

Special Research Report:  
**Distressed Debt &  
Special Situations**

August 18th 2007

For further information please visit: [www.preqin.com](http://www.preqin.com)

# Special Research Report: Distressed Debt & Special Situations

With the recent well-publicised turbulence in the global credit markets, many commentators have questioned whether the time is ripe for distressed debt and special situations funds to prosper. Whilst it is indeed true that the prospects for these investment strategies look better than ever, the reality is that these funds have already been enjoying great success for quite some time, with stellar returns for LPs and strong fundraising conditions for GPs.

Preqin's LP database lists nearly 400 leading LPs worldwide that have either already invested in distressed debt or special situations funds, or who have these funds clearly in their investment plans. They will undoubtedly be joined by many others over the coming months and years.

This Preqin Research Paper explores the distressed debt and special situations market, looking at the historic performance of distressed debt and special situations funds; the success that GPs have had in raising funds; the 'Dry Powder' currently available in the industry; and the LPs who have already been investing in the sector.

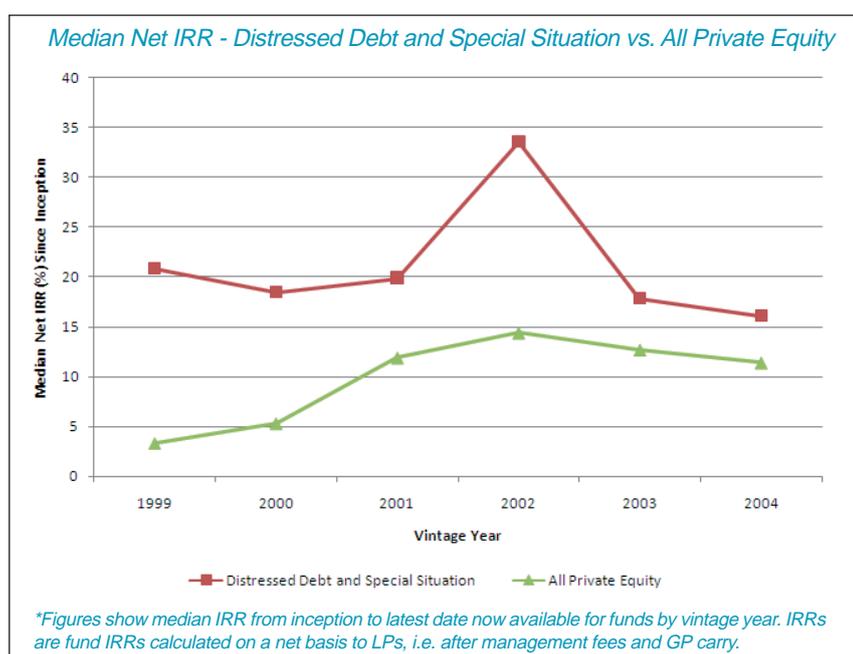
**The outlook is positive for both LPs and GPs in this growing market:**

- **Good news for LPs:** returns from these funds have been excellent, and even though many funds have been raised recently, GPs have evidently been able to put the money to work. There are several new funds from leading firms currently on the road, so there are plenty of opportunities for LPs who want a piece of the action.
- **Good News for GPs:** the funds that have been raised over the past three years have been put to work very quickly, and the net returns for LPs have been excellent. As a result, the appetite for new funds is very strong, and the prospects for GPs are excellent – both for those already active in this space and for buyout firms considering entering it.

We hope that you find this Research Paper helpful, and as always we welcome your feedback and questions. Please visit [www.preqin.com](http://www.preqin.com) or contact us at [support@peqin.com](mailto:support@peqin.com) for further information.

# Special Research Report: Distressed Debt & Special Situations

## Performance of Distressed Debt & Special Situations Funds:



Preqin has identified 130 general partners, managing a total of 167 distressed debt funds and 79 special situation funds. By combining performance returns of 124 of these funds we have collected a sufficiently large pool of fund data to create performance benchmarks for these specialist fund types.

The graph compares the performance of distressed debt and special situation funds against the benchmark for all private equity benchmark for funds of vintage years 1999 to 2004. The graph confirms that distressed debt and special situation funds have performed very well, with funds of all vintage years consistently outperforming the overall private equity industry, providing excellent returns to their investors.

Investors willing to invest in this specialist industry should always consider that although distressed debt and special situation funds show healthy

median IRRs, there does exist a large variation in returns between the most and least successful fund managers, so fund selection risk is significant.

Recently, increased investor interest in this sector has prompted fund of funds managers such as Morgan Stanley, Goldman Sachs and Siguler Guff to create vehicles specialising in distressed debt investing, offering diversification across different investment styles and managers. Such vehicles provide an excellent opportunity for smaller investors and investors lacking experience in this niche sector of the industry to gain exposure.

The table below summarizes the net performance of some of the best-performing distressed debt and special situation funds showing the potentially substantial returns that funds of this type are capable of returning to investors. Further information is available through Preqin's Performance Analyst database, which has transparent net-to-LP returns for over 3,400 private equity funds worldwide.

### Sample Top Performing Distressed Debt & Special Situations Funds

Fund	Vintage	Fund Size (Mn)	Multiple (X)	Net IRR (%)	Date Reported
WLR Recovery Fund II	2002	400 USD	2.56	88.9	31-Dec-06
KPS Special Situations Fund II	2002	404 USD	2.34	61	31-Dec-06
Carlyle Strategic Partners	2004	211 USD	1.46	56.3	31-Dec-06
OCM Opportunities Fund IV-B	2002	1505 USD	2.42	44.7	31-Dec-06
TowerBrook Investors	2001	1000 USD	2.88	41.8	31-Dec-06

# Special Research Report: Distressed Debt & Special Situations

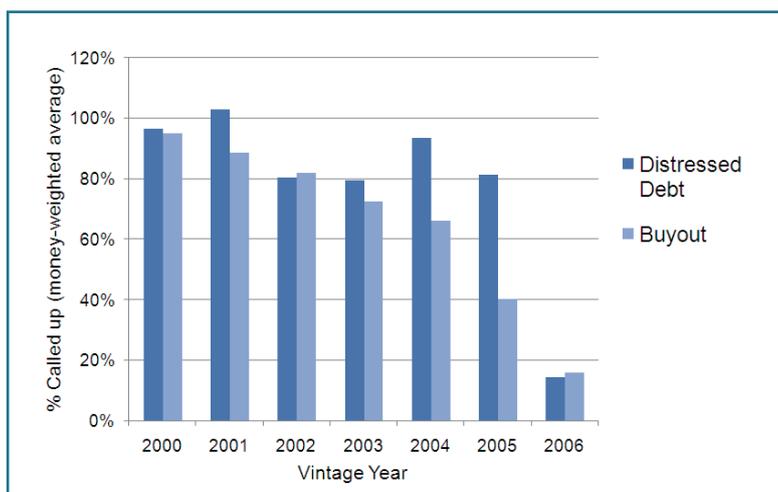
## Rate of Call Up & Dry Powder:

With 2006 being a record year for distressed and special situations fundraising, and 2007 already having surpassed the 2006 record (as of August 15th), it is important to ask whether these record amounts of funds raised are being called up and invested equally quickly, or whether there is a risk of an excessive build-up of 'Dry Powder' that could depress returns and dampen future fundraising?

However, far from there being any overhang of uncalled capital, all the evidence suggests that distressed and special situations managers have had no trouble in putting the newly-raised funds to work. The table and graph below shows the rate of call-up of capital by distressed debt funds raised over the period 2000 to 2006, with the chart showing the percentage of committed capital that had been called up by December 2006, comparing this with buyout funds as a benchmark.

*Benchmark Call-up of Distressed Debt Funds vs. Buyout Funds*

Fund Vintage	Fund Type	
	Distressed Debt	Buyout
2000	97%	95%
2001	103%	89%
2002	81%	82%
2003	80%	73%
2004	93%	66%
2005	81%	40%
2006	14%	16%



It is quite clear that the funds raised in the most recent vintages (2004 and 2005) have been called up and invested very quickly indeed. The average 2004 vintage distressed debt fund is now almost fully invested (93% called, as compared to only 66% called for buyout funds), and the average 2005 vintage fund is well on the way also (81% called, as compared with only 40% for buyout funds.) The 2006 vintage funds (many of which were raised in the third quarter or subsequently) were only 14% called by December, as would be expected.

The rapid rate at which newly-raised funds have been put to work provides an encouraging outlook for fundraising – 2007 has already broken 2006's record, and there is no sign of any slow-down in the pace. (It is also great news for LPs in terms of their management fees being spread over a larger invested base.)

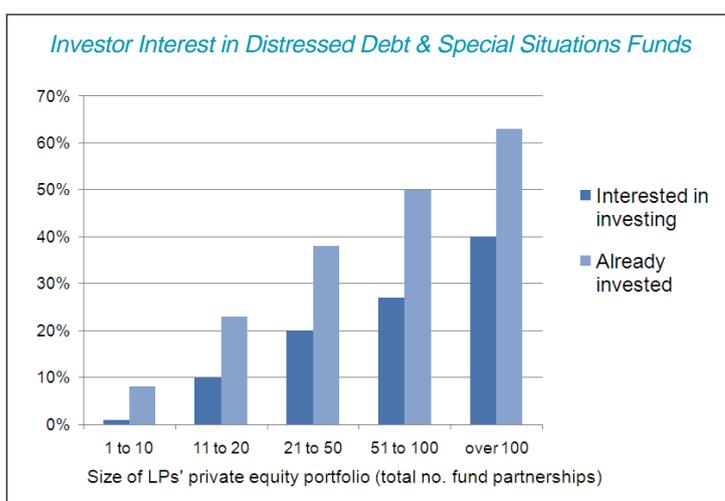
Based upon the volume of funds raised over these recent vintage years, and the percentages already called up, we estimate the current amount of 'Dry Powder' available to GPs at \$40 billion globally – certainly a significant sum, but no signs yet that it is in any way excessive.

# Special Research Report: Distressed Debt & Special Situations

## Investors in Distressed Debt & Special Situations Funds:

With the excellent returns that distressed debt and special situations funds have generated for their investors, one would expect them to be on the radar screen for a growing number of LPs. The evidence bears this out: Preqin's database of LP profiles includes nearly 400 separate LPs that have either already invested in these funds, or are including them in their current investment plans.

Distressed debt and special situations funds are clearly specialist in nature, and are therefore of greatest interest to the more experienced LPs, and those with larger private equity programs. The graph below demonstrates this – with the proportion of LPs who have already invested in these funds rising from only 10% of LPs with small PE programs (11 to 20 funds) to 40% or more among those LPs with extensive portfolios of 100 funds or more. (These statistics count only those LPs where Preqin knows which specific distressed or special situations fund the LP has invested in, and so probably understates the true level of participation in these funds.)



Interestingly, a growing number of LPs are expressing interest in investing in these funds, and the interest in investing in these funds is also spreading down into the smaller LPs – as might be expected as the funds have performed well and grown to the point where more and more LPs will consider them to be in the mainstream.

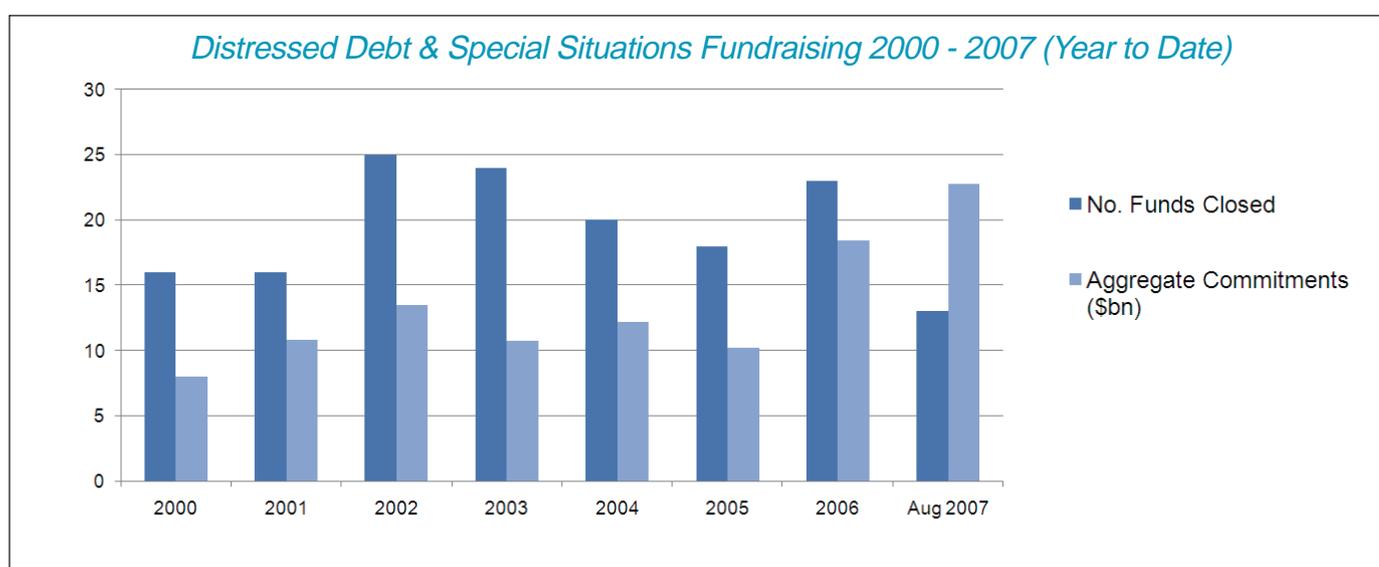
Looking at the most recently raised funds, the table below lists some of the LPs known to have made commitments to 11 distressed debt and special situations funds that achieved their final closes during the period January to June 2007. The list of LPs includes many of the largest US public pension plans, but also a number of international investors, insurance companies, asset managers and others. The mix of LPs will clearly broaden further as distressed and special situations funds grow into a mainstream choice for investors.

Fund	Sample Investors
OCM Principal Opportunities Fund IV	Australia Post Superannuation Scheme, Kuwait Financial Centre S.A.K.
Cerberus Institutional Partners (Series IV)	Allstate Alternative Investments, Pennsylvania Public School Employees' Retirement System, Indiana Public Employees' Retirement Fund, Glenmede, Los Angeles Fire and Police Pension System
OCM Asia Principal Opportunities Fund	Public School Retirement System of Missouri, Indiana Public Employees' Retirement Fund
Alchemy Special Opportunities Fund	California State Teachers' Retirement System, West Midlands Pension Fund
TPG Credit Strategies	California Public Employees' Retirement System
Sankaty Credit Opportunities Fund III	Pennsylvania State Employees' Retirement System, Los Angeles Fire and Police Pension System, San Francisco City & County Employees' Retirement System
CVI Global Value Fund	Pennsylvania State Employees' Retirement System
Varde Fund VIII	New Hampshire Charitable Foundation
Clearwater Capital Partners Fund III	California Public Employees' Retirement System
Unitus I	Kensington Investment Group, Kensington Capital Partners, Omidyar Network
1903 Equity Fund	Varma Mutual Pension Insurance Company, Key Capital Corporation

# Special Research Report: Distressed Debt & Special Situations

## Funds Closed:

We have thus far examined how distressed debt funds are being called up at a fast pace, and have looked at the excellent returns that funds of this type can potentially provide to investors. With an increasing number of opportunities for distressed managers, and with a strong track record to draw upon for many managers, are firms enjoying success in the fundraising market, and what does the future hold for the industry?



As the above graph shows, 2007 is already a record year for distressed debt and special situations fundraising. A total of thirteen distressed funds have achieved a final close by August 2007, raising \$23bn in aggregate commitments. This already exceeds the previous record year of 2006, when 23 funds had a final close raising an aggregate \$18bn.

It is interesting to note that the average fund size has also increased over the past few years, with the average fund closed in 2007 being almost \$2 billion in size. Fuelled by strong returns, high levels of investor appetite has enabled the more established firms to raise funds of ever increasing size. Further information is available through Preqin's Funds in Market Database.

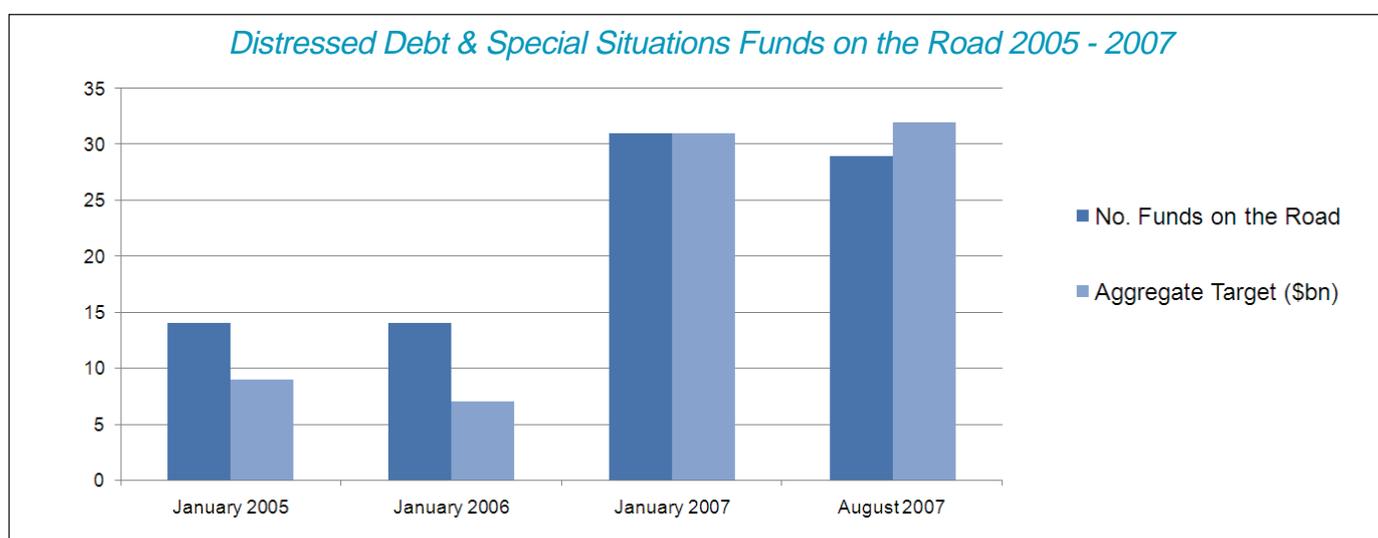
### *Largest Distressed Debt & Special Situations Funds Closed in 2007*

Fund	Firm	Fund Size (Mn)	Manager Location
Cerberus Institutional Partners (Series Four)	Cerberus Capital Management	7,500 USD	US
CVI Global Value Fund	CarVal Investors	5,750 USD	US
OCM Principal Opportunities IV	Oaktree Capital Management	3,000 USD	US
Sankaty Credit Opportunities III	Sankaty Advisors	2,000 USD	US
Clearwater Capital Partners III	Clearwater Capital Partners	900 USD	US

# Special Research Report: Distressed Debt & Special Situations

## Fundraising:

The record-breaking levels of fundraising and growth in average fund size demonstrates the high levels of enthusiasm currently being shown to distressed vehicles by investors - hardly surprising when the excellent returns that these funds have been providing are taken into account. Has recent fundraising depleted the stock of new funds currently looking for investors, or is bumper fundraising set to continue over the next twelve months?



Between 2006 and 2007 the number of distressed debt funds and special situations funds on the road rose dramatically, from just 14 funds targeting \$7bn in January 2006 to 31 firms targeting \$31bn in January 2007. During 2007 a record number of funds have achieved a final close, but the number of new vehicles hitting the road has kept pace with this, so the stock of new vehicles on the road being as good now as it was at the beginning of the year. Excellent news for investors seeking new fund opportunities. More information is available through Preqin's Fund in Market database.

With such an excellent stock of vehicles on the road, and with investors appetite running at such a high pace, fundraising for distressed debt and special situations is certain to remain strong throughout 2007. If fundraising in the remainder of the year keeps pace with funds closed so far, and the evidence suggests that it will, then we predict fundraising for 2007 will exceed \$30bn by year end.

### *Largest Distressed Debt & Special Situations Funds Currently on the Road*

Fund	Firm	Fund Size (Mn)	Manager Location
MatlinPatterson Global Opportunities III	Matlin Patterson Global Advisors	4,500 USD	US
Avenue Special Situations V	Avenue Capital Group	4,000 USD	US
OCM Opportunities Fund VII	Oaktree Capital Management	3,500 USD	US
MHR Institutional Partners III	MHR Fund Management	3,000 USD	US
Tennenbaum Opportunities Fund V	Tennenbaum Capital Partners	3,000 USD	US

# Private Equity Intelligence

Private Equity Intelligence provides information products and services to private equity and venture capital firms, fund-of-funds, investors, placement agents and advisors across four main areas:

## **Fund Performance**

Transparent performance data for over 3,400 private equity and venture capital funds and fund of funds worldwide. Customers have access to key performance metrics - Called, Distributed, Unrealized Value, Multiple, IRR, Cash Flow - to compare individual funds and firms against each other and the benchmarks.

## **Fundraising**

Comprehensive monitoring of the global market for new fundraising, showing which funds are currently on the road, who has succeeded in closing a fund recently, which LPs committed to the new funds and the firms likely to be raising a new fund in the near future.

## **Investor Profiles**

Detailed, continually updated profiles for over 3,500 LP investors worldwide plus a powerful and flexible search tool helping GPs, placement agents, fund-of-funds and advisors to find the LPs that best match their criteria.

## **Fund Terms**

Based upon an exhaustive analysis of data from over 1,100 funds of all types and sizes, Private Equity Intelligence's publications and databases give users unique and valuable information on fees, costs and key terms for all types of funds. GPs, LPs and advisors use it to ensure that negotiated terms are in line with industry best practice.

Our customers can access this market intelligence in three different ways:

- Hard copy publications
- Online database services
- Consulting and research support

**For more information please contact [info@peqin.com](mailto:info@peqin.com) or call us at +44 (0)20 7822 8500**