



## **Distressed Debt Investors in the Current Market**

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The tightening of global credit markets over the past 15 months following years of low interest rates and a permissive lending environment, has brought about conditions in credit markets which many believe will present attractive opportunities for distressed debt funds.

Distressed debt funds, or “vulture funds”, look to acquire the debt of a company that is either bankrupt, or, more often, near bankruptcy, at a considerable discount. This debt can either be purchased in the secondary market from creditors who are either not willing or able to continue to hold it, or from the companies themselves, many of which have become desperate for liquidity as traditional sources of financing have dried up. Once the fund becomes a major creditor of the troubled company, it is able to yield considerable influence over any restructuring or liquidation process that follows. Distressed debt funds will often push a company into receivership at the first available opportunity in order to jump-start the bankruptcy proceedings, a key element of the fund’s investment plan. The purchaser of distressed debt hopes to make a profit either through the liquidation of the assets of the company, or to have its debt converted to equity in a restructuring of the company and to emerge as a major shareholder. Following a transaction of this nature, the fund will operate in a fashion more typical of a buy-out fund, using its position as a major shareholder to initiate change in an attempt to increase the value of its equity stake in the company.

While we have yet to witness a flurry of distressed debt transactions in the Canadian marketplace, signs indicate that many fund managers are waiting for what they judge to be the right time to enter the market. To begin with, there are numerous companies that have been reliant on the inexpensive, easily available credit provided during the last credit boom that no

longer have access to funding. These companies are natural targets for distressed funds who understand the obvious implications of this greatly reduced access to short-term funding. As these funds continue to monitor a deteriorating debt market, they are preparing for action.

During the first six months of 2008, distressed funds raised 38% more funds globally than they did over the corresponding period in 2007. Conventional buy-out fundraising declined 21% over this same period. Currently, there are two large active distress funds in Canada: Tricap Partners Ltd., an arm of Brookfield Asset Management Inc., currently funded with \$1.1 billion from both the parent company and various partners, and The Catalyst Group, which manages \$1 billion of assets.

Some commentators have attributed the lack of action by distressed funds thus far to the continuing uncertainty with regards to the lending practices of the current cycle. While high-risk or “distressed” debt is currently trading at or below the historical recovery rate of this type of debt in bankruptcy, some have doubts whether historical rates serve as a useful guide. These individuals caution that the debt issued over the past few years is of a lower credit quality than that issued in earlier cycles, and may not provide the same return to creditors in a restructuring or liquidation proceeding. Funds will therefore wait for the discount on this debt to increase, or will wait until they are at least able to price the debt with greater confidence.

Others speculate that the best opportunities will come to those that wait. “In bad times we are a little more cautious” commented Raquel Palmer of KPS Special Solutions, at the 2008 Private Capital Symposium hosted by on-line publication “The Deal”. “The companies that are worst in their industry are usually the first to fail, so we’re being cautious here. We think companies that have trouble in the future are going to be the best opportunities”.

Whatever the reason for a lack of immediate action in the distressed debt market to date,

companies should be aware that distressed investors are gathering steam, looking for targets as the current down-cycle in the broader markets continues. Management should keep a close watch on who holds their company's senior debt, whether it be a primary lender or through secondary markets, as distressed investors may be focused on making their returns through a restructuring or liquidation process.

Given the current market and economic conditions, distressed debt investors may be a company's only available source of funding. Borrowers, however, must realize that these funds differ drastically from traditional lenders, both in their motives and their operations.

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*If you would like further information regarding the issues discussed in this update or if you wish to discuss any aspect of this commentary, please feel free to contact us.*

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