INTERNATIONAL FINANCING REVIEW

Funds acquire control through distressed assets, as mezz bounces back
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Funds are increasingly gaining influence over companies by acquiring distressed assets, according to **CP Eaton**, a placement agent that finds institutional investors for asset managers.

"The general consensus is that the opportunity to make significant gains in liquid trading strategies has passed," said **CP Eaton**. "Rather, distressed-for-control remains popular given a wealth of ongoing market opportunities, and given that control funds resemble closed-end private equity funds, they are a natural fit for most investors."

It is particularly evident in mid-cap companies (US$200m–$1bn market cap) that are number one or two in their sector, where demand for their product is still strong and that are backed up by significant assets, for example, machinery or real estate, said Bradi Rodi, a director at **CP Eaton**.

The trend is one part of a broader return in the popularity of private equity and hedge funds, especially in the US and Asia. Mezzanine is particularly attractive, **CP Eaton** said, owing to its diversification, downside protection and attractive returns.

"The demand for mezzanine capital [in the US] is enormous given the private equity overhang and a wave of debt coming due soon that will drive a flood of refinancings," said **CP Eaton**.

The exit of many from the sector, including hedge funds and business development companies, has created a shortage of mezzanine financing to meet demand it believes could total US$400bn over five years – or double that when refinancings are taken into account. According to Preqin, an information provider for the alternative investment industry, today's demand coming from mezz funds is about US $21bn.

There is no sign of an end to the supply of distressed portfolios coming on to the secondary market in the US, although forced selling has allowed buyers to focus exclusively on deeply discounted deals, discouraging some sellers, and bid-ask spreads have also proved prohibitive.

The "residual effects from the credit crisis continue to apply pressure on [asset] managers to unload non-core portfolio holdings", said **CP Eaton**. It expects 2010 to witness renewed activity as buyers and sellers align expectations. "A recent industry study predicts the secondary volume of partnership interests to double this year compared with 2009," it said.

Meanwhile, Gamma Finance, a financial boutique providing alternative investment services and specialising in helping investors acquire these kinds of portfolios from asset managers looking to liquidate their positions, is officially up and running, having been awarded FSA approval.

Gamma was founded by Deutsche Bank's former head of structured equity sales for Europe, *Florian de Sigy*, and *Javier Rodriguez*, previously senior strategist and head of strategic accounts in Barclays Global Investors' clients' solutions group.

The firm is looking to exploit the increasing number of such opportunities that arose from the spike in the imposition of gates and the creation of side pockets, where illiquid assets are ring-fenced and locked up until their value rebounds.

"This process has left many investors with the urgency to reorganise their alternative portfolios, creating several disposals that are perceived as long-term investment opportunities by professional investors," said de Sigy.

The firm's strategy is to actively analyse such distressed situations and facilitate introductions with appropriate investors with matching risk profiles. In this way it distinguishes itself from the more passive approach taken by the investment banks, according to Rodriguez.

The firm currently has four employees, with two more – one analyst and one relationship manager – set to join soon, and with business coming from Europe, the US and Asia.

Rodriguez acknowledged that the business has come about because of the excess of distressed or restructured assets currently in the market, estimated at more than US$10bn, but predicted an active secondary market in such securities would remain when the business cycle turned more favourable.