Then and now

Executive summary

- While some investors have been invigorated by the rich pickings and abundant opportunities created by the credit crunch, many lenders, companies and consumers are suffocating. But there is money in distressed debt. For treasurers, the advice is to keep the dialogue open with the lender as the predator might just turn out to be a saviour after all.

How times change. Just a few years ago, benign was the standard term for describing the financial environment. Defaults were at historic lows. Liquidity was abundant. Treasurers and leveraged buy-out (LBO) issuers could write their own clauses – or exclude them in the case of covenant-lite agreements – and offer alternatives to paying interest. And asset underwriters were so relaxed they floated into work. Financially, it was all a summer breeze, but amid the haze and euphoria, few saw the storm clouds of complacency and excess brewing.

WINDS OF CHANGE Who would have thought that the winds of change would turn as dramatically as they did in mid-2007? But, as Thomas Huertas of the Financial Services Authority (FSA) reminded delegates at the Distressed Debt Conference back in 2006: "Bad loans are made in good times."

The astute minority of investors, including Goldman Sachs (according to Seeking Alpha, a provider of stock market opinion and analysis) and certain hedge funds, called it just right by shorting the US housing market. Those happy few caught the crest of the wave as sub-prime mortgage defaults rose in the US and asset values came crashing down on structured security prices, washing off $200bn of value, according to Reuters.

Investors were sent scrambling to hoard their money in traditional safe-havens and banks refused to lend to each other, fearful of what they might find lurking in the dark damp recesses of each other's balance sheet. For some, notably investment bank Bear Stearns in the US and mortgage bank Northern Rock in the UK, the financial wheels came off.

The shockwave in the US markets was felt in the European banking sector, shaking the very foundations of household names such as RBS, HBOS, UBS and Bradford & Bingley, which had to go cap in hand to their shareholders to shore up their creaking equity after billions of pounds' worth of asset write-offs.

THE AFTERMATH Banks battened down their hatches to stem further credit losses, conserve cash and ration their depleted capital. They tightened their lending criteria for companies and consumers, bypassed the mortgage broker market so they could take control of volumes, and ramped up the cost of mortgages to many – especially those with adverse credit histories – or simply denied them access to debt altogether. The property markets contracted and commercial and residential property prices began to fall: almost 20% on average in the UK since mid-2007, according to Reuters.

To complicate matters, inflationary pressures from a run on energy, commodity and food prices constrained the Bank of England's attempts to reduce interest rates further to stave off a recession, and Libor stubbornly stayed well above UK base rate.

Some investors were invigorated by the atmosphere of doom and gloom. They saw rich pickings and an abundance of opportunities ahead, whereas many lenders, companies, investors and consumers were suffocating.

One barometer of financial distress is the price at which investors can buy an ailing company's debt. As companies get into distress, their debt becomes less valuable, and cheaper to buy. Why is this?

In mathematical terms, it is because investors use a higher risk-adjusted rate of return to discount the cashflows of the debt, owing to its higher perceived risk. This greater discounting reduces the present value of the debt (its mark-to-market value or price).

Investors sensing this fall in prices seek to buy the debt of those companies whose debt price they believe is lower than what it would be if the company were no longer in distress or the market returned to pricing efficiently. This is a big if, but for investors with an eye for a bargain or the experience to turn distressed companies around, the returns can be substantial.

HERE COME THE GRAPHS *Graphs 1*, *2* and *3* illustrate the increasing pessimism about corporate credit risk since mid-2007 to June 2008.

WHAT GOES AROUND COMES AROUND? **PERMJIT SINGH** LOOKS AT DISTRESSED DEBT.

The iTraxx Crossover (see *Graph 1*) shows the annual premium in basis points to insure 10m of debt against credit default over a five-year period of a representative basket of sub-investment-grade European corporate debt. Since mid-2007 the cost of insurance has risen from 200bp to over 600bp in April 2008.

The LevX Index (*Graphs 2* and *3*) illustrates the same story, but this time for credit default swaps (CDS) on non-investment-grade leveraged senior and junior corporate debt.

The price of such CDS (*Graph 2*) fell sharply in mid-2007 to a low of 90% of their face value in April 2008. *Graph 3* shows the bid-offer spread has been volatile and widening, which reflects the greater uncertainty over the future performance of corporate debt, premium for liquidity, and difficulty in valuation.

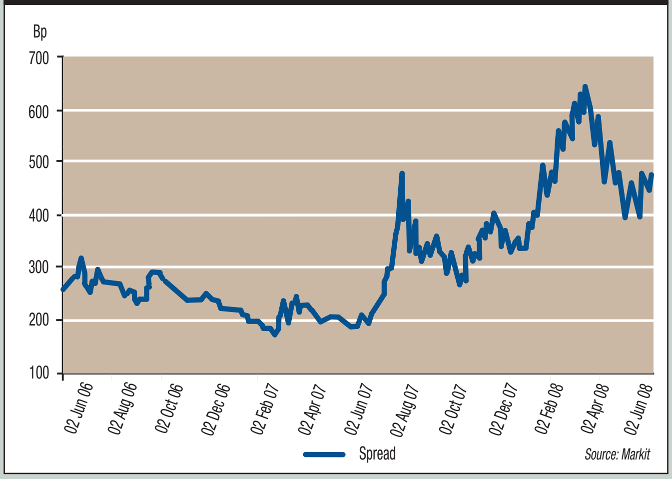
DEFINING DISTRESSED DEBT At what point does debt become distressed debt? A difficult question because there is no standard answer. According to the International Insolvency Institute (III), among others, it could be when:

- The borrower is unable to service its debt obligation in a timely manner (either once or for three consecutive periods) and any grace period has expired;
- The borrower has begun insolvency or reorganisation proceedings; or
- Its debt is trading at a price of less than 70% of par, or greater than 10% over government treasuries.

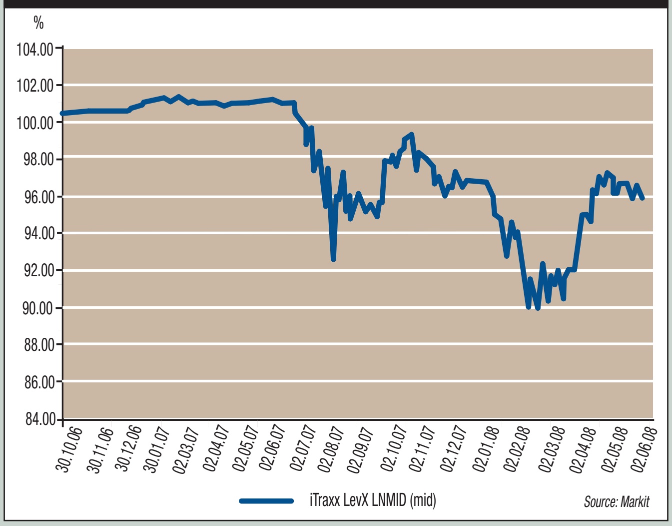
It's perhaps worth clarifying that distress in this context refers to the borrower, since it is the borrower that is in distress to meet its obligation to service and repay its debt.

Lenders might feel distressed for other reasons. These might include insufficient capital, overexposure to a sector (such as leveraged buy-out debt a bank had intended to sell on), and insufficient return on performing assets. To offload performing debt,

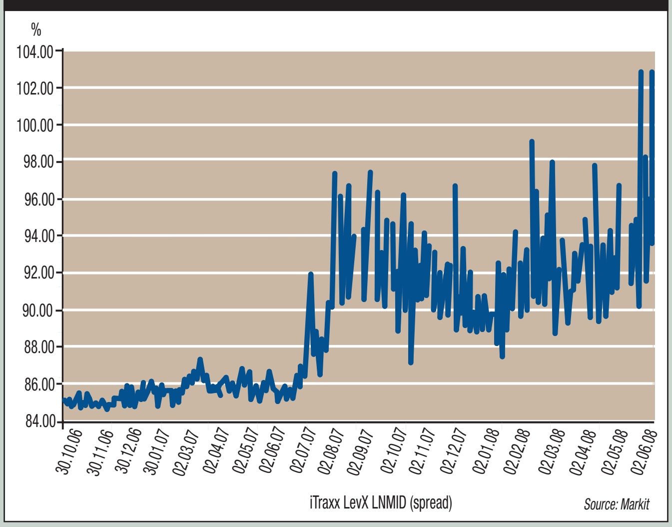
Graph 1: iTraxx crossover Jan 2006 to Jun 2008



Graph 2: iTraxx LevX mid-price Jan 2006 to Jun 2008



Graph 3: iTraxx LevX spread Jan 2006 to Jun 2008



banks might be willing to accept a discount, but such debt would not fall within III's definition of distressed debt.

Neil Murray, Partner at London law firm, Travers Smith, says: "Usually, debt trades at a discount because there's something wrong with the borrower. The curious situation here is it's to do with the banks because they want to unload it."

So what are the options for lenders and buyers of distressed debt?

- **Lenders can:** sell the debt, simply hold on to it, try to turn the borrower around to recover their investment and earn a return on it, obtain the borrower's consent to sell the debt, transfer the credit risk or total return of the debt using derivatives such as CDS or total return swaps.

- **Buyers can:** hold the debt with the intention of selling on when its price rises, or hold it to maturity to enjoy other benefits such as conversion to equity and voting rights.

According to Annerose Tashiro, a specialist cross-border restructuring lawyer at Schultze & Braun in Germany: "In Germany, buyers typically seek to turn an ailing company around and then either refinance the former distressed debt or continue to hold it and earn a return from the improved cashflow of the company. IPOs [initial public offerings] are not a common exit route."

As in most professions, there are rogues: nuisance buyers who acquire distressed debt because it gives them the right to participate in negotiations with the company and other investors, and who use this right to get paid off handsomely so they are no longer a nuisance.

WHAT ARE THE FACTORS TO CONSIDER WHEN BUYING OR SELLING DEBT? As is often the case, understanding and pricing properly the finer points of a transaction can mean the difference between creating value and destroying it. According to the FSA's Huertas, factors to consider when buying or selling debt include:

For lenders
- opportunity cost of future earnings forgone if the borrower relationship is terminated or soured by selling;
- potential breach of the FSA principle that customers should be treated fairly if the buyer is less sympathetic to the borrower;
- probability and net present value of achieving a successful turnaround; and
- net present value of getting consent to sell, and then selling, the debt, versus the net present value of a hold and turnaround strategy.

For buyers
- whether title over the assets providing security has been acquired;
- whether rights to remedies available to the seller have been acquired;
- obligations (past, present and future) taken on by the buyer;
- position in the debt repayment queue in the event of bankruptcy;
- legal preference given to the rights of debtors relative to creditors;
- bargaining strength relative to creditors of the same class or of other classes;
- should the buyer acquire control of the borrower, whether it could effectively operate it or have to outsource the operation;
- the ability to properly value the debt and/or borrower in relation to selling it; and
- likely relationship with the borrower and other stakeholders – antagonistic or amicable – and the influence of this on the exit strategy.

SILVER LINING The distress of companies and the banking sector credit crunch is a combination of events whose potential value has not gone unnoticed by opportunistic investors (more about euphemisms below).

Companies such as Assetz have been set up to provide seed capital for property developers – funding that pre-credit crunch would have been provided by banks.

Shore Capital, the boutique UK investment bank, is setting up a $500m fund to invest in undervalued commercial property of distressed European companies, and to provide mezzanine funding to entrepreneurs seeking to exploit a weak market – a funding gap left by cash-strapped banks.

Invista Real Estate, the UK-listed real estate fund management group, set up a £250m opportunity fund in January 2008 "to identify and exploit real estate opportunities arising from mis-pricing".

That same month, Evans Randall, the UK investment banking and private equity group, created a £1bn opportunity fund "to take advantage of a short-term yield shift in the market that has seen certain property owners seek to liquidate assets in response to redemptions by their investors, or because of other liquidity issues".

Cynics might say that opportunity fund is a euphemism for vulture fund. Others see vultures and similar predators as providing a valuable service. A blog in *Hedge Fund Review* in April this year quoted a lawyer: "The vulture funds serve the same purpose as sharks do in the ocean. They are coming in to clean up the mess from all the bad debt, in the same way sharks eat fish in the ocean. It's actually a service."

According to Creditwire, Assetz is establishing the UK's first vulture fund to buy up hundreds of repossessed residential properties every month. Repossessed properties – and there are forecast to be 40,000 of them in 2008 – are typically bought at an average discount to market value of 15-20%.

Germany's former Vice Chancellor, Franz Müntefering, dubbed opportunists "locusts". The current administration seems to have endorsed his view by pushing for a law to restrict the trading of corporate debt and a recurrence of asset-stripping.

"Although the law will empower borrowers to block a transfer of their debt, it will on the other hand allow banks to respond by increasing their loan interest rate to ensure a risk-adjusted rate of return," says Tashiro.

Iain Burnett, co-head of European distressed debt at London-based asset manager BlueBay, sees opportunities ahead in the distressed market. He points to increasing acceptance among sellers, traders and buyers of distressed debt as a tradeable instrument complementing the established market for trading of performing debt. The poor economic outlook is also likely to tip further companies over the edge into financial distress. And it's not just overstretched LBOs that have to worry, but more conventionally capitalised companies unfortunate enough to be in the wrong sector at the wrong time – such as retail, leisure and travel. Those companies may now be reaping the consequences of lax financial decisions made in easier times.

"What's unique about the current cycle is the increase in the number of financial companies we are seeing in distress," says Burnett.

Northern Rock is perhaps the most spectacular example. At one point, its preference shares were trading at a 70% discount. Its senior debt has been less volatile, with a discount of 10% to par at one point.

THE PROCESS Corporate debt that is distressed is usually sold by investors to other investors via a specialist broker or trading desk of an investment bank, for which the intermediary takes a spread. So, for example, Northern Rock senior debt might be offloaded by a pension fund (a primary market investor) to a trading desk at 66% and on-sold by the desk to an opportunity fund (a secondary market investor) at 67%. The intermediary might also act as a principal.

After initial interest is confirmed by the buyer, and a confidentiality agreement signed, the seller releases relevant information so the buyer may complete due diligence. This includes confirming the creditworthiness of the borrower (to determine a price for the distressed debt), and assessing the legal documentation relating to the borrower's current capital structure (to determine the buyer's rights and remedies in relation to other investors).

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Having acquired the debt, the buyer will then make direct contact, usually for the first time, with the borrower's management to discuss a turnaround strategy (if that is the buyer's intention). Generally, the buyer's strategy will be to:

- increase the market price of the distressed debt;
- increase the market value of the borrower; or
- improve the cashflow of the borrower.

Each strategy will enable the buyer to earn a return on investment through refinancing the debt, selling the borrower, or holding onto the debt and receiving its par value on maturity plus interim interest.

The buyer will need to negotiate, agree and then co-ordinate its strategy in conjunction with other investors, such as private equity investors, and agree a common exit route, such as an IPO or debt-based refinancing.

Defining and executing a strategy can be undertaken by the buyer in association with turnaround specialists, especially where the buyer (such as a hedge fund or collateralised loan obligation manager) does not have in-house expertise.

HEDGE FUNDS Hedge funds often also outsource the ongoing administration of their distressed debt portfolio.

Typically, once the fund has bought the debt, the administrator will confirm the trade, enter it into its administration and accounting system, arrange and reconcile settlements, and perform and distribute monthly net asset valuations to hedge fund investors (valuations are based on either market prices for the distressed debt, or, if they are not available, mark-to-model).

"The percentage of our administration service dedicated to distressed debt portfolios has increased owing to increased interest in the asset class from brokers, hedge funds and hedge fund investors, and we see this continuing," says Tim Thornton, Managing Director at hedge fund administrator Fulcrum Fund Administration.

Administrators such as Fulcrum are also more in demand because investors increasingly want an independent valuation and verification of hedge fund portfolios.

Just as there's money in muck, so there is in distressed debt. For treasurers the advice is to keep the dialogue open with the lender – whoever it is. They might not be a predator but a saviour after all.

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