“If you want peace, prepare for war”, goes the Latin military adage. It could well apply to the preservation of wealth during a stock market correction or a recession by planning when the economic environment is benign. Private equity offers interesting strategies for such a purpose, helping investors capitalize on opportunities while other assets suffer from the downward phase of a macroeconomic cycle.

Distressed debt investing is arguably the strategy that capitalizes the most on downturns. The purpose of this type of investment is to take control of a company by acquiring some of its debt at a significant discount during a bankruptcy procedure. The distressed debt fund manager and the management of the company engineer a restructuring plan, which is submitted to the bankruptcy court for approval. This plan usually implies that some or all of the debt acquired by the fund will be converted into equity, after washing out previous owners. The fund will then take control of

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1 “Si vis pacem, para bellum” quote from Publius Flavius Vegetius Renatus in De Re Militari.

2 This strategy, called “debt-for-control” (or “loan-to-own”), differentiates distressed debt as practiced by private equity funds from how it is practiced by hedge funds (which practice “debt-for-trading”).
the company\(^2\), restructure it and resell it once the business is on a firmer footing. Companies acquired are therefore fundamentally sound, but suffer from specific adverse events or an excess of debt. They usually have significant assets and an otherwise sound business model.

Distressed debt investing requires efficient and rather quick bankruptcy processes. Proceedings have to be predictable and decisions enforceable. This strategy also assumes that creditors are willing and able to sell their claims at a discount and that their ranking is only determined by the seniority of their credits. Many jurisdictions do not provide such a context. Some, like France, provide a specific status to public claims (they are “super-privileged” and non-negotiable). The consequence is that distressed debt investing is not evenly distributed worldwide, and largely an American phenomenon (Fig. 1).

Figure 1 – Geographical breakdown of distressed debt funds (by number)

![Pie chart showing geographical distribution of distressed debt funds.](source: eFront Insight, as of Q4, 2017.

However, many jurisdictions have undertaken changes in their bankruptcy procedures to facilitate the intervention of distressed debt investors. Legislators have notably concluded that fundamentally viable companies should benefit from the support of specialized investors.

Distressed debt investing helps to preserve employment and economic activity, for example. Some jurisdictions such as Italy and France have started to adapt their bankruptcy code to provide a more favourable environment for this type of investment.

Nevertheless, to date, most distressed debt investments take place in developed markets with a common law background. Thanks to the high-quality data provided by eFront Insight, it is possible to take a deeper look at this market’s dynamics and so be better prepared to take advantage of any future upheaval.
Initial analysis

At first glance, North America exhibits the most attractive pooled average past performance (Fig. 2). The aggregated total value to paid-in (TVPI) is 1.52x, which compares favourably with the 1.25x from Europe and 1.36x from the rest of the world (RoW). North America and RoW exhibit attractive features, and notably a positive performance for their bottom quartile funds: aggregated, they deliver a return of respectively 1.18x and 1.25x. European funds fall at 0.92x.

Source: eFront Insight, as of Q4, 2017.

Figure 2 – Quartile distribution of distressed debt fund, by region
However, two factors have to be taken into account. First, the underlying currency of these performance figures is the US dollar. When converted to euros, the pooled average TVPI of North American distressed debt funds is 1.55x, 1.40x for funds from RoW and 1.35x for the European ones.

Second, the maturity of funds from these geographical regions differs. The pooled average distributed to paid-in (DPI) is 0.48x in Europe and the residual value to paid-in (RVPI) 0.76x. These figures are respectively 1.16x and 0.35x for North America, and 1.07x and 0.29x for RoW. One might argue that the European pooled average RVPI still does not compensate the gap of overall (TVPI) performance between regions noted above. It is necessary to apply caution when analysing RVPIs. Unlike for LBO or growth capital funds, the value of companies in distressed debt funds is not marked to market: as these companies are in a distressed situation, they are valued in the same way as start-ups, essentially relating to their historical cost. Therefore RVPIs do not reflect the potential future performance of investments. As the performance of European distressed debt funds is still largely theoretical, it is difficult to draw definitive conclusions on their relative attractiveness when compared with funds from other regions. As it is too early to assess European distressed debt funds, but as they represent a significant part of the investment universe, we will include them in the rest of the analysis. The rationale is that they represent a younger part of an investor’s portfolio and provide a perspective on the dynamics of returns of distressed debt funds.

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3 Or the most recent round of financing in the case of start-ups, a situation which does not apply to companies in distressed situations.
A closer look

Distressed debt funds seem to fare better when macro-economic conditions are challenging. Vintage years 2001 and 2008 are testament to this, but the performance of other vintage years is rather attractive as well (Fig. 3). In fact, none of the vintage years considered exhibits a negative performance. Admittedly, the performance of recent funds is still largely theoretical. The RVPI accounts for most of the overall multiple up to 2011.

Figure 3 – Pooled average TVPI, RVPI and DPI of distressed debt funds by vintage year

Source: eFront Insight, as of Q4, 2017.
Even mature funds, of vintage years 2004 to 2007, active for longer than the usual 10 years of a fund’s lifespan, are still gathering significant unrealized assets. Turning around businesses and selling them requires a significant amount of time. A quick calculation shows that the average time to liquidity for older vintage years (2010 and before) ranges from 3.3 to 5.9 years (Fig. 4). Vintage years 2001, 2008 and 2009 (recession years) exhibit a faster time-to-liquidity (four years or less). It seems therefore that not only returns are higher (at least for vintage years 2001 and 2008), but companies can be restructured and sold also more rapidly. One might argue that such companies might not have been in distress were it not for the recession and present more

Fig. 4 – Evolution of the average time-to-liquidity for mature vintage years of distressed debt funds

Source: eFront Insight, as of Q4, 2017.
attractive features (to distressed investors) than they would in a benign environment. They require a specific intervention that improves their situation more quickly and supports an exit more rapidly.

What could explain this relatively high amount of unrealized investments in older funds? Possibly the fact that distressed debt funds routinely recycle distributions to deploy more capital. Their paid-in to committed capital is above 1.0x in 2004, 2005, 2006, but also 2009, 2010 and 2011. During these vintage years, funds probably could sell some assets rather early, and therefore reinvest the proceeds during the investment period (as limited partnership agreements often allow them to do). This could explain why the time-to-liquidity looks overall long, as the relative weight of early distributions is counterbalanced by investments made later in the life of the funds.

Conclusion

Distressed debt investing should be a staple of a private equity portfolio. It offers attractive returns and performs particularly well in challenging environments. Private equity investors cannot reasonably expect to time the market and only invest in distressed debt prior to recessions, but including these funds even when macroeconomic conditions are benign ends up being rewarding. Investing in distressed debt makes sense, whatever the economic weather. It is just more rewarding when ‘the rest is less’. It is therefore necessary for a sound asset allocation.

Note

The aim of this research paper is to provide readers with elements of analysis and understanding of the private finance universe, based only on data collected by eFront Insight. It does not intend to draw any definitive conclusion, nor judge the performance of fund managers. By providing a guided reasoning, FrontLine hopes to contribute to the overall progress of understanding of the asset class in a short monthly format, with all the limits that this entails.
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