

Investing in Distressed Security

Treacherous Terrain Rife with Opportunities

Executive Summary

- The present credit cycle will likely prove to be one of the most severe in recent history. The period between 2006 and 2008 saw easily available credit, contracted risk premiums and competitive pricing all supported by historically low default rates. Credit creation was unprecedented. The volume of leveraged buyout loan skyrocketed to 19x the issuances seen at the bottom of the past cycle in 2001. Issues of high yield debt – debt rated below B- and often utilized in LBOs – doubled from 21% of the market in 2001 to 49% of the market in 2007. Average debt multiples rose sharply to 6.2x mid sized and large¹ LBOs and small 5.6x for small² LBOs. Meanwhile interest coverage declined from 3.1x in 2002 at its peak to just 1.7x in 2007. These excesses made the fall utterly predictable and now, we find ourselves in an unprecedented place with many “cyclical” distressed opportunities being created, but an equal amount of investment pitfalls with the current state of the credit markets and economic recession implies that any kind of rescue is impossible. In this environment, expertise and experience is essential.
- There are two types of distressed opportunities that could be mixed into a diverse distressed investment program – cyclical distressed opportunities, which are created by the credit cycle and which are being created in numbers by the current cycle and core distressed opportunities which are created in any functioning economy by the business cycle through the growth, maturing and decline of corporations. These different opportunities often require different skill sets.
- The market for distressed managers is large and can be placed on a continuum from Passive Traders to Active Investors. Passive Traders focus on liquid securities high up in the capital structure and attempt to exploit mispricing and dislocation in the capital markets for profit. These strategies typically work well in cyclical situations. Active investors focus on less liquid financial instruments and seek to control the target after restructuring, often acquiring equity in a debt-for-equity swap. These strategies work best in core situations, where the underlying economy supports an operational turnaround.
- The number of private equity managers focusing on the distressed market has been increasing since the turn of the century, rising from approximately 30 firms in 2001 to 92 in 2008. In addition, the current cyclical opportunity has caused many new entrants to raise capital. Currently, there are 113 distressed funds in the market raising \$101 bn in capital. In 2008, 37 funds raised a total of \$62 bn. Not surprisingly, many distressed managers lack experience, with more than half being first time distressed managers and only 11% having managed at least 3 previous funds. Disturbingly, 14 of the 26 managers raising distressed funds of greater than \$1bn have less than one year of experience. In this market, caution is advisable.

¹ Greater than \$50mm in Earnings before Interest, Taxes, Depreciation, and Amortization (EBITDA)

² Less than \$50mm in EBITDA

- Terms and conditions for distressed managers are similar to the rest of the private equity market. Fees range from 1.25 to 2%, with the space skewing toward the higher end of the range. Transaction and monitoring fees are very often credited 100% to the LPs' management fees and GP co-invests range from 1 to 3%.
- Based on available statistics, multiples for distressed strategies averaged 1.4x and net Internal Rate of Return (IRR) for mature funds were in the 14% range, implying a fast return of capital. During the last recession in 2001, multiples and IRRs skyrocketed, implying that this may be a good time to enter the space. Very Active investors tended to obtain higher IRRs, but there did not seem to be an obvious pattern in the multiples achieved. Fund size does seem to matter – smaller funds achieved a higher IRR and a higher multiple. However, one should be cautious about survivorship bias. Our data set contains only managers with multiple funds, which by definition includes their successful early funds which tend to be smaller than their current less mature funds.

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1. The current economic environment seems to be a good time to invest in the distressed space, either through traditional distressed corporate, debt for control players or passive strategies which benefit from financial market dislocation.
2. Many new, inexperienced managers are entering the space which is making it more and more difficult to find distressed investments. A distressed investment program should therefore only focus on the most experienced managers.
3. One should have reasonable expectations of returns. Typically, multiples are lower than in LBO strategies while IRRs are higher, implying a quick return of capital.

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1. The Credit Cycle

1.1. A new credit cycle

The current global credit crisis and economic contraction began in earnest in July 2007 with the failure of two Bear Stearns hedge funds focusing on sub-prime mortgages. The crunch quickly escalated with the suspension of a hedge fund by BNP Paribas, the failure of Northern Rock Bank and the beginning of quantitative easing – the injection of capital into the world’s financial system by global central banks. Ultimately, the credit crisis caused a severe recession in which liquidity constraints have led to operational and capital structure distress.

We now find ourselves in a new credit cycle as overheated credit markets shrink, a complex environment, full of opportunities and pitfalls, is unfolding.

1.2. Credit Cycle Phases

The phases of the credit cycle are defined by the availability of credit, the cost of money and the prevailing default rates.

Phase I – Recovery – In the first phase of the credit cycle, availability of credit is low while the spread between the cost of money for lenders and the cost of money for borrowers is high. This is usually a result of the end of a macroeconomic recession, when the lenders acted cautiously while the central bank aggressively reduced interest rates. In this phase, the lending business is most profitable, as lenders can demand high prices and effectively control risk. For private equity firms, this is a difficult time to complete leveraged transactions since there is only little and expensive leverage and lenders are unwilling to take significant risk.

Phase II – Expansion – The prudence displayed by lenders in the first phase of the credit cycle in conjunction with wide credit spreads, entice lenders to increase the volume of their transactions. This creates competition for deals and begins to reduce borrowers’ cost of capital. At the same time, the macro economy enters an expansion mode and central banks begin to tighten money supply. Credit spreads, and therefore lender profitability, begin to contract. In this phase, a traditional private equity investor can begin to consummate LBOs, as credit becomes more available and terms improve.

Phase III – Euphoria – The relatively low default rates observed in Phases I and II of the credit cycle embolden lenders to further increase the volume of their activities. New opportunistic lenders begin to enter the market which drives down prices. Central banks, sensing an overheating economy, aggressively tighten money. Spreads and lender profitability decline significantly and causes some lenders to stretch for yield (make risky loans in an attempt to maintain profitability). In this environment, traditional private equity can easily obtain cheap debt, but often overpays for acquisitions.

Phase IV – Collapse – Some catalysts, such as the collapse of Bear Stearns in the current cycle, triggers the fourth phase of the credit cycle. In this phase, some of the lenders’ riskier investments begin to fail causing an erosion of capital. Default rates soar, distracting lenders. Some lenders fail because of the weight of their non-performing loans. Other lenders stop lending because their capital has been significantly impaired. Economic decline, which often accompanies this phase,

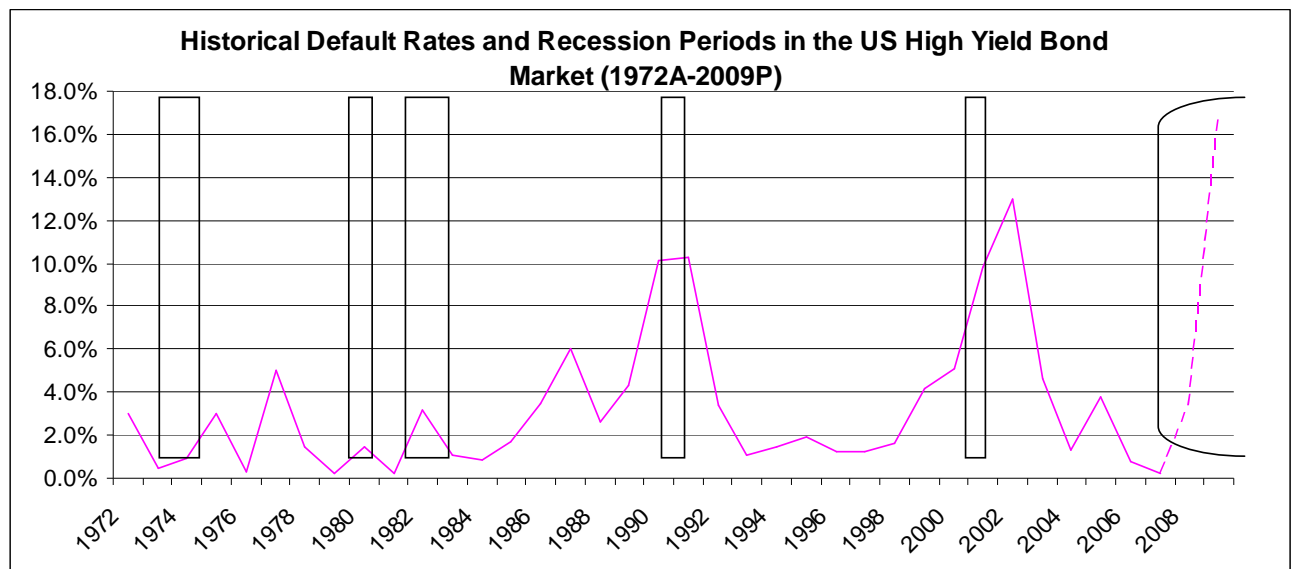
causes a decline in EBITDA and triggers defaults. The lack of available capital forces many companies into liquidation and reorganization. Traditional private equity investors struggle in this environment since they cannot obtain leverage and are preoccupied with problems in their existing portfolio. Skilled distressed investors, however, may find many good investment opportunities.

	Phase I	Phase II	Phase III	Phase IV
Availability of Credit	Low	Moderate	High	Low
Credit Terms	Tight	Moderate	Loose	Tight
Credit Pricing	High	Moderate	Low	High
Economic Activity	Recovery	Expansion	Boom	Collapse
Defaults	Low	Low	Moderate	High
Monetary Policy	Easy	Tightening	Tight	Easy
Spreads	High	Moderate	Low	High
PE Activity	Distressed / Growth	LBO	LBO	Distressed

Current Cycle

The turn of the credit markets had long been expected and anticipated by many analysts even before the onset of the sub prime crisis in 2007.

Easy US monetary policy, a building global savings rate and an overly accommodating Federal Reserve has caused increasingly severe credit cycles in the US since the late 80s. However, the major factor that influenced this current credit cycle is the widespread misreading and mispricing of risk.

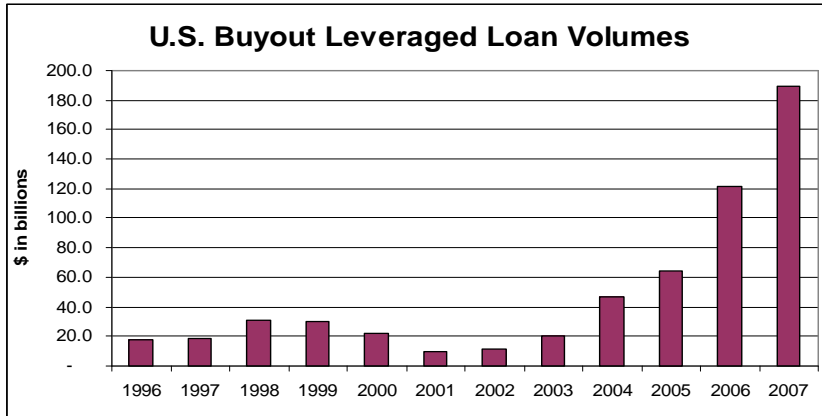


Sources : Probitas Partners, Edward Altman (NYU Salomon Center), National Bureau of Economic Research, Garmen Research (Projections)

A glut of global liquidity has been building since 2001 and spurring a corresponding growth of the institutional debt market. This capital often chased yield, which led vehicles that provided a spread over traditional debt products to blossom. Collateralized Debt Obligation (“CDOs”) and Collateralized Loan Obligation (“CLOs”) vehicles along with second lien and under securitized loans grew tremendously along with non-bank lenders such as hedge funds and specialty finance companies.

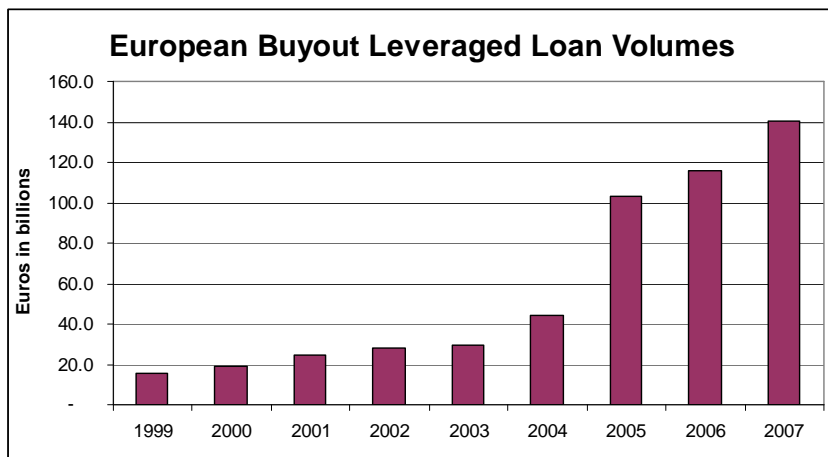
Since many new intermediaries focus on originating loans and selling them to the ultimate holder of risk all around the world, rather than holding the risk themselves, the credit cycle gains a size and reaches an unprecedented level.

Using this ample debt, sponsors significantly increased the number of deals and the amount of equity invested into traditional leveraged buyouts.



In the US, leveraged loan volume tripled in two years between 2005 and 2007.

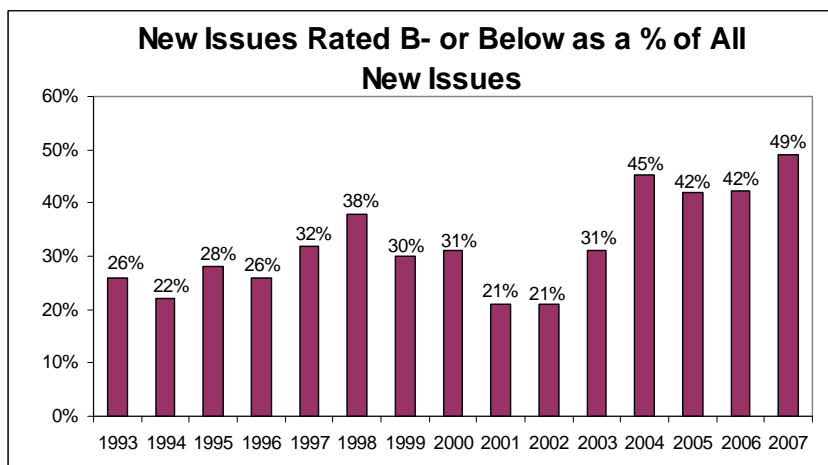
Sources : Probitas Partners, Standard & Poors Leveraged Buyout Review



A similar LBO boom was simultaneously occurring in Europe. Although less severe, levered loans in Europe spiked in the 2005 to 2007 time period.

Sources : Probitas Partners, Standard & Poors Leveraged Buyout Review

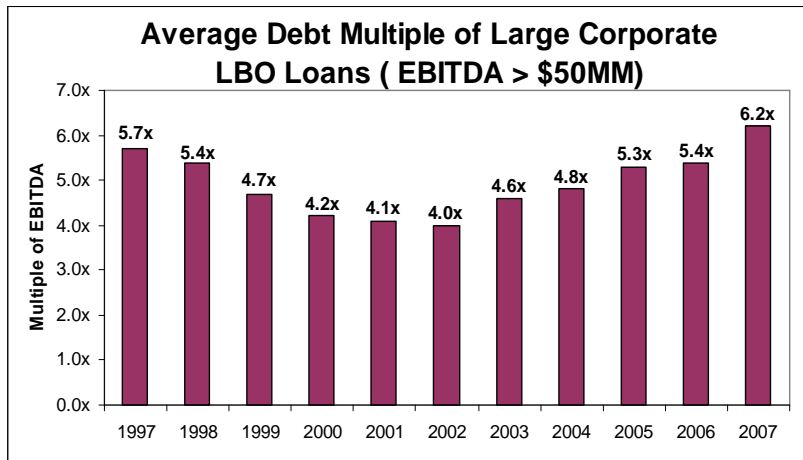
As pricing decreased, lenders were increasingly starved for yield and issued increasingly riskier loans.



New high yield issues grew from 21% of the market in 2002 to almost half the market in 2007.

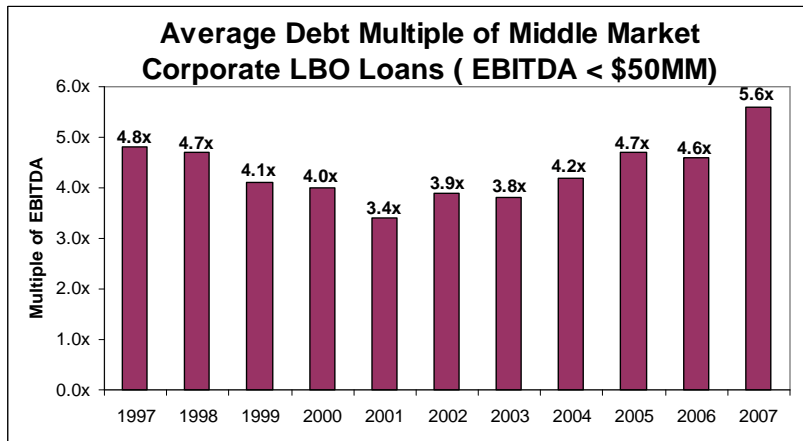
Sources : Probitas Partners, Standard & Poors LCD

In addition, lenders began to go deeper into the capital structure and applied less stringent controls and covenants to their loans.



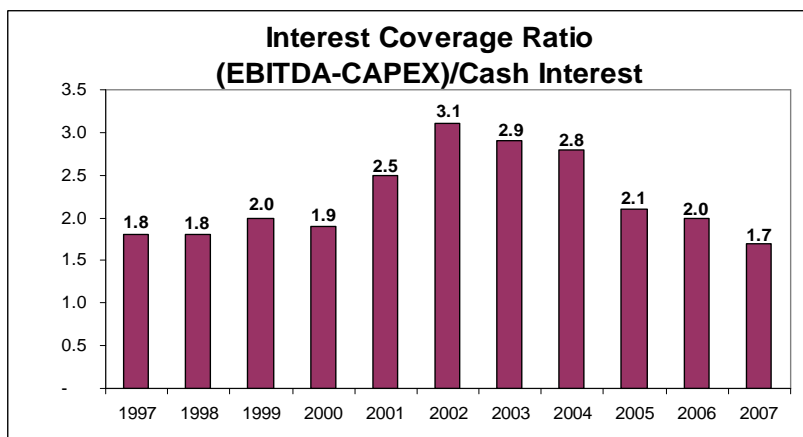
Sources : Probitas Partners, Standard & Poors LCD

For larger buyouts in 2007, lenders, on average, went 6.2x deep into the capital structure, up from approximately 4.0x in 2002.



Sources : Probitas Partners, Standard & Poors LCD

For smaller buyouts in 2007, lenders averaged 5.6x debt to EBITDA, up from a low of 3.4x in 2001.



Sources : Probitas Partners, Standard & Poors Leveraged Buyout Review

At the same time, lenders relaxed their coverage ratio requirements which declined from 3.1x in 2002 to 1.7x in 2007.

Although the various danger signs for private equity credit markets were obvious, it was ultimately the sub-prime mortgage market that catalyzed the next phase of the cycle. Though many first thought, that the damage in the sub-prime mortgage market would be contained, it was not.

Lenders to leveraged buyouts began re-evaluating the risk they had taken in their transactions and began re-pricing the risk. At the same time, macro-economic factors began to deteriorate.

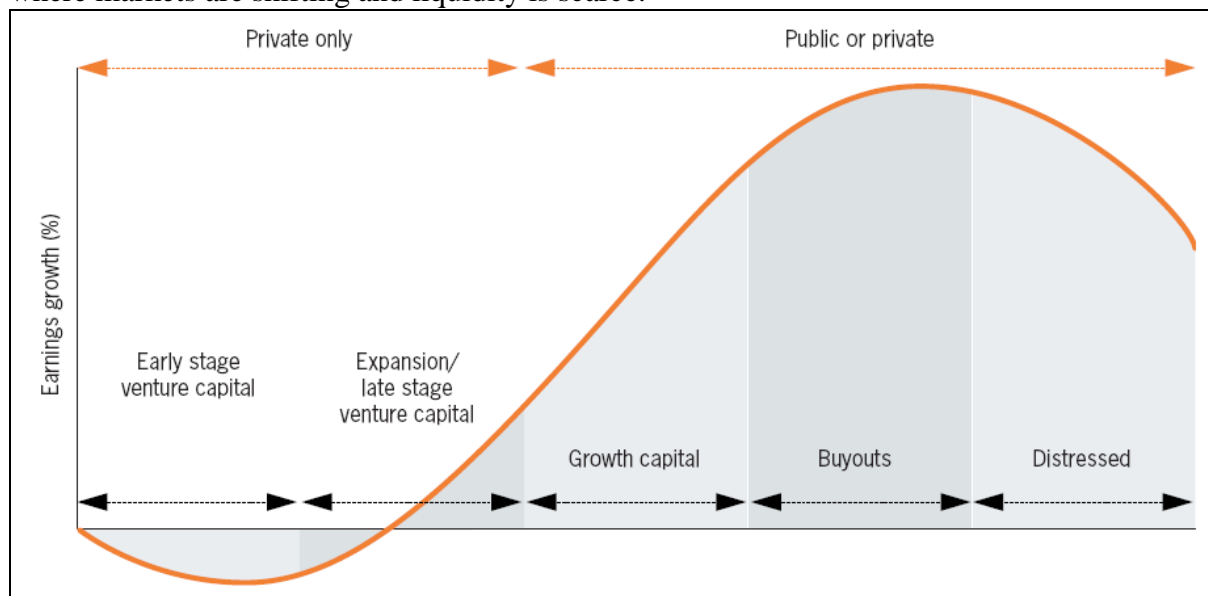
LBOs and other highly leveraged companies now find themselves caught between declining EBITDA and a more demanding credit environment unwilling to refinance the mountain of debt that had been accumulated during the boom. At the same time, Debtor-In-Possession (“DIP”) financing is becoming more difficult to obtain for bankrupt companies in Chapter 11. In bankruptcy, a company is known as a DIP when management remains in control of the bankrupt estate, rather than control being assumed by a Trustee. DIP financing is used as a tool to help bankrupt companies operate post-bankruptcy. DIP is usually provided by a bank or a non-bank lender and is third in line for the bankrupt firm’s assets (after taxes and attorney’s fees). This position in the capital structure makes DIP financing very secure.

As expected in Phase IV of the cycle, the lack of available credit has made LBOs impossible to complete, while the deteriorating economic environment and upcoming debt maturities have created both chaos and opportunities in the distressed debt environment.

2. Private Equity Distressed Investing

2.1. Defining Distressed Investing

Distressed investing encompasses strategies in which either public or private equity and/or debt securities are traded in companies that are experiencing financial or operational distress or mismanagement. As shown below, these situations often affect mature companies. However, it could strike at any time during a company’s development, especially in the current environment where markets are shifting and liquidity is scarce.



Source : Morgan Stanley

The investment category is defined by companies that:

- a) Have breached its debt covenants;
- b) Are approaching a payment default on its debt obligations;
- c) Have defaulted on its debt obligation;
- d) Have filed for court protection from creditors; or
- e) Whose debt is trading at a distressed premium, usually 1000 bps above the comparable risk free rate.

A company's failings can stem from strategic failures such as missing market opportunities or losing ground to a competitor; operational failings where poor execution leads to a reduction of EBITDA, or financial failings which are the result of an over levered balance sheet.

A distressed fund's main challenge is to:

1. Identify and purchase securities at a discount to intrinsic value;
2. Influence or control the resolution of creditor issues;
3. Possibly convert the debt into equity and operate the company;
4. Address and correct the source of the distress; and
5. Exit the company.

Distressed managers employ various strategies from active distressed for control strategies, where debt is purchased and covered to equity, to passive trading strategies.

2.2. Cyclical vs. Core Strategies

There are two different categories in which a distressed investment can be placed – Core and Cyclical.

The Cyclical opportunity is generally correlated with the credit cycle described above. The Cyclical opportunity is usually preceded by a series of observable market events where after a period of expansion of credit, capital markets degrade and the availability of credit contracts. These events occur with some regularity, as can be seen in the chart above (page 5) entitled "Historical Default Rates and Recession Periods in the US High Yield Bond Market (1972A-2009P)". In recent history, cyclical opportunities have been catalyzed by some geopolitical or market event that was quickly followed by a market downturn.

Examples from history include commodity shocks, corporate scandals and crisis of confidence. In this cycle, we observe all those and more such as the sub-prime crisis which led to the failure of Lehman Brothers and the near failures of AIG, Citi and other banks. This was followed by an unprecedented increase in commodity prices which was in turn followed by several corporate scandals including Madoff Securities and Stanford Group. At the end of 2008 a severe crisis in confidence began. The severity of this downturn has exposed many credits that would otherwise be stable in other economic situations.

The Core distressed opportunity is described as the background noise of struggling businesses inherent in any well functioning economy³. Therefore the Core opportunity is less correlated with

³ Morgan Stanley

the credit cycle and more dependant on the approximately 40,000⁴ US businesses that file for protection under the bankruptcy code every year. Ironically, it may well be easier to execute the core strategy in a robust macro-economy than in one that is struggling.

Given the different causes for distress, managers may require different skills to address cyclical and core opportunities.

Since Cyclical opportunities arise from a fundamental change in the credit environment, the opportunity involves managers taking advantage of credit market dislocation and acquiring securities at attractive risk-reward prices.

Core opportunities, since they occur in all markets, are more likely than Cyclical opportunities to include a fundamental problem with a business model or revenue stream. Therefore, Core opportunities are more likely to require turnaround expertise and are less likely to be profitable through simple trading.

Core managers, therefore, should have expertise in turning around failing or declining business, while the same skills may not be necessary for a Cyclical manager, who could produce good returns through excellent deal sourcing, strong credit analysis and excellent creditor relationships.

2.3. Restructuring Example

The example below illustrates a simple restructuring situation where a company, due to a decline in EBITDA, finds itself in a situation where it is carrying more debt than it can now support. These types of situation cross various strategies, but are more common in core distressed situations.

	Initial Purchase	Distress	Post Restructuring
EBITDA	\$100	\$60	\$60
Market Multiple	8.0x	8.0x	8.0x
Enterprise Value	\$800	\$480	\$480
Total Debt % EV	75%	125%	63%
	Senior Debt \$300 @ Face (3x EBITDA)	Senior Debt \$300 @ Face (5x EBITDA)	New Senior Debt \$150 @ Face (2.5x EBITDA)
	Sub Debt \$300 @ Face (3x EBITDA) <i>Total debt : 6x EBITDA</i>	Sub Debt \$300 @ Face (5x EBITDA) <i>Total debt : 10x EBITDA</i>	New Sub Debt \$120 @ Face (2x EBITDA) <i>Total debt : 4.5x EBITDA</i>
	Equity \$200 (8x EBITDA)	Equity \$200 @ Cost (13.3x EBITDA)	New Equity \$210 (8x EBITDA)

In the above example, this hypothetical company is bought by a financial sponsor who contributes \$200 million in equity and borrows \$600 million, or 75% of the value of the firm. At the time of purchase, the firm is worth 8 times its LTM EBITDA of \$100 million, or \$800 million dollars. In this transaction, the debt load is acceptable. Distress and bankruptcy can occur as follows:

⁴ Number of companies that filed in 2005 per Morgan Stanley

Beginning of Distress

1. A disruption in the company's core business reduces steady state EBITDA from \$100 million to \$60 million. Assuming that the market continues to value the company at 8 times its EBITDA, the total value of the firm is now \$480 million, less than the \$600 million value of its debt. This scenario would likely be accompanied by a payment or technical default.

Default

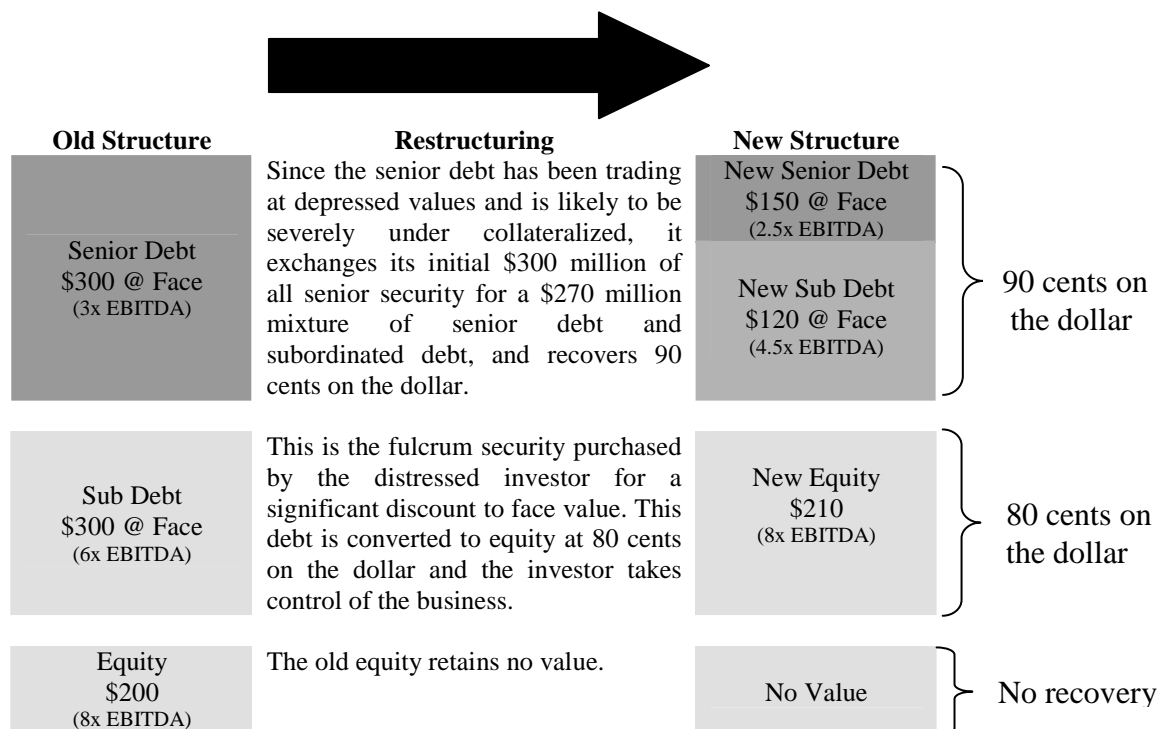
2. Given the distress of the company, its senior debt and subordinated debt trade below par, anticipating either a restructuring or bankruptcy. The equity would only retain option value.

Distressed for Control

3. This creates an opportunity for a distressed manager to take control of the company by purchasing debt. Through an analysis, an investor identifies this firm as one whose debt is in distress. The investor further identifies the subordinated debt as the fulcrum security, or the security that is most likely to be converted to equity given the company's capital structure, EBITDA level and market trading multiple. The investor begins to acquire the subordinated debt of the firm. Once 1/3 of the debt is acquired, the investor steps into a blocking position. Once 2/3 of the debt is acquired the investor controls the class of security in any restructuring process.

Restructuring

4. Once a controlling position in the fulcrum security is in place, the investor can begin to develop a new, post restructuring capital structure. In this case, the restructuring plan is as follows:



New Company

5. After the restructuring process, the company emerges with a lower enterprise value (\$480 million instead of \$800 million), with a more rational capital structure, managed by the new investor. The senior lender receives 90% of its value, the subordinated investor receives 80% of its value and the equity is wiped out.

3. Distressed Investing Market

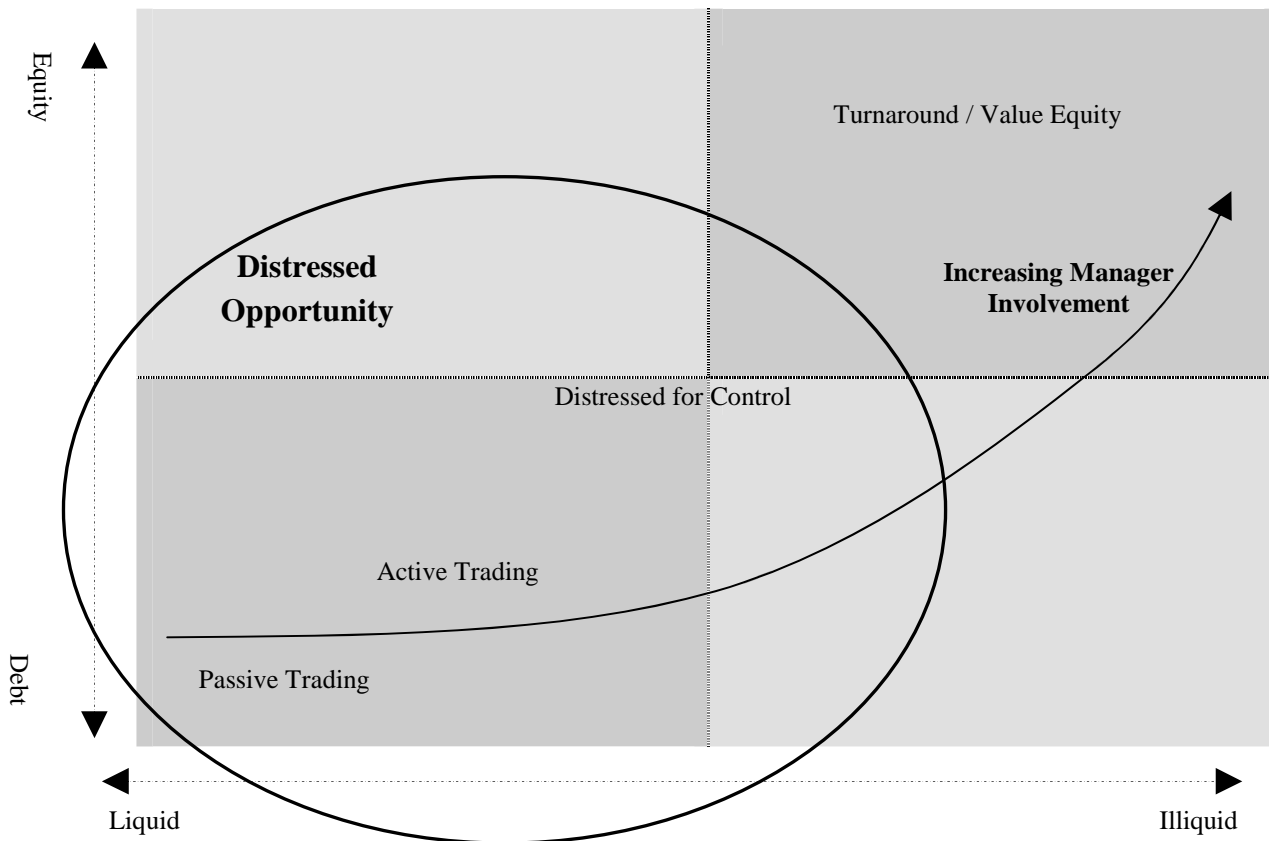
3.1. Market Overview⁵

Distressed security investors are essentially value investors, trying to pay the lowest price for an asset which they think has intrinsic value. A significant upfront effort is exerted to identify an investment, determine its intrinsic value and acquire the security.

Typically, a distressed investor would purchase the firm's bonds or debt, since in a distressed situation the equity has little if any value. Once a distressed investor becomes involved in a situation, the investor will first calculate the true value of the debt, given the firm's existing assets and the strength of the debt's claim on those assets. Depending on the investor's capabilities, some value may be ascribed to the investor's ability to affect an operational turnaround. If after the analysis the investor perceives a good opportunity, the investor purchases the debt. Once a turnaround is complete, the investor can sell his debt for a profit, or convert it to equity and sell the company as a going concern.

Given the wide variability in the type of strategies that can be employed to participate in the distressed market, it is not surprising that there are several different distressed investment styles. The styles are distinguished by (1) Type of security purchased; (2) Attitude toward liquidity and control; and (3) Attitude toward active ownership. The different investment styles in distressed debt investing can be thought of as follows.

⁵ Source : Morgan Stanley



- **Passive Trading** – Measured by the amount of capital committed to the various distressed strategies, passive trading is the largest sector of the distressed investing universe⁶. It is still largely dominated by event-driven and multi-strategy hedge funds. Passive traders attempt to identify distressed mispriced securities and acquire them with the intention of selling them quickly. For instance, a passive trader may acquire a security for 60 cents and sell it for 70 cents several days later. This style has an extremely short investment horizon and requires the deployment of significant capital into a liquid instrument. Targets for these investors are typically large, publicly traded companies where debt trades in high volumes on the open market.
- **Active Trading** – The objective of an active trading strategy is to benefit from the restructuring of a distressed company by holding on to a blocking position in a security and influencing the outcome of the restructuring process. Since a supermajority of investors in any given class of security is required to approve a restructuring plan, a blocking position would require the acquisition of 33.4 % of any individual class of security. Furthermore trading of large blocks of securities is required, the liquidity profile of the investment is reduced and the amount of time required to get to the exit is increased. The security could be senior debt or can be lower in the capital structure. Typically, active traders seek higher per deal returns than passive traders, become active on creditor committees and can wait for a post-restructuring exit. The target security must be liquid enough for the buyer to acquire a blocking position. Therefore, the target companies for this strategy are distressed middle market firms, often with publicly traded debt.

⁶ JP Morgan “Understanding Distressed Investing: A Practical Approach”

- **Distressed for Control** – The biggest difference between this strategy and active trading is that an investor in this strategy will seek to acquire control of the target. Here, the investor must correctly identify the fulcrum security, or the security that will be converted to equity after the restructuring is complete. Ideally, the control of the fulcrum security would reach 66.7%. Also, unlike the active trading investor who seeks to influence the restructuring, the distressed for control investor seeks to control the restructuring and to operationally turn around the restructured firm. This is the most complex of all the distressed strategies because it requires credit skills to identify the correct security, skills and knowledge of the bankruptcy laws to control the restructuring process and operational skills to affect the turnaround. Typical targets include significantly distressed middle market companies with an easily acquirable fulcrum security.

The depth of the current credit crunch and the elimination of many traditional DIP (Cf. page 8) lenders have made DIP financing very expensive. Some current packages include 3% closing fees and coupons of L+1,200 and target 25%+ IRRs. In addition, some DIP “Vultures” have emerged which provide DIP financing with the intent to eventually control the equity of the target.

This dynamic has made the distressed-for-control strategy very difficult to execute. Previously, one could identify the fulcrum security by doing a valuation analysis. With the current state of the DIP market, either the DIP becomes the fulcrum security or creates a situation where the fulcrum is much higher in the capital structure. This has significantly obstructed current distressed for control strategies.

- **Turnaround / Value Investing** – This strategy works best at the beginning of the credit cycle and is the only strategy where the investor purchases equity securities. In this strategy, the manager purchases a stressed, but not distressed, corporation and actively engages in the management and the turnaround of the property. Exit timings are usually long, since a full operational turnaround needs to be affected before value is created. This is the broadest distressed investing category, as many firms claim to apply operational skills to their purchasers.

	Passive Trading	Active Trading	Distressed-for-Control	Turnaround
Strategy	Profit from pricing anomalies, credit analysis and trading expertise	Profit from influencing the outcome of a restructuring by holding a blocking position in a class of security.	Control a distressed firm through the acquisition of a large position in a fulcrum security. Restructure firm. Apply operational expertise to further improve it.	Acquire the equity of a stressed company and affect an operation turnaround before a default occurs.
Actions	Trading	Influence restructuring	Control restructuring to control asset	Purchase equity and control company
Critical Skills	Trading; credit	Trading; credit; restructuring; negotiations	Trading; credit; restructuring; negotiations; operational expertise	LBO; Operational expertise
Security	Debt / Bonds	Debt / Bonds	Debt / Bonds	Equity
Liquidity	High (Large cap)	Medium (Large cap; Mid Cap)	Medium-Low (All companies)	Low (mid-cap / small cap)
Hold Period	Days to 12 months	1-2 years	3-5 years	3-5 years
Recycling	High	Medium	Low	Low
Gross Fund Target IRR	12-18%	15-20%	20-25% ⁷	25%+

Distressed Opportunity

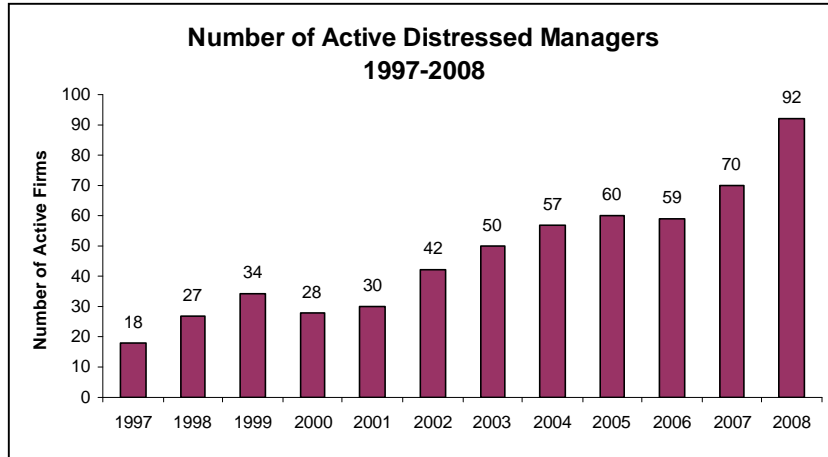
Traditional Buy Out

Since the Turnaround category is broad and could itself encompass a wide variety of strategies, this paper will focus on the distressed credit strategies in the Passive Trading, Active Trading, and Distressed for Control categories.

⁷ Including toe hold positions that don't convert into equity and are unwound

3.2. Capital Raising

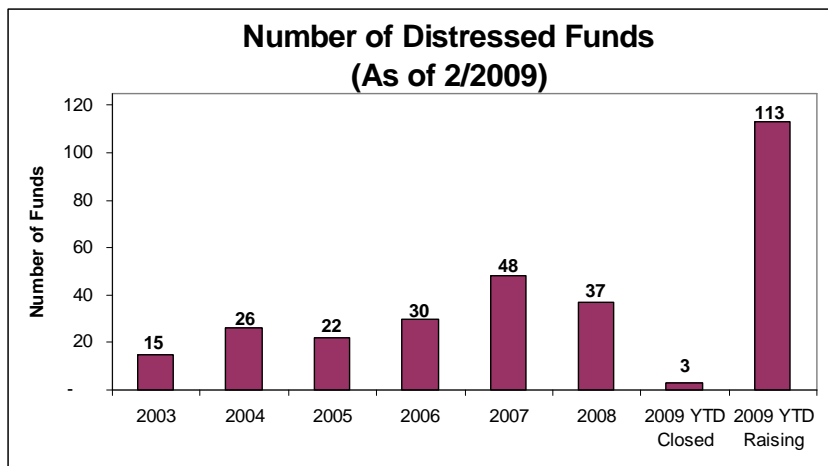
The number of managers focusing on distressed opportunities has been steadily increasing



In the last recession, the number of active distressed managers increased 66% from 30 in 2001 to 50 in 2003. Last year, the number of active managers spiked 17%.

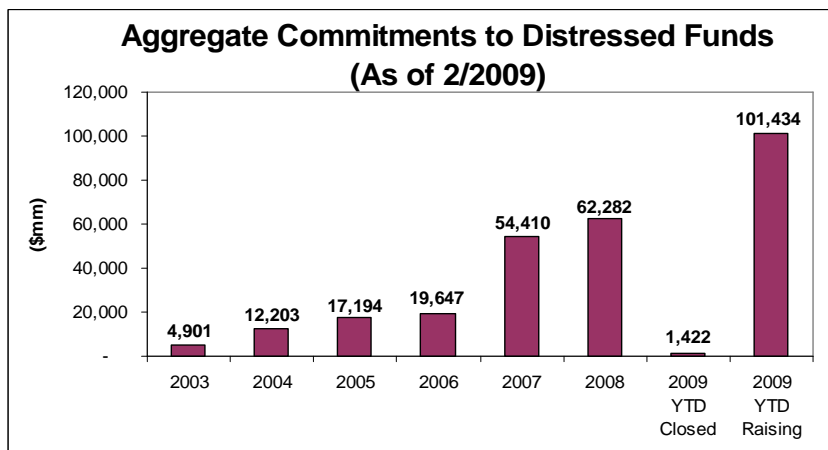
In the last 11 years, the number of distressed managers increase by almost 5 ½ times.

Source : UBS



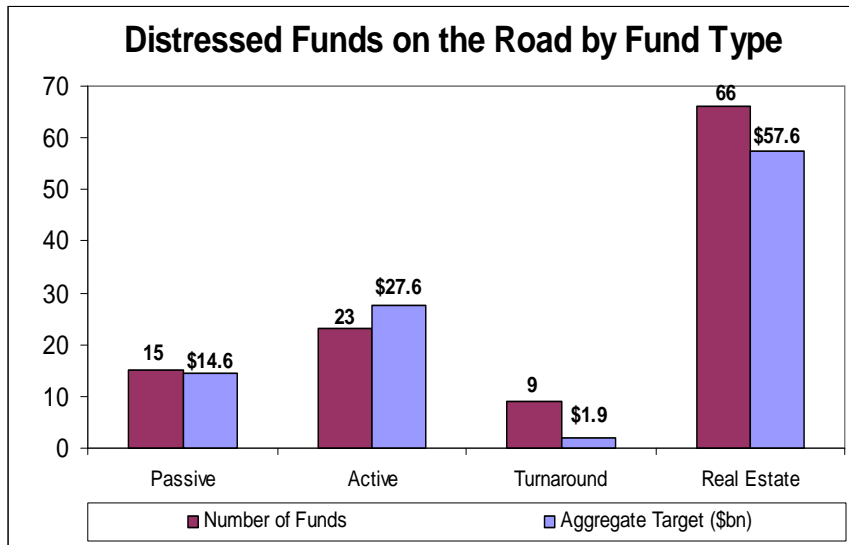
In 2009, the numbers are even more dramatic, with 113 new funds in the market – or three times as many as closed in 2008

Source : UBS, Private Equity Intelligence



This represents a more than 60% increase in the capital sought

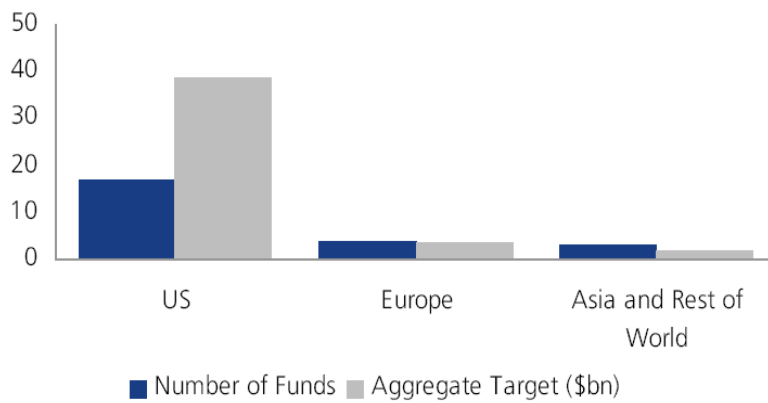
Source : UBS, Private Equity Intelligence



Most of the funds being raised, however, focus on distressed real estate, with only 23 new funds focused on active distressed opportunities, 15 focused on passive and 9 focused on turnaround strategies.

Source : UBS

Distressed Funds on the Road by Geographic Focus

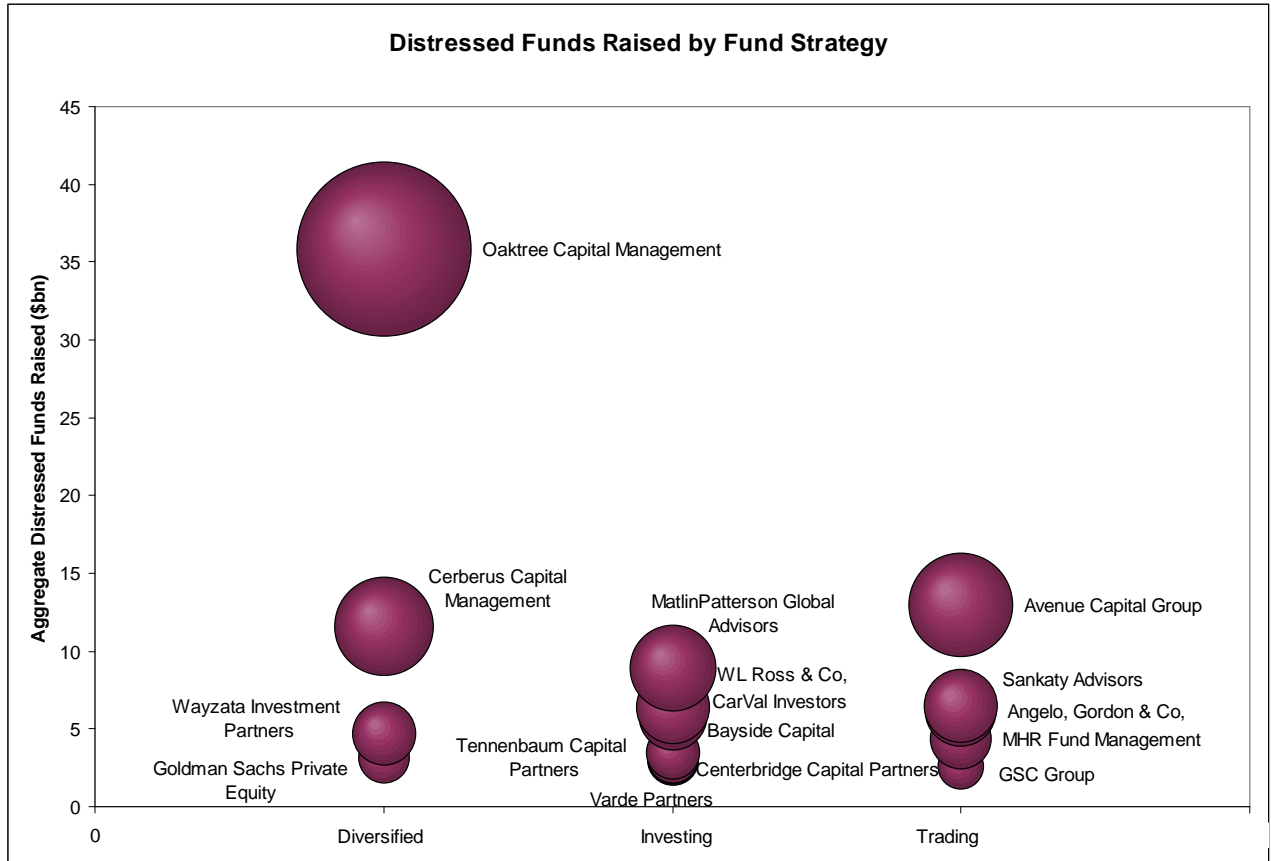


Most of these funds are targeting the United States.

Source : UBS

3.3. Manager Map⁸

Below is a sample of managers operating in the distressed space according to their strategy.

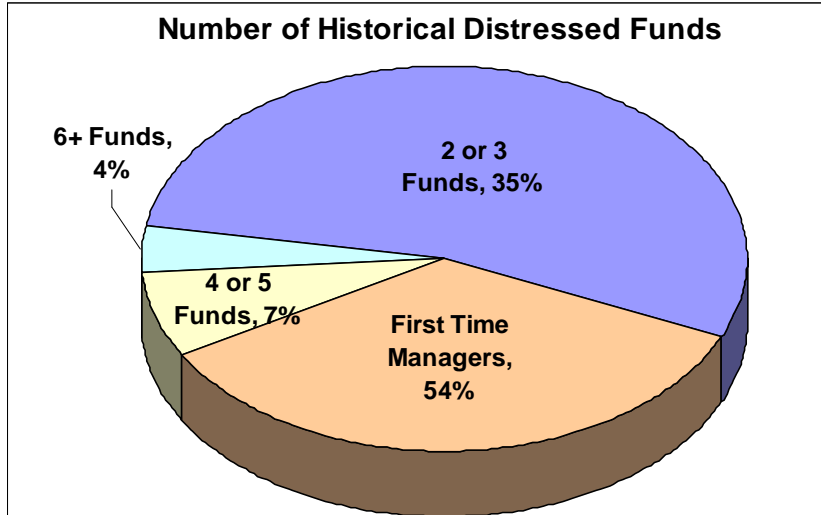


Source: UBS

⁸ Source: Park Hill Group / CAAM-CI / UBS

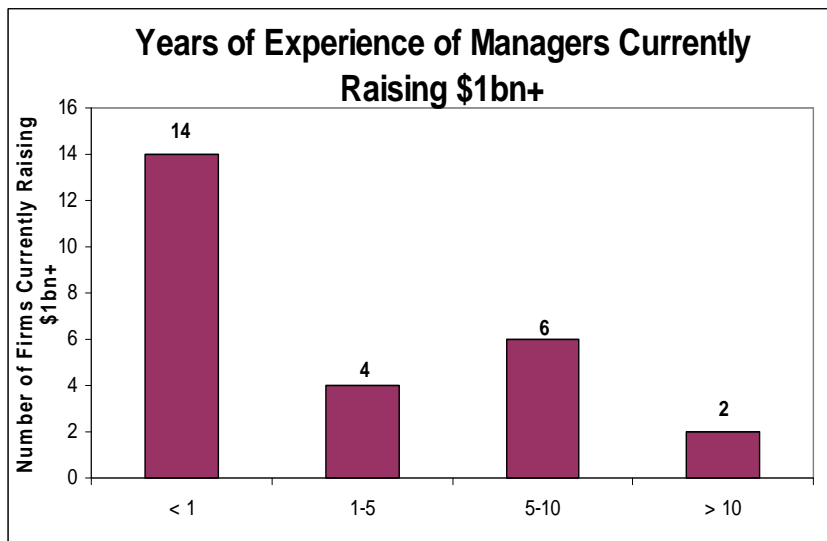
3.4. Manager Experience

Since the growth of the distressed sector has been quite rapid, there are very few truly experienced managers in the space.



According to UBS, 54% of managers are currently managing their first fund and only 11% of all managers have raised more than 3 previous vehicles

Source : UBS

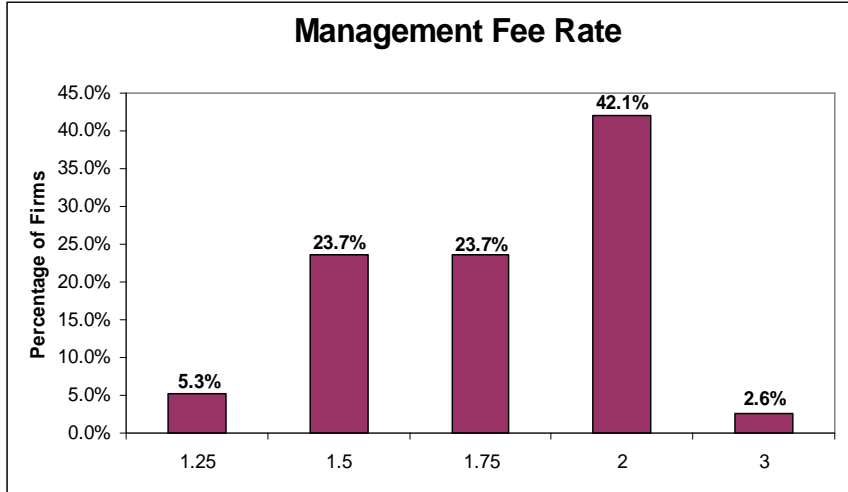


Indeed, of the managers currently raising more than \$1bn, only 2 have been in business more than 10 years

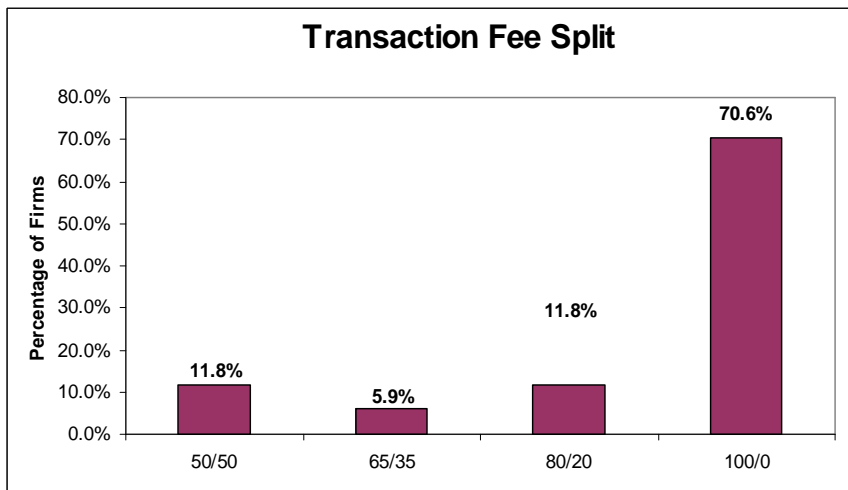
Source : UBS

3.5. Terms

According to a survey completed in February 2009 by UBS, distressed managers' terms are similar to those in the broader private equity market.

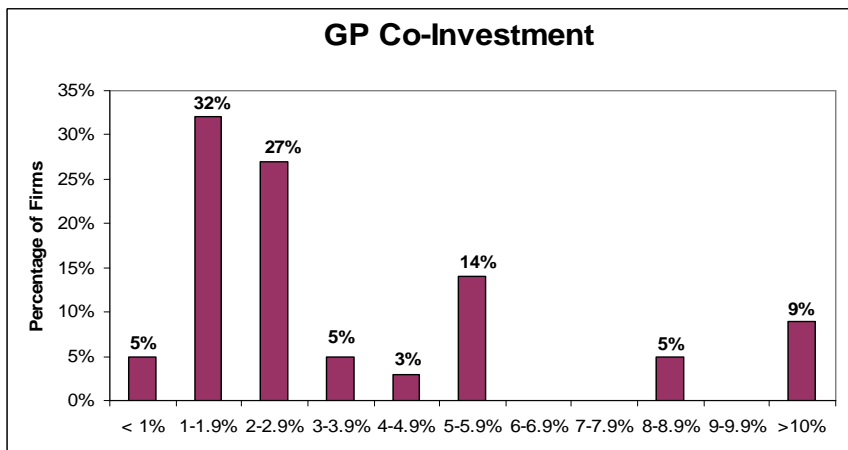


Although fees tend to trend toward the higher end of the 1.25 to 2.0% range with 42.1% of managers charging a full 2.0%, managers are generous with respect to monitoring, directors and transaction fees with more than 70% crediting 100% of those fees to the fund.



54% of managers utilize the standard method of calculating the basis for the management fee – using committed capital as the basis during the Commitment Period and invested capital as the basis thereafter. 76% of distressed funds utilized the whole fund method for calculating carried interest, while the rest did it deal by deal.

Sources : UBS

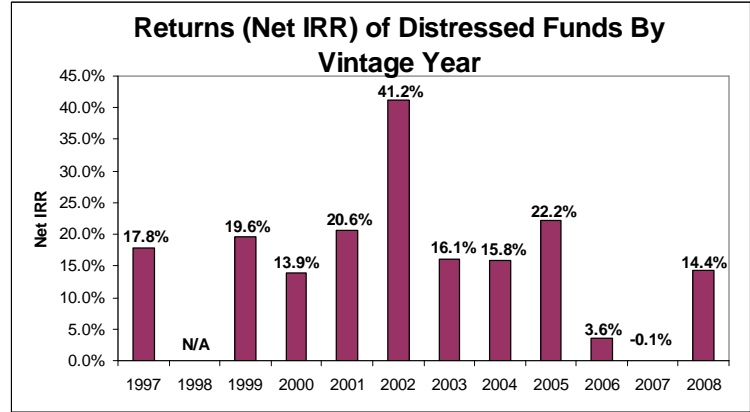
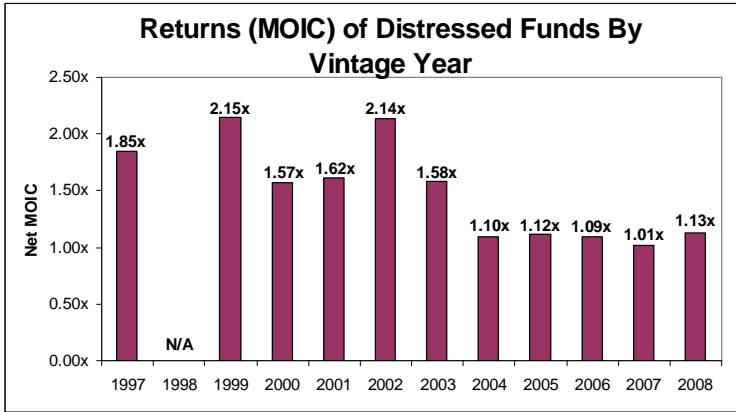


Most GP fund commitments were between 1 and 3%.

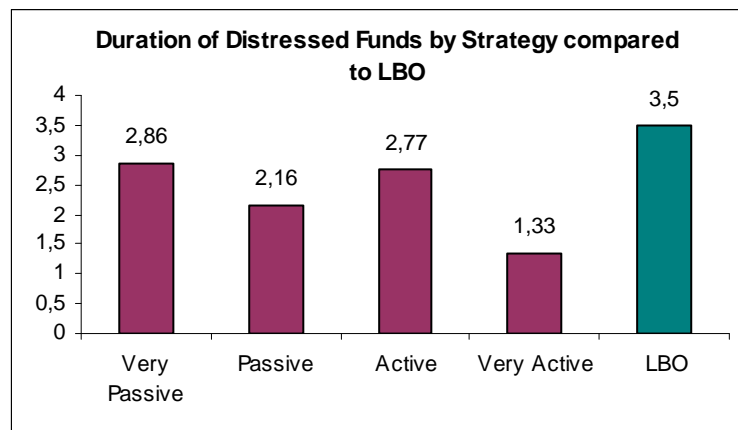
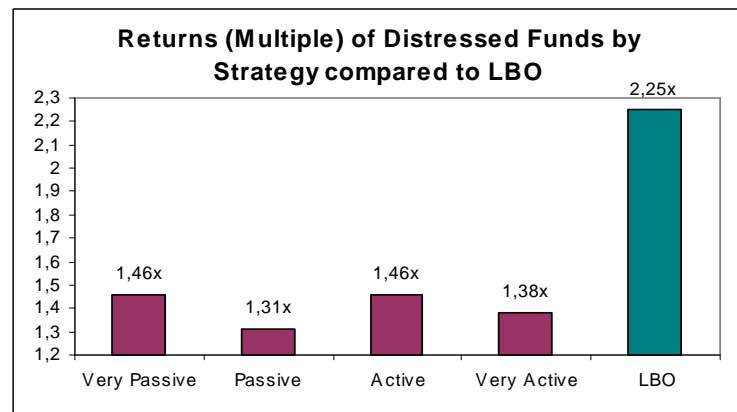
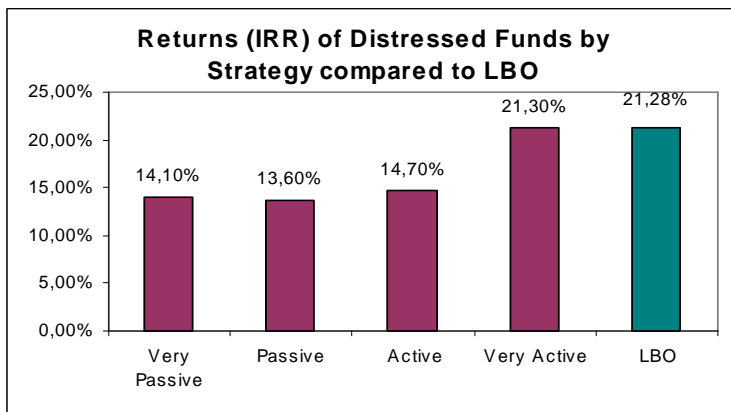
Sources : UBS

3.6. Historic Returns⁹

Since 1997, historic returns for mature funds have hovered around 1.4x multiple and approximately 14% Net IRR.



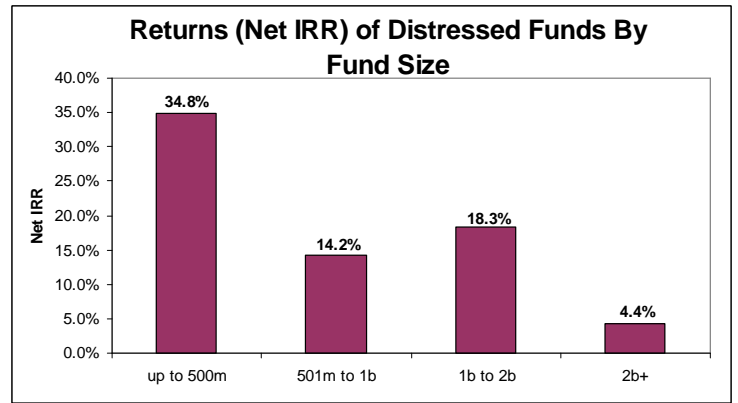
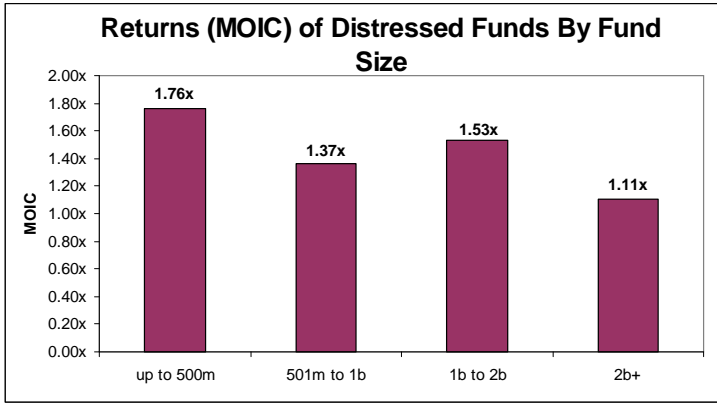
There did not seem to be a difference the multiple of the active and passive managers, but very active/distressed-for-control managers seemed to produce higher IRRs.



These graphics show that LBO strategy has a much higher multiple than distressed debt strategy, as well as a higher IRR and duration, implying a slower return of capital.

⁹ Data from Park Hill Group and CAAM-CI database. These two sources aren't totally comparable because CAAM-CI's sampling contains only US best received funds from 1997 to 2008.

There does seem to be a correlation between fund size and returns, with smaller funds producing larger returns. This statistic may not be reliable, since many large funds were raised recently and are not yet mature. In addition, the data used for this analysis was based on successful multi-generational funds and is subject to survivorship bias (data includes successful early funds of well known managers and excludes small funds from failed, single fund managers).



4. Appendix 1 –Leading Distressed Managers

20 Leading Distressed Managers by Funds Raised¹⁰

Firm	Style	Aggregate Distressed Funds Raised (\$bn)
Oaktree Capital Management	Diversified	35.8
Lone Star Funds	Real Estate	23.2
Avenue Capital Group	Trading	13.0
Cerberus Capital Management	Diversified	11.6
MatlinPatterson Global Advisors	Investing	8.9
Sankaty Advisors	Trading	6.5
WL Ross & Co.	Investing	6.4
Angelo, Gordon & Co.	Trading	6.2
CarVal Investors	Investing	5.8
Wayzata Investment Partners	Diversified	4.7
MHR Fund Management	Trading	4.4
Colony Capital	Real Estate	4.1
Bayside Capital	Investing	3.5
Centerbridge Capital Partners	Investing	3.2
Goldman Sachs Private Equity	Diversified	3.2
Tennenbaum Capital Partners	Investing	3.1
Varde Partners	Investing	3.0
LaSalle Investment Management	Real Estate	3.0
Aetos Capital	Real Estate	2.9
GSC Group	Trading	2.6

¹⁰ Source:UBS

5. Appendix 2 – Distressed Funds Raised Since 2003

Distressed Funds Raised Since 2003 larger than \$2b¹¹

Fund	Style	Size (\$bn)	Year Raised
OCM Opportunities Fund VIIB	Trading	10.9	2008
Lone Star Fund VI	Real Estate	7.5	2008
Cerberus Institutional Partners (Series Four)	Investing	7.5	2007
Avenue Special Situations V	Trading	6.0	2008
CVI Global Value Fund (CarVal)	Investing	5.8	2007
Lone Star Fund V	Real Estate	5.0	2005
MattlinPatterson Global Opportunities III	Investing	5.0	2007
WLR Recovery Fund IV (WL Ross)	Investing	4.0	2008
Colony Investors VIII	Real Estate	4.0	2007
MHR Institutional Partners III	Investing	3.5	2007
OCM Opportunities Fund VII	Trading	3.5	2007
Sankaty Credit Opportunities Fund IV	Trading	3.5	2008
Wayzata Investment Partners II	Investing	3.4	2008
OCM Principal Opportunities Fund IV	Investing	3.3	2007
Centerbridge Capital I	Investing	3.2	2006
Avenue Asia Opportunity Fund III	Trading	3.0	2006
H.I.G. Bayside Debt & LBO Fund II	Investing	3.0	2008
LaSalle Asia Opportunities Fund III	Real Estate	3.0	2008
Rockpoint Real Estate Fund III	Real Estate	2.5	2008
Lone Star Real Estate Fund	Real Estate	2.4	2008
OCM European Principal Opportunities Fund II	Investing	2.4	2008
Aetos Capital Asia II	Trading	2.2	2005

¹¹ Source:UBS

6. Appendix 3 –Funds Currently in the Market

Distressed Private Equity Funds Currently in the Market¹²

Firm	Fund	Size (\$bn)	Status
Lone Star	Lone Star Fund VII	10.0	Raising
Ares Capital	Ares Corporate Opportunities Fund III	4.0	Allocating
Carlyle Group	Carlyle Distressed Financial Services Fund	3.0	First Close
Angelo Gordon & Co.	AG Capital Recovery Partners VII	3.0	Raising
Ashmore	Ashmore Global Special Situations Fund V	2.6	Raising
Crestview	Crestview Capital Partners II	2.5	Third Close
Avenue Capital	Avenue Europe Special Situations Fund	2.4	Second Close
Apollo Management	Apollo European Principal Finance Fund	1.6	Eighth Close
The Carlyle Group	Carlyle Global Financial Services Partners	1.0	Raising
Highland Capital Partners	Highland Restoration Capital Partners	1.0	Raising
Guggenheim	NZC Guggenheim Opportunities Fund II	1.0	First Close
Strategic Value Partners	Strategic Value Special Situations Fund	1.0	First Close
Aurora	Aurora Resurgence Fund	0.8	First Close
Ares Capital	Ares Distressed Securities Fund	0.8	First Close
York Capital Management	York Special Opportunities Fund	0.8	Second Close
Monarch	Monarch Capital Partners	0.6	Third Close
Versa	Versa Capital Fund I	0.6	Second Close
Aureum Capital	Aureum Capital Distressed Fund	0.5	First Close
Littlejohn & Co.	Littlejohn Distressed Securities	0.5	Raising
Z Capital Partners, LLC	Z Capital Special Situations Fund	0.5	Raising

¹² Source:UBS February 2009