt or equity	Primarily debt
Focus Companies	Large and midsize	Large and midsize	Large, SMEs	Large, SMEs	Large, SMEs
Entry Point	Secondary market	Secondary market	Secondary market or new lending	Secondary market or new lending	Secondary market
Timeframe	Less than 2 years; holding period is often days or weeks	1–2 years	2–5 years; can be longer	2–5 years; can be longer	Varies. This is a hold to maturity strategy; can sell prior to maturity
Expected Returns[1]	12–18%	15–20%	18–25%	20–25%+	25%+ or 1.75x

[1] Note that performance varies significantly based on a number of factors, including but not limited to investor/firm, fund, timing, location and sector. The return expectations outlined in this article are meant to serve as a guide based on average approximation.

Note: The definition of “special situations” varies significantly by investor; typically refers to distressed investing in an event-driven or complex situation, such as spin-offs, mergers or share buybacks.

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Defining Distressed Private Equity

In the broadest sense, the distressed subset includes any asset that is undervalued.¹ Anthony Stalker, a Partner with Hong Kong-based distressed asset manager ADM Capital, notes, "Distressed can refer to a company, a seller, or the fact that the market is broken and there is no liquidity." In terms of securities, distressed investing most often refers to the purchase of non-performing debt or debt-like instruments, although this occasionally includes equity. The most common types of distressed securities are bank debt, private debt (such as trade claims), and bonds including fixed/floating rate public debt or convertibles. Some distressed strategies employ a "loan-to-own model," whereby as a distressed company reorganizes its capital structure, the pre-restructured debt ends up converting to equity.

Distressed investing strategies can be segmented into (1) single-credits and (2) non-performing pools and/or portfolios (NPLs). (See **Exhibit 1** for a more detailed summary of each strategy.) Single-credit strategies involve the purchase of a single company's securities, either via a controlling or non-controlling position. Non-control strategies can range from

passive trading up to acquiring a significant minority stake that carries influence in the restructuring process, while control strategies entail active engagement in the restructuring process with investors as leading stakeholders in the distressed company. Under a non-performing loan (NPL) strategy, investors buy from financial institutions to clear their balance sheets of non-performing assets, packaged at discounts to par value in portfolios (10–15 loans) or pools (100–1,000 loans).

Distressed Opportunities in the Emerging Markets

The supply of distressed instruments in the emerging markets is small relative to North America and Western Europe, largely because of less company reliance on leverage and comparatively small credit markets. (See **Exhibit 2** for a sampling of firms active across various strategies in emerging markets.) There is a growing consensus, however, that distressed deals will continue to expand beyond the range of existing opportunities in regions such as Emerging Asia and Central and Eastern Europe.

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OPIC will consider providing up to \$150 million in capital to each of one or more selected fund managers, which financing will represent generally no more than 33% of a fund's total capitalization. The balance of each selected fund's capital is to be raised from private investors, international financial institutions, and other interested parties.

Please consult the announcement of the call for proposals appearing on OPIC's website (www.opic.gov) in mid-October 2009.

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¹ The technical definition of distressed debt refers to debt trading at yields in excess of 1,000 basis points over the risk-free rate (e.g., United States Treasury bonds). In the context of emerging markets, where a risk-free rate usually does not exist, securities designated as distressed refer to instruments of an entity in default, under bankruptcy protection, or likely heading towards either of these two conditions.

The crisis appears to be yielding greater opportunities for entrepreneurial activities, according to Parham Pouladdej, Managing Partner of turnaround specialist CRG Capital. “Six months ago, we may have seen 10–20 deals per month and now we’re seeing 30–50. It’s actually becoming more challenging to pick and choose where to invest,” he says. “We’ll continue to see an increase in opportunities—at more reasonable valuations—as the banks become more realistic about restructuring their portfolios. The effects of the crisis are likely to last beyond one or two quarters.”

However, few players expect the global financial crisis to yield a distressed boom in the emerging markets. One emerging markets distressed investing specialist notes, “We haven’t seen a great deal of activity in terms of defaults or forced selling in the emerging markets, and this is not a case where the flood gates will open in the near future. Distressed situations will develop gradually over the next several years.”

To date, the opportunity set within the emerging markets has tended more to non-control single credit strategies, typically arising from a handful of large entities that became highly-levered and/or made derivatives bets that resulted in sizable currency losses. The credit crisis has also begun to yield opportunities with small and midsize companies struggling to access financing due to tighter local credit markets and challenging market conditions putting strain on their balance sheets.

Control strategies are the most difficult to execute in the emerging markets. Because most control deals assume bankruptcy, investor comfort with local rule of law and credit rights is essential. Additionally, the family-control model and cultural biases against such deals often hampers distressed transactions in the emerging markets. Restrictive employment policies can significantly hinder an investor’s ability to make personnel changes. Rob Petty, Managing Partner at Clearwater Capital Partners, an investment firm focused on distressed investing in Asia, remarks, “When there is an alignment of interests, control is possible; however, the number of control deals that have been successfully implemented in the region is a short list.”

In fact, non-control investors in single credits can significantly influence outcomes simply by securing representation on a creditor committee—i.e., by owning 10% of a particular security, an investor can by default be the largest single holder and therefore represent all creditors in the bankruptcy process.

While there are many non-performing or equivalent loans in the emerging markets, most developing countries lack an active NPL market with the exception of a few countries in Asia. In particular, China, India and Korea have made significant progress in developing a local NPL market, and similar markets are emerging in the Philippines, Malaysia, Thailand and Indonesia. Phil Groves, President of DAC Management, an Asia-focused distressed and special situation specialist

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—Rob Petty, Clearwater Capital Partners

and the first non-Chinese investor to purchase an NPL portfolio in China, observes that, “in some emerging markets, there is currently a greater focus on restructurings than on NPLs. But you have to choose carefully and do your homework since in a few of the jurisdictions where Western-style bankruptcy laws do exist, they’re insufficiently developed or inadequately enforced.”

Emerging Asia

Asia’s distressed industry emerged to seize on opportunities created by the Asian crisis in the 1990s. Companies saw their foreign-denominated debt burdens surge in the face of major local currency devaluations, and the subsequent capital flight resulted in a flood of non-performing assets throughout the region. Many Asian governments responded by requiring financial institutions to record write-downs and remove non-performing assets from their balance sheets. Several Asian countries, including China, South Korea, Malaysia, Indonesia and Thailand, created institutions called Asset Management Corporations (AMCs) to help financial institutions solve their balance sheet problems.

During the Asian crisis, an estimated US\$7.5 billion was raised by distressed private equity investors pursuing opportunities in the region. Early entrants included a number of private equity firms such as Lone Star, The Carlyle Group, Newbridge, Warburg Pincus and J.P. Morgan Partners, as well as a number of larger hedge funds doing PE-style deals.

Several buyers, particularly hedge funds, have since exited the market due to internal credit and liquidity constraints. Clearwater’s Petty points to the shorter lockup period for hedge funds as a handicap in the distressed market, noting, “Hedge funds have tried to do distressed deals in Asia, but ran into problems once they were faced with redemptions that they couldn’t meet. It takes time to build up and exit positions, which hedge funds are not well equipped to do.” Specialists also point to

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Exhibit 2: Sampling of Distressed-Focused Funds Investing in Emerging Markets

Fund Manager	Fund Name	Vintage Year, Fund Size	Geographic Focus
3 Degrees Asset Mgmt.	ADF Special Opportunities Fund	Raising, US\$300 million	Asia, ex-Japan
Spice Finance & 3 Degrees Asset Mgmt.	Spice 3 Degrees Special Opportunities Fund	Raising, US\$100 million	India, Southeast Asia
ADM Capital	ADM Capital CEECAT Recovery Fund	Raising, EUR300 million	Central and Eastern Europe, Central Asia and Turkey
Ashmore Investment Mgmt.	Ashmore Global Special Situations Fund V	Raising	Emerging Markets
Avenue Capital Group	Avenue Asia Special Situations Fund IV	2006, US\$3 billion	Asia
Clearwater Capital Partners	Clearwater Capital Partners Fund IV	Raising, US\$1 billion	Asia, ex-Japan
CRG Capital	CRG Central European Special Situations Fund	Raising, EUR200 million	Central and Eastern Europe
DAC Mgmt. S.O.	DAC China Special Opportunity and Situation Fund	2007, US\$285 million	China
mCAPITAL	European and Asian Special Situations Fund	Raising, US\$500 million	Europe and Asia
Mount Kellett Capital Mgmt.	Mount Kellett Capital Fund I*	Raising, \$3.5 billion	North America, Asia and Europe
NBD Sana Capital	NBD Sana Pakistan Distressed Fund*	Raising, US\$200 million	Pakistan
Shoreline Capital Mgmt.	Shoreline China Value I	2008, US\$178 million	China
Sphinx Private Equity Mgmt.	Sphinx Turnaround Fund	2009, US\$100 million	Egypt
TEKT Group	TEKT Private Equity Fund I	Raising, US\$64 million	Ukraine
WL Ross India	India Asset Recovery Fund	2006, US\$300 million	India

* Exact fund name unknown.

the bandwidth and expertise required to successfully execute these deals, estimating the average PE-style turnaround deal requires a team two to three times the size of a normal PE deal. The “real work” is said to begin once the papers are signed—closing the deal is only the beginning.

Until this year, most distressed investing opportunities in China have involved portfolios of non-performing loans. Government pressure and efforts to list Chinese banks have resulted in many banks removing such assets from their balance sheets, providing a continuous source of supply. In China and India, additional supply is coming from struggling foreign institutions such as Lehman Brothers and AIG look to unload their Asian holdings. However, systemic regulatory issues made for thinner trading volume than many investors originally expected, observes Ben Fanger, Co-founder and Managing Director of Shoreline Capital, a private investment firm that specializes in Chinese distressed assets and special situations. “Eventually there will be a robust debt trading market in China, but there isn’t yet. Banks are operating under oversight that is often less than effective at forcing banks and their branches to quickly recognize and sell bad loans,” Fanger says.

However, single-credit opportunities are increasingly becoming available according to DAC’s Phil Groves. “NPLs have historically been the biggest component of the Chinese distressed market, but in the last year, we’ve become aware of numerous single-credit restructuring opportunities,” says Groves, noting that many of these new opportunities tend to be non-control. Many businesses are family-owned, and the “loan-to-own” model is not popular culturally. Clearwater’s Rob Petty adds, “It is rare in Asia, and throughout the emerging markets, to get enough equity in a distressed deal to gain control of a company. Historically, only 10% to 40% of a company has been available for a debt-to-equity swap. However, if you are willing to take a minority position, and proactively help a company back on to a growth path, it has often proven to be a win-win for the company and the investor.”

The few notable examples include the 2006 acquisition of Chinese cable operator Pacnet by a consortium of private equity investors led by Ashmore Investment Management, with participation from additional investors such as Clearwater Capital Partners and Spinnaker Capital.

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For both NPLs and non-control single-credit strategies, investors in Asia look to exit through negotiated workouts rather than via the court system. Bankruptcy laws in some Asian countries, such as Korea and India, are more fully developed than in other Asian jurisdictions, such as Indonesia, Thailand and China. The lack of consistency among the application of laws by local jurisdictions in a single country poses another challenge. Requirements, application and enforcement can vary significantly. Foreign creditors seeking to seize assets designated as collateral do not have a clear expectation for how the process will be conducted in court.

Investors' options for recourse in a bankruptcy remain unclear, and several recently adjudged cases have underscored the legal uncertainty facing distressed investors in Emerging Asia, reinforcing investors' view of local courts as the last resort. For example, Asia Aluminum Holdings (AA), one of China's leading aluminum processors, fell victim to the recent drop in global demand. The Hong Kong court overseeing the liquidation rejected the proposed sale to Norwegian aluminum firm Norsk Hydro ASA, leaving a court-approved plan that guarantees bondholders only 20% of their investment returned. Holders of the company's US\$800 million payment-in-kind notes (many of which are held by foreign investors) are likely to receive only a few cents on the dollar.

Emerging Europe

Due to rapid escalation in foreign currency-denominated borrowing among companies in the region, Central and Eastern Europe has become one of the most distressed regions across the globe. Although ripe for investors, only a handful of firms are active in the region, including Avenue Capital Group, ADM Capital, CRG Capital and Ashmore Investment Management. CRG's activities are wholly focused on the region, and ADM, which invests across the globe, is currently raising a vehicle targeting Central and Eastern Europe, Turkey and Central Asia.

According to Richard Furst, Senior Portfolio Manager at Avenue Capital Group, which invests in distressed single credits in the U.S., Europe and Asia, "Eastern Europe is a new territory for most folks. In terms of meaningful investment opportunities, there are not a lot of deals and those that exist are small. The majority of opportunities tend to be worked out directly between banks and borrowers."

Distressed investors in Emerging Europe focus less on NPLs and more on those companies that have made mistakes and now need to restructure their balance sheets. ADM's Patrick O'Brien, Partner, adds, "One feature of the region is there is no mountain of bad consumer debt, either secured or unsecured. Funds that specialize in this area don't have much to do in the region."

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—Ben Fanger, Shoreline Capital

The Central and Eastern European region has proven generally more conducive to single-credit, control-oriented strategies, particularly in European Union (EU) accession countries considered to have greater legal transparency and stronger rule of law. Pouladdej of CRG notes, "There is a clear distinction in Emerging Europe between those countries that have legal and political structures to support free enterprise—and therefore have more developed capital markets and insolvency laws—versus those that do not, such as Russia and the Caucasus."

Ukraine, Hungary and Southeast Europe in particular have seen increased interest from investors such as CRG Capital in recent months. However, investors remain cautious, particularly in markets that don't follow the EU legal model. Richard Furst of Avenue Capital asserts that investors avoid dealing with the courts. "If you are a local investor in places like Bulgaria or Romania, you may take a chance if you know the judge, but outcomes depend on each court. Judges can play favoritism and trample on creditor rights."

Considerations for LPs

Many LPs are convinced that distressed assets present one of the best investment opportunities at present. An LP actively investing in Western market distressed funds reasons, "Peak EBITDA multiples paid in market were around 9-10X. Now, when you can pick up distressed assets as cheaply as 5X, why would you even look at non-distressed comparable companies?"

While investors in traditional private equity might be looking for returns greater than 30%, with distressed, returns of 20% are considered exceptional given the lower entry valuations that "bake in" the risk. Projected IRRs range from 12% to 18% for passive trading strategies, and up to 20% to 30% for turn-arounds. While many LPs increasingly understand the case to invest in distressed funds, fewer are fully convinced that the emerging markets are the best destination for distressed investments at this time, as the emerging markets have traditionally been viewed as a riskier place to direct money. Western distressed funds with an 18% yield may be more compelling than funds offering 25% yield with a 5-year lockup period

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in an emerging market. However, Shoreline's Ben Fanger sees risk as potentially overstated and addressable, saying, "These markets are not as corrupt and uncertain as they're perceived to be. Investors doing distressed in China should expect that exits may require some level of creativity, and that they should price in the unknowns at the outset."

For those LPs comfortable with the risk of investing in distressed assets in emerging markets, there is a small but well-positioned field of managers from which to choose. Distressed specialists with emerging market operations don't expect a flood of new managers to fill this void, as the requisite skill set is broad and the barriers to entry are significant. As Anthony Stalker of ADM notes, "You need the ability to source opportunities locally, structure them intelligently and manage them well. A local presence is critical as most information is not freely available in these markets and most companies are privately held, family-controlled businesses."

Few entities in the emerging markets benefit from coverage by the research departments of local and/or global banks or financial institutions and the resulting lack of knowledge can lead to huge pricing disparities. An NPL-centric distressed strategy, for example, requires a deep base of contacts with the holders of these assets in order to truly understand what is available and consequently pay a fair price.

Good information on the reputation of a company, as well as the backgrounds and style of the management team, is also crucial for distressed investors. However, the best distressed targets—good companies with bad balance sheets—are not typically inclined to make themselves well known. Rather, such firms are more likely to discreetly seek out investors they deem trustworthy. Ashmore Investment Management's Head of Research Jerome Booth explains, "If you operate a family-owned business in the emerging markets and need capital in

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—Limited Partner

a transformative way, you want to be able to raise the money discreetly. You do not want a public bidding process whereby you hire an investment bank and all of your competitors become aware of your distressed situation. You will go to a firm that you can trust.”

Outlook

Despite the fact that many emerging market companies are facing various degrees of financial distress, the distressed deal pipeline, while on the rise in a few select markets, has not yet fully developed. Some distressed specialists believe it may be some time until these regions warrant more serious consideration. According to Ashmore's Booth, "There will be a greater shake-out over the next year and a half. Many companies are not distressed enough to be forced sellers, and those investors who have lost a lot of money in their Western-focused portfolios will likely wait to restructure until the markets normalize."

The retreat of global hedge funds and global distressed private equity teams from the emerging markets has left a handful of players capable of recognizing local distressed opportunities. When a more robust distressed opportunity set does emerge, these few teams that possess established track records in distressed investing combined with a solid understanding of local market idiosyncrasies will be best positioned to successfully exploit it. ■