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GLG Views

In times of stress, get distressed

The asymmetric return profile of distressed securities

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Introduction

The term 'distressed investing' traditionally relates to the purchase of securities in corporations that are unlikely to meet their debt obligations. In fact, some of the companies concerned may already have filed for bankruptcy while others are widely expected to do so in the not too distant future. As a consequence, the securities often trade at a significant discount to their par value and are considered attractive because substantial profits can be generated through receipt of a higher settlement during the liquidation process, or by accepting an equity stake in the restructured business.

Investing in a business that is close to bankruptcy does not sound like a particularly intuitive strategy. However, as Alumni Award Winner Charles Gradante once observed, "The key to distressed companies is that they all have bad balance sheets, but they could have either good or bad business models". Consequently, an important aspect of the distressed philosophy is to recognise that companies with unsustainably weak balance sheets, stemming from financial mismanagement, can actually be operationally sound and potentially profitable businesses.

Although distressed investors are usually able to find attractive investments throughout an economic cycle, periods of 'peak harvest' generally coincide with austere economic conditions. This is when a combination of corporate fallibility and financial complexity creates significant opportunity. Indeed, the concept of actively investing during, or shortly after, periods of recession makes a lot of sense as financial asset prices are usually depressed, while risk aversion effectively prevents mainstream investors from getting involved until signs of a broad recovery are evident.

In stressed or distressed scenarios, the valuation of a company's debt securities can fall disproportionately relative to its degree of financial difficulties because of subjective influences such as fear and stigma. Regulations are also unsupportive as rules prevent institutional investors, such as pension funds, from holding a security once its rating has fallen below specified levels.

Similarly, high-yield funds cannot continue to hold bonds once they are in default. Such investors become 'forced sellers' which can create artificial downward pressure on the price of affected securities. Consequently, distressed investors can derive substantial profit from purchasing securities at depressed prices which do not fully reflect the break-up value of the related business, let alone its recovery potential.

Amend and extend

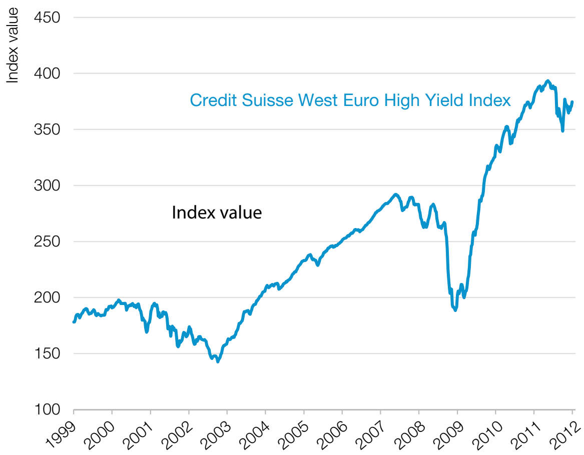
'This time it's different' is an assertion which is often referred to as the most expensive phrase in investment, but there are clear grounds for asserting that the current distressed cycle is unique. As in previous credit cycles, a period of strong economic growth combined with low interest rates and rising asset prices resulted in complacency and injudicious lending at the top of the cycle.

However, this is arguably where the comparison ends. What preceded the credit crisis was an unprecedented period of stability, which is often referred to as the 'Great Moderation'. As a consequence of the adoption of pre-emptive monetary policy, inflation was contained more successfully than at any other time in history, interest rates gradually moved into a significantly lower range and the peaks/troughs of the business cycle became less pronounced.

In this supportive climate, bonds, as an asset class, became increasingly attractive with credit risk, interest rate risk and inflation risk receding simultaneously. This is reflected in the chart below which illustrates that high-yield bonds achieved an aggregate return of more than 100% in a 5-year period commencing in late 2002 (while a similar trend was also evident during the late 1990s).

A golden period for high-yield bonds

7 January 1999 to 5 January 2012



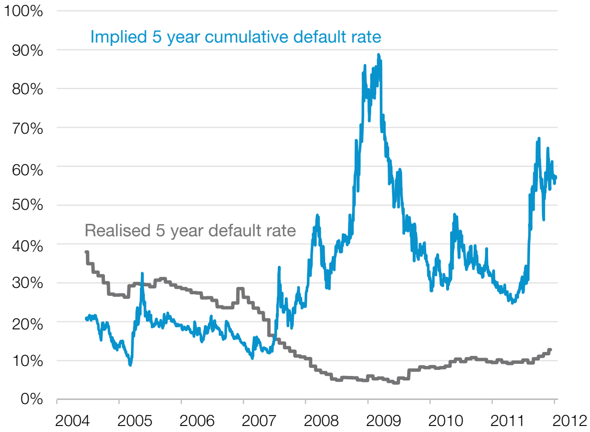
Source: Credit Suisse.

This 'golden period' for high-yield bonds coincided with greater institutional demand for income in a low interest rate environment. These conditions also led to heightened competition among the world's largest banks to develop scale to combat ever-decreasing margins. As a consequence, enhanced quantitative models were developed to enable the slicing, dicing and restructuring of credit into new financial instruments. The sub-prime residential mortgage markets were seen as attractive solutions to the demand for high yields, especially as advanced financial engineering made it possible to package it up in structures with investment grade credit ratings.

The debt securitisation model may have dispersed risk more evenly across the financial system as a whole, but it also presented huge difficulties in accurately assessing risks at the issuer level, and indeed aggregating them at the global level. So much so, that uncertainty surrounding the distribution of losses remains a key reason why banks remain reluctant to offer debt finance, or indeed lend to each other.

Default rates appear set to rise significantly

22 June 2004 to 10 January 2012



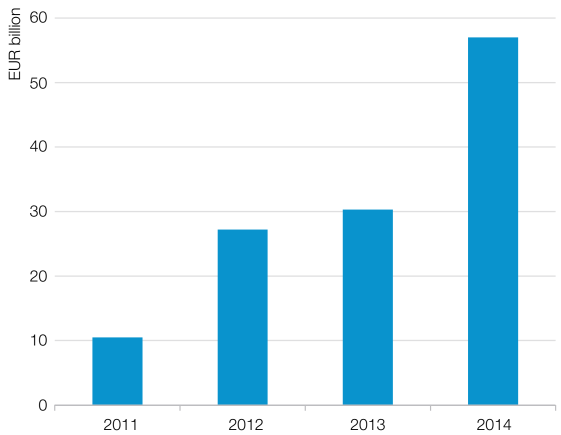
Source: Bloomberg and Moody's Investor Services.

In the absence of fresh capital injections, many corporations have sought to broaden the horizon of their existing loan agreements. According to Moody's Investor Services, the 'amend and extend' (or 'delay and pray') practice resulted in artificially low default rates during both the 2009 and 2010 calendar years (see chart above), with actual default levels coming in some way below the forecasts of ratings agencies.

Lenders have also benefited by agreeing to reschedule loan repayments because it means that they can delay making provisions against non-performing loans. Nevertheless, the practice is conceptually similar to attaching unaffordable debt to a boomerang; it will inevitably come back one day, creating an even bigger problem. Consequently, we firmly expect actual default rates to soar as neither overly-indebted firms or their lenders will be able to push the moment of truth further into the future.

As can be seen from the chart below, an unprecedented amount of debt is now due to mature over the next three years, which is likely to completely overshadow the availability of credit. Very few companies will be able to refinance debt through operating cash flow, so most will seek external sources of capital or simply file for bankruptcy.

A wall maturing debt



Source: Morgan Stanley. Figures have been compiled by adding the maturity profiles of European leveraged loans to those of financial and non-financial speculative grade issuers to create a proxy for potential defaults.

Consequently, it is likely that the most lucrative phase of the distressed cycle remains ahead of us – because history suggests that the best returns are typically achieved after default rates have peaked – even though we are entering the fifth year of the financial crisis. Moreover, the potential rewards for distressed investors may eclipse those seen in the aftermath of previous credit implosions.

A downward cascade of capital

An escalating default rate implies an expanding opportunity set for astute distressed investors to take advantage of. As defaults rise, the price of non-investment grade securities is likely to fall to levels that are grossly unjustified on a fundamental basis. This provides the potential to generate attractive, asymmetric returns, with limited downside and much greater prospective upside.

At current valuation levels, the market is pricing in a 5-year cumulative default rate of more than 50%, which appears excessively pessimistic. Should actual default levels come in some way below this figure, it means that certain securities must be priced at a level which assumes an adverse event that does not materialise. These prices, in part, reflect a rapid dissipation in appetite for risk over the summer months and an escalation in the cost of obtaining insurance through the credit default swap (CDS) market.

Risk aversion is also evident in the investment grade segment of the credit market, where relative demand for the highest-rated paper means that BBB rated securities are currently offering an unprecedented yield premium. With interest rates across Europe seemingly destined to stay at low levels for the foreseeable future, especially given nascent weakness in Germany, it is reasonable to assume that capital will flow into lower-rated securities as the search for yield intensifies.

Indeed, as the prospective flow of investor money drives down yields at successive levels of the investment-grade spectrum, it seems almost inevitable that capital will ultimately cascade into speculative grade and distressed securities, thus potentially constraining the downside and adding to price asymmetry.

Knowledge flexibility and patience

While there appears to be an abundance of opportunity for distressed investors, it is important to consider that investing in distressed securities is essentially an alpha strategy which has historically had very little correlation to the performance of capital markets.

Instead, it relies on company-specific opportunities, extensive research and, in particular, manager skill. Success or failure is dependent on how effective the research has been in uncovering all of the variables specific to a distressed company. It is also important to focus on those opportunities where the risk of total loss is lowest and yet irrational fear is abundant.

Regardless of whether the intent is to profit from a business break-up or the non-default of an undervalued issuer, experienced distressed investors can derive sizeable returns from the application of three attributes that are not necessarily shared by the broader investment community – knowledge, flexibility and patience.

A proven fund manager is a pre-requisite

Distressed investing can be very lucrative but there is significant potential for capital losses to be incurred from poor investment decisions. Any shortcuts in research efforts can result in inaccuracies in the valuation of the underlying assets, which will invariably lead to miscalculations of the true value of the securities. Such errors are costly because the liquidation process will determine which claims on company assets are ultimately honoured – investment decisions will thus prove wholly justified or extremely imprudent; there really is no middle ground.

Historically, distressed investors have tended to focus on the US market, mainly due to its breadth and depth. The high-profile accounting scandals affecting Enron and WorldCom also conspired to create staggering returns for US investors in the post tech bubble meltdown of 2001-02.

However, given the stress being experienced by countries in Southern Europe and the exposure of European banks to sovereign debt, there is likely to be an abundance of opportunity for distressed investors across the continent. Indeed, it has been widely suggested that the intertwinement of banks and sovereigns means that a Greek default would inevitably cause a domino effect across other EU constituents and their banking systems.

Similarly, any withdrawal of cooperation among the stronger economies in respect of contributing to the European Financial Stability Facility could actually catalyse the contagion, rather than protecting state interests. In any eventuality therefore, it seems the balance of the distressed opportunity has shifted in favour of Europe. Nevertheless, one of the singular challenges associated with exploiting the opportunity set in Europe relates to the differing regulatory regimes that are in situ within individual jurisdictions. This idiosyncratic backdrop is far removed from the established order uniformly provided through the provisions of Chapter 11 bankruptcy in the US and highlights the importance of choosing experienced European distressed practitioners to manage assets in this singular arena.

Harnessing the opportunity

Throughout the last two years or more, we have maintained our conviction that the leverage in Europe's financial system is unsustainable. As such, we have sought to protect ourselves from a sudden realisation of the immense gravity of the situation on the part of other market participants. We have therefore been broadly defensive and yet positioned to benefit from volatility in the near term through our focus on liquidity.

Unlike many of our peers, we are maintaining net short positioning for the time being. This reflects our view that many investors refrain from entering the distressed space through fear of a recurrence of the 2008 carnage. In our experience, many potential clients are also concerned about the perceived importance of timing their entries and exits. With this in mind, we have adopted a dynamic and flexible approach, which allows us to adjust our positioning as the environment changes and provides us with the potential to deliver more consistent returns to our investors.

We continue to believe that the major opportunities to capture substantial alpha on both the long and short side lie ahead of us. Nevertheless, the recent sell-off, which has primarily reflected concerns over the perilous state of peripheral countries, has undoubtedly created some valuation anomalies in core Europe. This provides us with the chance to access the paper of some household names with defensive qualities at oversold prices.

From a similar perspective, we see no shortage of opportunities to harness returns from short positioning. We expect corporate stress to continue to increase in the coming months and years as a result of austerity measures imposed by governments, falling GDP and limited access to funding. Overall, we believe it is important to combine an overarching view of the market, in order to determine levels of relative net exposure, with a fundamental, research-driven approach to individual investment decisions.

Conclusion

As we have seen, distressed managers have the ability to generate high returns in the aftermath of acute market stress. Nevertheless, we believe that by adopting a flexible and adaptable approach, using long and short positioning, it is possible to generate superior and recurring investment returns over time. Distressed strategies therefore do not need to be constrained or motivated by the volume of defaults.

Distressed investing inevitably becomes popularised during extreme phases of the credit cycle, and there are sound reasons for believing that the potential rewards may eclipse those of previous distressed cycles. However, the premise that the pattern of investment returns must therefore be deeply cyclical is false. Investors should seek fund managers with a proven record of generating solid performance in varying market conditions in order to make the most of the distressed opportunity now and in the future.

European distressed debt team

Galia Velimukhametova

Galia Velimukhametova joined GLG in June 2008 as a Portfolio Manager, managing distressed strategies. Galia joined GLG from King Street Capital where she was a Managing Director and Member of the Investment Committee. Prior to this, Galia was at JP Morgan for almost 7 years. Prior to JP Morgan, Galia held positions in the Emerging Markets Groups at Baring Asset Management and Rothschild Asset Management. Galia received an MBA from Washington University, St Louis in 1995 and an Honours degree in Economics from Moscow University in 1985.

Till Heimlich

Till Heimlich joined GLG in April 2007 and has been responsible for identifying relative value investment opportunities in loans, bonds and credit derivatives since that time. Prior to joining GLG, Till worked at Goldman Sachs as a Credit Analyst and Ratings Advisor. Till graduated from the University of Hamburg in 2000 prior to gaining his Master's degree from ESCP-EAP in 2003.

Selina Scales

Selina Scales has experience working across multiple aspects of credit investing, in investment banking and for the fixed income strategies at GLG. She is an analyst and Product Specialist for credit and convertibles funds at GLG. Previously she worked at Nomura where she was a top Institutional Investor™ ranked convertible bond research analyst. Prior to that, she trained as a corporate strategy analyst valuing business units for pre-transaction private equity deals. Selina holds a Masters in Economics from Edinburgh University.

Ide Kearney

Ide joined GLG in 2009 to work with Galia Velimukhametova on the European distressed portfolio. Ide joined from King Street Capital Europe, where she was on the investment committee for 3 years and acted as a senior analyst working across a number of sectors within the high yield space. Prior to King Street, Ide worked at JP Morgan as a high yield and special situations analyst. Ide holds an MSc in Marketing from the University of Manchester and a Bachelor of Business and Legal Studies from the University College Dublin.

Christophe Akel

Christophe Akel graduated from Ecole Normale Superieure, Cachan, France, in 2003 with a BSc in both Economics and Management before graduating from the University of Paris, France, in 2005 with an MSc in Finance.

Christophe trained as an intern with the credit team at GLG during summer 2002 and during his gap year commencing September 2003. In June 2005 he joined GLG permanently as a Credit Analyst working and Trader.