

DISTRESSED DEBT ANALYSIS, *Stephen Moyer*

INVESTMENT OBJECTIVES

Constraining factors

1. Differing tolerances for risk across investors
2. Institutional willingness to deal with the procedural complexity and "hassle" with distressed debt reorgs
3. Absolute level of risk tolerance often changes with the macroenvironment/perception of competing asset classes
 - In a difficult macro environment, investors seek out situations with zero downside and limited return in HY
 - When other asset classes start performing, investors in HY seek out more risk in order to compete

PASSIVE INVESTING OUTSIDE OF CHAPTER 11

Purchasing a bond, at some point, in the capital structure because it is deemed to be below "fair value"

May think that it is fundamentally undervalued

May anticipate a deleveraging transaction in which the firm buys back some debt, causing complex prices to rise

In a complex capital structure, it is necessary to weigh the risk/reward trade-offs of each security

Make a table comparing the risk/reward tradeoff and upside return/downside return % for each part of the cap structure

Also, compare different combinations of long/short positions within the capital structure

ACTIVE INVESTING OUTSIDE OF CHAPTER 11

After identifying an undervalued security, the investor recognizes the necessity of active investor participation to realize it

Typically, the investor sees that the distressed firm has good options for avoiding Chapter 11 (buybacks, exchanges)

These opportunities are most commonly available when the target's distress is solely a function of overleverage

Also, typically, it has a simple capital structure and/or significant cash

Here, the investor increases the probability of the target taking the necessary action

For example, the investor acquires a large block and organizes other investors to approach the firm with various scenarios

In order to have credibility, the group has to have a fairly significant position

If the deleveraging transaction fails, then there can be significant downside risk

The passage of time works against distressed firms because their liquidity and the range of options generally decline

Trying to unwind a large position in a declining market can be very difficult

The investor needs to be very cognizant of the target's ultimate value to properly assess downside risk

An alternative strategy is to purchase bonds with a view to using them as currency to buy some of the target's assets

The risk is that the target is unwilling to contemplate a sale

Also, if the target files within 90 days, the sale may be avoided as a preference or fraudulent conveyance

Make a table comparing each potential option with its challenges

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CHAPTER 11 INVESTING

Key decisions to make when the investment strategy contemplates recovering value in post-reorg securities

How much risk to take?

What type of post-reorg securities is the investor willing to accept? Debt or equity?

What type of post-reorg recovery, in terms of new debt or equity, will likely be allocated to various pre-filing securities?

Valuation of the post-filing entity? That is, what will the *plan* valuation look like

What is the appropriate amount of post-reorg leverage? What will pre-filing creditors push for in their negotiations?

Timing of the investment --> it may be better to wait for the decline in value post-filing, particularly lower-down cap structure

FEASIBILITY CONSIDERATIONS

Factors to analyze

Capital structure

Sources of misvaluation

Market liquidity

CAPITAL STRUCTURE

Assess the amount of leverage represented by the secured bank debt relative to firm value

Greater the amount of bank debt, the less likely it will be that the investor can get involved in a meaningful way

Other than by purchasing a large block of the bank debt

Banks have great influence over the firm under the threat of either cutting access to W/C or threat of acceleration

Banks use this power to extract fees, additional collateral pledges, demand asset sales, block interest to unsecured

Bank debt also protected by the concept of adequate protection

Bank loan agreements designate the agent bank as the representative of the bank facility

SOURCES OF MISVALUATION

Deviations from true value typically driven by the following

Significant negative information event that causes an overshoot

Financial stress primarily driven by a significant near-term liquidity requirement (maturity or interest)

Cyclical industries going through a down phase have much higher leverage ratios

Total capitalization appears less than \$500m

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MARKET LIQUIDITY/CONCENTRATION OF HOLDINGS

Using an information network to allow the investor to assess the playing field

- Data on the distribution of mutual fund holdings

- Frequency of quotes on broker-dealer axes

- General market inquiries (including discussions with broker-dealers and other participants)

Check out the presence of other distressed investors

- Are they well-known? This would validate the investment thesis

- Do they have a preferred outcome?

- Is it possible to be active if they are already there?

Who owns the bank debt?

Who are the large block holders of public debt? Are they potentially sellers?

COMMON CAPITAL STRUCTURE ARBITRAGE TRADES

Pari Passu Securities with Different Maturities

Buy one and sell the other, picking up the differential in price

Attractive in two contexts

- When there is a near-term maturity that leads to a price discrepancy that may collapse (overvalued refinancing option)

- When two securities deemed pari passu, trading at similar levels are suspected of having different claim status

Senior vs. Junior Securities

Put it on when the trading price difference between a senior and more junior security is deemed inappropriate

Attractive if the investor has a view on the deteriorating credit quality of an investment-grade company

- In IG companies, the trading spread between senior and sub notes can be trivial (30-50 bps in yield spread)

- Widens significantly on any downgrade to sub-investment grade

- Can become even wider if the firm quickly becomes financial distressed

Bond vs. Equity

Like the senior vs. junior trade but with a couple of tradeoffs

- Easier to short equity

- But, equity is usually much more volatile than the debt --> general direction is predictable, magnitude less so

Contexts for bond vs. equity trades

- Hedging an in-the-money convertible bond

- In any situation where the investor is considering going long a junior security, equity may be the right hedge

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PROPERLY ASSESSING THE DISTRESSED COMPANY'S ACTIONS IS KEY TO ASSESSING INVESTMENT OUTCOMES

Strategic options to resolve financial distress outside bankruptcy

- Raise additional capital

 - Could be good if it enhances credit support; bad if it reduces credit support

 - Example: new secured debt that pledged previously unencumbered assets would reduce credit support for the unsecured

- Sell assets

 - Key criterion is price: what is the relationship of the sales multiple to the leverage multiple?

 - When asset sale proceeds can be used to retire debt at discounted market values, it is probably accretive to remaining debt

 - This depends on whether or not the multiple for the asset sale is greater than the market leverage through the debt repurch'd

- Secured financings

 - 3 scenarios in which this may be possible

 - Fallen angels

 - Tech companies

 - Possibility of layering in additional second-lien financing

- Sale/leaseback financings

- Equity sponsors

 - Where financial protections for creditors are weaker, there is less of an incentive for sponsors to fix the problem co

Other options to reduce leverage

- Open market repurchases

- Direct purchases from holders

- Cash tender offers

- Exchange offers (coercive or non-coercive)

Constraints on the range of options

- Liquidity

- Time-to-liquidity event

- Magnitude of the problem

- Complexity of the capital structure

- Severability of business units

- Causes of financial distress

Bankruptcy strategies

- Maintaining liquidity

- Preplanned filings

