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Asia Pacific Distressed Debt & Special Opportunities Outlook 2012

April 2012

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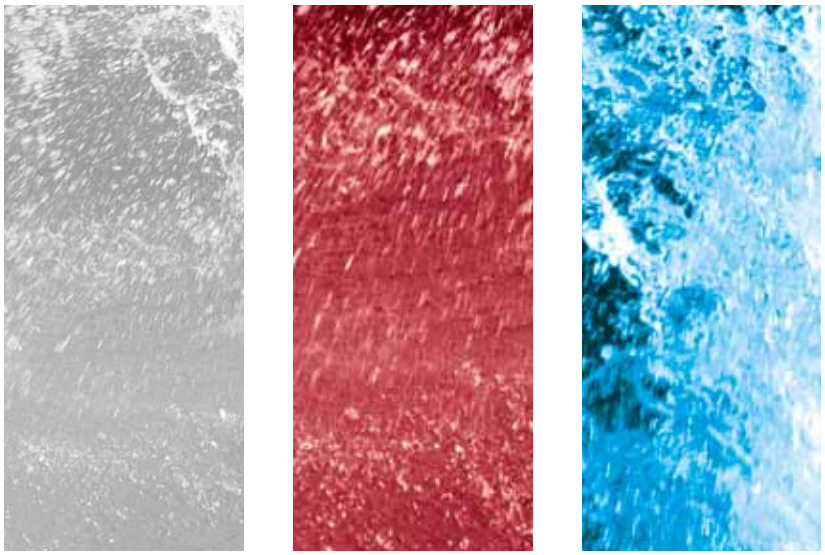

ASIA-PACIFIC DISTRESSED DEBT & SPECIAL OPPORTUNITIES OUTLOOK 2012

APRIL 2012

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CONTENTS

FOREWORD

Problems in the eurozone are far from being resolved and economic problems lurk almost everywhere else in the world, but these concerns are once again being pushed to the side as central bank printing presses flood global markets with liquidity. It is in this context that respondents to this survey are looking at Asia's distressed debt and special situations market with a mixed and cautious view.

The picture that emerges from this survey is that while a severe funding squeeze for Asian corporates isn't expected, liquidity will be tighter and funding costs will rise as European banks continue reducing their exposures in the region. With European banks scaling down their Asian operations, US and Asian banks will be able to provide ample liquidity but at a higher cost, according to 52% of the survey's respondents. While 39% of respondents say significant liquidity shortages could occur as European banks withdraw from Asia, many also point out that hedge funds and prop desks will likely step in to replace banks as lenders. However, 22% say hedge funds and prop desks will decrease Asian investments in favor of Europe.

With borrowers likely to find it tougher to obtain commercial bank loans, 60% of survey respondents say they expect volumes for the primary mezzanine loan market to increase, while 35% say it will remain unchanged and only 5% expect a decrease. Similarly, 56% expect CB issuance volumes to pick up in 2012 while 35% expect it to remain unchanged and only 9% expect a decrease. The jury is out for high yield bond issuance: 43% expect an increase against 42% who see volume remaining unchanged and 15% who expect a decrease. The outlook is also mixed for the private placements loan market: only 41% expect volumes to increase while 38% say the market will remain unchanged and 20% expect a decrease.

Clearly, tighter liquidity conditions are expected to generate defaults: 55% of the survey's respondents expect the amount of distressed debt in the Asia-Pacific region this year to increase from 2011 levels, while 26% expect it to remain the same and 19% believe it will decrease.

However, the market appears divided as to how much distressed debt investment will be seen over the course of this year: 40% of the respondents state they expect to set aside more capital for distressed debt while 43% say they will keep their allocations the same and 17% say they will decrease their allocations for distressed debt investing.

It's also a mixed picture in terms of the outlook for market volatility and its impact on liquidity and distress: 34% state they expect volatility will have a greater impact in 2012, 41% say they expect it will be about the same and 25% expect a decline.

While survey results indicate eurozone problems as the most likely cause of an increase in distressed debt over the year, many respondents also cite monetary policy/regulation around the region and the possibility of China's economic bubble imploding as being potential catalysts.

For the third consecutive year, investors see China as their most favored target for distressed debt/special situations investments.

No doubt, China ranks first on the list of countries investors are targeting in Asia for distressed opportunities because of the country's faltering Real estate sector and its flailing export market. The spate of corporate governance scandals exemplified last year by events surrounding Sino Forest also point to the potential for more distressed situations. Given that roughly half of outstanding Asian high yield bond issues are from Chinese property companies and 13% from Chinese industrials, there are potentially many situations that could provide interesting opportunities for investors.

Meanwhile, for the second year in a row, survey respondents see Japan and Australia as the second and third most targeted countries for distressed debt/special situations investments.

Indeed, these results are in part reflected by expectations for loan sales by banks: 70% of respondents say sales of Japanese loans will be most pronounced, followed by Australia/New Zealand and Indian loans.

Indonesia, in previous years a favorite target for distressed debt/special situations investors, seems to be getting scant attention in 2012, ranking behind India, South Korea, the Philippines and Malaysia. This is perhaps a reflection of Indonesia's improving fundamentals, ample local liquidity and the relative absence of high yield bond issues and private placement loans from the country since the 2008 financial crisis.

In terms of indentifying special situation/distressed debt opportunities in Asia, 62% of survey respondents say they expect private equity investments to be the most attractive over the course of this year and 48% point to secondary market trading as offering the potential for good returns. Opportunities arising from convertible bonds, corporate asset sales, debt-to-equity conversions and amend and extend situations also look to be popular menu items, as investors sample different options amid a challenging but potentially rewarding investment landscape.

Luc Mongeon
Editor
Debtwire Asia

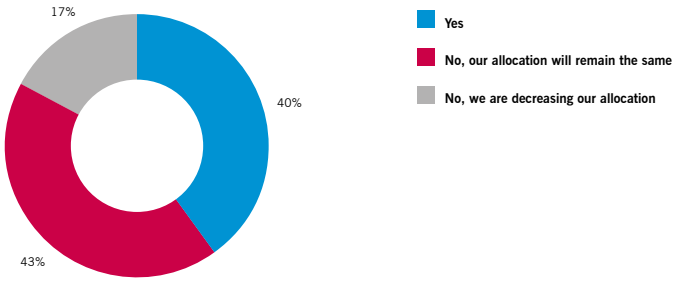
SURVEY FINDINGS

METHODOLOGY

Clifford Chance and KPMG commissioned Debtwire to canvass the opinions of 100 professionals involved in distressed investing to gain their views on Asia-Pacific distressed debt and special opportunities for the coming year. The survey was conducted over January and February 2012, and all responses are presented anonymously and in aggregate.

In 2012, respondents are more bullish with 40% setting aside more capital for distressed debt opportunities than in 2011.

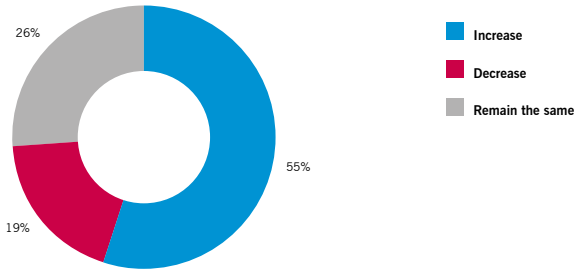
For 2012, is your firm setting aside more capital for distressed debt?



Compared to last year's survey, distressed debt investors are more bullish in 2012. Indeed 40% of respondent firms (compared to 32% last year) have increased their capital allocation to distressed debt this year compared to last year. While 43% expect to match 2011 allocations, only 17% expect to decrease their allocation, which is down from 22% who expected to decrease this allocation last year.

Over half of respondents expect the amount of distressed debt in Asia-Pacific to increase in 2012.

Do you expect the amount of distressed debt in Asia-Pacific (inclusive of Japan and Australia) in 2012 to:

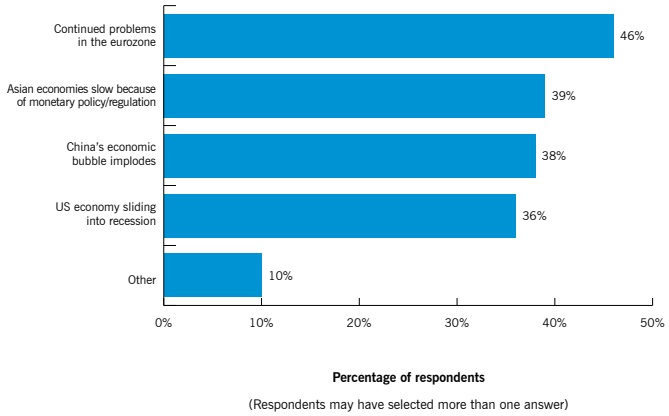


In last year's report, 42% of respondents expected a W-shaped economic recovery. With European economies teetering, further threatening global markets and heightening the prospects for distress, 55% of respondents expect the amount of distressed debt in Asia-Pacific to rise in 2012. Among those expecting such an increase, one respondent explains, "In 2012, there will be a significant amount of non-performing assets that could turn out to be good opportunities for distressed investors. Distressed debt markets in Asia have gained momentum in recent years, and economic crises and reduced demand have only compounded the trend."

With a handful of respondents still uncertain, 26% expect distressed debt levels to remain on par with 2011, and only 19% expect levels to drop. Perhaps representative of this view, one respondent says, "There are still a lot of prospects for increased earnings in Asian markets and the worst performers have already bottomed out. While the market is not yet deleveraged, refinancing should not be an issue for debt holders."

For those expecting an increase in distressed debt, problems in the eurozone are most likely to be the cause.

If you expect an increase in distressed debt, which of the following is/are likely to be the cause?



While there are certainly a number of factors affecting an increase in Asia-Pacific distressed debt, 46% of respondents agree that the most likely cause is the continued problems in the eurozone. Other factors coming into play are threats of slowing Asian economies due to policy changes (39%), an implosion of China's economic bubble (38%) and the US entering another recessionary period (36%).

Around 10% of respondents opine on a varied number of alternate causes for distress in Asia-Pacific markets. These opinions range from instability among banks and a general shortage of liquidity to volatile commodity prices due in large part to the political flux in the Middle East and its effect on crude oil prices.

While many debate Asia-Pacific's ability to withstand a significant downturn in the West, one respondent believes, "The European crisis has not affected Asian markets in the short-term, but a prolonged problem in Europe will adversely affect Asian markets and Asian business in the long-term. Asian markets could start feeling the pinch and slip into distress because many Consumer and Manufacturing companies still rely largely on the European business."

SURVEY FINDINGS

Among those not expecting an increase in distressed debt, many see opportunities in other special situations.

If you do not expect a significant pick up in distressed debt in Asia do you expect to see more special situations opportunities in 2012?

Of those respondents who do not expect an increase in distressed debt, 92% say that they anticipate more special situations in 2012.

While a number of special situations are expected, the ones believed to create the greatest opportunities for investors are mergers and acquisitions (M&A) activity as well as actions involving private equity, according to around 30% and 40% of these respondents, respectively.

One respondent states, "We expect to see new portfolio investments by private equity as well as business expansion by corporates either through M&A or organic growth." These activities could perhaps present IPO-related and arbitrage opportunities, while other respondents mention prospects ranging from non-performing assets to high-yield bonds, as companies look to clean up balance sheets as well as raise new funds given a dearth of traditional sources. Indeed one respondent says, "We expect to see more disposals of non-performing assets," and another echoes, "We expect to see more acquisitions of non-performing assets as well as investments in bonds, both domestic and international."

A number of investors expect an uptick in secondary market trading in general. One respondent, says, "We will not see any specific special situation with significant opportunities, but secondary market trading will see solid growth." Another states, "We expect to see continued dispositions of non-performing assets as well as an increase in secondary market deals."

"The initial outlook based on known activity to date indicates that both single credit and portfolio deals in Asia are on the rise, but not at former crisis levels. Deals are being seen or are coming on stream in Australia, Korea, Japan, India, Thailand and Malaysia. Pakistan may also feature later this year depending upon debt owner strategies. While many of these deals are being driven by European exposures, particularly Australia and Japan, selling of debt is an accepted loan management strategy in Asia and a number of Asian banks continue to utilize this strategy for selected loan categories. Countries including Thailand, Taiwan, India and Malaysia will see domestic banks offloading portfolios in 2012. And while the cost of capital is certainly a factor, many Asian buyers have the balance sheet to buy and are actively seeking transactions across multiple territories."

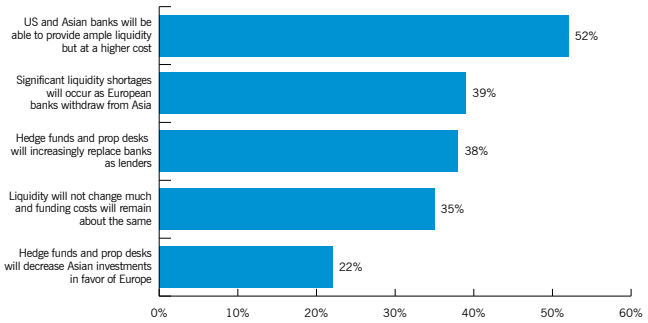
Frank Janik, Portfolio Solutions Group, KPMG

"The comments regarding portfolio disposals of non-performing assets certainly ring true. We are also seeing financial institutions across the globe with a continuing interest in disposals of non-core assets. Sell-side activity is particularly strong on the part of the European banks, as illustrated by recent high-profile disposals announced by RBS and others, which may give rise to opportunities in Asia as disposal programmes continue and valuation gaps narrow."

Andrew Brereton, Partner, Banking and Finance, Singapore, Clifford Chance

Retrenching European banks expected to drive up the cost of borrowing in Asia-Pacific

How do you expect the eurozone crisis to affect Asian debt markets?



(Respondents may have selected more than one answer)

Given the crisis in the eurozone, the pullback by European banks is being felt globally. More than half of respondents (52%) expect that while banks based in the US and Asia will fill the void of European lenders, the laws of supply and demand will drive prices up. One respondent states, "Large Asian banks will cover the liquidity shortage but at a higher cost. Furthermore, banks might also be more selective in providing liquidity." Echoing the sentiment that lending banks will be more selective, another respondent says, "Liquidity will be affected not only due to the withdrawal of European banks, but also Asian banks staying away from financing due to the crisis."

Another 38% expect hedge funds and prop desks to fill this void, no doubt at higher costs as well. Still another 39% anticipate significant liquidity shortages. "Liquidity shortages have not yet occurred to a level of concern in Asia, until now. If growth continues to decline and demand from Europe does not return, then there will be an issue with liquidity," says one respondent.

On the contrary, just over one third of respondents anticipate no decline in liquidity and no change in the cost of funding.

"European banks are being forced to raise significant levels of capital in response to new regulatory requirements and the threat of increased loan losses. Many have pursued a strategy of retaining greater levels of profit, reducing new lending and selling non-core assets – this de-leveraging strategy is likely to continue. The European and US banks' participation in the Asian loan markets has been falling for a number of years, and to date, the regional banks have stepped up and filled the void. This capital cycle has already driven margins up and we would expect this trend to continue in the medium term. Ironically, the upward margin pressure may ultimately attract capital from Europe and the US as it seeks out diversification and absolute yield."

Richard Dawson, Principal, Head of Debt Advisory – Asia, KPMG

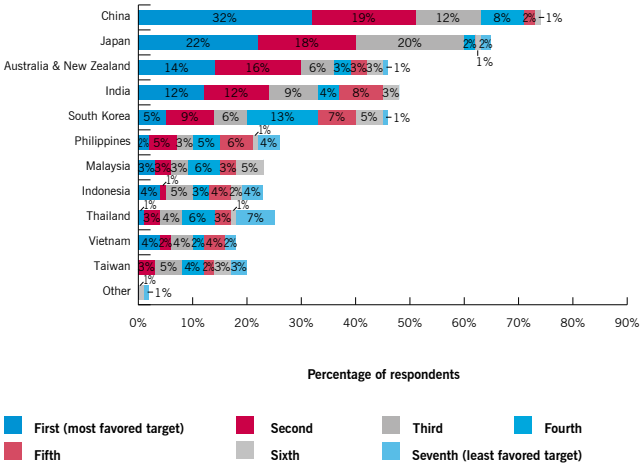
"The rise of 'shadow banking' is a systemic shift in global capital markets. Funds are already important participants in the credit markets and are likely to perform an increasingly significant role in the future."

Mark Shipman, Partner, Hong Kong and Global Head of Funds and Investment Management Sector, Clifford Chance

SURVEY FINDINGS

China and Japan top the list of target geographies for distressed debt and special situations opportunities.

Please rank the top seven geographies where you expect to target distressed debt/special opportunities in 2012?



In varying degrees, 74% of respondents point to China as a top investment target, with 32% listing it as their primary target geography. Second to China, two thirds of respondents rank Japan as a top-seven target market for investment opportunities, with 22% indicating that Japan is their primary focus.

While China topped the list of most attractive destinations for distressed opportunities in last year's survey, Japan has jumped ahead of India and Australia, which were ranked second and third in 2011, respectively. On the contrary, Indonesia fell a few spots after ranking fifth in last year's survey. However, given such a diverse landscape, there is no doubt many geographies will continue to receive attention from investors.

"Many of the respondents must have strong stomachs and a liking for Chinese food. Whilst there are opportunities, execution risk in China is very high given the inherent difficulties in the usual offshore to onshore funding structures used in China. The key to success is being relevant to the solution. Having offshore rights in a bust capital structure is of little relevance to solutions that are driven more by political rather than purely economic outcomes. Given the abundance of Chinese capital available to Chinese owners it is difficult for international investors to convince Chinese stakeholders that they are relevant in a new capital structure unless they have some intangible benefit that warrants a seat at the table."

Scott Bache, Partner, Sydney and Head of Asia-Pacific Restructuring and Insolvency Group, Clifford Chance

"Interesting. Very interesting. In the equivalent ranking last year, Indonesia ranked fifth, ahead of South Korea, and the Philippines did not register at all. This year, by contrast, the Philippines enters the chart straight in at number six while Indonesia comes in eighth, behind both the Philippines and Malaysia. This may be a quirk of the statistical analysis as, on activity seen in recent months, those targeting Indonesia ahead of the Philippines this year are likely to acquire more air miles than those with the reverse view."

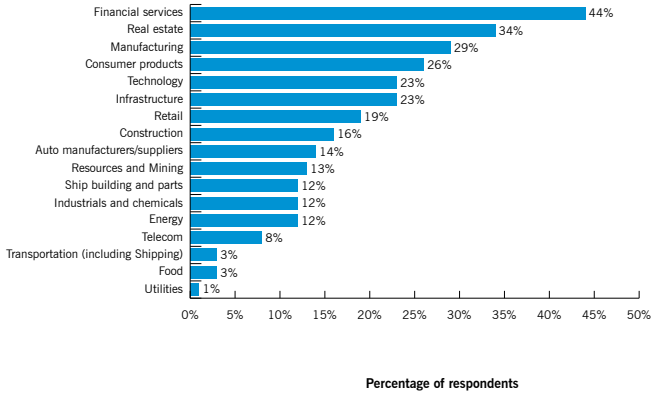
Edward Middleton, Partner, Head of ASPAC Restructuring, KPMG

"It would seem from our own analysis of recent financial results of Chinese listed corporates that there is increasing pressure on cash flow and working capital caused by a tightening in liquidity in the market. Corporates lacking adequate visibility and control over cash flow will be more susceptible to a downturn in the economy. We've witnessed recently an increasing number of opportunities for investment in corporates who are overtrading, thus presenting attractive propositions to distressed investors."

Fergal Power, Partner, Restructuring & Insolvency – China/Hong Kong, KPMG

In the rearview mirror, Financial services, Real estate and Manufacturing were the top three target sectors in 2011…

Which three sectors did you target in 2011 for distressed debt/ special opportunities?



Respondent views reflect the diversity of Asia-Pacific markets with many sectors receiving attention over 2011. Most prominently, 44% of respondents maintain that they targeted Financial services opportunities in 2011. This stands in contrast to expectations prior to 2011, as last year's survey anticipated few opportunities for distressed investments in the Financial services sector.

However, the pre-2011 expectation that the Real estate sector would hold the most opportunities proved somewhat accurate as around one third targeted this sector in 2011.

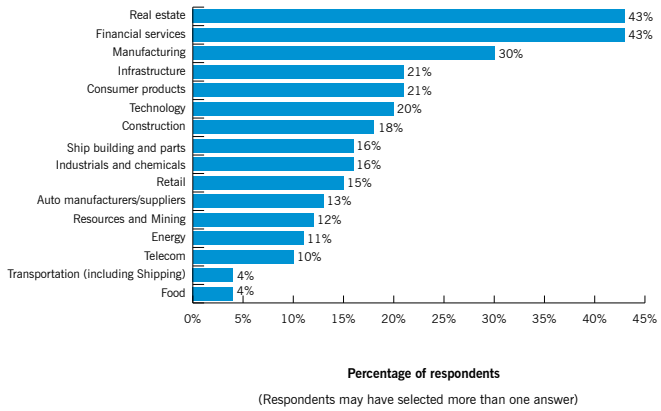
"It is interesting to see Financial services at the top of this chart. No doubt this links back to the comments made earlier by Richard Dawson and Frank Janik explaining how the eurozone crisis has driven opportunities as financial institutions have sought to manage their own balance sheets. Continuing interest in Lehman Brothers' claims trading and the autumn failure of MF Global may also have served to keep Financial services at the top."

Patrick Cowley, Principal, Restructuring & Insolvency – China/Hong Kong, KPMG

SURVEY FINDINGS

… and going forward, these will remain the target sectors in 2012

Which three sectors will you target in 2012?



According to respondents, 2012 looks to be more of the same in terms of sector focus. Even more respondents (43% in 2012 as opposed to 34% in 2011) will target distressed Real estate opportunities as warnings of distress in property markets deepen, particularly in China.

Financial services sector opportunities will receive roughly the same attention from respondents in 2012 as it did last year, with 43% indicating this as a target. Again, third on the list will be Manufacturing sector opportunities, as export activity declines and the likelihood of distress rises.

Other movers include Consumer products, which is expected to see slightly less activity in 2012 than in 2011, and Retail, which, on the contrary, is expected to see slightly more activity. Furthermore, both Industrials and chemicals and Ship building and parts are expected to receive slightly more attention in 2012.

"The ongoing pressure in the European economy will also bring opportunities to Asian companies as certain Western companies are forced to divest Asian operations and European asset values fall to attractive levels. Financial services is going to be a particularly interesting sector. We have seen some Chinese, Taiwanese, and second-tier Japanese banks expanding their regional footprint as European banks have retrenched. I note also the rise up the charts of the Ship building and parts sector. The table on the previous page shows that it ranked eleventh as a target last year, but is now eighth. No doubt the troubles seen at Berlian Laju Tanker out of Indonesia and Sanko Line out of Japan will have implications for that sector. Given the evident stress in the shipping sector globally, I am intrigued that Transportation (including shipping) does not rank higher as a target; perhaps market participants see that sector as less inviting than others, even if opportunities do become plentiful."

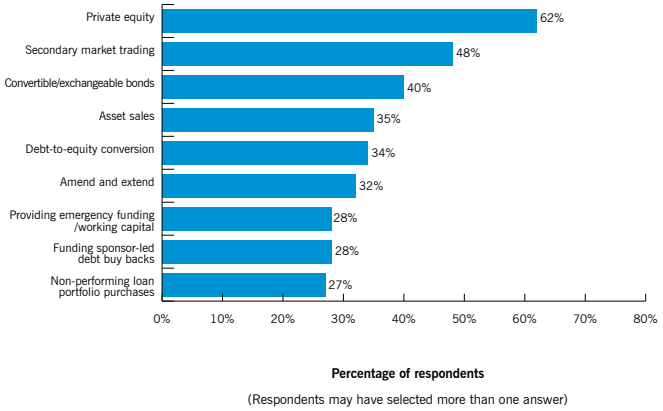
Edward Middleton, Partner, Head of ASPAC Restructuring, KPMG

"It is no surprise to see the same three sectors top the survey results again this year, but what is always interesting is the breadth of sectors that distressed investors are happy to consider."

Scott Bache, Partner, Sydney and Head of Asia-Pacific Restructuring and Insolvency Group, Clifford Chance

Situations involving private equity are expected to offer the most attractive opportunities according to 62% of respondents

Which of the following situations do you think will offer the most attractive opportunities for special situation/distressed debt investors in 2012?



With a number of private equity portfolios nearing the end of their stated hold periods, 62% of respondents expect private equity related activity to generate opportunities for distressed debt and special situations investors over 2012. Following private equity is secondary market trading, which 48% of respondents highlight, as well as convertible/exchangeable bonds, an opportunity highlighted by 40% of respondents. Indeed, one respondent states, "Currently, high yield debt and structured bonds are undergoing restructuring and are being traded at attractive prices in the secondary market. Additionally, private equity portfolios that have matured and could be sold in the secondary market." Another echoes, "Secondary market trading has been very attractive in Asia. I think also private equity will be a good opportunity as many portfolios are nearing maturity."

"The closure of the IPO market since mid-2011 and the maturing of PE portfolios mean that GPs are looking for alternative solutions for exit. Selling down or refinancing these investee companies might provide interesting opportunities for special situations funds. Without funds being able to exit, there may be constraints on liquidity within the investee, which may drive the common convertible structures under water and prevent investors from being cashed out. We expect this may be seen in the Real estate sector where government policies have dampened demand and reduced the potential for realizations of developers' property stocks and in Manufacturing where sluggish export markets and rising input costs have put pressure on businesses."

Jeremy Fearnley, Head of M&A – Hong Kong & Southern China, KPMG

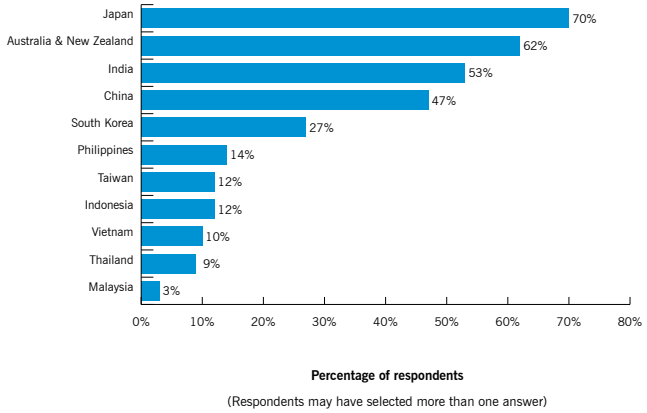
"In addition to the interest that some of the challenged buyout portfolios continue to attract, particularly in Australia and Japan, we expect to continue to see a great deal of interest towards illiquid private equity investments undertaken by alternative investment funds in the lead up to the global financial crisis. Many of these investments were highly structured making them ideal for special situation/distressed investment."

Andrew Whan, Partner, Corporate, Tokyo, Clifford Chance

SURVEY FINDINGS

70% of respondents expect banks in Japan to be the primary sellers of loan holdings

In which geographies do you most expect banks to sell their loan holdings?



According to 70% of respondents, banks in Japan are expected to sell down loan holdings ahead of any other geography. Following Japanese lenders are banks in Australia and New Zealand, say 62% of respondents. With the expectation for rising distressed debt across Asia-Pacific, banks will be looking to offload non-performing loans in order to shore up capital positions, and as banks sell down loan holdings, opportunities arise for distressed investors. According to respondents, the top six geographies in which they expect banks to sell down loan holdings are the same six targets for distressed debt and special situations opportunities in 2012.

According to one respondent, "China is the epicenter of non-performing loans and there will be significant disposal of these loans in China. Even India, Australia and Japan will clear their loan holdings that are either non-performing or at high risk of default."

"In Japan, due to the one year extension of the "Moratorium Act" (SME Financing Facilitation Act) by FSA, the pressure of selling down bad loans may be frozen for another year. But, the investor community in Japan expects that when the extended Moratorium Act is over next year, Japanese banks may re-start substantial amounts of bad loan disposition to recover their loan portfolio, thus investors will have more opportunities in investing in distressed debt portfolios in the foreseeable future."

Masahiro Yoshioka, Partner, Head of Restructuring – Japan, KPMG

"In addition to Japan and Australia, traditional markets such as Thailand, Korea and India are likely to provide a steady stream of portfolio opportunities. This will generally be non-performing loans of mixed type, albeit there are more and more retail, consumer and mortgage loans being offered in these markets. Multiple transactions are expected in all three of these markets."

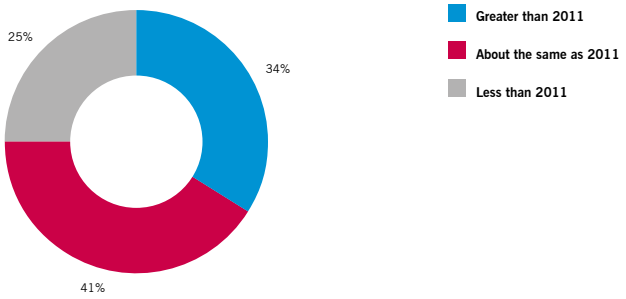
Frank Janik, Partner, Head of ASPAC - Portfolio Solutions Group, KPMG

"In Australia, although much of the leverage in the stressed large caps has already been sold to distressed funds or restructured, the banks in the Australian market still have significant refinancing-related stress in medium-cap companies. The exit of many of the European banks from the market has accelerated this issue. The need to reduce bank exposure to stressed property (from both the European banks and the domestics) will also drive substantial sales of property portfolios. In summary, the demand side for distressed debt positions remains strong and the banks now understand the option of selling debt (which arguably they didn't three years ago), and so we would expect Australia to remain a strong market for continued sell-side activity."

Nicholas Dunstone, Partner, Restructuring, Hong Kong, Clifford Chance

Little consensus on whether the volatility in debt and equity markets will subside in 2012

Market volatility in debt and equity markets in 2012 and its effect on liquidity and distress will be:



"Uncertainty generally has the effect of reducing liquidity, with some bank credit committees increasingly reluctant to sanction transactions in perceived high-risk jurisdictions or sectors. There are likely to be opportunities for distressed and mezzanine investors due to the resulting shortfall in financing requirements."

Andrew Brereton, Partner, Banking and Finance, Singapore, Clifford Chance

After an extremely volatile second half of 2011, it appears early 2012 has given investors little confidence as to where markets are heading. With so many factors still hanging in the balance, one respondent explains, "Continued optimism and improving conditions will depend on some crucial international decisions and their effects, including resolution in the eurozone, crude oil prices and supplies, business relations of Asian countries with major oil exporters and regulatory decisions made by the Asian governments to keep inflation in check. These decisions could improve the business environment or could further dampen it."

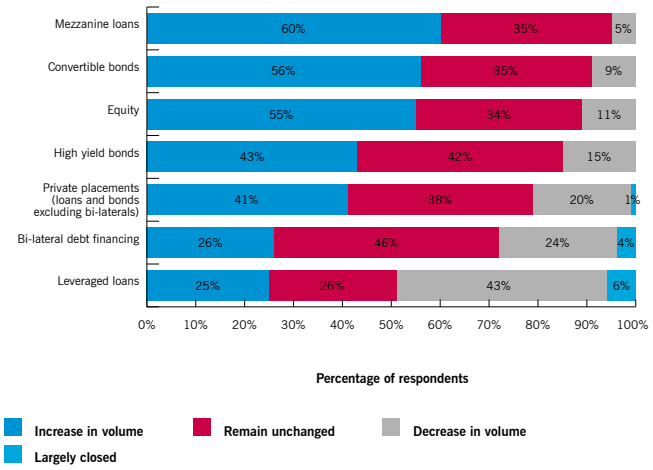
As a result, the effects on liquidity and distress are also uncertain. While there was no strong consensus, 34% of respondents believe that 2012 will see greater volatility, with one respondent saying, "Continued volatile debt and equity markets will further affect investor confidence and will reduce liquidity."

On the other hand, 41% expect 2012 to remain on par with 2011, seeing no signs of clearing in the near future. However, a smaller 25% of respondents maintain that market volatility is declining and with it, the effects on liquidity and distress. In fact one respondent believes, "The market will be less volatile in Asia and its effect on the liquidity will be minimal." Another suggests, "The market has overreacted and will normalize in 2012."

SURVEY FINDINGS

Borrowers seeking alternative funding methods in primary markets

Do you expect primary markets for the following products to increase in volume, decrease in volume, remain unchanged or to be largely closed in 2012?



With many expecting (and already experiencing) higher costs for traditional bank lending, primary issuance of mezzanine loans, convertible bonds and equity are set to rise, according to respondents. Indeed, topping the list are mezzanine loans, for which 60% of respondents expect primary markets to increase in volume. Convertible bonds and equity are two other instruments expected to grow in primary issuance according to 56% and 55% of respondents respectively. On the other hand, as lenders become more averse to risk, a combined 49% expect new issues of leveraged loans to either decrease in volume (43%) or dry up completely (6%).

One respondent who sees an increase in high yield bond issuance (a view shared by 43% of respondents) says, “Many companies have poor credit ratings making it difficult to find direct bank debt or other easy financing, thus high yield bonds will be the most significant source for raising capital and refinancing debt.”

“The bank loan market - whether bilateral, syndicated or leveraged - will continue to be the principle source of funding in the primary markets. New loan issuance is likely to rise slightly in 2012 through organic growth and as regional banks fill the gap left by many foreign lenders retreating to their home markets. The 'non-bank' debt markets are becoming increasingly influential in the region, driven by growth and investor appetite for alternatives to traditional Asian investment opportunities. The local currency bond markets have seen dramatic growth over recent years, and we expect this to continue in 2012. The number of corporate, non-government issuers will rise and the Asian markets are likely to attract more offshore investors as a result of ongoing de-leveraging in the West as well as a search for diversification and absolute yield.”

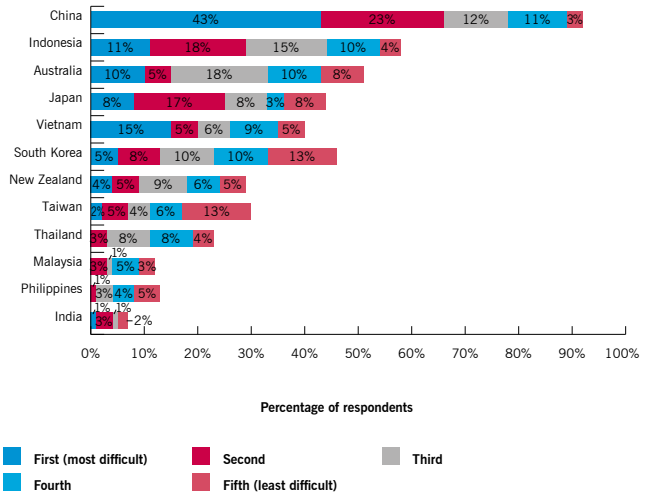
Richard Dawson, Principal, Head of Debt Advisory – Asia, KPMG

"Certainly, funds could be part of the solution for frustrated corporate borrowers. Collectively, funds represent an attractively large pool of capital: they are sufficiently diverse in their specialist knowledge and strategic objectives to accommodate a wide range of business borrowers and financing propositions. But in a sea of change, roiled by waves of new regulation, nothing is plain sailing."

Mark Shipman, Partner, Hong Kong and Global Head of Funds and Investment Management Sector, Clifford Chance

China is overwhelmingly the most difficult legal and regulatory jurisdiction for distressed debt investing

For distressed debt investing, please rank the top five geographies/ jurisdictions that are most difficult from a legal and regulatory perspective.



China is almost unanimously one of the top five most difficult geographies in Asia-Pacific from a legal and regulatory perspective, as a total 92% of respondents place it in the top five. Furthermore, 43% of respondents believe China to be the most difficult, while the jurisdiction receiving the second highest marks, is Vietnam, with 15% of respondent opinions. Overall, the second most difficult geography is Indonesia, which is listed in the top five by 58% of respondents.

It appears not much has changed as last year's survey also indicated that China and Indonesia were the two most difficult and home to the least reliable judiciaries. One respondent states, "China still has very difficult legal policies and regulations, and the laws there for restructuring are very complex."

"Nearly five years on from the implementation of the Enterprise Bankruptcy Law, China remains a difficult legal environment for implementing restructurings. The concern is always how this new law would be implemented at a local level. As KPMG's case study of the restructuring of Skyfame (on which we acted for KPMG in their capacity as liquidators of Lehman Brothers) demonstrates, the key to restructuring in China remains finding the right levers (both legal and practical) to press and exerting pressure on them at the right time."

Scott Bache, Partner, Sydney and Head of Asia-Pacific Restructuring and Insolvency Group, Clifford Chance

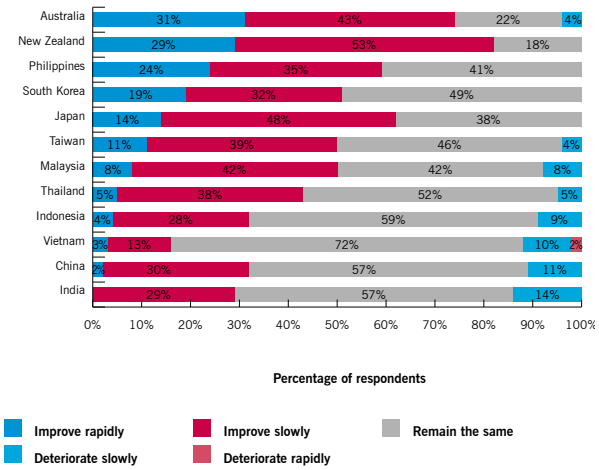
"It is somewhat surprising respondents have indicated that they consider Australia one of the more difficult legal and regulatory jurisdictions given its sophisticated legal and regulatory framework. Investors need to be wary of the personal risks directors of stressed companies face given punitive insolvent trading laws, as an unexpected filing has the potential to significantly erode value. However, investors can generally take comfort, compared to other jurisdictions in the region, in a certainty of implementation and protection of downside risk."

Nicholas Dunstone, Partner, Restructuring, Hong Kong, Clifford Chance

SURVEY FINDINGS

Legal and regulatory environments seeing modest improvement across the region

For each of the five geographies you named, please indicate whether you believe that the legal and regulatory landscape in 2012 will improve, deteriorate or remain the same.



While ranked as one of the top five most difficult jurisdictions by 51% of respondents, the better-developed legal and regulatory landscape in Australia is expected to see the most improvement over 2012, with 31% anticipating rapid improvement and another 43% expecting slower improvement.

Notably, South Korea and Japan are also expected to see moderate improvement with 51% and 62% of respondents believing these jurisdictions will see progress, respectively.

On the other hand, China could see slow improvement according to 30% of respondents, but the majority (57%) expect no change, and another 11% see the legal and regulatory landscape deteriorating. Similarly, Indonesia and Vietnam are expected to remain unchanged by 59% and 72% of respondents respectively. One respondent goes so far as to say, "Vietnam is still conservative and is not yet open to foreign investment."

"The issue for Australia and New Zealand is not focused so much on the legal and regulatory framework which largely mirrors the UK, but the general market acceptance of distressed debt sales as local practice, with local banks yet to establish their own debt trading desks and operating on an ad-hoc basis through offshore third parties. As the first banks open their own distressed debt trading desks, change will become more rapid."

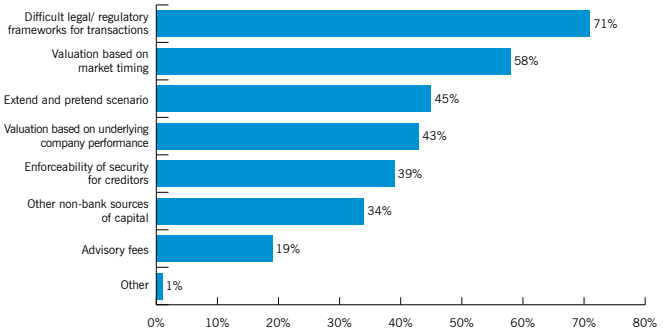
Damien Hodgkinson, Partner, Head of Restructuring – Sydney, KPMG

"In Australia, there are no substantial reforms on the regulatory side or legal side which would be supportive of an expectation of 'improvement'. The recent introduction of the Personal Properties and Securities Act in Australia (which has been in place in New Zealand for some time) will no doubt have an interesting (and perhaps unexpected) impact in future restructurings; however, it is difficult to see buy-side funds characterising this as an improvement per se. I think, rather, that the survey response reflects, in part, the successful implementation of a number of large-scale debt for equity swaps and non-insolvency process restructurings (notwithstanding Australia's draconian insolvent trading law) in recent years, and that this has led people to feel generally optimistic that the legal and regulatory framework can provide the tools for achieving outcomes desired by activist debt investors."

Nicholas Dunstone, Partner, Restructuring, Hong Kong, Clifford Chance

Difficult legal and regulatory frameworks hinder transactions

When assessing whether or not to enter into a distressed debt transaction, what hinders the transfer of assets?



(Respondents may have selected more than one answer)

According to 71% of respondents, difficult legal and regulatory frameworks for transactions most often hinder closing, proving to good effect that navigating legal and regulatory landscapes across Asia-Pacific can be trying. One respondent laments, "Liabilities on distressed assets are very difficult to deal with in many jurisdictions across Asia-Pacific."

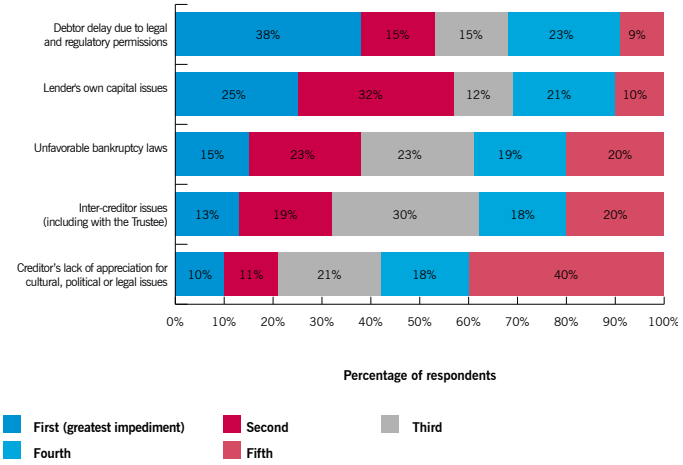
Second to legal and regulatory frameworks, respondents say discrepancies in valuation based on market timing (58%) or underlying company performance (43%) often hinder closing. At the same time, 45% of respondents see 'extend and pretend' scenarios keeping distressed assets out of the hands of distressed investors.

"It is no surprise at all to see market participants identifying difficulties in the legal and regulatory environment as the top inhibitor to the transfer of assets. I also think this links to the valuation disconnect since, in large parts of Asia, there is still not the same degree of divorce between ownership and control as there is elsewhere in global markets. This is manifested in owners of distressed businesses – in many cases still first generation entrepreneurs – attaching an 'emotional premium' to valuation, which they can use the local legal and regulatory framework to protect."

Edward Middleton, Partner, Head of ASPAC Restructuring, KPMG

Legal and regulatory permissions delay debtors and impede restructuring efforts

Please rank from one to five the greatest impediments to restructuring efforts.

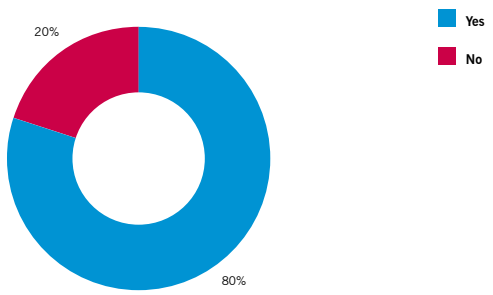


Again, respondents cite legal and regulatory problems, in this case with debtor permissions, that cause delay and slow restructuring efforts. Indeed, 38% of respondents rank this as the top impediment to restructuring, followed by capital issues of the lender, which is said to be the foremost hindrance by 25% of respondents. Unfavorable bankruptcy laws is third overall, followed by inter-creditor issues and the creditor's lack of appreciation for local issues.

SURVEY FINDINGS

China and Indonesia expected to remain the most challenging markets for creditors

In last year's survey, China and Indonesia were ranked as the most challenging markets for creditors. Do you believe this to be true for 2012?



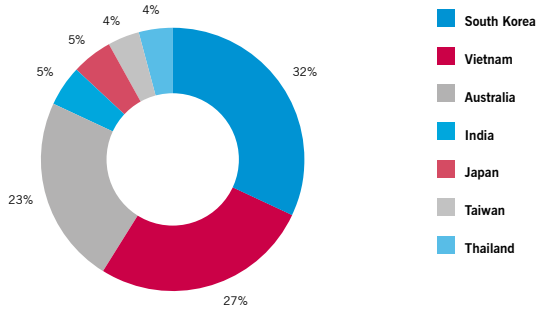
In line with previous years, 80% of respondents expect China and Indonesia to remain the most difficult markets for creditors. A private equity respondent in India believes, "China is still the most challenging market for investors. Its unfriendly laws as well as the attitude of authorities make it very challenging." However, a private equity investor based in China holds a contrary view, "Chinese policies have recently changed and the government has eased regulations."

"It is not surprising that respondents continue to regard Indonesia as one of the most difficult Asian jurisdictions for distressed debt investing from a legal and regulatory perspective. An understanding of the pressure points, including recourse to offshore assets and counterparties, relationships with local co-investors and other stakeholders, and the options available under the Indonesian bankruptcy laws, is often key to a successful outcome."

Andrew Brereton, Partner, Banking and Finance, Singapore, Clifford Chance

But according to some, South Korea, Vietnam and Australia could hold the most problems for creditors

If no, please indicate the other markets you expect to be most challenging for creditors in 2012



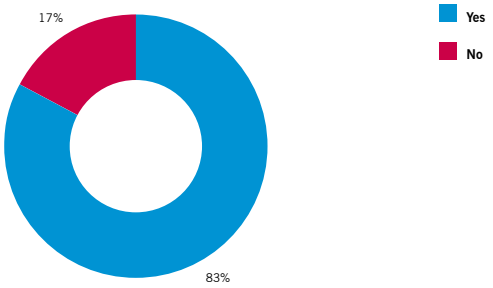
Of the 20% indicating greater difficulty outside of China and Indonesia, 32% point fingers to South Korea, some 27% see Vietnam as the most challenging, and 23% see challenges ahead for creditors in Australia. While these opinions represent only a small portion of respondents, in last year's survey, South Korea ranked as one of the least challenging markets for creditors and Australia was not even considered. This goes to show that even in traditionally creditor-friendly markets problems can still arise.

"Respondents' views regarding Vietnam come as no surprise as the country wrestles with significant economic challenges, and I think that Vietnam may have received even more votes if it had a greater significance in international debt markets. In 2011, Vietnam experienced double-digit inflation, tight domestic liquidity and a slowing of foreign direct investment. Furthermore, the domestic Real estate sector stalled and local equity markets were flat. While some of the macroeconomic challenges associated with Vietnam as an emerging market are not new or unique, what has changed over the last year or so is that Vietnam is now on the radar of international debt markets due to problems faced by high-profile Vietnamese enterprises. These include the ongoing efforts to restructure the Vietnamese Shipbuilding Industry Group ("Vinashin"), which in late 2010 missed payments on an international syndicated loan, as well as financial concerns faced by other large state sector and private corporates."

Phil Smith, Director, Restructuring & Insolvency – Vietnam, KPMG

India and the Philippines expected to remain the easiest markets for restructuring and settlements in 2012…

In last year's survey, India and the Philippines were ranked as the easiest markets for restructurings and settlements. Do you believe this to be true for 2012?



Also in line with last year's survey, India and the Philippines are believed to be the easiest markets for restructurings and settlements in 2012, despite their largely underdeveloped and unreliable judiciaries. One respondent flags political instability in India as a growing reason for caution, a concern that is particularly pertinent in a market where much of the government organization is said to be fragmented.

"The very high profile cases might have given the public a perception that India is a relatively easy market for restructurings and settlements. Large restructurings like Kingfisher can be done relatively quickly because there was a lot at stake for the lenders. In India, most companies need to go through a Corporate Debt Restructuring (CDR) process which can be quite cumbersome. This is because there are always multiple lenders involved in any restructuring and so it takes time to agree to the terms of the restructuring with each lender. The lead banker in the consortium does not have the authority to negotiate the restructuring terms on behalf of the other bankers. Each banker has his own objectives and portfolios, and the risk of NPAs weighs heavily on the negotiating tactics that they adopt for any restructuring. Finally, as most banks are public sector banks (i.e. government owned) decision making is slow and subject to independent scrutiny. Hence, we have found restructuring in India not as easy as the public views it."

Vikram Utamsingh, Partner, Head of Transactions and Restructuring – India, KPMG

"There have been a number of successful outcomes in relation to distressed Indian companies over the last two years, and these seem to have created a favourable market perception. Our experience remains that distressed situations can be challenging to work through due to the local corporate debt restructuring regime. This is treated as binding by Indian banks and borrowers, but offshore lenders generally do not participate. The Indian courts have relatively limited experience in balancing the interests of the creditors in these situations, which has given rise to negotiated settlements triggered by insolvency proceedings in some cases."

Andrew Brereton, Partner, Banking and Finance, Singapore, Clifford Chance

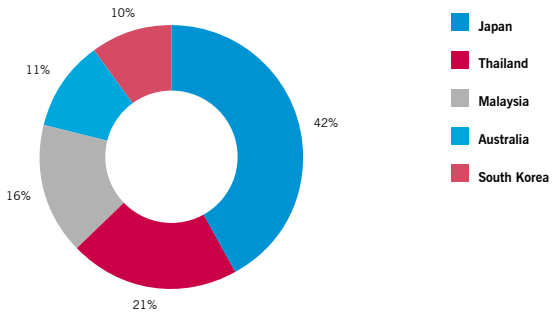
"Our experience is that restructurings in India continue to be difficult to predict and close out. Often heavily negotiated, they can be time consuming and vulnerable to changes in the broader economic and regulatory environment in India."

Emma Christian, Consultant, Restructuring and Insolvency, Hong Kong, Clifford Chance

SURVEY FINDINGS

…though some expect Japan, Thailand and Malaysia to be the easiest markets

If no, please indicate the markets you expect to be easiest for restructurings and settlements in 2012



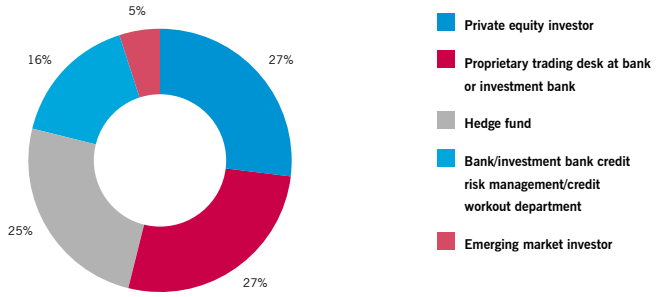
Of the 17% that expect a market other than India or the Philippines to be easiest for restructuring and settling, more respondents cite Japan than any other market. According to two respondents, investors have transparency to thank, with one saying, "Japan is very transparent and has open communication system," and another, "Japan has simple and transparent restructuring regulations."

"Thailand, Malaysia and South Korea have long track records for portfolio transactions, so while the legal/ regulatory environment may result in longer work-outs, the promise of future deals and banks willing to transact will likely see high interest in these jurisdictions."

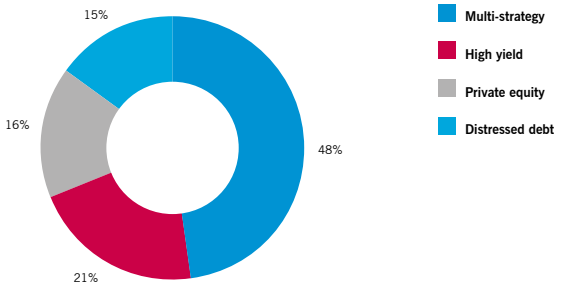
Frank Janik, Partner, Head of ASPAC - Portfolio Solutions Group, KPMG

RESPONDENT INFORMATION

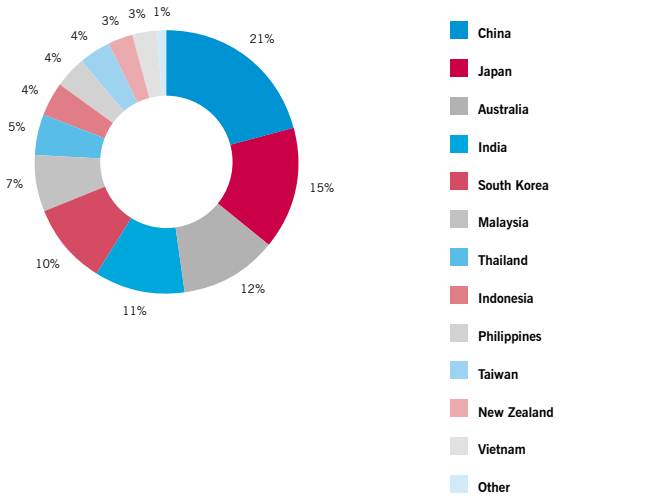
Please describe your firm:



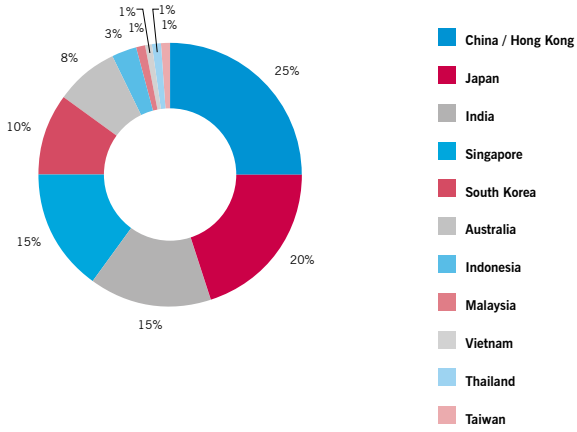
Please describe your core investment strategy



Please indicate all geographies in which you have made distressed debt investment in the last two years



Where are you based?



NORTH DOWN, SOUTH UP?

... in this land of continued negativity, where are the windows of opportuntity?

Scott Bache, Partner, Clifford Chance, Sydney
Nicholas Dunstone, Partner, Clifford Chance, Hong Kong

Across Asia...

Another year on, and where are we? Well, the survey results support what has long been suspected – no single jurisdiction in Asia-Pacific has "done an Adele" and turned from the brink of a career ending injury to triumphantly sweep the awards.

Instead, in what is a familiar echo of the stories of 2010 and 2011, restructurings and work-outs across the Asia-Pacific region continue to be difficult to complete – and often prove painful along the way for all involved. Many, if not most, of the key jurisdictions still have plenty of archaic legal and regulatory shrubbery for local debtors to hide amongst, safe from the gaze of foreign investors, as many newbies to the region, lured into the China high yield market, can attest.

In addition, the region faces ongoing liquidity issues as well as continuing uncertainty over the prospects for Asia-Pacific economies. Without a solid prospect for recovery in the short-term and some jurisdictions still without any form of director responsibility for trading in the 'twilight zone', debtors remain content to limp along. They are all too aware that the fortunes of their creditors are tied to their star, making creditors unlikely to pull the plug.

So in this land of continued negativity, where are the windows of opportunity?

One area in which we currently see an opening is in the purchase of European banks' portfolios of both performing and non-performing assets. As ever increasing regulatory and liquidity demands are placed on financial institutions, some banks are choosing to opt out of certain asset classes or jurisdictions altogether and deploy what capital they have closer to home. This can present opportunities to those with the resources, skills and willingness to take on board and manage an entire portfolio.

In addition to portfolio sales, the continued problems in the eurozone may result in other opportunities across the region. As the survey results suggest, as traditional markets in Europe dry up, manufacturing businesses across Asia-Pacific may find themselves facing cash flow difficulties – and further recessionary pressures in the US would have a similar effect. Knock, knock. Any budding shadow bankers out there willing to step up to the microphone?

Looking ahead, the number of pre-global financial crisis deals coming up for refinancing continues to mount and creditors will need to eventually abandon the 'amend and pretend' culture and deal with the ever more difficult debt burden faced by these debtors. With the IPO market no longer the reliable exit that it was, lenders are going to face some difficult decisions in the coming 12 months. Those without the appetite for a FerroChina or Asia Aluminum situation may look to exit, providing opportunities for those with a stronger stomach.

A lack of tangible reform across Asia has continued to make Australia attractive to investors looking at safe returns provided by its predictable legal and regulatory system. The influx of foreign capital (and international law firms!) into Australia is testament both to its robust insolvency system and to its long-term prospects for growth, particularly in the provision of raw materials to the rest of Asia-Pacific.

... and in Australia

So what has happened in Australia in the past 12 months and what can we expect for the future for distressed and special situations investing Down Under? Three key events have affected the shape of the market:

First, **Alinta** and **Centro** were successfully restructured, led by distressed investment funds swapping debt for equity in schemes of arrangements.

Second, the senior and junior financiers of **I-Med** ganged up on the private equity sponsor and managed to squeeze out their "out of the money" equity position into a consensual restructuring. All eyes are on **Nine Entertainment** to see whether this will be repeated.

Notwithstanding insolvent trading issues for directors, these complex groups successfully managed to restructure without the need for an insolvency solution that would have led to value destruction and further complexity.

Third, some much anticipated property portfolio trades occurred, and after a slightly faulty start, appear to be gaining traction from a number of Australian banks (both domestic and foreign).

Undoubtedly, domestic and foreign banks now appreciate the benefit of selling stressed or distressed loans in large syndicated situations. As the number of large syndicate restructurings slow, the big question for the next few years is to what extent banks will explore the liquidity option in the medium- to small-sized syndicates or bilateral situations (typically lent to SMEs). Although this is where we expect substantial financial stress, the smaller situations are by their nature: harder to source, more time intensive, less liquid and stickier for the banks. It will be interesting to see how this market develops, and who will be participating on the buy-side.

Aside from the acquisition of distressed debt positions, we believe a great source of opportunity lies in primary lending to fill the void left by the departing Europeans. The departure of capital from these banks has been anticipated for many years, but is now a reality. The extent to which the domestics or the equity markets can fill this capital gap is uncertain.

Leaving aside the high Australian dollar, Australia looks like it will continue to present some good investment opportunities, especially for those funds with the patience and time to invest in less liquid situations.

A COMPLETE SERVICE ACROSS ASIA PACIFIC

Clifford Chance provides the full range of restructuring and insolvency services throughout Asia Pacific Our award-winning team has acted on many of the most important restructuring and insolvency matters in the region.

With over 30 restructuring and insolvency lawyers based in Asia Pacific, supported by another 100 lawyers in 18 offices worldwide, we provide a multi-lingual English, US and civil law service, as well as local law advice wherever regulations permit.

Experienced in restructuring from every angle

We have extensive experience of voluntary and involuntary restructurings – having acted for both creditors and debtors, we understand the tension points that often arise during a restructuring and are well placed to guide our clients to ensure that their interests are best served.

As Asia Pacific has become more open to non-bank, non-relationship based participants, our involvement in these complex cross-border restructurings has meant that we know and act for some of Asia Pacific's most active distressed debt investors.

Clifford Chance has advised on all aspects of restructuring and insolvency transactions including:

- reschedulings
- loan-to-own transactions implemented through debt-for-equity swaps
- distressed M&A
- schemes of arrangement
- administration
- voluntary reorganisation
- court-driven rehabilitation
- receiverships
- voluntary and compulsory
- liquidations
- bankruptcy

For more information, please contact any of the individuals listed on page 24.

ABOUT CLIFFORD CHANCE

International law firm Clifford Chance combines the highest global standards with local expertise. Leading lawyers from different backgrounds and nationalities come together as one firm, offering unrivalled depth of legal resources across the key markets of the Americas, Asia Pacific, Europe and the Middle East.

The firm operates across Asia Pacific, with offices in Bangkok, Beijing, Hong Kong, Perth, Shanghai, Singapore, Sydney and Tokyo. With over 400 lawyers in Asia Pacific alone, it is one of the largest international firms in the region, enjoying a market leading reputation across a number of practices.

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Scott specialises in finance and securities matters with a particular emphasis on corporate restructuring, distressed mergers and acquisitions, and special situation investments. He regularly advises on insolvency issues, security enforcement, distressed debt trading and general banking litigation.

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Nicholas has extensive experience in distressed debt investment, restructuring of distressed companies and other special situation investments. He has worked with an international client base including many alternative investment funds and is a frequent commentator on distressed debt and restructuring matters.

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Donna specialises in insolvency, banking and commercial litigation, security enforcement and regulatory matters (both contentious and advisory).

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Emma specialises in finance and securities matters with a particular emphasis on private capital and special situation investments, financial and corporate restructuring and distressed mergers and acquistions.

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Andrew is a leading finance lawyer with extensive experience in restructuring, distressed situations and security enforcement. He regularly advises on cross-border workouts, restructurings and related matters.

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Nish is regarded as a leading expert in the field of dispute resolution, in particular arbitration, restructuring and insolvency. He has advised on many of the complex cross-jurisdictional disputes in South and South East Asia in recent years, including insolvency, restructurings, receiverships, judicial managements and liquidations.

CASE STUDY: SKYFAME REALTY (HOLDINGS) LIMITED

"…You wanna know how to get Capone? They pull a knife, you pull a gun…"

Patrick Cowley, Principal, Restructuring & Insolvency – China/Hong Kong, KPMG

One of the most rewarding aspects of the Lehman Brothers liquidation over the last 3+ years has been the number of other restructurings the KPMG team has had to get involved in as a lender / investor, so as to protect and enhance the return of Lehman's own creditors.

The Skyfame restructuring was one of these, and it provides a useful commentary on some of the issues that lenders and investors continue to face when confronted with a China-based investment that is not performing to expectations as well as providing an interesting option as to how these challenges might be overcome.

Most people reading this article will be familiar with the structure for this sort of investment in China, so I will not dwell on it. In short, the loan is usually to an offshore vehicle, which invests the funds onshore as equity. The investor ends up too far removed from the underlying assets, which are 'onshore', in the PRC, and are often secured to local onshore lenders. The investor's ability to enforce its offshore share pledges provides only limited power or leverage.

In the Skyfame situation, Lehman's exposure was twofold. First, by holding 25% of a USD200 million convertible note, and second, via a 51% interest in a HKD220 million bridge loan – both of which adhered to the typical structure described above.

The initial stages of the restructuring were cordial – a 'phony war' of sorts. Discussions were held with the chairman, the lenders' concerns aired, forbearance offered, and commitments to dispose of assets made by the chairman. Skyfame's main real estate assets were neatly compartmentalized with separate holding structures, so the proposal to dispose of certain assets, generating sufficient proceeds to repay both local and offshore lenders, appeared sound.

However, the situation rapidly became more sticky. Receipt of the proceeds from the sale of Skyfame's major asset, that would have been repatriated (once SAFE approval was obtained) to settle the USD200 million note, became "stuck" and the subject of extended further negotiations. Likewise, the proposed sale of another real estate project (Tianhe), the proceeds of which would have repaid the Bridge Loan, was voted down by the independent shareholders, who interestingly – for a body of supposedly independent shareholders – acted with almost complete unanimity in blocking a transaction that would have freed the business from a significant portion of its debt burden.

A further unwelcome twist came about in early 2010, when the Tianhe asset, an undeveloped site, was placed on the Guangzhou government's official record as being at risk of forfeiture, based on the relevant 'use it or lose it' regulations. It was unclear as to whether the timing of this was entirely a coincidence, but as a number of other undeveloped plots in Guangzhou had also attracted the authorities' attention, it was another cause for concern.

Many of the characteristics of this situation will be familiar to those of us working in the Chinese market, and the lenders' initial response was to turn to their well-thumbed playbook, appointing receivers and directors wherever their security package allowed them to. At about this time, a hitherto unknown creditor from Guangzhou petitioned the Hong Kong Court to wind up Skyfame's Hong Kong listed entity and applied for the appointment of provisional liquidators. The PL application was granted by the Court, without particular objections from Skyfame itself. Messy becomes messier….it had become clear that the chairman was not inclined to repay his group's debts in full, and indeed he appeared willing to go to extreme lengths to pay nothing until the various lenders accepted his terms.

The deterioration in this situation was made complete when it was revealed that the onshore Skyfame subsidiary that owned the Tianhe asset, still controlled by the chairman, had entered into an agreement with a Guangxi based state owned enterprise, Guang Li, under the terms of which, in return for certain services, Guang Li would receive a 50% interest in the asset. The threat to the lenders was clear, and made worse by the default provisions of the agreement, which provided for Guang Li to take the entire asset, at a very low price – half its book value – if the Tianhe offshore holding company, now under the lenders' control, did not invest a further RMB150 million within two months! Clearly, the gloves had now come off…

Although terms for the settlement of the USD200 million were eventually agreed, the bridge loan settlement proved significantly more difficult to resolve. By signing the Guang Li agreement, the chairman had demonstrated both his connectivity to certain local authorities, his willingness to deprive the offshore lenders of any value from the underlying asset, and an unwillingness to engage in constructive discussions – a strategy was clearly needed to bring the chairman back to the table. This is where the obviously melodramatic idea of 'bringing a gun to a knife fight' comes in. The lenders and their advisors, which we at KPMG were, determined that the only way to drive an acceptable outcome from this situation was to put ourselves in a demonstrable position of strength, from which to negotiate. We needed to show that the lenders posed a 'credible threat' to the chairman and his business interests, even in China, where he appeared to consider himself invulnerable.

The strategy required two main prongs:

1. Onshore litigation – Having reached a position where to do nothing would only result in the lenders gaining nothing, it became clear that we would need to spend money litigating this in China. The lenders obtained strong advice from PRC counsel, and then set about the arduous task of getting all of the relevant documents translated, as well as the drafting of writs, etc. to initiate a 'derivative action' by the offshore shareholder of the Tianhe land.

2. More importantly, the lenders agreed to hire a Guangzhou-based firm of consultants, who committed to being able to facilitate the changing of the legal representative of the onshore entity within 40 days. They also made it clear that their 'connectivity' within the Guangzhou government would comfortably 'trump' the chairman's – investigations were undertaken, and plans laid.

Despite now being in possession of the 'gun' we needed, the lenders' purpose was neither to litigate nor take control of the assets. With that in mind, there was little or no attempt at secrecy – the lenders wanted the chairman to know what we were up to, and that it was clear we intended to make a fight of this.

We will ultimately never know what brought the chairman back to the table, but at the time, it seemed clear that he was responding to the 'credible threat' strategy devised and employed by the lenders. There remained a number of hurdles to navigate, but once it was clear that a settlement would be reached it was only a question of when and at what price.

ABOUT KPMG

Across Asia-Pacific, KPMG Restructuring teams get busy on some of the most celebrated cases …

Lehman Brothers Asia
MF Global Hong Kong Limited
MF Global Singapore Pte. Limited
MF Global FXA Securities, Ltd., Japan
Vietnam Shipbuilding Industry Group
Transfield Er Cape Ltd.
Oasis Hong Kong Airlines Limited
Aero Inventory
Reliance Rail Pty Limited
PT Davomas Abadi, Tbk
Evergrande
Blue Star Print Group
Daihan Eunpakgy
Continental BioEnergy Singapore
Large wine making company in India
Colorado Group Limited
Centro Properties Group
FerroChina Limited
Asia Aluminum
Madras Aluminium Co. Ltd.
EganaGoldpfeil Holdings Limited
ABC Learning Centres
BBQ factory in New Zealand
Canterbury New Zealand Limited
ARRK Corporation, Japan
Mosel Vitelic Inc.
ProMOS Technologies
Philippine IT Hardware
Industrial Bank of Korea
Automotive Assembly Plant in Thailand

Wherever and whenever value is at risk, KPMG Restructuring professionals can be quickly mobilized to protect, preserve and recover the values for the lenders, stakeholders and creditors.

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