INVESTMENT ADVISORY

Distressed Debt

January 2010

PENSIONS

We believe there is a compelling argument to consider investing in distressed debt.

The information contained herein is of a general nature and is not intended to address all circumstances of any particular individual or entity. No-one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

Distressed debt assets are bond investments trading at significant discounts to par, and offer attractive yield spreads, typically in the order of at least 10 percent above government bonds, (reflecting the markets assessment of the asset's risk).

Most distressed debt investors seek to invest in strong companies with weak balance sheets. Investors look to purchase non performing assets, at a significant discount to par with the expectation of profiting when either:

- The debt recovers to par;
- The debt undergoes restructuring and the investors emerge with an equity ownership stake in the restructured business, which subsequently recovers; or
- The debt remains at distressed levels and investors receive a series of high coupon payments.

Distressed debt investing is rooted in fundamental analysis of companies, credit research and a good understanding of documentation, legal environments and legislative frameworks. **As such, distressed debt investing requires a distinct, highly specialised range of competencies, that only specialist investors possess.**

We believe that given current market valuations following the credit crisis, there is an opportunity for clients to benefit from an allocation to distressed debt, over a minimum investment period of 3-5 years.

Background

A large proportion of the existing sub-investment grade debt was issued at the height of the credit bubble between 2003 and 2007. This environment of cheap and abundant credit led many companies to borrow large levels of debt to fund expansion and acquisitions. The majority of debt was issued based on aggressive corporate earnings growth assumptions and low borrowing costs.

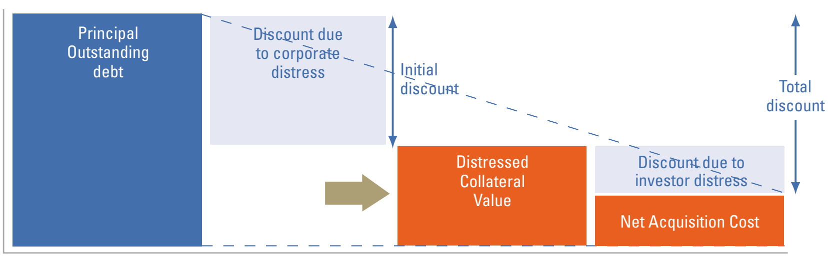
The credit environment has changed fundamentally in the current recession following the credit crunch. Many companies find it increasingly difficult to service aggressive debt levels, from falling profits. As debt falls due, it has also become more difficult to refinance and even if re-financing occurs it is usually on more punitive terms:

- Many debt-laden companies with decreasing earnings and approaching

Typical characteristics of distressed debt*	
Investment horizon	Up to 10 years
Investment period/lock-ups/liquidity	1 – 5 years
Minimum investment/capital commitments	£1m - £5m
Target performance**	15% – 30% p.a. (gross)
Management fee	1% - 2% p.a.
Performance fee	Up to 20% p.a. (subject to a hurdle rate)

*For illustration only. Actual characteristics are dependent on the strategies employed and the types of vehicle used
** Wide band is due to the nature of different investment vehicles available

How are discounts constructed? example investment



Source: KPMG

debt maturities are likely to default or undergo some sort of financial restructuring. As a result a large proportion of debt is trading at distressed levels (Chart 1).

The opportunity

Going forward it is likely that the supply of debt will far outstrip demand in this capital constrained environment and a large volume of credit matures over the next 6 years (over US $1 trillion).

As more debt matures it will become increasingly difficult to re-finance and the already large pipeline for distressed assets is likely to increase.

Providing new capital to heavily indebted companies can allow investors to negotiate favourable terms with existing creditors and company management.

- Distressed debt fund managers take into account potential returns in the event of a restructuring or default and can emerge with ownership of a business (i.e. become new equity holders) following a restructuring exercise.

Distressed debt has a strong historic performance track record (Chart 2).

- The most attractive phase to invest in distressed instruments have been towards the end of a recession after corporate defaults peaked. Consensus views in the market place estimate defaults to peak toward the end of 2009 into 2010, making this an attractive period to invest in distressed assets.

We believe that skilled specialist managers are likely to generate attractive returns and investors with capital (such as pension schemes) are well positioned to benefit from this.

Whilst it is difficult to call markets, and we would not expect Trustees to do so, given the risk/return characteristics of the asset class, along with current valuations, we believe there is a compelling argument to consider an investment in distressed debt during 2010.

Distressed debt fits within the growth component of a portfolio given its risk return profile. Accessing skilled investment managers is key.'

What are the risks?

A more protracted recovery, or a slide back into a deflationary environment for a persistent period of time, could adversely affect corporate profitability and hence performance over the longer term.

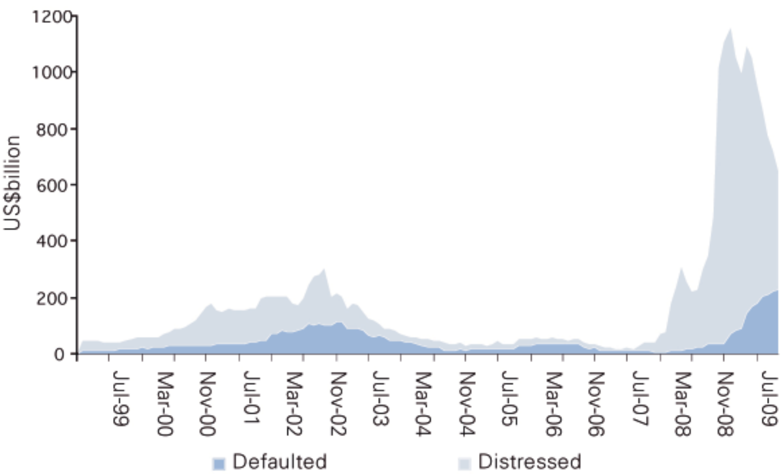
It is likely that the dispersion in the performance of high yield bonds and loans may increase going forwards.

With concentrated portfolios, comparable to private equity funds, manager skill is key, especially in terms of credit research, due diligence and restructuring competence which will be drivers of returns.

The majority of funds are denominated in either Dollars or Euros which introduces currency exposure, although there is a possibility that some managers may be prepared to establish sterling share classes.

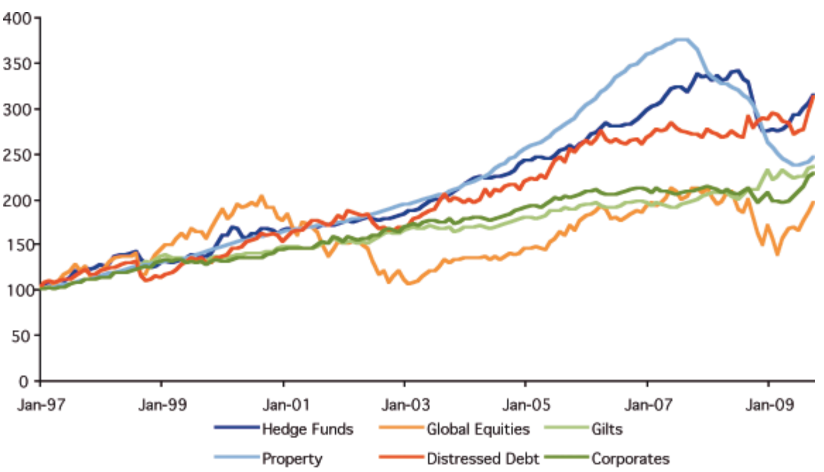
There are political and legal risks that may affect restructuring events and could impact prospects for the asset class as a whole.

Chart 1: Par value of distressed and defaulted sub-inv grade debt



Source: BNY Mellon, S&P Leveraged data

Chart 2: Performance of distressed debt versus traditional asset classes



Source: HFRI, Merrill Lynch, Bloomberg

Note: Cumulative performance rebased to 100 at 31 January 1997

Characteristics	Single Manager Direct	Fund of Fund
Expected return	Higher	Lower
Expected risk	Higher	Lower
Liquidity	Lower	Higher
Investment horizon	Longer	Shorter
Minimum investment	Higher	Lower
Fees	Higher	Lower
Governance	Higher	Lower

How distressed debt could fit in a pension scheme's portfolio

We would view distressed debt as an "alternative" asset class that offers a diversified source of return. We believe it should form part of a pension scheme's growth portfolio as an alternative to equities. We would advise allocations in the region of 5 - 10 percent.

Due to the illiquidity of the asset class it is difficult to come up with reliable correlation assumptions. However based on experience with hedge funds, high yield and private equity, we believe distressed debt will offer some diversification benefits with equities and bonds.

There are a range of approaches to distressed debt investing, which can be accessed through different vehicles, possessing a variety of different characteristics.

How do pension schemes invest in distressed debt?

There are two main types of vehicle that investors can use to access distressed debt:

- Single manager direct access funds (which invest in underlying businesses); or
- Fund of Fund vehicles (which invest in a range of single manager funds).

Both vehicles may be able to invest in a wide range of instruments including direct loans, primary or secondary financing, public or private markets and require the ability to locate, source and execute deals.

Both methods of accessing distressed debt offer different characteristics making them suitable for different client circumstances (as set out in the table opposite).

Summary

We believe that current valuations offer an attractive opportunity for clients to access a strategic allocation to distressed debt via a specialist manager, as part of an allocation to "growth" assets.

Distressed debt investing involves a set of unique skills that the majority of investors do not possess. While this creates barriers to entry and less competition, it also means manager skill will be a critical success factor for this strategy.

The sheer volume of debt that matures over the next few years will likely ensure there is a large pipeline of distressed opportunities going forwards.

With increased defaults and volatility, distressed debt is not a low risk investment. However, despite this, we would expect managers that do possess the necessary competencies to be able to take advantage of this opportunity and generate attractive returns on a risk adjusted basis.

Ultimately given valuations and the point in the credit cycle, it is likely that skilled distressed debt managers are well positioned to benefit.

- We believe that long term investors (like pension schemes) are well placed to benefit from attractive opportunities in this space and now is an opportune time to consider an investment.

We look forward to discussing with you whether distressed debt could

KPMG Investment Advisory View

We believe that the current stage in the economic cycle offers an attractive opportunity for clients to access distressed debt via a specialist manager, as part of an allocation to "growth" assets.

With increasing defaults and volatility, distressed debt is not a low risk investment. However, with the huge volume of debt maturing that will struggle to be refinanced, we would expect to see a large pipeline of attractive opportunities.

We believe that skilled specialist managers with access to capital and the technical expertise to source deals, value companies and manage restructuring events are very well placed to capitalise on these opportunities. However manager skill and manager specific risks are key considerations in this type of investment.

We believe the outlook for distressed debt investing is favourable going forward and now is an opportune time to consider investing.

Investors, with an investment horizon of at least 3 – 5 years, are well placed to capitalise on attractive opportunities with expected returns in excess of c.15 percent p.a. over this period.

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