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Alternative Investments
Distressed Debt: Ailing Credit is still the next big thing

Intervention did the trick, to an extent. Last month, the credit bulls, if not exactly bellowing, were certainly peeping out of their hiding places following the Federal Reserve's 50 basis point interest rate cut, the Bank of England's bail out of Northern-Rock and injections of three-month liquidity, better-than-expected earning from the US investment banks after modest write-downs of LBO loan commitments, and signs of easier conditions for issuers seeking to roll over commercial paper.

Spreads rallied in late September to the point where Citi's credit analyst suggested "further tightening would take us precariously close to where spreads were in May".

Is the great credit scare over, then?

Moody's analyst John Lonski points out that the non-financial corporate debt to pre-tax profits ratio, which rose to 5.8:1 in the second quarter of this year, looks decidedly healthy compared with 10.9:1 in the recession of 1990 and 8.4 times pre-tax profits at the end of 1998, and are positively robust next to the peak in the second quarter of 2002 of 17.4 times.

In addition, a failing Libor rate will curb corporates' interest expenses, which hovered around 16.8% of profits in the second quarter, well under 1998's 26.7% and 2000's pre-recession 40.2%. Net interest expense was an even steeper 52.1% of profits from current production during the 12 months leading up to the July 1990 start of the 1990/91 recession.

Lonski suggests "" A relatively low level of non-financial-corporate debt to pre-tax profits should held fend off a pronounced erosion of corporate credit worth and might help to contain recession risks."

It's tempting to believe that credit markets might have escaped the worst – tempting and quite probably over-optimistic.

Alex Jurshevski, Chief Executive of Recovery Partners, a specialist distressed debt investor that competed a fund-raising in March, scours the market for opportunities to buy up portfolios of distressed assets from banks and bond investors and turn them around. Three or four years ago, his firm would regularly receive three or four brokers' quotes on distressed corporate names; at present that list does not cover a single page.

Yet Jurshevski has never been more bullish on distressed debt. “Within two years, we’ll have default rates in double digits,” he says, “with meaningful increases in the next six to 12 months. Don’t mistake how fundamental housing has been to consumption and to the whole economic picture, given that consumption is 70% of GDP.”

He ads: “The best single leading indicator is the high-yield new-issue market and in particular the portion rated single B and below. We have never had so many issuers of such poor quality. And remember, it was only back in 2002 that the default rate in the US was around 12%. It fell to zero in 2003 and that’s where it’s been since. But over the last 50 years the means have averaged just under 5%, and just getting back to that level now implies a potential market of $400 billion to $500 billion in defaulted and distressed securities. And given recent lax covenant structures, I would suggest that loss given default will be much higher than in previous downturns.”

Since March, Jurshevski’s fund has undertaken one debt portfolio restructuring as principal, is now working on a large distressed debt restructuring for an Asian sovereign in an advisory capacity, and is developing plans to commit capital to market-making in commercial loans in his native Canada where no such market now exists.

Jurshevski has enjoyed a varied career as an investment banker at Bankers Trust and Nomura and debt advisor for the government of New Zealand. He has seen plenty of credit cycles. What intrigues him about this one is a new factor: Basle II capital adequacy rules.

“At a time when banking is increasingly about high-velocity throughput and recycling of capital, Basle II is especially punitive of riskier assets from a capital perspective. In addition, it imposes additional (operational) risk capital requirements on bank workout groups and many banks have cut back significantly on these activities as a consequence. Some banks now just feed problem assets to an internal group which seeks to refinance them; usually passing them over to leveraged loan hedge funds. Banks are heading into a credit storm with fewer experienced work-out people and in many cases shaky credit portfolios. In today’s world a few bad $10 million assets can seriously undermine the return on equity on a $1 billion portfolio.”

It was Jurshevski’s experience advising banks on Basle II compliance earlier this decade that inspired him to set up a distressed debt fund. Now, he is backing his team’s ability to evaluate likely loss given default, underlying collateral value and time-to-collection and make prices to banks that just want out from under the bad positions. He believes that the new capital rules will incentivize banks to sell quickly in the low 90s even those loans that after some work, might deliver full interest and principal.

It remains to be seen how quickly distressed debt investing will establish itself among alternative asset classes and investment styles. The experts in corporate value are, of course, the private equity fund that have created the opportunity in distressed debt by over-levering weak credits, simply because they could. Buying distressed debt as a cheap entry into equity of turnaround companies is a game many are itching to play, and funds have been committed since August.

Today, there is still little evidence of distressed pricing. Pieces of LBO financings being discounted to 95 or 96 cents on the dollar in the new-issue market don’t leave much room for distressed investors to make returns. But there have been signs of market weakness, including subordinated bonds trading in the high 70s. The head of investment-grade debt origination at a European bank sees this as a signal of dysfunction in the credit markets. “Credits are never worth 70. They are either worth 80 and up with a chance of returning par, or trade on recovery value at 60 and below.”

Jurshevski says: “We’ll be seeing assets change hands in the 50s”.

Euromoney October 2007, Peter Lee, editor