what's the alternative?

When it comes to sources of turnaround capital for stressed and distressed assets, necessity and opportunity are causing the Australian market for capital to mature, reflecting a powerful structural change in funding models.

Cast your mind back 10 years. There were some seemingly unassailable certainties at that time: Justin Timberlake would be in the top 10, John Howard probably wouldn't win the next election... and there were only two material key domestic funding markets for Australian corporates – the traditional banking sector for debt and capital markets for equity.

Today, necessity has turned into opportunity for a range of alternative investors, including Australian and international hedge funds, special situation funds and others. "The banking sector has been less willing to lend to this market given their stronger desire to manage their impaired loan books, limit sector exposure and the impact of new capital adequacy requirements," comments Raj Bhat, Partner, Debt Advisory Services at KPMG.

"At the same time, it has taken some time for the traditional banking sector in Australia to fully adopt the secondary debt trading market operating very efficiently across the globe – they have less of an appetite to trade their way out of distressed situations," he says.

Matthew Woods, Head of Restructuring Services at KPMG adds, "this is not unexpected as the traditional banking sector in Australia quite rightly pride themselves on being relationship bankers."

Turning points

The 2010 recapitalisation of Alinta was a significant turning point, with private equity behemoth TPG and Oaktree executing a landmark debt-for-equity-swap acquisition that was a watershed transaction for the Australian market.

"Australia has caught up to the rest of the world in terms of alternative funding sources for stressed and distressed assets. This is a market that has been mature in Europe, the US and parts of Asia for some time. These alternative investors started to look for opportunities in Australia around the recapitalisation of Alinta and the Channel 9 Group, and more recently we've seen similar deals, such as Billabong, Boart Longyear and most recently McAleese Group," comments Woods.

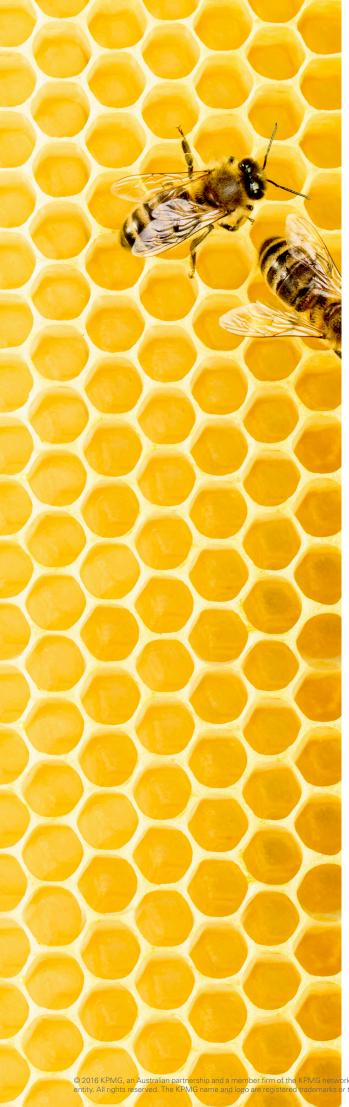
Growth in the distressed market is currently being driven by structural change in the energy and natural resources markets due to a sustained period of depressed commodity prices and most recently by significant shifts in oil and gas prices. "We've been left with mining and mining services businesses that have experienced significant growth over the 12 years to 2014, but are now dealing with a cooling market," says Woods. "This has left many businesses heavily over leveraged."

There are also pockets of activity in the distressed market in the property and retail sector. "These sectors rise and fall on the confidence of consumers," notes Bhat.

A deep pool

There's no lack of interested buyers in the alternative universe. More and more offshore funds are active in Australia.

Comments Woods: "The reason players are coming to Australia is that it's a relatively easy market for them to understand in terms of how it's regulated.



And there has been that lack of capital for turnaround scenarios as it is not a market the big four banks traditionally play in." We've seen an influx of international funds from US, Europe and the Asia set up shop here over the last 12 months and the advent of a wide variety of homegrown funds.

At the same time, special situation funds are also growing as part of the alternate investor universe, including players like Arowana International, Helmsman Funds Management, Macquarie Special Situations Fund and Anchorage Capital.

"Special situation funds and hedge funds have a greater appetite to take aggressive positions in business and then seek to implement rapid operational and financial turnaround through their own in-house turnaround management experts. The traditional banking sector is not set up to do this," comments Bhat.

What investors want

There are some growing pains to be navigated with this investor base. It's highly competitive, which means there are some frustrations with the delta between valuations that they perceive on an asset versus the sellers of the debt. But this will resolve over time.

The consolidation in the market over the last two years also reflects a growing understanding of how this market works. "Whilst there has been significant offshore capital looking for deals, many of those deals haven't gone forward. So we have seen some rationalisation of players," notes Woods.

While the funds appetite can differ, typically they're after 3-year terms. "The size of deals they're interested in has changed significantly," says Bhat. "Previously anything under \$100 million wasn't really of interest, but now we see them playing heavily in the mid-market space and coming in as low as \$20 million." This reflects a general trend towards mid-market M&A, where there is more activity in the market, he adds. "Some of these offshore players can also feasibly do longer term funding – up to 7 years," comments Woods, providing the business has an adequate runway to turnaround its operations.

Some offshore fund managers are also raising capital locally and combining their offshore funds with a local AUD fund in order to reduce their overall costs by eliminating the need to swap funds back into their home currencies. This may well help to reduce the delta in the valuation between the investors and the sellers of debt.

Ultimately, as market conditions continue to exhibit a high degree of volatility either as a result of commodity price movements or disruptive new businesses, corporates will need to seek support from alternative funding sources to help them trade through these events. The good news is, new and alternative pockets of liquidity are emerging for Australian borrowers and they are here to stay as a permanent feature of the Australian debt and equity capital markets.

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