



Distressed Investing Weathers the Tempest of 2002. Do Clearer Skies Lie Ahead?

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In just 24 short months, it seems the distressed markets have come full circle, experiencing the best of times and the worst of times. Beginning in early calendar 2001, the distressed community enjoyed a renaissance as opportunity flow picked up, liquidity spigots began to flow and it seemed that low hanging fruit was everywhere in high yield returns. Against a backdrop of misery in the global equity markets it appeared the distressed community was enjoying a long-awaited day in the sun.

Unfortunately, by mid-year 2002 those dream conditions had turned into a nightmare. Triggered by a tidal wave of corporate fraud announcements, culminating in the surprise implosion of WorldCom in late June, the market went through a classic liquidity crisis. The impact of the WorldCom debacle rippled across the market over the ensuing months, wreaking

havoc with liquidity and security prices and leaving virtually all distressed managers reeling in its wake.

While the recent past has put many investors off of the distressed asset class, or at least led them to view the strategy with skepticism, a closer look at the business and the opportunities it presents paints a much brighter picture. In fact, notwithstanding some bumps in the road, the distressed investing business is still in the relatively early phases of a historic buying opportunity. As with Mark Twain, reports of its death have been greatly exaggerated.

Bankruptcy

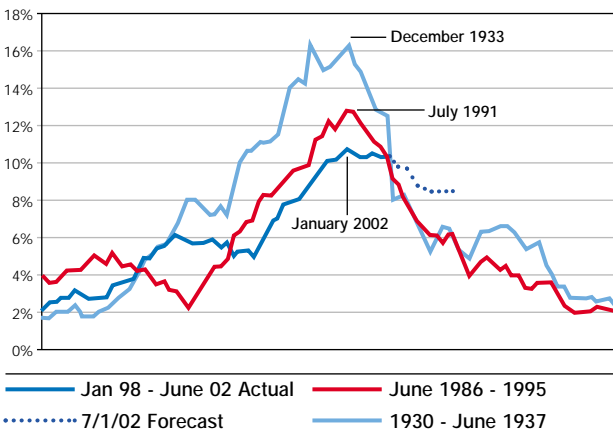
The concept of bankruptcy is an old one, tracing its formal roots to 16th-century England, when Henry VIII enacted the first laws concerning bankruptcy. This punitive approach to dealing with debtors, immortalized in the fiction of Charles Dickens and others, has over time been replaced

with a system that seeks recovery and rehabilitation, particularly for corporate borrowers. It is this system, largely a U.S. invention built on a series of legislative mandates tracing back to 1800, that over time has created opportunity for distressed securities investors.

Even so, that opportunity was fairly limited for many years. Notwithstanding a rash of bankruptcies during the Depression and a handful of spectacular corporate bankruptcies in the 1970s (chief among them Penn Central Transportation), it was not until the 1980s and 1990s that bankruptcy and distressed investing came into its own. This was, not coincidentally, directly following the rise to prominence of the high-yield bond market, which provided access to the capital markets for companies that hitherto would have been deemed unfinanceable.

As a result, investors in distressed securities face an opportunity that, as Moody's Investor Services has noted, is positively historic and rises to the level of being one in three extrema in recorded financial history (see Exhibit 1). At the same time, the cycles of the early 1990s and of 2001-2002 correspond to the economic downturns since the effective advent of the high yield market. And in fact, there is every reason to believe that the distressed investing strategy is an opportunity that is here to stay, as long as high yield bonds are a part of the financial firmament.

20th Century Speculative Grade Default Rate Extrema
Default surge of 2000-2002 one of only three extreme events in the past 80 years



Source: Moody's Investors Services

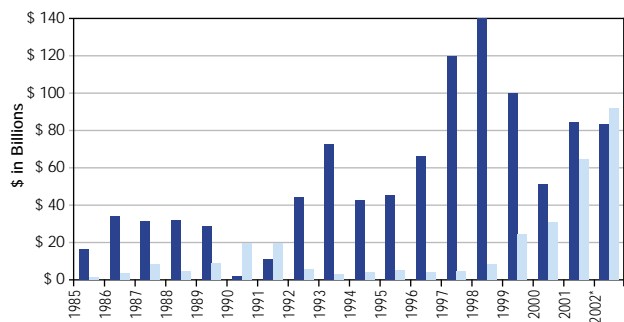
While it is fairly obvious to even the casual observer that the distressed business is cyclical (and counter-cyclical relative to the business cycle) few investors go much beyond that basic observation. In fact, while the turn in the business cycle has historically been a triggering mechanism for a turn in the distressed market, it is not the sole factor, nor is the distressed opportunity completely reliant on an

economic downturn for all investment gains. There is a great deal of complexity to the cycle of distressed debt opportunity and there are sub-cycles within the broader cycle, which typically extend beyond the downturn of the economy. Broadly, opportunities in the distressed market break down into three discrete phases of a longer-term cycle: the implosion phase, the restructuring phase and the resurgence phase.

The Implosion Phase

The initial implosion phase is exactly what it sounds like: after a boom period of high-yield issuance there is typically a period in which companies hit the wall or implode, resulting in a flood of supply of defaulted paper. According to research from New York University professor Edward Altman, from 1989 to 2002 roughly half of all bond defaults occurred within the first three years of issuance (Altman and Bana, 2002). Thus, when the market sees record issuance on the scale of the late 1990s, it is a pretty good bet that a massive influx of defaulted paper will hit the market within a few years and historically that has proven out (see Exhibit 2). This is all the more true when the preceding boom cycle is characterized by a relaxation of credit standards that drives issuance of substandard companies. Qualitatively, the last major cycle, in the early 1990s, was driven by a boom in leveraged buyout financing, while the latest cycle has been marked by a preponderance of technology, media and telecommunications (TMT) companies using the high-yield market as a round of venture capital financing in the late 1990s.

High Yield Dept Issuance and Defaults 1985-1H2002



*2002 figure is annualized based on the first 6 months of the year

■ New Issue Volume ■ Par Value Defaults

Source: Securities Data Company and New York University

This dynamic resulted in what Altman terms the «bad cohort of 1996-1998» (Altman and Bana, 2002), describing a group of high yield issues that was particularly vulnerable



to the inevitable slowdown in high-yield issuance. When that slowdown came in 2000, the impact on these companies was fairly predictable and indeed Moody's Investor Services estimates that in the first half of 2002, over half of all high-yield defaults were in the telecom sector, in line with the breakdown for 2001.

Further complicating this latest cycle is a substantial component of «fallen angels», or original investment grade issues that have descended to distressed levels or even into default. The most notable of these have been in the energy sector, where companies like Enron, Dynegy, Williams, Calpine and Mirant created a largely fictional energy trading market that came crashing down in a series of massive financial scandals. It is these companies that spread the meltdown into the broader market and ultimately broke the back of the high-grade sector.

Anecdotally, the implosion phase seems to play out over 12-18 months, unfolding in the latest cycle from the beginning of 2001 until mid-2002. During this phase the market has certain characteristics, including: weak or uncertain business cycle and economic fundamentals; rapidly fluctuating supply-demand characteristics, as the market is flooded with supply and capital is allocated to the sector to take advantage of the growing opportunity; and a fragile (usually downward biased) overall market environment.

While this dynamic creates challenges for managers in

distressed strategies, it also is a source of opportunity. Many managers de-emphasize the classic value-oriented restructuring investments in favor of shorter-term, trading oriented opportunities during this phase of the cycle. Given our overall event orientation, York has focused especially on event-oriented trades, where the primary driver for returns is some form of significant corporate event such as a merger (e.g. Finova/Berkadia), a lawsuit (Northpoint Communications vs. Verizon), an exchange offer (Level 3 Communications) or some form of industry or sectoral trend (asbestos liability or the California utility crisis).

Another trading-oriented strategy popular among distressed investors, and one that happens to work exceptionally well during the implosion phase of the cycle, is capital structure arbitrage. Capital structure arbitrage, where investors exploit the relative inefficiencies in the various elements of a company's capital structure (e.g., long a bond and short the stock of the same company), works particularly well during the implosion phase as the virtually chaotic market conditions and capital flows facilitate the creation of significant mispricings in both bonds and stocks.

Broadly, these trading-oriented approaches during the implosion phase have the advantage of reducing overall market risk exposure and duration during an uncertain environment. Further, versus the long-oriented value approach, they reduce exposure to business cycle risk and to specific business risks, both of which can be challenging during the early stages of an economic downturn.

The Restructuring Phase

As the implosion phase plays out, the market gradually moves over to the restructuring phase, as the pig-through-the-python of defaulted debt moves from recent default to full-scale workout. This restructuring phase is really the «guts» of the longer-term distressed cycle due to the length of the typical restructuring – according to aggregate market statistics, the average time spent in bankruptcy is just over 22 months (Eberhart, Altman and Aggarwal, 1998) – and the size of the market opportunity.

Within the restructuring phase, the most productive and best-known strategy is what might be referred to as classic distressed investing. In fact, it is this value-oriented approach that many people think of when they think of distressed investing.

In its most basic form, this approach involves purchasing debt in a bankrupt company at a deep discount, working through the restructuring process (perhaps taking a seat on

a creditors committee to represent debtholders' rights) and typically undergoing a debt-for-equity swap through the restructuring process. Ultimately, the investor is looking for companies that have tipped into bankruptcy for reasons that are fixable within a Chapter 11 context (the classic case being over-leverage cured by a debt-for-equity swap) and the strategy allows that investor to create equity in the post-bankruptcy Newco at a deep value basis, taking advantage of the inefficiencies of the bankruptcy process. The characteristics of this strategy are long-term, often illiquid and labor-intensive investments, but the return possibilities far outweigh any disadvantages to the approach.

It is during the restructuring phase that the idiosyncratic qualitative nature of each longer-term cycle is most pronounced and largely determines the nature of the investment opportunity. For example, the early 1990s cycle, the result of the over-leveraging of corporate America during the buyout binge of the late 1980s, presented a supply of good basic businesses that in large part suffered a problem that was fairly easy to fix: too much debt. As a result, opportunities to restructure these companies and clean-up their balance sheets offered fairly straightforward and attractive return prospects.

This latest cycle is more complex. While certainly there are good companies suffering from over-leverage, the majority of the supply flow has come from the aforementioned TMT sector. The challenge this presents is that unlike the relatively simple «good company-bad balance sheet» opportunities of the early 1990s, many of the defaulted TMT companies simply will not survive the bankruptcy process. To the extent then that these situations devolve into liquidations and thus asset plays, that has presented challenges as well, particularly within the telecommunications sector, where a glut of capacity has made asset values difficult to gauge. The energy sector component has created a complicated dynamic as well, with a significant fraud element that must be analyzed and treacherous technicals, as investment grade holders become hairtrigger traders on the downside. Even so, the sheer volume of defaults has ensured that there is ample opportunity in the current cycle in a variety of sectors.

As previously mentioned, restructuring plays entail significantly more business cycle and company-specific risk than event or trading-oriented distressed investing. As a result, the strategy works best at the bottoming-out inflection point in the economic cycle, where the company in question faces systematically improved business conditions as it emerges from bankruptcy. Managers pursuing this strategy

must also have strong fundamental analytical skills and pay particular attention to their sectoral and cyclical exposure vis-à-vis the business and economic climate. At the same time, the strategy can be subject to substantial market risk and particularly periods of illiquidity, a risk which was brought to the fore last year. That risk, however, which is ultimately a mark-to-market issue versus a fundamental or real loss issue, is at the end of the day largely immaterial to investment return.

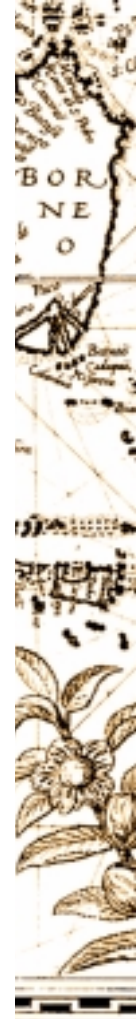
The Resurgence Phase

The last phase of the distressed cycle is the resurgence phase. As companies emerge from bankruptcy, they form a class of what are often referred to as «orphan» equities, stocks that have no research coverage or institutional following and have largely been abandoned by the mainstream investing public.

Ideally, these companies have eliminated the causes of their bankruptcy (over-leverage, liabilities, bloated operations, poor management, etc.) and have emerged as strong and viable companies. As such, they are poised to enjoy improved operating conditions, particularly as the stigma of bankruptcy recedes, allowing normalized access to capital, vendor relationships, etc. Assuming the economic cycle has improved as well, the companies are likely to benefit from a broadly improved business climate.

Unfortunately, as orphan equities these companies can be misunderstood and, in many cases, substantially undervalued. They also may be extremely volatile, particularly given the potential for shareholder rotation as former debt investors seek liquidity in their newly swapped equity stakes. This dynamic clearly is a two-edged sword. For restructuring investors creating equity via the Chapter 11 process, timing liquidity events in post-bankruptcy equity is critical. At the same time, systematic under-valuation can create opportunity to establish de novo positions in post-bankruptcy equities if liquidity is available.

The returns for this post-bankruptcy investing can be profound. Although various studies have shown equivocal results, the most recent and authoritative studies on the subject, notably a 1998 study by Georgetown University Professor Allan Eberhart, demonstrate substantial outperformance of post-bankruptcy equities (Eberhart, Altman and Aggarwal, 1998). Studying the returns of all post-bankruptcy equities for companies emerging from bankruptcy between 1980 and 1993, that report found average cumulative abnormal returns (returns in excess of the those



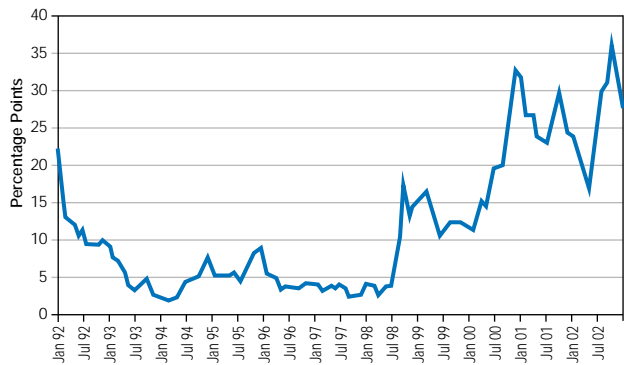


experienced in similar, non-bankrupt companies) in the 200 days following emergence of anywhere from 25% to 139%. Clearly, with careful security selection hedge fund managers can reasonably expect to be in the higher end of that range.

Recent Past – Where Are We Now?

There is no question that 2002 was a trying year for distressed hedge fund managers and their investors. But many of the dynamics must be put into the proper perspective. In the wake of the waves of corporate accounting fraud and scandal experienced in the U.S., the high-yield markets saw significant technical deterioration – buyers pulled back just as supply flooded the market and forced and discretionary selling hit the market broadly. The liquidity crisis that followed pushed prices down across the board, resulting in a dramatic increase in credit spreads, which according to Merrill Lynch research by mid-August had taken the high-yield market on average to distressed levels (1000 basis points over treasuries) for the first time since the early 1990s. As evidenced by the Merrill Lynch distress ratio (see Exhibit 3) this level of value was positively historic. But there is an important distinction for many distressed investors that was lost in sturm und drang of the market's meltdown. In fact, the phenomenon the market experienced

2001-2002: High-Yield Distress Ratio Soars to Record Levels



The distress ratio is the percentage of issues in the Merrill Lynch High Yield Master Index outyielding Treasuries by 1,000 basis points or more.

Source: Merrill Lynch & Co.

was essentially a technical meltdown, accompanied by little or no fundamental deterioration. This distinction between mark-to-market (temporary) loss and fundamental (permanent) loss is one of the greatest sources of misunderstanding about the distressed investing business.

On the one hand, distressed investments can be and are marked to market on a daily basis, leaving them vulnerable market gyrations, which can be severe in a relatively thin, opaque market that trades inefficiently and is known for periods of extreme illiquidity and dislocation. At the same time, these investments have many of the same characteristics of private equity investments. To wit, managers enter these investments looking to capture a value gap between fundamental value and market price. Almost without exception, the companies are undergoing processes, finite in nature, that are moving them toward an endgame that should result in value realization if the original thesis was correct. Along the way, the markets may go into complete freefall, but investors need to remain focused on the endgame, the original *raison d'être* of the investment. To many experienced distressed investors, the market did not experience a crisis in 2002. Rather, it experienced an expected period of illiquidity that did nothing to diminish the ultimate returns from the strategy. Indeed, the sector experienced similar dislocation in the early 1990s cycle when the high-yield markets were thrown into disarray by a combination of the removal of the effective market-maker (Drexel Burnham Lambert) at the same time that the largest buying constituents (thrifts and insurance companies) were essentially regulated out of the market. Then, as now, those markets stabilized and credit spreads came back in to levels that better reflected fundamental value. In fact, by year-end 2002, we had come a long way toward recapturing the

mark-to-market losses created by credit widening, allowing many long-biased distressed managers to fight back to even or better on these investments.

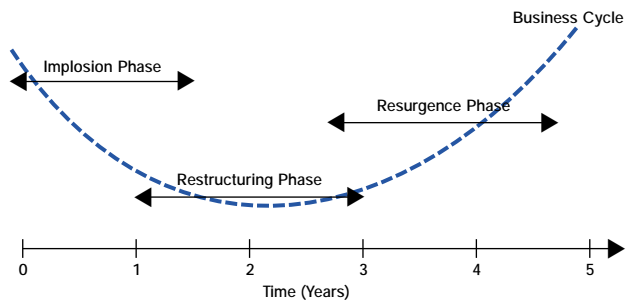
Furthermore, there are clear signs of substantial opportunity ahead for distressed securities investing. We are still in the early days of the restructuring phase of the longer-term cycle. Defaults reached a record level in 2002, spiking to almost 11% by the third quarter (Altman and Bana, 2002), and given the long-term nature of those restructurings, that supply will present opportunities for at least the next 12-18 months.

Looking ahead, there is some disagreement as to whether we have seen the highpoint of defaults. While Altman believes we have seen the peak, consistent with historical norms where defaults peak at the end of a recession, Moody's KMV projects a robust default rate in 2003, with expectations that 5% of public companies will default on their debt this year, roughly in line with 2002 totals. The debate is more than academic, since there is a demonstrated correlation between default rates and recovery rates (Altman, Brady, Resti and Sironi, 2002).

At the same time, these defaults provide the fodder for restructuring investments. This supply in turn should easily support the capital committed to the distressed strategy. In fact, while investors frequently question supply-demand dynamics within the distressed sector, fearing that too much capital flow to distressed strategies will eliminate the opportunity, historically that concern has been misplaced. The inquiry fundamentally misconstrues the basic nature of the distressed and high-yield market, where structural inefficiencies have historically conveyed competitive advantage to established, experienced players. It also ignores overall market data, which demonstrate, as Altman notes (Altman, Brady, Resti and Sironi, 2002) that the ratio of supply to demand is roughly even at 10:1 in 1990-1991 and in 2000-2001. As recent volatility in returns has slowed fund raising in the sector, this supply demand picture is unlikely to worsen substantially.

Looking ahead, in addition to restructuring value opportunities, post-bankruptcy equity opportunities show promise. Although still in the early stages, the resurgence phase and post-bankruptcy equities are already beginning to create opportunities. As more companies emerge from the restructuring pipeline, the post-bankruptcy equity sector should become a major theme for distressed investors in the next 12 months and should be a major source of profitability well into 2004 and beyond.

Exhibit 4 | Distressed Market Cycle



Source: Securities Data Company and New York University

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