

Distressed Debt

Private market education

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This primer provides an overview of distressed debt and covers the strategy basics, manager value-add, performance, and benefits in an investor's portfolio.



The distressed debt (DD) strategy targets companies that are in financial distress and are at or near bankruptcy.



Managers leverage their legal expertise in debt restructuring, legal expertise, and operational execution to identify, value, and monetize on distressed assets.



The strategy can add an element of counter-cyclical opportunity in a portfolio versus traditional long-only fixed income exposures.

Summary

- Distressed managers target assets in financial or operational stress and aim to monetize investments through normalizing firm profitability, restructuring, or asset liquidation.
- A typical distressed target is a company at or near bankruptcy struggling to meet interest payment obligations from existing cash flows.
- Managers typically acquire debt at significant discounts and extend maturities, defer interest payments, or obtain/provide emergency financing.
- Other actions can involve renegotiating leases and contracts, cutting costs, improving sales, and disposing of non-core assets to improve a company's balance sheet health.
- The opportunity set for DD is typically counter cyclical. Lower corporate earnings growth, higher debt levels, financial tightening and default rates typically provide more situations to invest.
- Historically, the DD median vintage year IRR from 1997 to 2019 was 9.6%. The standard deviation of vintage year IRR was 3.7% over the same time frame.
- In a portfolio, distressed debt can offer an element of countercyclicity in the credit market versus traditional long only fixed income exposure.
- While the potential for returns is high, there are risks. Given the weaker nature of target companies, defaults can be high. The restructuring process may be long and complex. Entry/exit timings matter.
- Other, more general private market risks also apply, including significant illiquidity of fund vehicles, limited control, and additional fees.

This report is part of a series of short primers on specific private market strategies. For a deeper understanding of private markets, [please read our Introduction](#). Find more information on the client portal or contact your advisor for assistance.



9.6%

Median vintage year IRR



1.36 x

Median TVPI (total value to paid in) multiple



-1.75%

Lower quartile IRR*



27.08%

Upper quartile IRR*



0.63

Correlation to public leveraged buyout

Source: Pitchbook, UBS estimates based on historical data for vintage years between 1997-2019. *Quartile IRR's reflect Pitchbook min and max values for lower and upper IRR's, respectively. Data as of December 2023

What does the distressed strategy do?

Distressed debt (DD) and special situation strategies represent USD 440bn, about 3.5% of private markets AUM.

Target investments

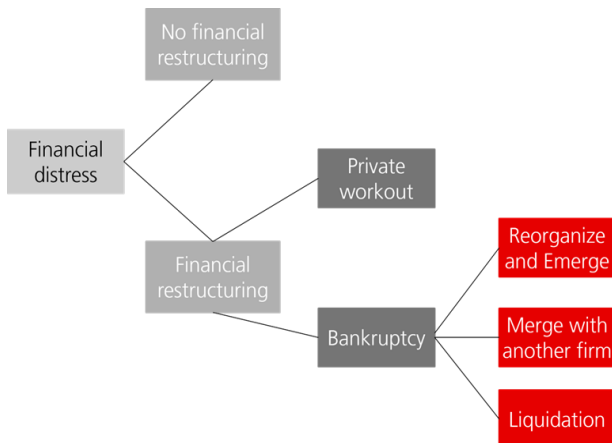
- The distressed debt strategy targets companies that are in financial distress and are at or near bankruptcy.
- The strategy aims to monetize investments by extracting maximum asset value through normalizing firm profitability, restructuring, or asset liquidation.
- Distressed securities are often undervalued by the market given:
 - 1) difficulties conducting financial analysis on troubled companies,
 - 2) presence of complex legal situations, and
 - 3) lack of reliable external sources of information on the company.

How does stress arise?

- A typical distressed target is a company at or near bankruptcy. These companies are struggling to meet their interest payment obligations from existing cash flows.
- The company can enter distress as a result from over leveraged balance sheets, loss of competitive position, litigation/regulatory challenges, or lack of access to capital.
- The distressed borrower can be publicly traded or private. Opportunities to purchase distressed debt can present themselves when debt owners (mutual fund or institutional investor) are mandated to sell out of the distressed credit given holding restrictions. Additionally, DD funds can identify private borrowers with businesses that are not tracking to plan.

Fig. 1: Illustration of financial distress

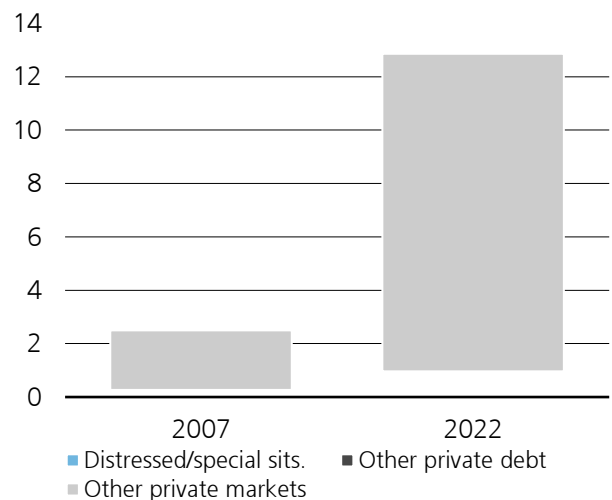
Distressed investing can involve various scenarios, with or without court involvement



Source: UBS

Fig. 2: The private market industry has grown rapidly in the last decade

With over USD 400bn, distressed/special situations represent about 3.5% of total private markets AUM



Source: Pitchbook, UBS. Total exposure as of year-end. December 2023

Restructuring process

Distressed debt managers perform financial analysis to estimate the cash flows and liabilities of the underlying company, along with legal due diligence to understand contractual rights and obligations to help navigate bankruptcy laws.

- Active distressed debt strategies can accumulate large positions in a company's debt or equity at steeply discounted prices to gain a controlling position to influence decisions.
- The distressed position may require a restructuring to reorganize outstanding obligations to keep the company in business.
- During a restructuring, DD managers can help extend maturity dates, defer interest payments on outstanding debt, or obtain/provide emergency financing. Other actions can involve renegotiating leases and contracts, cutting costs, improving sales, and disposing of non-core assets. The fund can also form creditor committees and serve on the board of directors to influence outcomes.
- The DD fund can exchange part of their debt with post reorganized equity positions that can enhance returns upon company recovery.
- The restructuring process can be accomplished through a private workout between lenders and borrowers to renegotiate terms on the loan that is in default. Out of court workouts can be less costly and provide flexibility in negotiating terms versus going through bankruptcy courts.
- Though more costly, bankruptcy courts can provide formal legal protection against creditors and allow for the company to continue as a going concern.
- Otherwise, the company can be liquidated if the company's value as a going concern is deemed worth less than the company's assets. In this case, a DD fund that purchases debt (usually senior in the capital structure) at a steep discount may profit if the recovery value is higher than the purchase price.

Holding period and exit

- A typical investment period is around 3-5 years, with the life of the fund averaging 10 years.
- Returns are primarily derived from capital appreciation as debt purchased at discounts are 'pulled to par' from refinancing or settlement of held securities (for example, purchase debt at 50 cents on the dollar, recover 70 cents), plus any income distributed from debt securities. Returns can vary depending on leverage use, which tends to be limited.
- Multiple exit options for post reorganized assets include a sale to a strategic buyer, IPO, recapitalization with existing owners, or the sale of securities back into the market.

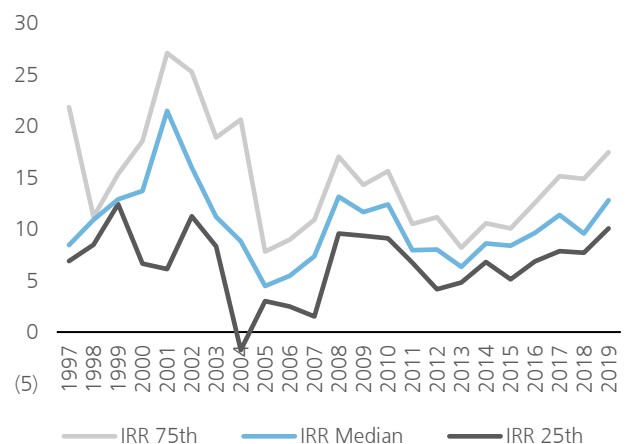
Sources of value-add

DD managers leverage their experience in financial analysis, legal expertise, and operational execution to identify, value, and monetize on distressed assets.

- *Extensive sourcing capabilities:* Managers that have deep industry knowledge and a network of financial/legal advisors can source a wider net of potential opportunities and provide a first mover advantage for transactions and thereby avoid competitive auctions.
- *Rigorous credit analysis:* Rigorous fundamental credit analysis helps evaluate the merits and nuances of each situation, especially for more complex and illiquid assets that are difficult to value. Experience across multiple credit cycles can provide better insight into potential opportunities.
- *Flexibility across region, sector, capital structure:* Flexibility to invest across different countries, industries, and across various parts of the capital structure (debt and equity) can widen opportunities in different macro environments.
- *Legal expertise:* Fund teams will require extensive resources to carry out legal due diligence. Knowledge of regional bankruptcy laws and credit agreements are crucial to navigating the distressed investment process.
- *Restructuring experience:* Exerting influence among other creditors, formulating/executing restructuring plans, and making operational changes to stabilize cash flows can help improve portfolio company prospects.
- *Managing the exit process:* Fund managers engage with investment bankers and solicit buyers to negotiate exit options on behalf of investors to best monetize invested assets. Managers must also time exits appropriately, given the potential cyclical nature of underlying holdings.

Fig. 3: Distressed debt IRR per vintage year 1997-2019

High level of dispersion within each vintage year shows the importance of manager selection (in %)



Source: Pitchbook, UBS, December 2023

Performance analysis

Introduction to vintage year returns

- Private market returns are assessed using vintage year, the year in which the first influx of capital is delivered to a project or a company.
- For example, if hypothetical fund ABC reported vintage year 2005 IRR of 15%, ABC was inceptioned in 2005 and the IRR reflects all investment activity performed over the course of its lifecycle: contributions and distributions made in 2005, 2006, 2007, etc., until the end of the fund.
- If hypothetical fund XYZ reported vintage year 2008 TVPI of 1.3x, the fund returned USD 1.30 for every USD 1 invested through the duration of the fund's life.

Historical performance

- The DD median vintage year IRR from 1997 to 2019 is 9.6%. The standard deviation of vintage year IRR is 3.7% over the same time frame.
- The DD median vintage year TVPI from 1997-2019 is 1.36x. The standard deviation of vintage year TVPI is 0.19x over the same time frame.
- We observe a wide range of IRRs for each vintage year, highlighting the importance of manager selection when considering distressed debt strategies.

Distressed debt and the business cycle

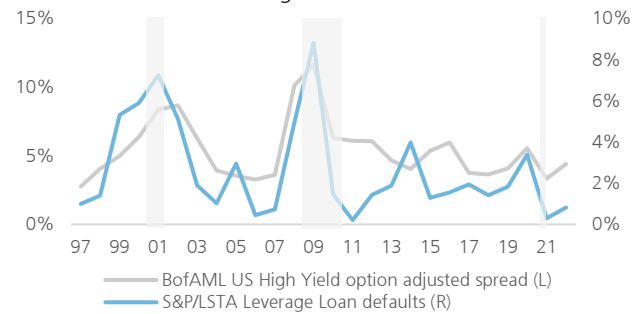
- The opportunity set for DD is typically counter cyclical, with lower corporate earnings growth, higher debt levels, interest rates, and default rates supportive for DD strategies.
- However, we note that managers that employ broader 'special situations' strategies can provide liquidity in markets experiencing dislocations caused by non-macro/idiosyncratic factors, which can present potential opportunities across the economic cycle.
- Distressed debt returns experienced vintage year median IRR peaks during market stress (2001, 2008). These years produced outsized returns given valuation dislocations, limited access to capital, and increased default rates.
- Distressed debt experienced lower median IRR between 1997 and 2005, corresponding to vintage years occurring 3-4 years before equity peaks. During these years, return prospects moderated given benign macro environments.
- Recent vintage years (2011-2018) have also exhibited more moderate returns given the limited number of defaults and dislocations experienced in the credit markets.

Distressed debt in your portfolio

- Distressed debt strategies can offer an element of contrarian and countercyclical opportunities in the credit markets versus traditional long only fixed income exposure.
- Distressed debt strategies add idiosyncratic exposure to companies or assets not often traded on public markets.
- While more illiquid than hedge fund distressed debt strategies, private managers can extract differentiated value from adding time and complexity to the reorganization process, with equity exposure potentially enhancing returns.

Fig. 4: High yield spreads and leveraged loan default rates

Widening spreads and higher default rates indicate a supportive market for distressed managers



Source: Federal Reserve of St. Louis, S&P LCD, UBS Estimates. Note: Leverage loan defaults reflect (Last 12 month \$ of defaults) / (total outstanding). December 2023

Risks

- Distressed strategies incur a high level of credit risk with potential widening of spreads and price fluctuations given the troubled nature of underlying companies/assets.
- Managers may face trading restrictions (for legal or market reasons) and may not be able to sell an asset at the desired price.
- Restructuring is a complex process. Many events are beyond the managers' control, including unforeseen regulations, unsuccessful reorganization or miscalculation of underlying assets.
- While managers strive to seek investments across the market cycle, a lack of opportunities can erode investor returns due to fees. Adverse market factors could negatively impact the exit environment for certain investments.
- Given the time and resources required to analyze and work through restructurings, managers may hold fairly concentrated portfolios.
- Reputational risk can arise in investing with distressed debt strategies. Some managers may engage in strategies perceived to be controversial (e.g. vulture investing), which may result in legal action or attract public and media criticism.
- Other, more general private market risks may still apply, including the lack of transparency, illiquidity, high fees, and long term lock up periods.
- These risks cannot be fully eliminated, but can be reduced significantly through thorough due diligence and strict investment and monitoring processes.



Appendix

Selected definitions

- **Correlation:** the degree to which the fluctuations of one variable are similar to those of another.
- **Leverage:** the use of borrowed capital or instruments to increase the potential return (but also potential losses) of an investment, a simple example is a mortgage used in real estate transactions.
- **Leveraged buyout funds:** a private equity strategy using borrowed capital to gain control of a company.
- **Illiquidity premia:** the premium that an investor can demand depending on how difficult it is to convert the underlying security can be converted to cash.
- **Multiples:** a term that measures some aspect of a company's financial well-being, determined by dividing one metric by another metric. The metric in the numerator is typically larger than the one in the denominator, because the top metric is usually supposed to be many times larger than the bottom metric.
- **Multiple expansion:** describes the way a particular valuation metric increases to reflect a higher value assigned to an underlying investment.
- **Value add:** describes the operational, business, or structural improvements private market managers seek through underlying portfolio investments.
- **Cash flows:** cash flow is the net amount of cash and cash-equivalents being transferred into and out of a fund.
- **Public Market Equivalent (PME):** a method that converts public market returns to a benchmark that can be compared to private market returns.
- **IRR:** a return method used to evaluate private market investments and reflects the discount rate at which the present value of an investment's future cash flow equals the cost of the investment.
- **TVPI (Total Value to Paid In):** a return metric that describes the total capital distributed back to the investor + residual value left in the fund divided by invested capital.
- **Exit:** the time period in which an investor can convert holdings into cash to be liquidated over a designated period of time.
- **IPO:** the first sale of stock by a private company to the public. Also referred to as an "initial public offering."
- **Standard deviation:** a measure of the degree to which individual values vary from the distribution mean. The higher the number, the greater the risk.
- **Dry powder:** refers to cash reserves kept on hand by a private markets firm to cover future obligations, purchase assets or make acquisitions.
- **J-curve:** illustrates a period of initial negative cash flows (contributions) towards positive cash flows (distributions back to the investor) over a period of time.
- **Sponsor:** the general partner in a limited partnership who organizes and signs up investors.
- **Secondary buyout:** describes a sale between private market firms
- **Trade sale/strategic sale:** describes a sale of a business to another business operating in a similar industry.
- **Senior debt:** loans or debt securities that have claim prior to junior obligations and equity on a corporation's assets in the event of liquidation.
- **Junior debt:** loan or security that ranks below other loans or securities with regard to claims on assets or earnings. In the case of borrower default, creditors who own subordinated debt won't be paid out until after senior debt holders are paid in full.
- **Vintage year:** is the year in which the first influx of investment capital is delivered to a project or company. This marks when capital is contributed by venture capital, a private equity fund or a partnership drawing down from its investors.
- **M&A:** mergers and acquisitions is a general term that refers to the consolidation of companies or assets through various types of financial transactions. M&A can include a number of different

transactions, such as mergers, acquisitions, consolidations, tender offers, purchase of assets and management acquisitions.

- **Blind pool:** money collected from several people which is put into a fund and invested for their profit. It is left unspecified which properties are to be acquired.
- **Unit economics:** a measure of direct revenues and costs on a unit basis for a particular business model.
- **Minority stake:** reflects a non-controlling interest that is less than 50% of a particular entity.
- **Spin off:** describes the separation of an independent company from a larger parent.
- **Control provisions:** designed to provide a level of influence over significant operational and business matters.
- **Redemption rights:** gives investors the right to force a company to repurchase their shares after a period of time.
- **Idiosyncratic risk:** risk associated with a narrow set of factors pertaining to a particular company. Risk that has little association with overall market risk.
- **Tag-along provisions:** provides a minority shareholder the right to join in on a sale of a company that is initiated by a majority shareholder.

Non-Traditional Assets

Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- **Hedge Fund Risk:** There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, "junk bonds," derivatives, distressed securities, non-U.S. securities and illiquid investments.
- **Managed Futures:** There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- **Real Estate:** There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- **Private Equity:** There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- **Foreign Exchange/Currency Risk:** Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer's "home" currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a U.S. investor.

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