Let the Feasting Begin
Markets careen, funds struggle: it's great news for one business sector

Jason Kirby | August 27, 2007 |

It's getting brutal out there. The meltdown in the sub-prime mortgage sector, with its no-down-payment loans to high-risk homebuyers, could cause 1.7 million Americans to lose their homes, sending shock waves through the housing sector. Several multi-billion-dollar investment funds have either collapsed or are struggling to survive. And stock markets the world over have been in free fall. Four years of optimism have suddenly given way to fear. Finally, things are starting to look up for Toronto money manager Alex Jurshevski.

If that sounds at all odd, it's not. Jurshevski is CEO of Recovery Partners, an investment firm he launched in 2005 to pursue the risky strategy of buying portfolios of under-performing corporate loans from banks in North America and Europe. By snatching up the debt of struggling companies, he aims to take over the businesses, turn their fortunes around, and resell them. It's a precarious strategy, akin, he says, to safely catching a falling knife, but it's one that promises huge returns.

Jurshevski is part of a relatively small but vital niche of the business world that thrives on the trials and tribulations of other companies. In addition to specialty funds like Recovery Partners, there are liquidators, appraisers, auctioneers, and insolvency lawyers and accountants. In each case they are experts at the fine art of pricing risk. One job of appraisal firms, for instance, is to estimate the value of a bankrupt company's assets, put up the cash for the right to sell those assets, and bet they can get a higher price in the market.

In short, these are the scavengers of the capitalist eco-system, a kettle of vultures circling the corporate carrion below. And the smell of blood is long overdue. Low interest rates and a flood of cash have helped many troubled companies skirt certain demise in recent years, which has led to an era of record low defaults and put a strain on the entire sector. "The whole industry has been depressed because of the default rate," says Jurshevski, who, despite having $500 million at his disposal, has yet to put any of it to work. Now, as the sub-prime mortgage collapse sends ripples beyond the housing sector, some foresee a credit crunch spreading to other sectors. "I hope so," he says. "All the bad loans have already been made. They're just waiting to turn bad, like fruit left out on the counter."

With credit woes threatening to infect the rest of the economy, it's easy to begrudge companies that capitalize on others' pain. In fact, the sector plays a crucial, and entirely natural, role in the economy. In heady times, investors and businesses tend to forget the risk side of the risk/reward equation, says Lawrence Kryzanowski, a finance professor at Concordia University's John Molson School of Business. "You have to be able to take the pain," he says. What's more, when things do start to sour, as may be the case now, the natural inclination is to do everything possible to avoid that pain. Central banks around the world have pumped hundreds of billions in cash into financial markets to stave off a crisis. Yet failure is an integral part of the business cycle. "If you don't have a cleansing process where certain firms go under, the pain is delayed," he says. "Generally that means the pain will be that much greater later on."

There's no denying the past four years have been great for businesses, investors, workers and homebuyers. After the tech bubble collapsed, and as America briefly tumbled into recession, the U.S. Federal Reserve slashed interest rates to less than one per cent. At the same time the global economy became awash in cash that fuelled powerful hedge funds and private equity funds. It was a great time to buy anything and everything. The housing boom was matched by a wild acquisition spree by companies and funds, who borrowed heavily to feed their appetites.
The deluge of easy money is largely what's kept Recovery Partners on the sidelines. Defaults, which are triggered when companies fail to make debt repayments or break the terms of their loan contracts, have hovered around zero for the last three years. In a typical year, default rates on corporate loans and bonds can be anywhere from three per cent to 10 per cent or even higher. Even the riskiest of loans have handily dodged insolvency until now. That's because companies struggling with their debt have found a steady stream of investment funds willing to give them ever more money. "On the one hand nobody is going bankrupt and nobody's getting thrown out of work," says Jurshevski. "But it also means there may be a lot of people lending money on non-economic terms and that means firms that shouldn't be surviving are being kept afloat by cheap credit."

There are signs easy money is drying up. Several high-profile takeover deals that involve billions in debt have run into questions over credit worries. Private equity firm Cerberus struggled to sell US$12 billion in loans tied to its acquisition of Chrysler, while the Ontario Teachers' Pension Plan has had to assure investors in BCE the terms of that massive takeover deal are still the same. Investors are worried buyers won't be able to handle their debt loads if interest rates rise further.

If credit worries deepen, those mega-deals could indicate what's to come for the small and mid-size companies that make up a chunk of bank-lending portfolios. The banks may tighten lending terms with borrowers, as U.S. mortgage companies are doing with homeowners, making it harder for companies to meet debt obligations. That doesn't guarantee a raft of insolvencies. Experts say banks have shifted away from their slash-and-burn ways of the past, when they would immediately put a debtor into insolvency if it failed to pay up. A new, more conciliatory approach allows companies time to seek alternatives. "I haven't seen very many close-the-door liquidations, and the ones I have seen are with fraud and gross mismanagement," says David Cohen, a lawyer with Gowling Lafleur Henderson in Toronto. "Higher liquidity has given financial institutions that luxury." How long that sunny approach will last, should defaults begin to rise, is the question.

For their part, liquidators and appraisers anticipate more work coming their way soon. There have already been industrial auctions in Ontario's stalled automotive industry and British Columbia's beleaguered forestry sector. Then in June, the auction process was on full display when Toronto liquidation firm Benaco Sales took bids on the assets of the Sam the Record Man store on Yonge Street. John Jefferson, executive vice-president of Hilco Appraisal Services, another firm in Toronto, says the last three years have been soft on the bankruptcy auction front. Hilco is no stranger to the muddy world of valuing assets of defunct companies. In the late 1990s the firm took part in the massive liquidation of the Eaton's retail chain. He sees things picking up again. "The fundamentals seem to be shifting, which creates a better environment for this type of work," he says. "We're prepared to step up and buy any kind of asset. There will be lots of opportunities."

The credit crunch that started in the U.S. sub-prime sector has also proven a boon for retailers like Liquidation World, a chain with more than 100 stores here and south of the border that gets its products through inventory clearances and liquidations. Two months ago the company bought 50 truckloads' worth of furniture from a distributor in southern California that had fallen on hard times as a result of the slowdown in the housing market. "This couldn't come at a better time for us because of the strength of the Canadian dollar," says CEO Jonathan Hill. "If the trend continues, that will lead to even greater distress situations." And more opportunities to buy goods at super-discount prices.

A major financial crisis is far from inevitable. Even Jurshevski isn't certain the sub-prime mortgage collapse will be enough to spark a wider reckoning. "Clearly sub-prime has put the wind into lots of people, but we don't think we're at the watershed event yet," he says. There's still lots of cash floating around world markets, while corporate profits have held up reasonably well. But with each passing month that default rates remain low, the backlog of potentially troubled companies continues to grow. Eventually the dam will burst. Until then, Jurshevski is a patient man. You have to be when you're dealing with such risky investments. "We're waiting for the flood," he says calmly. "Everyone else will want to get out and we'll be able to start pricing risk the way we want to price it."