

PE and Hedge Collide In Debt Deals

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The lines between the alternative asset classes have blurred in recent years. Venture firms take part in LBOs, buyout shops now snatch up distressed debt, and hedge funds have shed their skin to pursue control investments. Nowhere is this more evident than in bankruptcies.

This crossover in investment palates has been seen for years, but some recent examples seem to point to its growing acceptance. Private equity shop Silver Lake Partners is currently knee-deep in MCI debt, while the Ed Lampert-run-hedge fund, ESL Investments, has spent the past year and a half trying to orchestrate a turnaround of the retail tanker Kmart after gaining majority control.

To cater to this, a number of firms, both hedge funds and private equity sponsors alike, have begun raising dedicated investment vehicles to specialize in these deals. Cerberus Capital is an obvious example of this from the hedge fund side, while The Blackstone Group and The Carlyle Group are two of the more notable private equity players with access to distressed debt operations. Also, more recently, Oaktree Capital reportedly scaled back its OCM Opportunities IV and IVB distressed debt vehicles while simultaneously unveiling a \$1 billion private equity fund. (News reports indicate, though, that the firm is back in the market to raise money for the OCM Opportunities Fund V, which has a \$1 billion target.) In contrast, buyout shop H.I.G. Capital recently unveiled its first fund dedicated exclusively to distressed situations, while Sun Capital is reportedly in the market for its own securities vehicle.

"There are several instances when it makes sense for a private equity firm [to get involved in debt restructuring]," WL Ross & Co. Chief Executive and Chairman Wilbur Ross says. "First is that it gives you standing in the bankruptcy case, so you can play a role in the court proceedings. Second, if you buy a large enough stake, you can become a party of substance and that helps you add some influence to the process. And third, in the event someone else outbids you, it gives you a way to recoup what you spend on fees and legal counsel."

From the hedge fund's perspective, accumulating distressed debt can give firms the option to either wait out an investment until control is attained or flip the investment for a quick profit. While that decision often comes down to the dictate of LPs, if a fund can lock up commitments for an extended period of time, the option to hold tight or sell quick allows a great amount of flexibility.

"We use debt as an M&A tool," Longroad Asset Management Fund Manager Paul Coughlin says. "We look for companies that are operationally stable but financially challenged or stressed... Our game plan is to make our entrance through the creditors. We have the ability to look at more things because it doesn't have to be consensual, but we won't switch hats from creditor to a private equity holder until we're sure it makes sense."

Private equity and hedge funds may step on each other's toes as this convergence moves along, but that's not to say they're necessarily playing the same game. "It's really a different investor experience. Distressed debt is a world apart than just going in and doing a friendly buyout," Blackstone's Restructuring Group Head and Senior Managing Director Arthur Newman notes.

Robert Del Genio, a founding member at financial advisory firm Conway, Del Genio, Greis & Co., says that one of the primary differences is the composition of the firms participating in the asset classes. For a hedge fund with a distressed debt trading platform in place, it can be easier to move in and out of debt positions, while a private equity firm may have more resources available to affect change once control is achieved. "Sometimes it can be tricky for private equity firms to crossover [into buying distressed debt], which is why you'll often see private equity firms get in on the back end of a restructuring," he says. "Hedge funds already have distressed trading systems in place and can use their different businesses to their advantage."

The convergence of private equity and hedge funds also meets a fork in the road when the different groups defend their approach. Buyout shops contend the expertise isn't in accumulating debt, but rather in guiding the business once the investment is made, while distressed debt buyers argue that buyout firms are too lead-footed to reap the utmost rewards from a turnaround.

The Value-Added Approach

Michael Psaros, a founder and one of the managing principals at KPS Special Situations Funds, says, "Not a lot of value is created by playing with capital structures...Achieving control of a company by buying its bank debt or distressed securities only buys you a ticket to an opportunity. Thereafter, the new owner of the business has to spend months or years in the trenches, getting his hands dirty to affect a turnaround and create value."

KPS, which makes no qualms about buying in near the end of the bankruptcy process, has seen success by working with the company and its creditors on the restructuring. In the case of KPS's investment in New Flyer Industries, the firm took control of the company through an out-of-court restructuring that featured a renegotiation of the terms and conditions of the senior bank debt. Additionally, KPS worked with the bus maker's trade creditors to term out their exposure in the form of a note and obtained a subordinated loan from the Province of Ontario. This allowed KPS to put the entirety of its \$28 million investment into the company as working capital.

Once KPS gained control of New Flyer, the firm then went to work on the turnaround of the operations, which entailed bringing in new management, reducing the cost structure and pursuing other initiatives to pull the financials back into positive territory. The firm, in a little less than two years, was able to put up the rare 10-bagger on the exit, achieving a return of more than 10x its investment.

The Value-Finding Approach

The straight distressed debt investors, meanwhile, take the stance that by moving on a company before the conclusion of a bankruptcy, or even the start, the rewards are generally fatter in the absence of an auction crowd, while the risk is blunted by the potential upside in their debt positions. The drawback is that in most cases there isn't as much information to back up an investment as there is at a later stage in the process. Longroad's Coughlin compares it to a jigsaw puzzle, noting that in a 100-piece puzzle, private equity needs 95 pieces before they'll invest, while the distressed debt players will move on just 70 pieces.)

Additionally, he adds, "Private equity basically wants the answers to the test before they will invest, but they end up paying substantially more."

One notable win for the hedge funds, that also served to remind private equity to the benefits and traps of distressed debt investing, was the acquisition of Regal Cinemas by Anschutz Corp. and Oaktree Capital in October 2001. In January of that year, the hedge funds began stockpiling Regal's public debt amid creditor concerns the company would have to file for bankruptcy. Regal Cinemas, at the time, was a portfolio company of Kohlberg Kravis Roberts & Co. and Hicks Muse Tate & Furst, which jointly purchased the business for roughly \$1.6 billion in 1998.

Anschutz and Oaktree started with a \$350 million grab of Regal's bank debt in

2001 and followed up later that year by gaining control of Regal's high yield notes, giving the tandem roughly 70% of Regal's bank debt and 95% of the company's junk bonds, according to published reports.

In March 2001, *The Wall Street Journal* reported that KKR and Hicks Muse considered pursuing a recapitalization in order to regain control of the business. Their plan entailed rounding up commitments for \$600 million of new debt, and proposed buying Regal's \$1 billion of bank debt for 80 cents on the dollar. However, by the time the plan emerged, it was too late as Anshcutz and Oaktree already had control and didn't even blink at the prospect of losing its hold on the business. When the company emerged from bankruptcy, the hedge funds walked away with an over 80% stake in the business. Regal, which went public in 2002, has been a bonanza for the investors, and serves as a modern-day landmark deal in the distressed debt arena.

A Crowd at the Intersection?

As more capital flows into the space, some wonder where the money will go. Latham & Watkins' Mark Broude, a partner in the law firm's global insolvency practice, says, "With each recession that comes around, the number of funds [that target distressed debt] is exponentially larger than the recession before. There's definitely more money chasing deals, but the amount of deals has not necessarily grown in tandem with that."

While a number of private equity players see a convergence in the turnaround part of the industry, the everyday, generalist firms are not necessarily overly eager to get into the space. One source, who works at a firm with its own distressed debt operations, notes that the option is there if they want it, but buying up distressed debt as a means to gain control is not something they will go out of their way to pursue. "It's an interesting way to gain a foothold into a potential investment opportunity, but in general we've found that those opportunities are fewer in nature than seeking out good companies [in which to invest equity]," he said.

On the other hand, while the entire hedge fund community isn't necessarily targeting control deals either, some believe it is part of the natural progression of a fund to one day participate in control investments. Steven Persky, a founder and fund manager at Dalton Investments, says, "I think it's evolutionary. Our fund is just five years old, but as you get larger and gain more experience, you may start to move into that area. It particularly makes sense if you have a lot of money under management that's locked for an extended period of time. It could be an area we move into eventually."

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