Growth in Distressed Private Equity: Is Europe Approaching a Turnaround?

Preqin recently interviewed LPs to gauge investor sentiment towards distressed private equity. Louise Maddy and Joanna Nye explore the results of this survey and its potential impact on private equity markets such as Europe.

The renewed fears of recession and the ongoing eurozone sovereign debt crisis have meant that distressed private equity, with its countercyclical nature, has become increasingly attractive to investors. In our Preqin Special Report: Distressed Private Equity in October 2011, Preqin expected distressed private equity to play a greater role in the private equity market and believed the sovereign debt crisis in Europe would tempt a number of GPs to launch funds hoping to cater to investor appetite for distressed investment opportunities arising in the region.

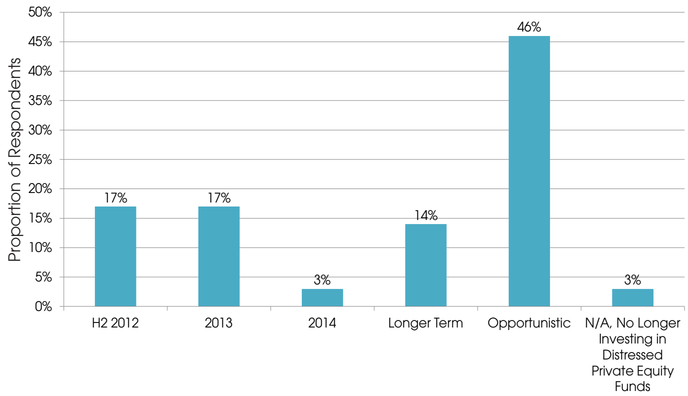
Recent interviews with investors conducted by Preqin in August provide new insight into changes in investor sentiment towards distressed private equity. Combined with Preqin's latest data on the current distressed private equity market, these interviews highlight both the changes and challenges in the current global fundraising climate and whether the predicted increased competition in the sector has materialized. Additionally, Preqin asked investors about their appetite for different regions, providing insight into the Europe-focused distressed private equity market and whether the region has become more attractive to investors due to greater investment opportunities resulting from the eurozone sovereign debt crisis.

Investors' Intentions for Future Commitments

Preqin interviewed 35 investors that had previously indicated a preference for distressed private equity funds. Of those interviewed, 80% had already made commitments to distressed private equity funds, with the remaining 20% expecting to make their first commitments to these funds at some point in the future.

As Fig. 1 shows, just under a fifth of investors (17%) expect to make their next commitments to distressed private equity funds before the end of 2012, with the same number expecting to commit to distressed private equity funds in 2013. Almost half of LPs (46%) stated that their next investment in a distressed private equity fund would likely be made on an opportunistic basis, committing to a new fund should an attractive opportunity arise.

Fig. 1: Investors' Plans for Future Commitment to Distressed Private Equity



Source: Preqin

Current Investor Attitudes

Investing in distressed private equity on an opportunistic basis seemed to be an attractive route for investors; 11% of LPs interviewed cited this as the sole reason for their exposure to investments in this area. However, investors also highlighted a number of other reasons for investing in distressed funds, including diversification of their investment portfolio, and the returns these investments can provide.

A number of LPs have changed their opinions of distressed private equity following turbulence in the financial markets, but none have stated that the impact has given them a more negative view of distressed private equity. Over a third (37%) of investors interviewed stated that their opinion of distressed private equity has been more positive following the financial crisis, with the majority naming the opportunities for distressed private equity created by the financial crisis as the reason for this positive outlook. Over half (57%) of LPs stated that the financial crisis has not altered their opinion of distressed private equity; several LPs recognized that the financial

Fig. 2: Top Five Distressed Private Equity Funds in Market

Fund	Manager	Type	Target Size (Mn)	Fund Focus
GSO Capital Solutions Fund II	GSO Capital Partners	Distressed Debt	4,000 USD	US
Cerberus Institutional Partners (Series Five)	Cerberus Capital Management	Distressed Debt	3,750 USD	US
Apollo European Principal Finance Fund II	Apollo Global Management	Distressed Debt	2,500 EUR	Europe
Sankaty Credit Opportunities V	Sankaty Advisors	Distressed Debt	3,000 USD	US
Wayzata Investment Partners III	Wayzata Investment Partners	Distressed Debt	2,500 USD	US

Source: Preqin

crisis has created good opportunities for investment, but believe that opportunities were not lacking prior to this.

A number of investors with unchanged opinions on distressed private equity cited that this is due to the fact that they only invest in these funds on an opportunistic basis. For LPs investing opportunistically in distressed private equity, the past performance of the GPs' funds plays an integral role in determining whether to invest. As a result, evidence suggests that first-time fund managers will find it even more difficult to raise a fund in this climate, with 95% of distressed private equity funds closed so far this year coming from established fund managers.

Distressed Private Equity Funds in Market

With LPs' increased appetite for investing in distressed private equity in recent years, it is no surprise to learn that there are now a greater number of fund managers marketing distressed private equity offerings to investors. In the first quarter of 2009 there were 48 distressed private equity funds vying for LP capital commitments, whereas the latest figures from Preqin's Funds in Market database show there are currently 62 distressed private equity funds in market targeting an aggregate $40.3bn. These figures demonstrate the increase in GP competition as fund managers try to tap into investor enthusiasm for distressed opportunities produced by the tough economic climate in recent years.

The largest fund currently in market is GSO Capital Solutions Fund II, a distressed debt fund being raised by GSO Capital Partners with a $4bn target size. This fund is seeking more than its predecessor, GSO Capital Solutions Fund, which surpassed its target of $2bn to raise $3.25bn in 2010, indicating an increase in the fundraising confidence of some fund managers in the sector. The largest Europe-focused fund is Apollo European Principal Finance Fund II, which is targeting €2.5bn, €1.1bn more than Apollo Global Management garnered in 2010 from the first fund in the series. Preqin's recent LP survey justifies the confidence of some GPs in fundraising, with over a quarter of LPs (26%) expecting to increase their allocations and 74% sustaining their current distressed private equity allocations. No LPs are set to decrease their levels of exposure in this area.

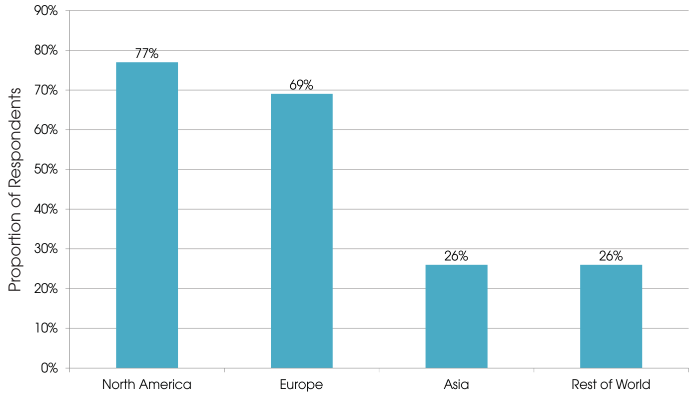
Distressed Private Equity Fundraising

Fig. 3 shows that between 2005 and August 2012 a total of 280 distressed private equity funds have closed across the globe, raising an aggregate $237.5bn in capital commitments. During the peak of distressed private equity fundraising in 2008, 43 funds reached a final close having raised $57.4bn in aggregate capital commitments. The decline in investor confidence at the beginning of the financial crisis meant that, along with the rest of the private equity industry, distressed private equity fundraising was not able to reach the same levels in 2009. In 2010, however, there was

Fig. 3: Annual Distressed Private Equity Fundraising, 2005 - August 2012

Source: Preqin

Fig. 4: Investors' Geographic Preferences for Distressed Private Equity Funds



Source: Preqin

a return in investor confidence and momentum in the distressed private equity sector, more so than in the rest of the private equity market, due to the investment opportunities arising from the economic downturn. The industry sustained this momentum in 2011, and from January to August of this year 20 funds have closed on an aggregate $27.1bn, already surpassing the aggregate capital raised in 2011.

In terms of the regional focus of distressed private equity fundraising, distressed funds primarily focused on investing in North America that have closed since 2005 have raised an aggregate $183.8bn, $16.5bn of which was raised by the 11 funds reaching a final close in January to August 2012. North America-focused distressed funds that closed during 2011 accounted for two-thirds of the global distressed private equity fundraising total that year, while Europe-focused funds made up 29% ($7.7bn), up from $4.8bn in 2010. This can partly be attributed to the largest ever Europe-focused distressed private equity fund reaching a final close in 2011. OCM European Principal Opportunities Fund III raised a total of €3bn in investor commitments. Europe-focused distressed private equity funds closed in 2012 so far have raised $6bn in capital commitments, and the aggregate total is expected to exceed the record set by Europe-focused funds closed in 2011. Asia and the Rest of World-focused distressed private equity funds closed in 2012 so far have raised $4.6bn, up from $1.6bn in 2011. This can largely be attributed to the final closing of the $4bn Mount Kellett Capital Partners II, an Asia-focused special situations fund.

Geographic Preferences

Although distressed opportunities in North America attract the majority of investor commitments at present, a greater proportion of the capital is likely to be channelled into European opportunities over the coming year. Preqin asked LPs about their preferred regions for investment in distressed funds when targeting investments in private equity on an international scale. As Fig. 4 highlights, over three quarters (77%) of LPs stated that they would look to invest in distressed funds focused on North America, a reduction from the 82% of LPs which planned to invest in North America-focused distressed funds in October 2011. Europe is also an attractive region among investors, with 69% of LPs stating they would target distressed funds in this region, up from the 65% of LPs that were looking to invest in Europe-focused distressed funds in October 2011.

Europe-Focused Fundraising Conditions

As shown in Fig. 5, all distressed private equity funds that reached a final close in 2005-2008 were raised in less than 19 months. However, as fundraising periods across the private equity industry increased due to the reduction in the flow of investor commitments in the aftermath of Lehman Brothers collapse, only 60% of funds closed from 2009 to August 2012 were raised in less than 19 months. Preqin data shows that European distressed private equity fundraising was more resilient than distressed private equity fundraising as a whole after 2009, with the overall proportion raised within 12 months maintaining the pre-2009 proportion of two-thirds. In contrast, globally, the proportion of distressed private equity funds closing within 12 months has decreased from 80% to 40%. The average number of months spent on the road by funds closed in 2012 so far has mirrored 2011's figure for Europe of nine months, and has fallen from 19 to 17 months for North America.

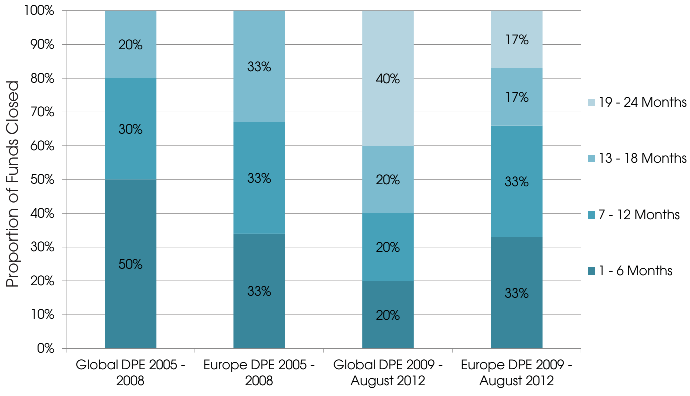
The average size of Europe-focused distressed private equity funds closed between January and August 2012 is just over $1bn, a 30% increase in the average fund size compared to 2011. This is a new record for the fund type. This figure has increased year on year since 2009, when the average size of Europe-focused funds was $409mn.

The short average fundraising time for Europe-focused vehicles and the increasing average size of distressed private equity funds reflects the strong interest from investors wanting to tap into the opportunities created by the increasing number of distressed European companies with looming debt maturities and insufficient leverage on offer from European banks. With the tough economic conditions unlikely to abate, more distressed investment opportunities will likely continue to emerge in the region.

Outlook

Capital commitments to distressed funds closed in 2012 so far have already exceeded those made to funds closed in 2011, and 2012's aggregate total is likely to be the largest in four years by the end of the year. The importance of distressed private equity within the private equity space is set to increase in the near future to take advantage of the investment opportunities created by the financial crisis in Europe and across the globe. However, the large number of fund managers competing for LP commitments means fundraising conditions will remain tough for firms marketing funds. The task is likely to prove even more challenging for first-time fund managers without a track record investing in the distressed private equity space, which are raising 27% of the distressed private equity funds currently in market. Distressed fund managers need to ensure they can market a compelling offering to investors that will allow them to stand out from the competition while also quelling any concerns from investors.

Fig. 5: Breakdown of Time Spent on the Road by Distressed Private Equity Funds



Source: Preqin

Subscriber Quicklink:

This month's feature article draws on data from Preqin's latest in-depth interviews with investors in distressed private equity funds. Subscribers to Preqin's Investor Intelligence can click here to view a list of all 1,343 investors in distressed private equity.

Not yet a subscriber? For more information please visit:
www.preqin.com/ii

Global private equity fundraising

We have a successful track record in raising capital for **private equity** and **real estate** firms from around the world.

Our ability to differentiate our clients in a highly competitive market and our longstanding relationships with active investors in North America, Europe, Asia and the Middle East are key to our success.

We are partners with each of our clients, helping them reach the next level in fundraising.

INDUSTRY ventures

Industry Ventures Fund VI, L.P.

Venture investmentss in direct secondary opportunities and limited partnership interests

$400m

L

L Capital 3

Pan European buyouts in aspirational brands

€400m

Capstone Partners

www.csplp.com

North America
One Galleria Tower, 13355 Noel Road, Dallas, Texas 75240
+1.972.980.5800

Europe
Grand-Rue 19, 1260 Nyon - Switzerland
+41.22.365.4500

Asia
Suite 1106, Metrobank Tower, 1160 Yan An Xi Lu, Shanghai 200052 - China
+86.21.6124.2668