

# TOTAL ALTERNATIVES

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In the News 

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Fund Strategies

## Credit Market Turmoil Presents An Opportunity Unseen Before in High Yield – Simran Capital is Positioned to Capitalize While Other Funds Close Doors.

While central banks have injected \$3 trillion into the global economy in the past two months, high yield corporate credit markets are still in a state of decline. Despite some signs of credit loosening in the commercial paper and other high grade markets, banks and capital markets continue to clamp down on lending to companies further down the credit curve. In the past few weeks there has been widespread liquidation of assets resulting from fund redemptions. All of these factors are bringing severe leveraged loan and high yield bond price declines to unseen levels. **Credits rated CCC fell 25.75% in the month of October and are off 37.83% for the year.** Global credit losses and write-downs may reach as high as \$1.7 trillion, affecting high yield mutual funds, hedge funds and other investors. **A negative feedback loop of selling begets redemptions that beget lower prices has led to irrational pricing in leveraged loan and high yield bonds.**

### An Opportunity for “Stressed” Debt in the New Market Environment

As a result of the market's blow out in September and October, the volume of stressed and distressed debt has now

reached record levels. The most severely distressed portion of the market, those bonds trading at or below 50% of par value more than doubled domestically in just the last month, from \$40.3 billion at the end of August to \$96.5 billion at the end of September. This surpasses even the levels in the previous retrenchment of credit in 2002 when \$84.7 billion reached in October 2002 traded at distressed levels. Bonds trading below 70% of par increased to \$198 billion domestically, a 65% increase just since August. Stressed and distressed debt now represents nearly 27% of the total domestic high yield market. This is the highest volume of domestic stressed and distressed debt in the market's history.

### Simran Asks the Value Question

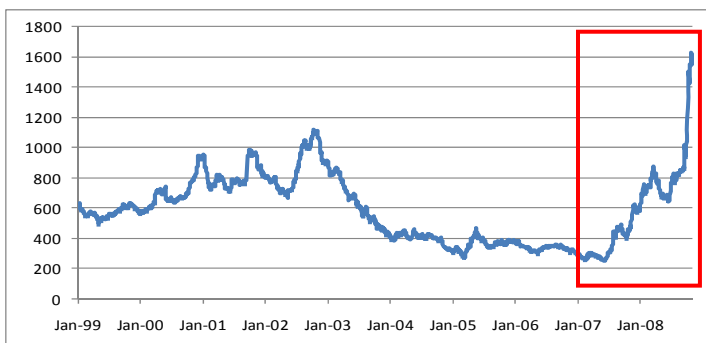
The sheer volume of debt trading at stressed levels begs the question, “Are these companies really that stressed or are market technicals driving bond prices lower?” The Simran team emphatically believes market technicals are driving this market. There are currently hundreds of companies with debt trading at stressed prices that have no near term liquidity issues, are free cash flow”: positive, and

are fundamentally strong even at trough earnings in a weak economy. Many of these companies will likely have no difficulty meeting current debt service payments for the next few years. What then has caused these steep declines in bond prices and where can an investor look for signs that further declines are not on the way? How can an investor take advantage of this market environment and what are the risks involved? In this article, Simran Capital Management explores some of the recent market technical factors that it portfolio managers believe have caused some of the fastest deterioration of credit prices since the high yield bond became a marketable instrument over twenty five years ago.

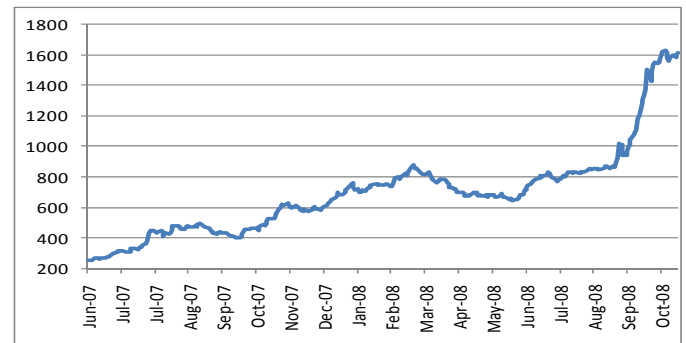
### Credit Spreads Have Approached the Widest Levels Since 2002

Spreads in high yield have increased 565% from the beginning of the credit crisis in June 2007 and have now matched levels reached in 2002. High yield spreads are wider by 899 basis points for the year and 1225 basis points since the beginning of the credit crisis in June 2007. CCC spreads have widened 1683 basis points this year.

High Yield Credit Spreads 1999 – October 2008



High Yield Credit Spreads: June 2007- October 2008



## Fundamentals vs. Market Technicals

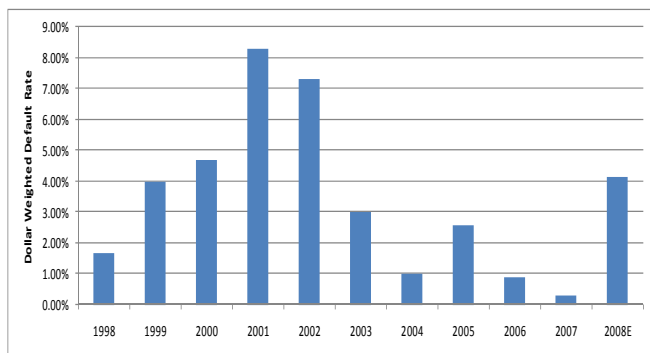
We look historically at high yield credit spreads in past market cycles that were negative for credit. The most recent negative market for credit was 2002. The market environment in 2002 was characterized primarily by a large number of defaults and bankruptcies of underperforming companies that could not survive through the recession that followed the collapse of the dot com era and the impact of 9/11. Many of these companies, particularly in growth segments such as technology and telecommunications, did not grow fast enough compared to their plan projections to meet debt service requirements. Credit spreads widened in reaction to the fundamental credit quality of the credit issuers. In contrast, the recent credit crisis has had a relatively low default rate. Companies have continued to service their near term debt payments and perform moderately well fundamentally compared to previous recession and pre-recessionary environments.

What has characterized this credit environment compared to previous markets is the amount of debt many of these

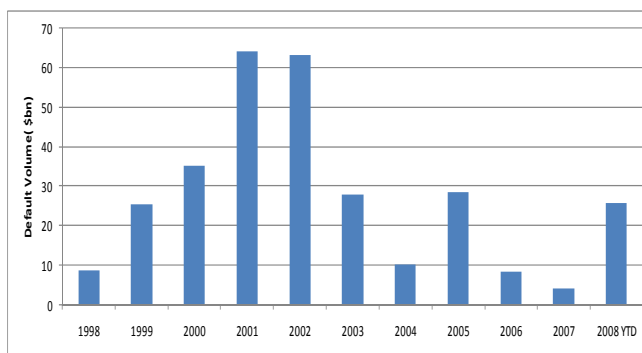
companies now carry. During the past several years, leveraged buyouts occurred at a record pace. High yield new issuance reached record levels in 2007, even with very little issuance occurring in the second half of the year. Private equity firms were able to purchase companies for a fraction of the equity contribution required in previous years despite paying record prices for assets. High yield financing was readily available in the market to pay for the rest of the transaction. Additionally, special one-time dividends to shareholders and other practices added further debt onto the balance sheets of companies. Financing costs for companies increased only modestly compared to prior years as yields required to attract investors to purchase this paper declined steadily since 2002. Companies for the most part have been able to continue to service their debt and maintain solid liquidity. **Now with credit markets closed, the real threat to credit issuers is not that they will not make their coupon payments, but that there refinance their outstanding issuance once it comes due.** This has been one factor causing investors to be wary of high yield and avoid allocation to the space.

Simran believes there are a number of options available to credit issuers before they approach a default or a bankruptcy which may keep the default rate lower than in past credit cycles. This typically involves working with existing bondholders to come up with alternative ways of refinancing. Simran Capital has completed a number of capital structure initiatives as an activist bondholder in this credit environment and expects the number to increase in 2009. Many of these bondholders have purchased this debt at significant discounts as a result of the credit crisis and are therefore willing to offer some of that discount back to the company if it means keeping them out of default. Covenant waivers, extended maturities, debt exchanges, and secondary market purchases are just some of the strategies we see being negotiated. The rewards can be substantial for investors who can successfully negotiate a deal with a struggling company. In addition to consent fees, these bonds typically offer a current yield of 10-20% because of the high coupon and price discount at which the bonds can be purchased.

**Historical Default Rate: Volume**



**Historical Default Rate: Percent of Total Issuance**



## Market Liquidity and Mark to Market Declines Have Created a Downward Spiral Effect

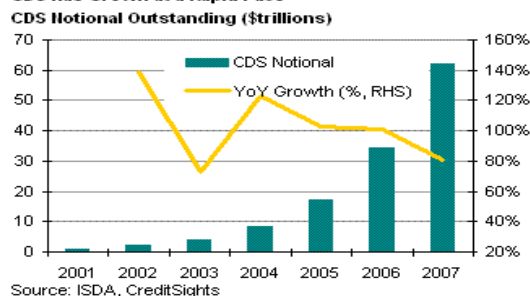
Corporate-bond trading volume has decreased about 40 percent to \$16 billion a day this year versus the same period in 2007, Federal Reserve data on primary dealers show. This is a staggering loss of liquidity in a short period of time. One primary driver of the loss in liquidity is larger firms, mainly the top tier investment banks, are committing less capital to market making bets. In some segments of high yield, larger investment banks have ceased market making altogether. In the absence of market making and decreased liquidity,

bid/ask spreads have widened considerably. For example, just one year ago a large investment bank may have made a live market on a particular high yield bond with a quarter or eighth of a point spread. Now in the absence of market making and a less liquid environment, this same bond may have a spread as much as five to ten points. It has now become more costly to move into and out of positions. As a result, bond investors are trading less frequently, which is having a further negative effect on market liquidity.

A low liquidity environment combined with a prolonged credit crisis has created a nightmare for those investors that are forced to liquidate positions due to

redemptions. The first group of investors to test this storm was the collateralized debt obligations (CDOs) that were unwinding in the second half of 2007, primarily as result of the blow up in the asset backed securities market. CDOs that held corporate bond positions in illiquid high yield bonds were forced to sell their holdings in some cases at five to ten points below market prices. The resulting market to market losses were felt in portfolios of mutual funds, banks, hedge funds, insurance companies, pension funds and other investors. The portfolio declines have caused further redemptions, pushing bond prices for some less liquid bonds down 30-40 points off prices just a few months ago.

**CDS Has Grown at a Rapid Pace**



**Estimated CDS Market Participation (% and \$trillions)**

	Buyer	Seller	2006 Pro Rata	2007
Banks	59%	44%	17.5	31.9
Hedge Funds	28%	32%	10.2	18.6
Pension Funds	2%	4%	1.0	1.9
Corporates	2%	1%	0.5	0.9
Insurance Companies	6%	17%	3.9	7.1
Mutual Funds	2%	3%	0.9	1.6
Other	1%	1%	0.3	0.6

Note: figures sum to 100%+ due to rounding

Source: BBA, CreditSights

## **Credit Default Swaps (CDS) and Its Impact on the High Yield Bond Market**

In the past five years the CDS market has exploded. The notional value of CDS contracts underwritten now tops \$60 trillion. The product was originally conceived as a hedging tool for hedge funds that were seeking a less costly and cumbersome way to short bank and bond exposure. At the

### **Concerns for the CDS Market**

There are a number of ways that a bond's risk profile and CDS risk profile can differ. A CDS instrument is governed by its own document and therefore its own set of rules. Since the CDS market is a privately negotiated OTC market, there is not a central repository for data and risk figures for the industry. Numerous questions surrounding settlement procedures, deliverable obligations, and CDS credit events have all caused market concern. Many concerns have been addressed as the product develops. For example, the auction process requires consent for adhering parties to participate and has the effect of setting a settlement price without unduly bidding up the underlying instruments. The auction process importantly addressed the problem of having many times the notional amount of CDS traded. However, it in turn created additional market disconnects as the amount of CDS ballooned to multiples of the size of the underlying credit. Many would argue that liquid availability of CDS created an incentive for credit risk to be taken without proper due diligence, as the CDS "hedge" created a sense of downside protection.

However as a result of the recent credit crisis and subsequent bank failures, counterparty risk has become a greater concern. The full extent of the impact of the Lehman default is not yet known. The largest impact on the overall markets stems from Lehman's significant role as a CDS counterparty. The default left CDS counterparties with Lehman facing a complicated series of questions. Would they have any claim in bankruptcy? Would their contracts be upheld? What should they do to mitigate risk?

### **Cause and Effect of CDS**

Quantifying a cause and effect response in the cash bond market as a result of CDS is difficult. Are investors selling underlying positions because they no longer trust deliverability of their CDS counterparty? Are hedge investors no longer buying cash bonds because the price of the CDS hedge is now too expensive? Will large investment banks continue to falter or fail due to the CDS they have underwritten, and thus end up needing to liquidate their own portfolios to shore up cash? We have seen some evidence of all of this in the current market and it has pushed bond prices lower. One could argue that the opportunity to buy so much high paper at such discounts now is in part due to the boom in CDS underwriting in the first place. The record appetite for high yield new issuance through the first half of 2007 may not have been as strong if

end of the 1990s, an increased number of hedge funds were looking to short a finite number of bonds. Bond borrow locates became hard to find and expensive and recall activity was frequent. Since each issuer has many different bonds outstanding, it is often difficult to take a negative view on a credit in an efficient manner. By attempting to aggregate the credit quality of an issuer and remove the

investors had not become accustomed to offloading some of the risk with the purchase of CDS.

Whatever the combination of factors, what remains is a tremendous supply of high yield paper in the secondary market, which has caused significant price declines in high yield bonds. Even with a weak economy, the forces behind these steep declines can be explained more by market technical factors rather than fundamentals of the credit issuers themselves.

### **How Can an Investor Take Advantage of This Market Environment?**

**The credit selloff over the past year has created what Simran views as the most opportunistic time for stressed investing in the last decade, even as markets have experienced increased volatility in the past few weeks.** We expect credit volatility to remain high in the second half of 2008. The Simran team recognizes the overall economy will likely remain weak in the near-term and credit markets have not yet completely stabilized. However, we believe federal government actions and falling commodity prices will begin to stabilize credit going forward. While this will surely come with some near term volatility risks (and we are already experiencing some of this in October), our analysis shows this market environment has credit priced at values that significantly limit the downside potential from these levels for many securities.

**We believe that with spreads as wide as they are currently, one does not even need to reach out to the riskiest segments of the high yield market for attractive yield.** We are finding strong value in solid credits higher in the capital structure with yields equal to what riskier credits were offering a just a few months ago. These credits are free cash flow positive with the ability to pay down debt over time. Many of these companies do not have significant portions of their debt coming due for another five to ten years, which gives capital markets ample time to open again before these companies need refinancing. Purchasing debt higher in the capital structure also permits an investor to take advantage of a deleveraging opportunity if certain covenants only allow debt reduction higher in the capital structure prior to addressing subordinated structures.

majority of interest rate risk in a trade, CDS allowed a two-way view of credit. The CDS instrument filled this market need by providing an instrument something like a short that would give hedge funds the ability to consider themselves "hedged". Since the late 1990s, the participants have grown to include banks, pension funds, corporate entities, insurance companies, mutual funds and other interests.

**An investor can also benefit from a strong current yield in this market environment, even if it takes the credit markets time to rebound.** Spread stabilization at this point with no price improvement would offer the portfolio an outsized return just based on the current yield of the credits in the portfolio.

### **Bondholder activism can achieve outsized performance in this environment.**

The rewards can be substantial for investors who can successfully negotiate a deal with a company that needs to right size its balance sheet in a difficult market environment. In addition to consent fees, these bonds typically offer a current yield of 15-25% because of the high coupon and price discount at which the bonds can be purchased. We believe the universe of names now trading at stressed levels will need to come up with capital structure initiatives once reserved for companies in much worse financial distress (i.e recapitalizations, debt rescheduling, debt for equity exchanges etc.) We believe it will be easier for these fundamentally sound companies to complete capital structure initiatives than deals completed in the past since these companies are not "stressed" in the traditional sense but find themselves in a stressed situation due to the technical factors driving this market. This scenario creates opportunity for activist investors to earn attractive current yield with a strong recovery value as well as upside potential from one time fees for indenture waivers, add-on participation incentives, and equity stakes that can add immediate value to portfolios. While building coalitions amongst bondholder groups and advising company management teams on capital structure changes may be out of the realm of individual investor expertise, partnering with a manager that has experience in this segment of the market or purchasing debt where there may be a likelihood of these types of events occurring are options for investors looking for outsized performance.