

“The Next Wave”: Distressed Funds Scan the Horizon

Six months ago, our firm spoke to traditional asset-based lenders about “The Next Wave” of credit issues. We found a diversity of opinions, depending on the lender’s size, product mix, geographical focus, industry focus, and other characteristics. This time around, we asked nontraditional lenders — that is, distressed funds that take debt and/or equity positions in companies and hedge funds that have loan origination businesses — for their perspective on The Next Wave. Managers of funds (several of whom were unwilling to be quoted by name due to securities regulations) ranging from large multi-strategy funds to small single-strategy funds were interviewed for this article.

by Thomas D. Hays, III, CTP and Roseanne Sweeney

Throughout the distressed fund community, investors are wondering what to make of the loose credit standards, increasingly complex capital structures, and continued economic expansion. As investors continue to track closely market indicators, they are asking: When will “The Next Wave” of credit and equity problems occur, and how severe will they be? Which industries are most likely to be affected? How will the downturn affect their current portfolios, and will it present new investment opportunities?

When Will The Next Wave Occur?

Credit continues to be plentiful, and markets remain liquid — as well as accommodating and forgiving. However, bad deals are mounting, and credit has continued to deteriorate over the past 12 to 18 months.

Other signs are present that the top of the credit cycle has been reached and the expansion period may be coming to an end. Interest rates are up. Housing starts are down. Debt-to-leverage multiples are high. Credit standards have loosened to the point where there is little room for error. Loan covenants are weak. Pricing compression over the last 6 to 12 months is raising questions as to whether lenders are being paid enough for the risks they are taking.

Three other indicators portend deterioration in credit. The first is the large volume of high-yield debt issuance, the second is the lower quality of high yield issues (more CCC-rated paper) and the third is the high volume of floating rate issuance. The underlying factors are present, but when will they build into The Next Wave? The majority of fund managers we interviewed ventured that The Next Wave could hit within the next 9 months to 1.5 years, although, one lender does not anticipate a general slowdown at all. Historically downturns usually occur 1 to 2 years after the top of the credit cycle.

The question, though, is whether we are at the top of the credit cycle. Dave Breazzano, Co-Founder of DDJ Capital Management, thinks we may be on the cusp. Breazzano has been an investment manager since 1980 and has weathered four cycles. He feels that “credit is still plentiful and robust, but it is turning.” He predicts that many high-yield bonds will become distressed over the next year or two, and that double-digit default rates are very likely in 2008 and 2009.

Ken Sands, Managing Director at the multi billion-dollar credit hedge fund Fortress Investment Management, says that, although it is difficult to predict when The Next Wave will hit, it does feel like we are approaching the top of the credit cycle now. “I’m not sure what the catalyst will be this time, but if forced to guess, I’d say things will turn down in late 2007 or early 2008.”

Jim Miller, Director of Origination for Summit Investment Management, points out that analysts have been predicting for the last two years that The Next Wave will hit within 12 months, and so far it hasn’t happened. Miller is of the opinion that The Next Wave will be precipitated by something that can’t be predicted — rising interest rates, high commodity prices, a crash in the real estate market, or a combination of all three, being possible catalysts.

Pete Cecchini, Managing Director for Mellon HBV Alternative Strategies, as well as Breazzano point to past history as a harbinger of The Next Wave. Cecchini mentions that, “distressed cycles have historically followed a pattern where the issuance of high-yield debt is followed 2 or 3 years later by an uptick in default rates. Typically about 35% of high-yield debt defaults in the subsequent 2 to 3 years, which could extend to 5 years during the current robust credit cycle”. High-yield debt issuance peaked in 2003 and 2004, so Cecchini looks for defaults to crest in 2006 and 2007. “We are already seeing an uptick in default rates. Defaults will accelerate by the end of this year and into next year, and The Next Wave,” Cecchini predicts, “is likely to be 9 to 18 months down the road.”

How Severe a Wave?

Cecchini further observes that, when The Next Wave comes, it will be unlike any that has come before. Complicating the picture is the high number of second-lien financing deals that took place in 2004 and 2005, and the relationships between the first and second lien holders are not particularly well defined. “Second liens will add to the high-yield effect and exacerbate the cycle since second liens are essentially unsecured claims in bankruptcy and are not good security,” he says.

Sands shares the view that second-lien loans are problematic. “In many cases, the holders of highly leveraged, syndicated second-lien loans will end up owning the equity in the reorganized company. Some capital

structures have become so complex with multiple classes of debt (first lien, second lien and unsecured) and collateral (first liens on fixed or current assets) that valuation arguments will be more prevalent and could result in prolonged restructurings.

Kjerstin Hatch, Senior Vice President and Portfolio Manager at Madison Capital Management concurs with the view that, when the downturn occurs, it will be different from any other. "I can't quantify the severity," Hatch says, "but those who do not plan will be exposed to sophisticated financial players." "Groups that currently own debt or that are poised to purchase distressed debt are motivated differently than they were in the past. Some are not looking to make a profit necessarily by trading, but to aggregate debt to get equity either prior to a Chapter 11, to cause a Chapter 11, or to pursue other strategies." Miller also adds, "The new and aggressive class of creditors are also non-regulated and therefore not under pressure to sell. They can hold onto assets longer than others, and it is probably more important for them not to take a loss than to move in and out of the investment."

Both Sands and John Brignola, Co-Founder of LBC Credit Partners, do not, at this time, expect The Next Wave to be unusually severe. "It will not be any worse than the past two cycles," predicts Sands. "The high number of distressed funds, may create some buoyancy in the market for a while," concurs Brignola. But, he adds "When the downturn does occur, this may add another layer of liquidity for distressed companies and the downturn may be more protracted as a result. "However, how long can you fund poorly run companies before the operational fixes that need to be made are implemented?" Hatch agrees, saying, "The refinancing out of trouble has to stop."

Which Industries Will Be Affected?

When The Next Wave arrives, the general consensus is that industries most likely to be affected are those that are struggling in the current environment. Obvious choices are the automotive industry and its suppliers, and energy or energy-dependent companies.

Several fund managers also see troubles ahead for industries such as airlines, utilities, commodities, paper, packaging, forest products, and chemicals as well as the usual suspects in consumer products. Cecchini, Hatch and Breazzano anticipate hard times for highly leveraged companies, especially over-leveraged companies with second-lien debt; companies with commodity exposure that cannot be passed on to customers, such as steel, aluminum, copper, and oil; and companies with Asian-sourced competition that enjoy low labor costs. In addition, Cecchini sees the Deficit Reduction Act of 2005 creating problems for some healthcare sectors.

Some see that there are no glaring industries fraught with problems, and that companies across all industries will be affected in the next downturn. Sands believes that, regardless of the industry, many deals will require restructuring because they were "overly aggressive transactions — the purchase price was too high, the leverage was too great, the business was too cyclical, or the management was poor."

How Will a Downturn Affect Current Portfolios?

Most of the fund managers we spoke to say they do not expect to be unduly affected by The Next Wave. Brignola, one of the pioneers in the second-lien market, says, "We try to be selective, and underwrite and structure credits with an eye towards a potential downturn."

Other fund managers emphasize the importance of refusing to relax credit standards, following conservative underwriting practices, monitoring portfolios closely, and identifying problems early and reacting accordingly.

Whether a downturn is imminent or a couple of years away, and whether it will be very severe or mild, most non-traditional lenders we spoke to agree it will be a downturn unlike any other.

Sands notes, "It is a combination of better monitoring and more conservative underwriting." In keeping with this defensive posture, managers are waiting for pricing to come back in line with risk levels and are staying away from suspect industries.

What Are the New Investment Opportunities in this Next Downturn?

One thing is certain: The Next Wave will bring with it new investment opportunities for those who are prepared. Several fund managers mentioned that they are keeping some "powder dry" in order to take advantage of any capital shortages. Several say they do not anticipate a shortage in funding for themselves, as endowments and retirement plans have made alternative investments a standard form of investment. Others mentioned that they are shoring up their balance sheets by extending maturities.

According to Breazzano, complex capital structures combined with inexperienced people will present new opportunities in long or short trading. He finds that in downturns there can be good debtor-in-possession opportunities based on enterprise value and not necessarily working capital assets.

Some fund managers are poised to act upon an anticipated price correction that is due in this highly competitive and overpriced market, Hatch says. Since some hedge funds are still open-ended investment vehicles, money can be withdrawn if returns are not hit and there will be a shake-out as funds unload their portfolios. Additional shakeout will occur when the leverage dries up for the funds that need to use leverage to achieve their return levels

Miller says he expects opportunities in the downturn to come from sponsored deals by the private equity funds, mezzanine funds, and hedge funds in every sector. Brignola also sees the downturn as creating re-financing possibilities, especially for opportunistic funds.

"In this cycle," Sands says, "there is so much secured debt in the capital structures that it will be impossible to totally refinance the secured debt prior to a bankruptcy or to refinance the secured debt with a traditional DIP loan." Thus, DIP loans will probably take the form of smaller priming loans or rollovers of pre-petition first-lien debt. He feels the downturn will provide a better environment for new deals in the areas of acquisition finance, re-financings for companies not leveraged, and growth financings.

So, How To Ride The Next Wave?

Whether a downturn is imminent or a couple of years away, and whether it will be very severe or mild, most nontraditional lenders we spoke to agree it will be a downturn unlike any other. Many new factors are present in the credit markets. There is an unprecedented amount of distressed debt and debt holders. Companies and consumers alike are highly leveraged, with unusually large amounts of variable-rate debt. Capital structures have grown increasingly complex, with a plethora of second-lien deals, unsecured deals and bifurcated collateral (i.e. first lien against fixed or current assets). Another complicating development is the

recent amendments to the Bankruptcy Code, which has significantly affected the ability of companies to continue as going concerns once in bankruptcy and to use bankruptcy as a tool to preserve their operations. Hatch states that, "It is highly recommended that turnaround consultants be employed way before the bankruptcy filings simply because, once in the bankruptcy process, eighteen months is not enough time to identify and solve issues and produce a viable reorganization plan."

Investors are also noting the entry of increasingly sophisticated financial players perhaps looking to "loan to own" or harboring other unknown motivations. The ill-defined relationship between the first- and second-lien investors is also a new development. Additionally, as the issuance of new high-yield debt peaks, time will tell whether historical default patterns will be applicable in the future and trigger The Next Wave.

Finally, all fund managers are in agreement that preparation is the key. The importance of doing research and being able to react quickly to new developments cannot be overemphasized.

That sums up the challenge nicely. Those who are best able to take into account all the factors in the credit markets will be the ones who are on top of The Next Wave, instead of under it.



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