INSOL International

Economics and Geographical Implications of Hedge Funds in Distressed Debt

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Economic and Geographical Implications of Hedge Funds in Distressed Debt

Contents

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Acknowledgements

INSOL Internationals Technical Research Committee are delighted to be able to introduce a new technical series, which will provide short papers on specific current issues. The Committee propose to publish three papers a year that will build into a technical resource for future reference for INSOL's members.

The first paper entitled "Economics and Geographical Implications of Hedge Funds in Distressed Debt" has been kindly written by Sandra A Larratt-Smith, Swing Bridge Capital and Steven P. Ordaz, BMC Group. We would like to express our thanks to them for producing an extremely interesting paper to commence the new series. This is an excellent subject to start with as it is very complimentary to our most recent publication Credit Derivatives in Restructurings A Guidance booklet by the INSOL Lenders Group, which members will have received in November 2006.

Some market leaders project that greater liquidity in the financial markets will ultimately result in increased defaults and even more difficult restructurings. Others believe using these fulcrum securities to gain control of a company is becoming a more common strategy. Whatever the strategy, it seems that hedge funds have proven to be of significant value not only to investors, but to thriving corporations all over the world. We are pleased to be able to present this first paper to you and hope that you will find it useful.

Economic and Geographical Implications of Hedge Funds in Distressed Debt

Hedge Fund Background: Brief History

When originally created, a hedge fund was simply an investment strategy designed to offset investment risk. The first hedge fund, established by Alfred Winslow Jones, as a private partnership in 1949, invested in equities and used leverage and short selling to "hedge" the portfolio's exposure to movements of the corporate equity markets. In effect, the fund shifted exposure from market timing, with the accompanying risk of holding long stock positions to stock picking, by short selling other stocks. Initially a general partnership, Mr. Jones converted the fund to a limited partnership, and created the first multi-manager hedge fund. Other funds in the 1950s also began short-selling of shares, but it was not their principal investment strategy.

In his work Hedge Funds and Managed Futures, excerpted in his article "The Origin of Hedge Funds"[i], Dr. Philipp Cottier, Ph.D., University of Gallen, Switzerland, follows the development of what today involves close to $1.2 trillion in assets under hedge fund management. What apparently set the hedge fund world ablaze was a 1966 article in *Fortune* magazine, where investors learned that the fund established by Mr. Jones had outperformed all other mutual funds, notwithstanding a 20% investment fee.[ii]

Not surprisingly, this created a very quick increase in the number of hedge funds in a short period of time, which were followed by failures by inexperienced managers in the late 1960s and in the early '70s.[iii] Since that time, there have been have been more successes and failures, and now according to Dr. Cottier (with notable successes of individuals like Julian Robertson and George Soros), the hedge fund industry since 1995 and 1996 has weathered the last round of substantial losses and bankruptcies and "has entered a more mature stage".[iv]

Today, as indicated, the hedge fund industry globally has grown exponentially, i.e., four-fold from the period from 1990 to 2003.[v] The SEC defines a "hedge fund" as a type of private and unregistered investment pool that employed sophisticated hedging and arbitrage techniques to trade in the corporate equity markets. Traditionally, hedge funds have been limited to sophisticated, wealthy investors. Over time, the activities of hedge funds broadened into other financial instruments and activities. Today, the term "hedge fund" refers not so much to hedging techniques, which hedge funds may or may not employ, as it does to their status as private and unregistered investment pools.[vi]

Compared to the asset class of mutual funds, hedge funds are similar in that they both are pooled investment vehicles that accept investors' money and generally invest it on a collective basis. Hedge funds differ significantly from mutual funds, however, because hedge funds [in the U.S.] are not required to register under the federal securities laws. They are not required to register because they generally only accept financially sophisticated investors and do not publicly offer their securities. In addition, some, but not all, types of hedge funds are limited to no more than 100 investors.[vii]

Unlike mutual funds, hedge funds are not required to adhere to certain regulations concerning leverage, liquidity, redemption, pricing, conflicts of interest and disclosure. For instance, they can use leverage to invest in illiquid products which may not be easily redeemable or marked to market. Also, they are not required to adhere to the strict conflict of interest and disclosure requirements mandated for mutual funds.

This freedom from regulation permits hedge funds to engage in leverage and other sophisticated investment techniques to a much greater extent than mutual funds. Although hedge funds are not subject to registration and all of the regulations that apply to mutual funds, hedge funds are subject to the antifraud provisions of the federal securities laws.[viii]

Hedge funds have incorporated the freedom and flexibility required to take immediate action of somewhat risky, but potentially more profitable investment opportunities as they are presented in the marketplace. They can invest in a multitude of strategies, including those categorized as "arbitrage", "event driven" or "mixed". For example, a convertible arbitrage fund will go long convertible securities (preferred shares or bonds) which are convertible into a number of common shares at a fixed price; by shorting the underlying shares value is gained in the spread. "Short Selling" can also be a lucrative arbitrage method for hedge funds. Buying equity in companies expected to be involved in a positive occurrence or a "Special Situation", as in an M&A transaction or a favorable new product roll out, is practiced by "event driven" hedge funds. Lastly, as various strategies are combined, a "mixed" hedge fund investment goal may be adopted. For instance, "Market Neutral" funds may go long and short to provide a neutralized risk for clients and "Macro-Global" funds can employ derivatives in order to speculate on interest rate and currency moves.

In this paper, we are highlighting "Distressed Debt" funds which incorporate many of the hedging strategies defined above. Hedge funds that invest in distressed debt are focused on the event of a company's restructuring or a Chapter 11 filing. By purchasing the public bonds, private bank debt or trade claims at a discount, the investor hopes to exchange those instruments for new securities in the reorganized company. This arbitrage provides either a high yielding rate of return when the securities are liquidated or a longer term holding initiated with cheap equity. Additionally, he may perform profitable transactions throughout the bankruptcy by shorting bonds against claims.

This specific subgroup of distressed debt investing by hedge funds has attracted enormous investor intrigue in recent years, especially since 2003, after investors posted huge returns and made sizable capital infusions.

Distressed Debt Hedge Funds: Impact, Value Proposition and Potential Concerns

Size

The total number of hedge funds specializing in distressed debt investing is estimated to be at least 160 in the U.S., with about 25-30 in Europe. The increase in the number of distressed focused funds has grown by about 10% per year since 2000, when only 100 such funds existed in the U.S., with only a handful in Europe. As of the summer of 2006, the size of the distressed debt market was said to be approximately $620 billion face value, or $500 billion market value. Distressed debt hedge funds saw net inflows of money in 2005 of $1.7 billion, according to Hedge Fund Research, a Chicago data firm, which while large, was actually down from $6.6 billion the year earlier. Funds are also being formed in Asia and Europe, with the focus of investing in non-performing loans (NPL's) from either the Japanese and Chinese banks or of those banks in Germany and Italy. A graphic borrowed from Edward Altman's article regarding default and recovery markets[ix] illustrates the rise in face value and market value of distressed debt in roughly the last two years:

ESTIMATED FACE AND MARKET VALUES OF DEFAULTED AND DISTRESSED DEBT 2004-2006 ($ billion)

	Face Value			Market Value			
	12/31/2004	12/31/2005	6/30/2006	12/31/2004xFV	12/31/2005	6/30/2006	Market/Face Ratio
Public Debt							
Defaulted	$ 152.0	$ 170.4	$ 165.6 (1)	$ 76.0	$ 93.7	$ 107.6	*0.65* (4)
Distressed	$ 36.6	$ 49.3	$ 27.8 (2)	$ 23.8	$ 34.5	$ 19.5	*0.70* (4)
Total Public	**$ 188.6**	**$ 219.7**	**$ 193.4**	**$ 99.8**	**$ 128.2**	**$ 127.1**	
Private Debt							
Defaulted	$ 334.4	$ 374.9	$ 364.3 (3)	$ 234.1	$ 299.9	$ 309.7	*0.85* (4)
Distressed	$ 80.6	$ 108.5	$ 61.2 (3)	$ 68.5	$ 97.6	$ 55.1	*0.90* (4)
Total Private	**$ 415.0**	**$ 483.3**	**$ 425.5**	**$ 302.6**	**$ 397.5**	**$ 364.8**	
Total Public and Private	**$ 603.6**	**$ 703.0**	**$ 618.9**	**$ 402.4**	**$ 525.7**	**$ 491.9**	

(1) Calculated using: (2005 defaulted population) + (1H 2006 defaults) - (1H 2006 Emergences)
(2) Based on 2.80% of the high yield bond market ($993.6 billion)
(3) Based on a private/public ratio of 2.2.
(4) The market/face value ratio was 0.55 for public defaulted debt, 0.70 for public distressed debt, 0.80 for private defaulted debt and 0.90 for private distressed debt in 2005

Sources: Estimated by Professor Edward Altman, NYU Stern School of Business from NYU Salomon Center's Defaulted Bond and Bank Loan Databases

Description

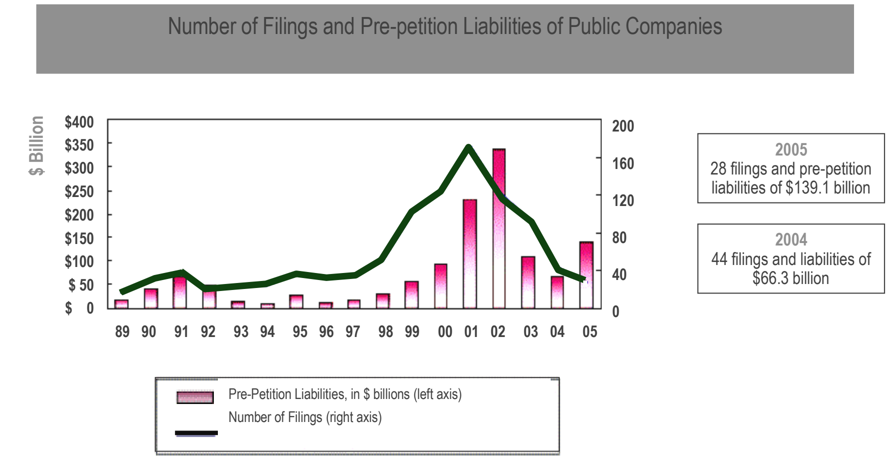
Distressed debt investors are also known as "Special Situation Investors" because of their interest in purchasing investments in companies experiencing financial trouble such as a restructuring or a Chapter 11 reorganization. By making speculative investment purchases at a discount in either public securities, such as high yield bonds or private debt including senior bank debt, 2nd lien loans, and trade claims, they hope to earn high rates of return on their holdings when the company emerges from bankruptcy and their claims are exchanged for new securities or cash. Investment in these obscure instruments require that the investor make the right decisions regarding the value of the potential business, the price he will pay for the investment and the strategic opportunity that will generate incremental value. Distressed debt investors have become quite successful in this speculative, yet profitable investment arena due to their willingness to take on risk and employ creative and innovative techniques.

Growth

In addition to the trend of investment banks like Morgan Stanley acquiring stakes in hedge funds such as Avenue Capital, FrontPoint Partners and the London-based Landsdowne Partners, private equity investors seem to be jumping on the band wagon by forming distressed debt funds of their own. Kohlberg Kravis Roberts' new $1 billion Strategic Capital Fund was formed to begin operation by this past June. Their rival in the buyout world, Blackstone, launched a $500 million distressed debt hedge fund, while Carlyle raised a $1 billion fund. In addition, the London based banking group of HSBC and LittleJohn, based in Greenwich, CT are also said to be putting together their own funds.

Howard Marks, the chairman of $30 billion Los Angeles-based fund OakTree Capital, which has $4.7 billion in distressed debt plus $9 billion in high-yield bonds, says the distressed debt market has been challenging due to less opportunities, but trends indicate distressed debt funds could be poised for better times ahead[x].

Although the size of funds dedicated to distressed debt investing has grown substantially, the deal size has contracted. There has been too much capital chasing too few deals. According to data provided by Edward Altman of NYU's Stern School of Business, the number of public companies filing for bankruptcy has continued to slow over the last few years. In 2005 there were only 28, with pre-petition liabilities of $139 billion, versus 2004's 44 filings and $66 billion in pre-petition liabilities. The heyday for distressed investing this decade was in 2002 when distressed investors were busy investing in mega cases making up 120 filings and $350 billion in pre-petition debt.



Source: E. Altman NYU Salomon Center

Many U.S. hedge funds are looking for more opportunities overseas in which to passively invest or possibly in having more control in a restructuring. Investors are establishing new investments in London or Germany, or are looking even further to the Eastern European markets.

Distressed Debt Investment and Trading: Impact on Financial Markets

U.S. Syndicated Loan Market

The U.S. has experienced a tremendous increase in the size of syndicated lending, rising more than 20% per year over the last three years. Loans outstanding equaled $1.5 trillion in 2005. One third of this market or $500 billion in loans is now estimated to have been placed with companies who have issued non-investment grade bonds.

The U.S. investor practice of purchasing bank debt investments has extended into the UK and continental European markets. Bank syndicates and other stakeholder groups, including bonds and mezzanine lenders, are being transformed when a company experiences a restructuring as the original par lenders are replaced by distressed debt investors. However, in the case of syndicated bank debt, UK facility agreements do require that the lender of record be a regulated financial institution. Therefore, as most hedge funds would not qualify as such they are required to become a sub-participant in the original debt. In essence, while they may be able to be influential, all voting would be conducted by the original lender of record. Marykay Fuller, director of Restructuring and Recovery at KPMG LLP has found that rather than act to independently seek a higher return only for themselves, the distressed debt community is working in tandem with the lenders to support the group's value proposition.[xi]

European Bank Debt Trading

European distressed funds had $13 billion in capital ready to put to work at the beginning of 2005. Required rates of return for the European investor range from 12-15% for moderately risky investments and rise to 30%+ for more speculative deals. Distressed trading kicked off in London, beginning with the power generation and telecom restructurings in 2001. Now traders are seeking opportunities offered in Germany, France and Italy, as well as developing markets in Eastern Europe. Activity has included familiar names such as Eurotunnel, British Energy, TXU, and Parmalat.

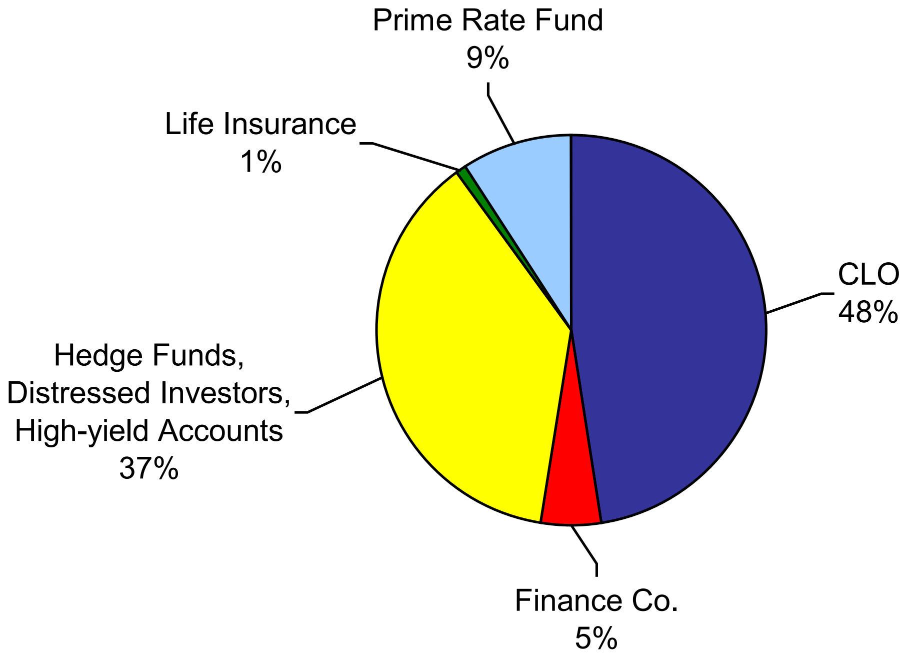
Distressed debt trading in Europe has been most active in the high yield bond market, but also includes syndicated bank debt. Although there are some parties who say that buyers of European senior bank debt got too sweet a deal, overall, the practice of bank debt trading has become an accepted and necessary process for banks in realizing current value. The ability of the investor to provide liquidity to a seller has helped to improve the banking system and its economy. Fortunately, as competition increases among buyers for the purchase of distressed debt, sellers will benefit through higher recovery prices.

Borrowers may appreciate the system's evolving efficiencies as the Capital Requirements/Basel 2 incentives lead them back to the table. The sale of NPLs by European financial institutions is expected to increase as these additional banking reforms are implemented. The Czech Republic has sold more than $6 billion commercial and small and medium enterprises (SME) debt since 2002 as part of its bank privatization process. Germany is offering investment opportunities in the realm of $300 billion. As Europe's insolvency laws continue to evolve towards one which favors restructuring rather than liquidation, the distressed debt investor will be able to look forward to additional opportunities in this market.

2nd Lien Debt

Second lien financing, also referred to as tranche B loans, was developed in the late 1990's to tap into excess collateral values. It is often used in place of high-yield and mezzanine debt. While junior secured debt is offered by some traditional lenders, the market is dominated by hedge funds and collateralized loan obligation (CLO) funds. Hedge funds entered the market and emerged as a dominant player due to their willingness to take subordinated positions to traditional senior-secured lenders, and their quick turnaround and flexible loan structures.

Second Lien Loans by Investor Type



Source: S&P/LCD

Loans are priced at about 500 to 600 basis points over LIBOR, and to hit the fund's target rate of return, are usually leveraged at two to three times. The existence of few investment restrictions for hedge funds has enabled them to form their own origination and loan servicing operation.

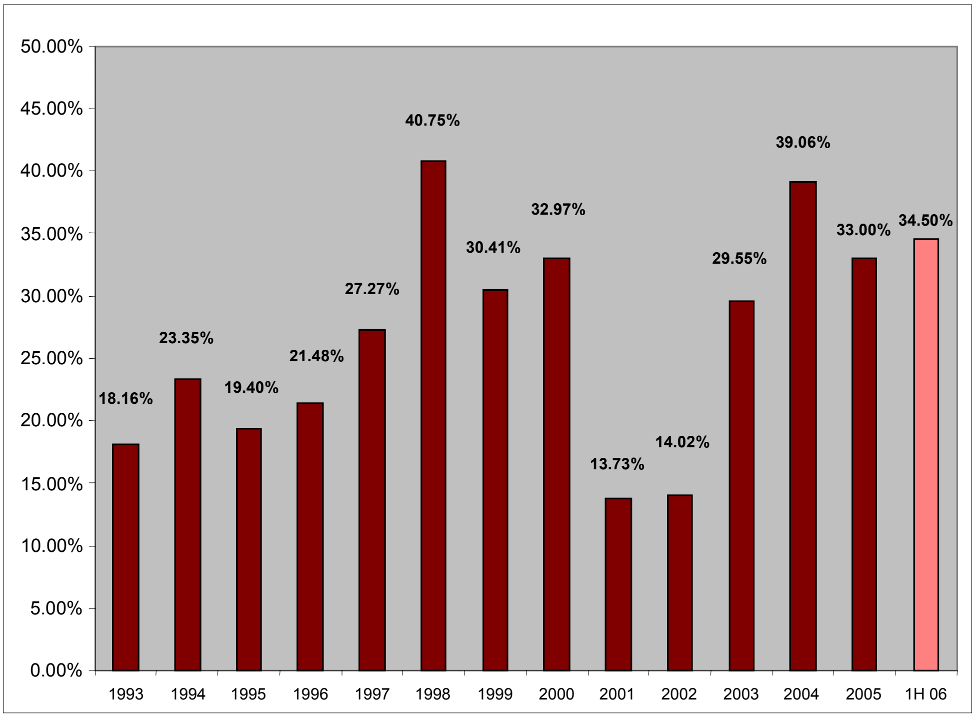
Credit Derivatives

Credit Derivatives, like Credit Default Swaps (CDS) which bet on falling prices of distressed debt have become a more popular instrument utilized by distressed investors. This risky investment has helped fuel the rise in recovery rates. GoldenTree Asset Management LP, a New York-based hedge fund that manages $7 billion gained 13% in 2005 using credit derivatives, said Chairman Leon Wagner[xii]. However, when the European index, iTraxx, lost 16% over the course of two weeks ending November 6th it caused panic selling in the U.S. and European CDS markets, affecting both hedge funds and investment banks as they were forced to unravel their holdings to cover their losses.

Lower Bond Default Rates: Are They Still a Reliable Indicator of Bankruptcy Filings?

A corporate bond is considered "distressed" debt if it has an interest rate that's 1,000 basis points (bps) or more over its respective Treasury benchmark. Defaults are now at an eight year low, even considering the number of major bankruptcies last year, including Delphi, Delta and Calpine. The S&P distress ratio's most recent high was 5.7% earlier in the year, 6.1% in 2005 and 7.4% in 2004. Over the last two years of high yield bond offerings, 42% were rated B- or lower and almost 18% were rated triple C, according to Edward Altman, Professor at NYU's Stern School of Business. Altman, who is known for his valuable studies and projections regarding default rates employs a method of estimating future bond defaults which considers the credit quality assigned at issuance. For instance, according to the Standard & Poor's graphic below, cited by Edward Altman in his recent article regarding default and recovery rates in distressed markets defying forecasts[xiii], the increase in junk bonds (which are rated B- or below) issued since 2002 would normally translate into greater defaults two to four years later. However, it seems that this event has simply not occurred.

Percentage of New High Yield Issues Rated B- or Below Based On Amount of Issuance (1993-1H 2006)



Source: Standard & Poor's, New York.

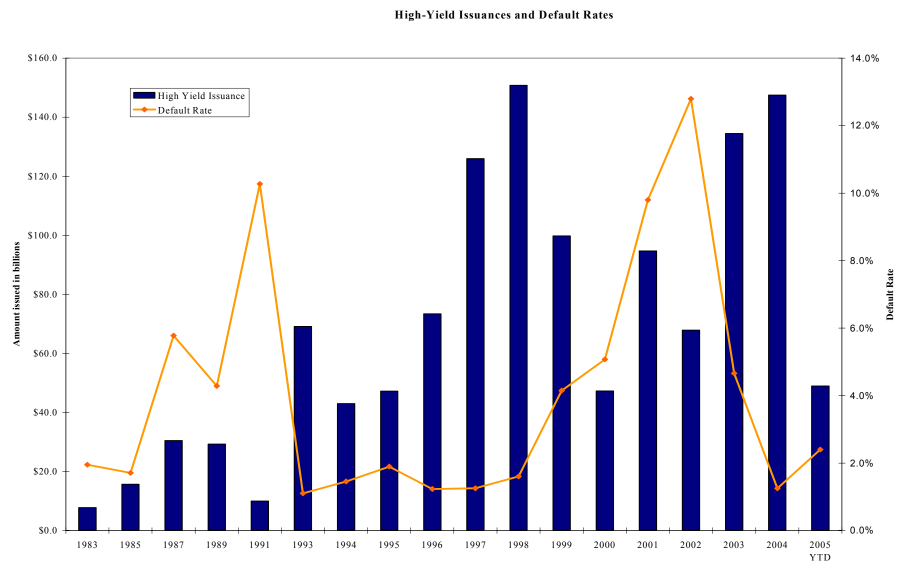
The increase in the capital allocation for distressed debt investing, combined with the ease in lending conditions seems to provide a reasonable answer as to why the number of speculative-grade defaults has been so incredibly low since 2002. Howard Marks, of Oaktree Capital Management, states that "There's been a lot of unwise financing extended" over the last few years, including debt to finance highly leveraged deals[xiv]. Could the impact of increased liquidity, exemplified by hedge funds, be providing the rescue financing that is prolonging bond defaults?

Is There Too Much Leverage?
What is the Impact of High Liquidity on Corporations?

Liquidity Effect

As in the housing market, where homeowners are less likely to default on their mortgages by accessing the invention of new products and flowing credit, a similar scenario has been created in the debt market. Distressed companies that may not qualify with traditional credit sources are being evaluated by distressed debt hedge funds for investment. This increased amount of capital being infused by hedge funds has provided companies with a second or third restructuring opportunity where in a less liquid environment they would have defaulted.

Issue and Default Cycle



Source: Citigroup Estimates and National Economic Accounts

The market is awaiting the verdict as to whether or not they will actually experience their 2004 speculative-grade bond issues default after three years, as forecasted by S&P. See also, illustration of issue and default cycle in the Kellogg School of Management table above[xv].

Lately, financing packages for distressed companies in this environment of massive liquidity have become more aggressive. Even leveraged buyouts which were once popular in the late 80's are making a comeback, deals rose to $256 billion last year, per Bloomberg data.[xvi] According to Miller Buckfire's Kenneth Buckfire, the amount of leverage, or the ratio of debt to cash flow of the typical junk-rated borrower increased to 5.3 times in 2005 from 4.3 times in 2004[xvii]. A study by Kellogg represents that the LBO purchase price to EBITDA multiples have become more aggressive as well (for example in 2005 they were 8.5x versus 7.2x in 2004).[xviii]

The amount of leverage taken on by companies recently is astounding. Over the past few years, St. Louis-based cable-television operator, Charter Communications Inc. and Intelsat Ltd., a Pembroke, Bermuda-based satellite operator, were among borrowers that sold a record $50 billion of debt which was rated below B3 by Moody's. Moody's records show that about 60% of bonds rated below B3 default within five years. Money flowing into the high-yield market has allowed "these companies to put off what we call 'the day of truth'" said Harvey Miller, vice chairman and a bankruptcy lawyer at investment bank Greenhill & Co. in a Bloomberg interview[xix].

Is greater liquidity in the financial markets actually a double-edged sword? Although its existence may allow stressed companies to remain afloat, are these re-financing packages adding far too much leverage which will result in increased defaults later and even more difficult restructurings? Fortunately, as the cycle moves from overly zealous financing of struggling companies to distress and bankruptcy, the distressed investor steps in. More purchases of distressed firms have taken place as investors recognize a company's viability given a new capital structure and new management.

Distressed Debt Hedge Fund Strategies

Impact of Active Investing on Reorganizations

Distressed debt investors may be passive investors who will purchase secured debt or bonds at a discount and hold the debt through the reorganization, collecting their recoveries once the company emerges. While many investors stand in the wings and allow the reorganization to evolve without interference, there are increasing numbers of "vulture investors" who, by accumulating blocking positions, are playing a more active role and are dramatically influencing the outcome of their recoveries. Their investment view is likely to be more short term than the longer term outlook held by the company's vendors and original lenders.

On the other hand, long term sighted investors have used these fulcrum securities to gain control of a company through a "loan to own" strategy; which not only provides them with more options but the company with a better chance of survival. Rather than being content with a short term transaction in a bankruptcy or keeping a stressed company on life support by providing financing, they may actively use their positions to get involved in the management of the company or to take control of the company. By adopting a committed investment approach, they are able to affect the long term viability of the business.

There have been many instances where "active investing" has been employed by the investor whereby a large position of debt is used to influence the reorganization of the company. "The investment activity of distressed investors has led to many successful cases of corporate restructuring in the U.S. and worldwide", says Tuck School of Business (Dartmouth College) Professor Karin Thorburn[xx]. This practice has resulted, not only in financial rewards for the investor, but in a greater valuation for the company post-emergence. In many instances, such as in Sunbeam, Kmart, and LTV/Bethlehem Steel, the active investor ends up with control of the company and ends up running it out of bankruptcy. "Active distressed investors can bring significant management skills and experience to troubled firms", stated Professor Thorburn.

Examples of distressed debt hedge funds utilizing their positions to positively affect the viability of struggling companies include an English luxury jewelry retailer, Asprey & Garrard's rescue by an American fund, Plainfield Asset Management and GMAC's (GM's financing unit) sale of a majority stake to Cerberus Capital. Distressed investor, Wilbur Ross purchased debt in Collins & Aikman Corp., an auto-parts supplier that filed for bankruptcy in May, 2005, and plans to convert the debt into a controlling equity stake in order to merge the unit with Lear Corp's automotive-interiors group. Ross, who is chairman of New York-based WL Ross & Co., has also made corporate rescues in the steel industry by purchasing debt and assets in Bethlehem Steel, Acme Metals and Georgetown Steel and then merging them into International Steel Group. He is well admired for his ability to step up to the plate and engineer creative solutions to rescue struggling companies.

Impact of Hedge Funds on Public Company Holdings

Hedge funds' corporate presence seems to be expanding, not only from their interest in distressed companies, but in their desire to be more active in all public companies. A UK fund manager, Gartmore, in an analysis presented for *Financial News* states that hedge funds hold at least a 5% stake in 38% of the world's public companies, having risen by 12% from 2004[xxi]. Gartmore also adds that the number of hedge funds, with a 10% or more holding in public companies, has doubled to 20% over the last two years. When these holdings are added up, eight hedge funds hold a 10% stake in the New York Stock Exchange; nineteen hedge funds hold 26% of MasterCard, 28 funds account for 38% of U.K. cable operator NTL and 10 hedge funds control 15% of Polo Ralph Lauren.

Have public companies become worried about the increasing hedge fund make up of their shareholders? Deutsche Borse may feel somewhat affected by this scenario, considering the forced management change imposed by large shareholders at *Children's Investment Fund Management and Atticus.* Although, one FTSE 100 company finance director commented when asked by *Financial News*, "They have become an important part of our shareholder base; it has changed enormously in just the past two years. The managers we have met have done their home work and ask stimulating questions". [xxii]

Conclusion

As reported in this article, the role of the hedge fund in today's marketplace has become extremely profound in regards to their ability to deliver the funding required for stressed companies to stay afloat and the exit financing for distressed companies to remain in business. They have provided the necessary liquidity for companies to either avoid bankruptcy all together or to reorganize and emerge stronger and better capitalized. Although there may be unresolved questions regarding a hedge funds' profit motives, corporate control issues, or potential regulation, this investment vehicle has proven to be of significant value, not only to investors, but to thriving corporations all over the world.

Endnotes

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[iv] Id.
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[xvi] Carol Salas, "Vulture Funds Get Little to Pick as Too Many Buyers Chase Yield", Bloomberg.com, 2/14/06, available at
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[xvii] Kenneth Buckfire, Miller Buckfire, as interviewed by Carol Salas, in her article, "Vulture Funds Get Little to Pick as Too Many Buyers Chase Yield", Bloomberg.com, 2/14/06.

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[xix] Harvey Miller, Greenhill & Co., as interviewed by Carol Salas, in her article, "Vulture Funds Get Little to Pick as Too Many Buyers Chase Yield", Bloomberg.com, 2/14/06,

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