This article was published prior to McKee Nelson LLP's combination with Bingham McCutchen LLP on August 1, 2009.

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creditmag.com DECEMBER 2008 special report

Discussing DISTRESSED DEBT

A ROUNDTABLE

In association with

McKee Nelson LLP

DISCUSSING DISTRESSED DEBT

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One area that looks poised to benefit from the turn in the credit cycle is distressed debt, with funds readying themselves to take advantage of any opportunities that may arise. Six thought leaders of the industry consider the outlook for distressed debt

The financial market turmoil has led to a number of new investment opportunities as assets have hit rock-bottom prices. But with the economic hardships set to continue well into next year, it would take a brave investor to put money into the market right now. *Credit* assembled a panel of distressed debt market participants to ask them about their views for future investment.

The firms represented on the panel were: credit investor **BlueBay Asset Management**, fund-of-hedge-funds manager **Financial Risk Management**, ABS investor **Highland Financial Holdings**, hedge fund **Lionhart**, alternative asset manager **LNG Capital**, and law firm **McKee Nelson**.

***Sarfraz Thind, Credit magazine*: Distressed debt is a very topical theme right now. But to begin with I wondered if we can agree on a definition of distressed debt?**

Paul Ullman, founder and chief investment officer, Highland Financial Holdings: Over the last 15 years assets that carried yields of 15% to 18% were commonly known as distressed. I think that assets with that kind of yield have real problems, whether they are credit or structural problems.

John Arnholz, partner, McKee Nelson: Conventionally, investors have characterised distressed assets as those that incorporate a credit element. But in the last year or so with the collapse of the ABS market, assets that have not suffered losses have nonetheless been included in the category. Typically, these are assets that are priced substantially below their intrinsic or fundamental value as a result of the fall-off in the sector.

Ian Burnett, co-head of distressed debt, BlueBay Asset Management: For me in the corporate world a distressed situation is one where the capital structure that's been created is not going to work. And that can happen when a security is trading at 90 cents on the dollar or when it drops down to 20 cents. Because of this, to my mind

> "The market is telling you that default rates and recovery rates are going to be something that we simply haven't seen before"
> Ingrid Neitsch, Financial Risk Management

it is quite difficult to use generic prices to define distressed debt. "Distressed" is when an asset is definitely going to have to be restructured, "stressed" is when it might have to be restructured.

Tom Scanlon, portfolio advisor, Lionhart: I would agree with Ian. We get companies that have some elements of distress from an operational, legal, regulatory or financial performance basis as opposed to price. The price alone does not necessarily define a distressed company or an asset.

Louis Gargour, chief investment officer, LNG Capital: Those answers are interesting but subjective. I think the technical definition is 1000 basis points over. If you look at some historical data, in 1990 the index traded at 1079bp, in 2002 it traded at 959bp and it currently trades at 1471bp. So basically the entire index is stressed when you hold the definition, which tells you something. It tells you that this is the big one.

Ingrid Neitsch, director, Financial Risk Management: If you talk about stressed capital structures, then you could argue that almost every company at the moment has a stressed capital structure because they cannot get financing. A company is stressed to me when the yield of their debt does not trade based on what their rating is. Distressed is either when you're bankrupt or there's such a stressed capital structure that you're thinking cents on the dollar, recovery value, and things trade upfront in the CDS world. I believe that 60% of the leveraged loan market is trading at distressed levels right now.

Investors raised a lot of capital in 2007 before the September crisis. But were funds moving into the market too early? What are they doing with the capital they raised?

IN: I think the market moved from a buy-on-dip mentality to a sell-on-strength mentality. And when the first wave came – I think we have had five waves of declines in the bank debt market – the instant reaction having seen 2002 and previous cycles was we must buy on dip because we are in a capital-rich environment. It took a while to recognise that we're actually in a capital-

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Ian Burnett, BlueBay Asset Management

poor environment. This is a deleveraging environment; you sell on strength, you don't buy on dips.

PU: What's also happened – to continue with my theme of yield as a relevant benchmark for the distressed marketplace – is that investors bought into distressed assets early with the idea that they were going to get a high teens or maybe even a low twenties return with asset values priced at a level where leverage is required. That meant that the underlying credit assumptions in the assets fundamentally changed over the course of the last year-and-a-half to incorporate new realities. One, underlying asset valuations have substantially declined. Liquidation value assumptions – whether that's in the corporate market or the home residential market – have declined substantially. Two, the marketplace assumption for the propensity of a borrower to default has increased substantially. Three, the ability of investors to get external leverage on asset purchases has gone down substantially.

JA: The US Treasury's announcement that it would probably not use TARP funds to acquire distressed assets took many by surprise. I've been told that several funds and investors who had bought assets early on in the expectation of the US Treasury buying assets got hurt by the Treasury's change in direction. I wonder whether the view is that this is a market more suited to a hedge fund model or a private equity model where investments are typically locked up for a substantial period?

LG: I think you need the funds locked up. At my previous firm, one of the funds is invested in quasi-private equity commodity special situations and the liquidity has dropped out of that market forcing them to go to shareholders and ask them to accept

Roundtable moderator, Sarfraz Thind

a voluntary three-year lock-up in order to ensure that they can work in investors' best interests and recover a substantial portion of their losses.

IN: It's definitely long-locked money that you need right now. And part of the reason for that is if you can't obtain financing, keeping the assets on your balance sheet is difficult. I think that something that makes it more challenging in this environment is that you're not necessarily earning the very large returns initially on an unlevered, pure return basis. The other issue is that everybody says that compared with the past this is all very cheap. If you look at historical default levels and recovery levels, my view is that the market is always predicting pretty accurately what is going to happen. Nobody looks back at 1998 and says the market moves weren't valid, it was just a technical hitch. So I think the market is telling you that default rates and recovery rates are going to be something that we simply haven't seen before, just like the environment for hedge funds is something we haven't seen before.

Time is a key issue here. But are investors willing to be patient? What do you tell them?
PU: I think it's an education. I think that many investors still have a buy-on-dip mentality. They see cheap bonds and they can buy and sell them in relatively short periods of time so it becomes like a technical trade. I personally don't like that approach. The view has to be based on fundamentals. And one of my mantras is to be given the latitude to do the fundamental credit work that needs to be done. The technicals follow that. It's hard enough to do the underlying credit work but to layer an accurate timing view of technicals on top of that is too much to ask.

LG: You need to look at what distressed is. Let's break down distressed into its component parts. One type of distressed is activist. You buy a company, you get on the board, you force change. This could be something that's under-valued or over-valued. The second type of strategy revolves around working with management and injecting rescue capital which can turn the company around. Another type of distressed is a workout process where the company is going through bankruptcy. All these types of solutions take time. For example, I would guess that the bankruptcy of Lehman is going to take two years. So if you're an investor in a distressed asset, and certainly in a bankrupt one, you're in it for the long run.

Are funds buying distressed assets at the moment or are they sitting back on their deals and waiting for the dust to settle?
IB: I think the actual number of trades happening right now is extremely low, specifically because broker-dealers don't want to take on risk positions. One of the reasons that very few people are stepping into the market is because they see technical pressure on prices continuing right through the year-end and well into 2009. So even if you do see that there are fantastic fundamentals, why would you step in?

LG: The technicals are terrible right now. If you think about liquidity most people think that a fund is or isn't liquid. But if you take a $100 million fund and it gets $20 million of redemption, it's going to sell the most liquid assets it can initially. The next $20 million is going to be the less liquid. When you get to about 50% or 60% of your fund, you're beginning to sell securities that aren't actively traded, or have a quasi-private equity element to them. These tend to be instruments with a longer-term investment horizon, lower liquidity, where deep value fundamental work has been done. However, very few market participants will be able to trade these and give you any liquidity.

Is it the same story for high grade assets?
TS: Not necessarily. If you look at some of the historical investment grade credits, particularly financial corporates that were trading at distressed levels, i.e., double-digit yields, I think we might have found some liquidity for those securities in the last few weeks because we're not trading at those levels any more and people are willing to buy these companies. As far as the high yield or distressed market goes, I agree there are very few trades being done.

PU: Of late a very significant amount of leverage at the non-agency mortgage market level has gone out of the market. And prices are still dropping. The marginal sellers now are mutual funds – i.e., non-levered investment advisors – because they too are experiencing substantial investor redemptions. And starting four or five months ago other asset classes like corporates and government bonds have

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John Arnholz, McKee Nelson

"Moody's expects high yield defaults to range from 8% to 15% worst case. I bet they are wrong. I think you will see 18% to 20% default in an asset class"
Louis Gargour, LNG Capital

experienced this. The pattern is very similar to how it's played out in the ABS market. There is still a substantial amount of direct bank leverage in the corporate market. My prediction is that that will completely go away, and that all of the levered investors in the corporate and levered loan market will go away, and then the mutual funds that manage high yield and corporate loans will start seeing substantial investor redemptions. The pattern will play itself out.

This sounds like total and utter destruction.
LG: One year ago to the day I was speaking at a conference and the guy in front of me was the chairman of one of the US government-sponsored agencies. He said, 'don't worry about subprime, it's only 8% of the total market and our default assumptions are that if 40% of it defaulted, it won't have an effect on the market'. Those default assumptions were completely wrong. Moody's expects high yield defaults to be 10.9% ranging from 8% to 15% worst case. I bet they are wrong. I think you will see 18% to 20% default in an asset class. So every single asset is repricing because expectations of default have been wrong so far.

PU: The best that governments can do is to manage the deleveraging process in a way that is under control so that vacuums of illiquidity don't appear, which is what has happened around the world in the last month and a half. Governments do not have the capacity to affect ultimate asset valuation, nor do they have the capacity to manufacture the conditions for substantial inflows of private capital. All they can do is maintain the sanctity of national institutions and protect the rule of law.

LG: The authorities wanted to bail out banks and avoid the systemic problems. However, banks have not passed on any of the rate cuts or benefited the consumer. I would argue that the US government is probably not doing TARP because it wants the mortgage asset class to revalue. I believe instead the US government will use the programme for assisting in the modification of mortgages so that the foreclosure rate can be brought down.

How do you feel the US government has handled the TARP situation?
PU: The original conception of TARP was not as sophisticated as it could otherwise have been. I think Paulson and Bernanke saw Armageddon. They looked at the markets and realised that what was needed was a 'hail mary' – something big. So Paulson put together a three-page summary, with $700 billion on it, and released it. And it worked from the perspective of giving the marketplace a reason to step back and take a deep breath. But because it was such a 'hail mary', the mechanism by which the $700 billion would be spent was not thought through in a particularly sophisticated way.

IB: I think one of the things that the authorities could do, particularly in Europe, is look at the insolvency regimes and try and create an environment which is more helpful for corporate recovery and preservation of value. There is a growing appreciation across Europe for the Chapter 11 process in the US. It is very good at allowing businesses to stay as going concerns once it becomes clear that their capital structures aren't serviceable any more. We don't have the benefit of a uniform and value-preserving insolvency process across Europe.

IN: Do you still think that will be the case now that the capital markets are closed and you can't get dip finance. Will Chapter 11 be as efficient as it was before?

IB: With no dip financing, every business that goes into insolvency needs to be funded in insolvency and sometimes to a greater degree than it did prior to insolvency.

LG: We'll find out very shortly how Chapter 11 works with General Motors.

There has been talk of the US government bailing out General Motors. Do you think that would ever be possible, as has happened with the banks?
LG: From a political point of view, the government needs to be seen to be helping

out GM in some way because it's not a smart move to let them go under.

PU: They're politically important, they're not economically important.

LG: And where do you draw the line? Banks are systemic. Banks failing is unacceptable. It only takes a certain amount of capital to keep banks from failing. Whereas with a corporate it needs to restructure.

So with all this doom and gloom in the market, can you tell me what opportunities you are looking at right now.

IB: I think the opportunity at the moment is not with distressed companies because the underlying fundamentals are so much worse and we have to think that we are in the early days of a long and deep recession. The opportunities are with issuers that are manifestly not going to fall into any sort of distress. These are market-leading, cash-producing businesses but their securities are trading at low prices because there have been distressed sellers. I would include some of the cable companies in this, some of the banks, and other credits in the investment grade world.

LG: I think that a sectoral approach would be best. Figuring out which companies do badly in recessions and which don't worked very well in the last major downturn. We don't go for companies whose elasticity of demand is very high. We look for businesses that flourish in a difficult economic environment and have steady recurrent cashflows such as infrastructure, media, gambling and others that are recession-proof, and I agree that one should move up the capital and rating structure. Investment grade companies probably offer the biggest opportunity. Cashflows are important. Current paying bonds that are going at stable prices are what we are looking at.

PU: Looking at lessons from the ABS world, the market was of the opinion that there were two reasonable areas to invest in at the beginning of this year in a distressed format. One was at the top of the capital structure – bonds with a relatively short maturity trading in the 90s with a calculated yield of 10%. The second area was deep credit where you were buying 25 or 20 cashflows with no expectations of return whatsoever. It was just a discounting of how long that security was going to be around and how many coupons you could get. Those $90 price securities are now trading in the 70s, and they are trading in the 70s for two reasons. Firstly, because there are more sellers than buyers. And secondly, because the last leg of the evaluative process is now occurring in terms of looking at what impact the legislative process will have on mortgage asset valuations. The question is how fast and how pervasive will the reworking process for mortgages be. That's a big worry right now. The MBS market was first to enter this crisis so there are lessons that can be taken from it to see how other markets will play out.

LG: Our analysis points to the fact that currently the market is paying a significant premium over expected defaults and looks on a historical basis to be very inexpensive. But what worries me is that this is not linear. If spreads go from 800 to 1000, you can intuit the default rate. If spreads go to 1500, then all bets are off. That implies there's no refinancing, that banks are not passing on interest rate cuts, it implies that companies would rather file and be unemployed than continue to burn cash. It means that a lot of people are going to throw in the towel. And don't forget we know that as soon as companies in an industry start to default, the assets are worthless, recovery rates are significantly affected, and banks feel that security in that industry is worthless. I'm therefore very concerned that we are in for much higher defaults than we've seen previously and that the banking system is not going to provide liquidity or capital. We have never seen 1500 over before.

What are the current legal issues you have encountered in the distressed markets?

JA: Legal issues on the ABS/MBS side of distressed investing depend on whether the investment is in securities or whole asset form. For example, there are substantial licensing issues if you hold a mortgage loan directly. As a result, it may not be economical or feasible in certain cases to acquire whole mortgage loans. Care must also be taken to evaluate recently enacted legislative changes relating to loan modifications and foreclosure. Finally, the level of diligence that should be completed on any distressed asset or ABS/MBS investment has substantially increased given the current challenges of the market. Funds must also evaluate the most appropriate form to hold these assets, both for tax and liability purposes.

TS: From our perspective, being global, we are looking at opportunities where there may be a misunderstanding or an incorrect interpretation between foreign and domestic inter-company guarantees. We'll look at opportunities in obscure areas and try to get a feeling about how people are interpreting the situation and take advantage of positive cashflow companies being sold based on liquidity and other issues.

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> Paul Ullman, Highland Financial Holdings

IB: In the corporate world legal issues are going to be front and centre for distressed investors. When you're sitting around the table doing a restructuring, the strength of your legal position is one of the key blocks on which you build your case. As we go into the next period of major across-the-board restructuring, we will be dealing with corporates that are more multinational than ever before and with capital structures that are more complex than we've ever seen. So there's going to be a whole raft of inter-creditor issues which have not necessarily been tested. I think we will also find that some of the documentation that was put together at the height of the credit bubble was not subject to as rigorous due diligence as it might have been in other times. In Europe we have relatively new insolvency regimes which haven't been tested. So it's simply an enormous set of issues for distressed investors to deal with.

What effect has a changing investor base had on the distressed debt market?
IN: The investor base has become much more complex. As a result, your internal rate of return timeline might shift simply because you're not getting consensus.

IB: Exactly. It's going to be extremely difficult to deal with whole new classes of investor. For example, we have the whole issue of the CDS market to deal with where you're trying to agree to a consensual restructuring for a trigger event when some of the investors around the table, unbeknownst to you, have CDS protection and are more motivated to create a default than a restructuring. We don't have a protocol to deal with that yet. I think that there is a real danger that, in the early days, some companies are going to go bust because the creditors can't get their act together to agree to a restructuring deal.

Finally, and it's probably a tough question to ask right now, but where do you see this market in one year's time?
IN: The first thing you're going to see is a fairly rapid increase in the default rate which in a way should be good. It sounds a bit sad but you almost want to get it over with; let's start the distressed cycle, let's do it properly, let's see the market default so you can pick and choose. What is a bit of a concern on the other side is that capital markets have to be stable. They don't need to go up, but the technical pressures, the lack of ability to do restructuring and banks not lending – you need these issues to stabilise in order to optimise returns on distressed.

PU: I think house prices are going to bottom over the next 12 months. That should be a great thing. They are not going to go up, but they should stop going down which should help enormously.

IB: I would say that house prices stabilising is a very early indicator of confidence, though after that point there is still a long way to go for the corporate investor.

LG: We did some research into post-war unemployment rates. The steep exponential rises and drops in unemployment take six months. The width of the unemployment peak is usually two years so we're in for a three-year approximate cycle before it gets better. We're only six months into those three years. It's going to be a very difficult period with higher crime, reduced resources from government, high unemployment, large number of insolvencies, just a mess. Investment grade is probably the best bet right now; you don't want to buy distressed yet. I would short high yield.

Thank you all for your time.

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