



June 1, 2010

Understanding Today's Distressed Environment

Abstract: *Distressed and event driven hedge fund managers continue to face a compelling opportunity set, but the distressed landscape today differs substantially from that predicted by many analysts during the depths of the credit crisis. Below we discuss the drivers of the 'new' distressed opportunity and suggest that smaller managers may actually be better positioned to profit in this environment than their larger peers due to a steep decline in default activity and a corresponding decrease in the size of today's distressed issues.*

I. Introduction: A Distressed 'Golden Age'

During the tumultuous 2007-2008 period, there was widespread agreement among market participants that distressed specialists were on the cusp of a generational opportunity. Economic conditions were deteriorating rapidly and financial markets were in the early stages of an intense deleveraging. Corporations were confronted by a crippling combination of weaker demand, decelerating revenue, and curtailed access to credit. Targets of 2005-2007 leveraged buyouts were seen as particularly vulnerable owing to previous years' loose lending standards. And of course, banks, so exposed to the imploding residential and commercial real estate markets, would be the objects of considerable distress themselves. Overall, the corporate default rate was projected to easily exceed past highs, and to remain elevated as over \$1 trillion of leveraged loans and high yield bonds matured over the next several years.

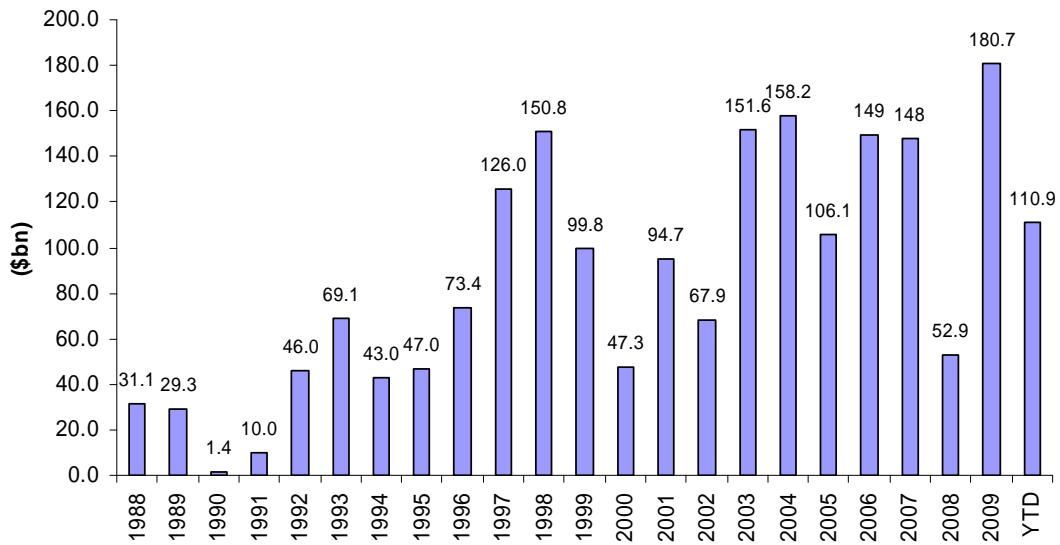
The consensus in favor of a distressed 'golden age' only grew as once-iconic firms began toppling in late 2008 and early 2009. Between 3 financial sector firms (Lehman Brothers, Washington Mutual, and CIT accounted for 3 of the 5 largest-ever US bankruptcies) and 2 in the automotive industry (GM and Chrysler filed within 30 days of each other) alone, more distressed supply had hit the market in less than one year than most managers had seen in their careers. The capital markets largely remained closed, banks were not lending, and secondary market activity was severely depressed. Not surprisingly given all of these factors, the largest distressed hedge fund managers were the recipients of robust investor inflows, and it was not uncommon to hear about hedge fund allocators running sizable overweights in their distressed and event driven books.

Judged by their 2009 and early 2010 rates of return, distressed managers' enthusiasm in the preceding years was more than justified. Core allocations to distressed financial and auto paper proved highly profitable; and several managers, particularly those better classified as 'event driven' than classic distressed, mixed corporate distressed investments with opportunistic allocations to the beaten-down high yield, convertible, and distressed mortgage markets to post returns of 30% or in some cases much greater.

II. What Changed?

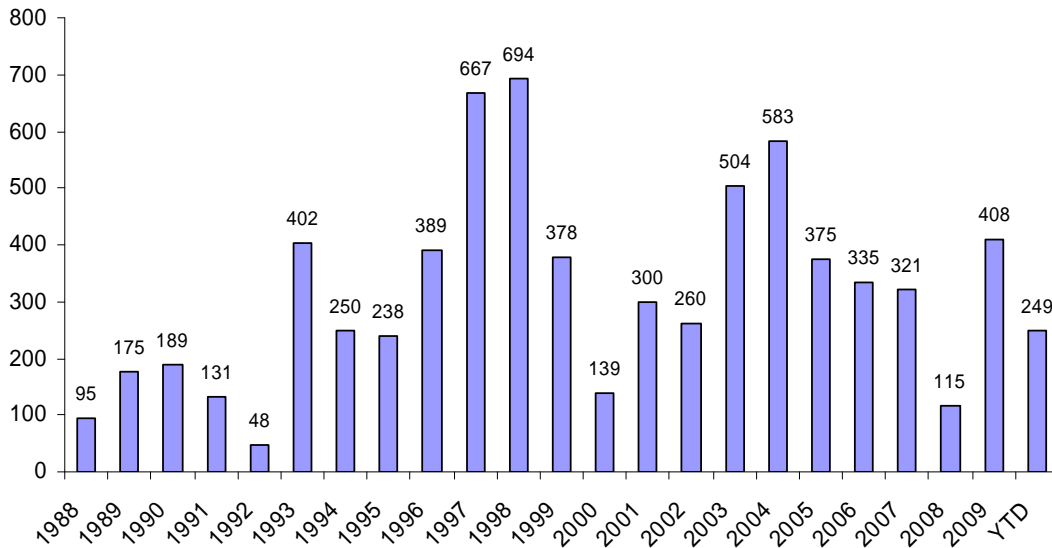
Policy actions taken in early 2009 proved to be a major turning point for the distressed opportunity set, however. As policymakers belatedly grasped the severity of the problems facing global financial markets and the economy, a suite of measures were put in place that back-stopped the financial system and arrested the decline in economic activity. In short order, risk capital returned to financial markets, sparking a broad-based rally which enabled corporations to begin the process of balance sheet repair. This phenomenon was reflected most prominently in the high yield market, where new issuance and refinancing activity exploded, allowing vulnerable firms to push off short term default risk. 2009's \$181bn in new high yield issuance, for instance, was the most in one year in market history.

High Yield New-Issue Volume



Source: JPMorgan, May 3, 2010

Number of New-Issues: High Yield



Source: JPMorgan, May 3, 2010

Over the course of the year, leveraged loans rallied from deeply distressed levels, and high yield spreads tightened dramatically.



Source: Bloomberg, May 25, 2010



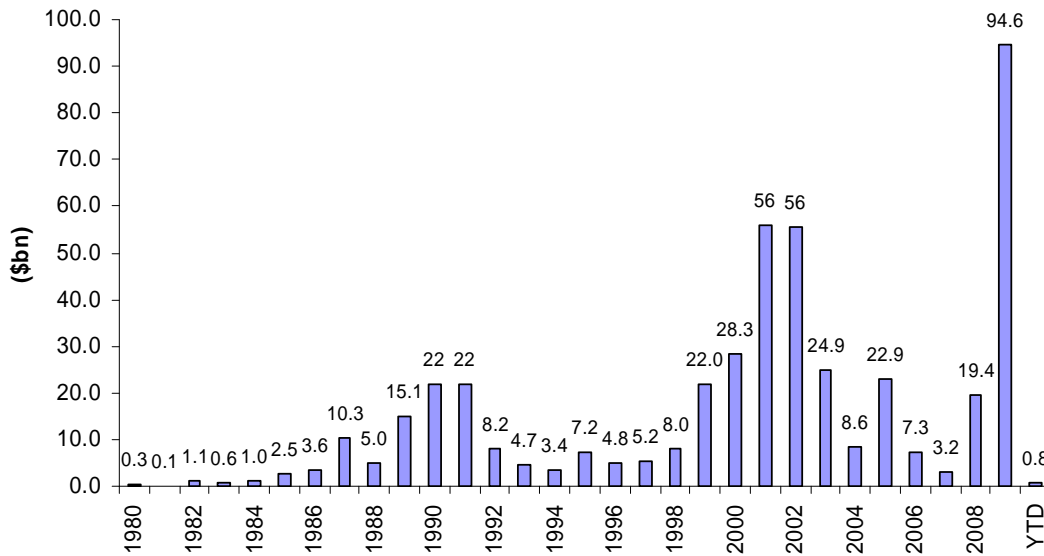
Source: Bloomberg, May 25, 2010

Easy global liquidity conditions were critical to the strength and endurance of the rally. Explicit commitments from global central banks to keep benchmark rates low also helped to anchor the front end of yield curves and provided an accommodative context for banks to begin earning their way back to health. Aggressive cost-cutting gave many corporations considerable leverage to any future

uptick in demand; as the economy bottomed and demand slowly returned, earnings consistently beat expectations.

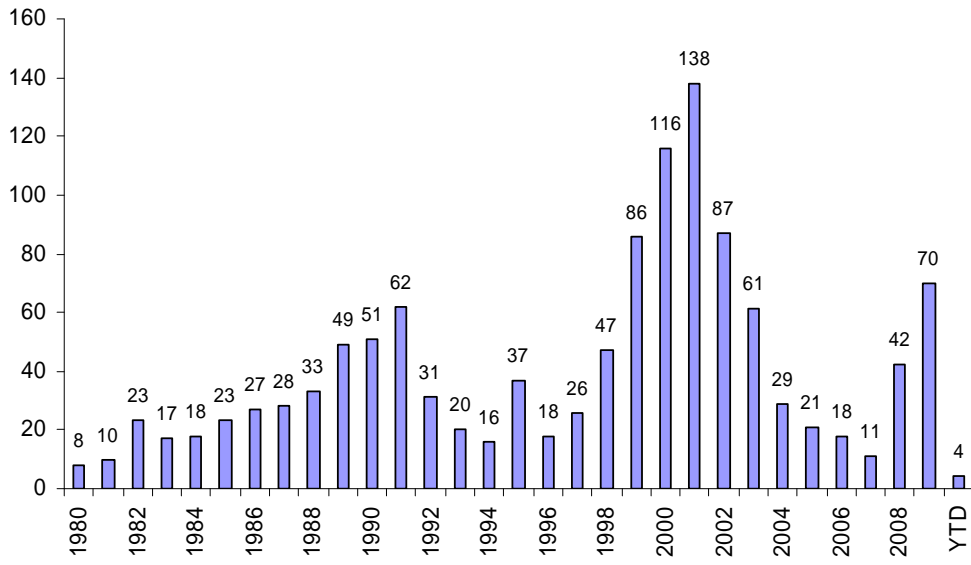
One key consequence of all of these developments was that firms seen in 2007-2008 as vulnerable to distress were given space to find their financial footing. Balance sheet restructuring, refinancing, and extension of debt maturities, made easier by extremely accommodative capital markets, helped these companies ward off the threat of default. This is clearly reflected in a steep decline in the overall default rate, measured in both dollar amounts of defaulted debt and number of defaults – a decline not at all anticipated just one year earlier. On current pace, for instance, default volume in 2010 is expected to be just 2.5% of 2009's. Similarly, the number of defaults this year is on pace to be just 17% of last year's number; and the default rate looks set to remain less than 5%, down from over 10% one year earlier.

High Yield Default Volume



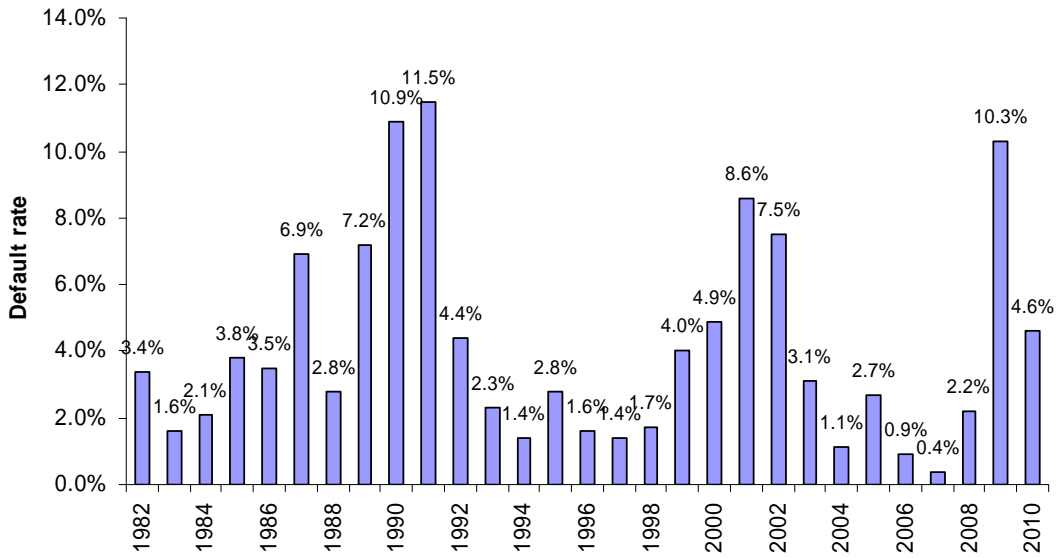
Source: JPMorgan, May 3, 2010

High Yield: Number of Defaults



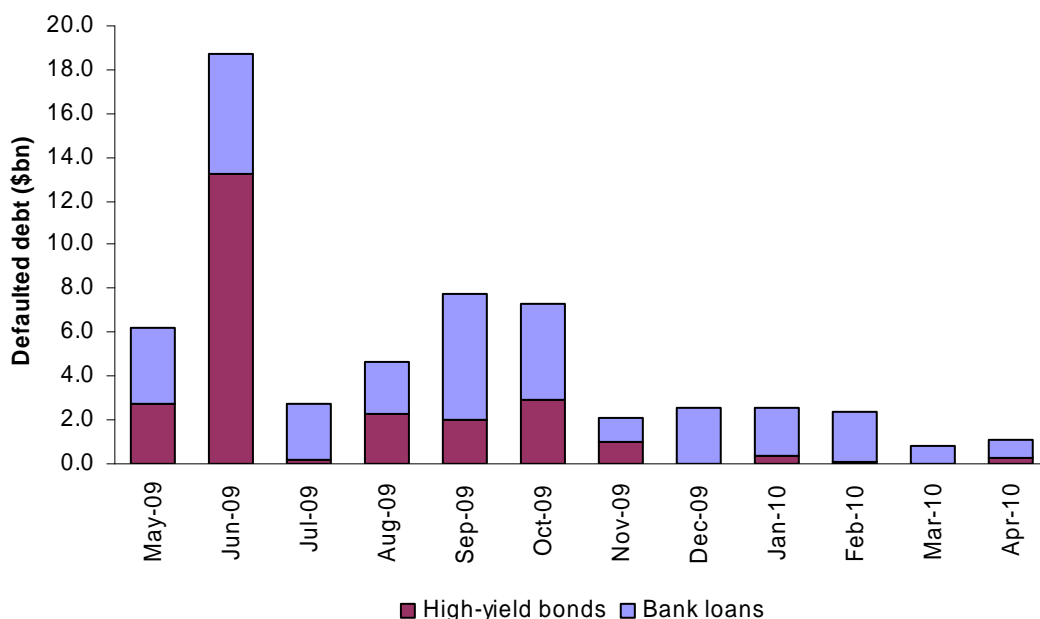
Source: JPMorgan, May 3, 2010

High Yield Default Rate



Source: JPMorgan, May 3, 2010

Default Activity since May '09

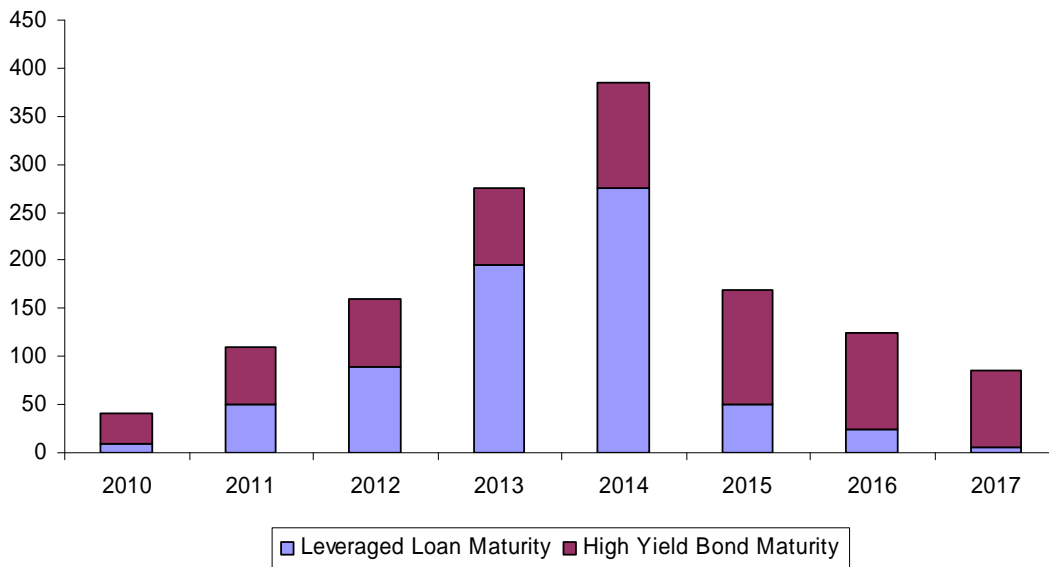


Source: JPMorgan, May 3, 2010

III. Who Benefits?

The above analysis does not suggest that distressed opportunities do not exist today. On the contrary, most estimates suggest that there is still approximately \$350 billion of distressed debt outstanding. Moreover, even if YTD bankruptcy filings are well off of their 2008/2009 pace, it is still true that default volume in 2008 and 2009 (at \$114bn) exceeded the previous high for volumes in the turbulent 2001-2002 period; as those bankruptcies progress and companies undergo restructuring, market participants will be presented with a variety of special situations and events, especially in post-reorganization equities. Additionally, private equity portfolio companies are still loaded with debt and will need to refinance over the next 5 years; most estimates still project over \$1 trillion in high yield bonds and leveraged loans maturities by 2016-17. And on the demand side, CLO formation is still sharply reduced, many hedge funds have not yet fully recovered from '08/'09 AUM drawdowns, and leverage is generally much harder to access.

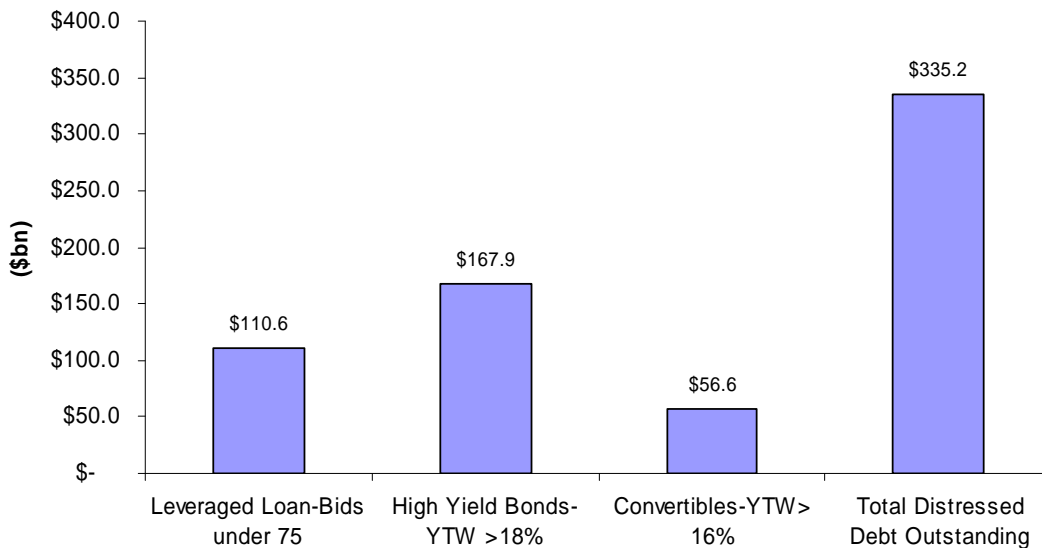
Maturities



Source: Credit Suisse

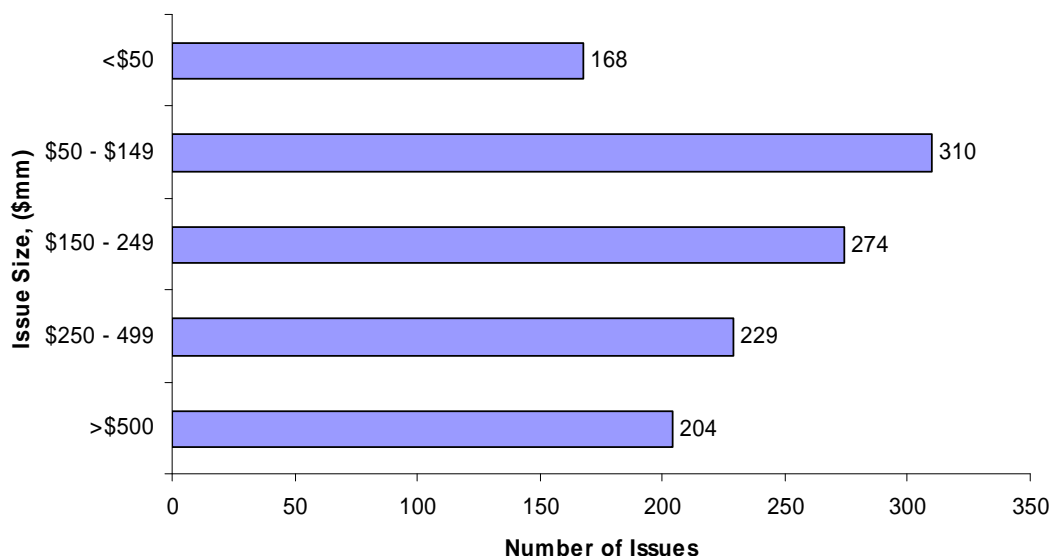
Nevertheless, it is clear that the present environment is not the one most analysts had been predicting. 2010 and 2011 supply of distressed debt is well below initial projections in terms of dollar volume and number of defaults, and on current trajectory peak years for distressed activity do not look set to appear until 2013-2014 (when some \$300bn in leveraged loans and \$100bn of high yield bonds are set to mature). Furthermore, present-day issue sizes are smaller, on average below \$250mm.

Distressed Breakdown



Source: GLC, April 23, 2010

Distressed Debt by Issue Size



Source: GLC, April 23, 2010

Two implications for the hedge fund industry flow from this.

First, the largest distressed shops probably have fewer opportunities today to deploy new capital in a manner consistent with their preferred risk/reward frameworks: they either cannot buy as much of a distressed issue as they might need to contribute meaningfully to overall fund performance, or they have to take down a larger percentage of a distressed issue and increase their liquidity risk. Faced with this kind of trade-off, it would hardly be surprising if some well-known distressed shops opted to return a portion of investor capital, worsen their redemption terms, or close to new inflows altogether. On the other hand, they could decide to expand their investment universe to include other distressed assets that are not traditional corporate bonds – for example, residential mortgages, structured credit, commercial real estate, European sovereigns, or even ownership of failed banks. Should they, their underlying liquidity warrants close oversight.

Second, smaller managers (i.e. \$2bn in AUM and below) represent a different risk/reward profile than many analysts probably calculated previously. For them, supply of opportunities is plentiful, and liquidity is reasonable. Assume, for example, a \$750mm fund had high conviction in a distressed situation and wanted to initiate a new position (say, 2.5% of AUM) in an issue that was \$250mm in total size; they could buy \$18.75mm of that issue and constitute 7.5% of its ownership, with reasonable room to add to their position over time as conviction grew higher. A manager running \$3 billion, on the other hand, would need to take down \$75mm, or 30% of that issue, to establish a 2.5% position.

| Fund AUM (\$) | Issue Size (\$) | 2.5% position in Fund (\$) | Ownership of Issue |
|----------------------|------------------------|-----------------------------------|---------------------------|
| 750,000,000 | 250,000,000 | 18,750,000 | 7.50% |
| 1,750,000,000 | 250,000,000 | 43,750,000 | 17.50% |
| 3,000,000,000 | 250,000,000 | 75,000,000 | 30.00% |
| 5,000,000,000 | 250,000,000 | 125,000,000 | 50.00% |
| 7,500,000,000 | 250,000,000 | 187,500,000 | 75.00% |
| 10,000,000,000 | 250,000,000 | 250,000,000 | 100.00% |

IV. Conclusion

It was hardly surprising that investor inflows skewed so heavily in favor of the largest distressed and event driven managers in 2009 and 2010. In addition to benefiting from a consensus that was forecasting a generational investment opportunity, large managers posed very little ‘career risk’ to hedge fund allocators – in the wake of the Madoff scandal, redemption suspensions, gates, and the like, and general uncertainty about what the hedge fund industry might look like after the turmoil of 2008, few hedge fund investors were interested in taking a chance on a manager with only a few hundred million dollars under management. Nonetheless, the environment has changed. Credit in general still remains significantly dislocated, and distressed and event driven managers continue to have their pick of complex situations either in formal bankruptcy or more informal restructuring. Over time, likely in a few more years, the ‘golden’ era of distressed opportunities may in fact materialize, particularly as leveraged loans associated with the buyout boom begin to mature in 2013-2014. In the meantime, the opportunity set for the largest distressed players is in no way straightforward, while some of the smaller players may actually stand optimally positioned to benefit from the altered, but still compelling, distressed landscape.

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