Viewpoint

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Private Market Opportunities in Distressed Debt

Siguler Guff Investment Team

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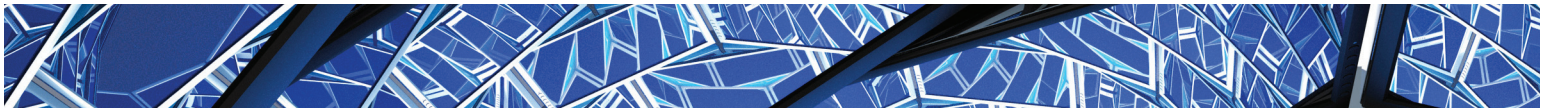

October 2011

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SIGULER GUFF

Executive Summary

The market uncertainty and volatility arising from the massive debt overhang in the U.S. and Europe vividly demonstrate the investment risks associated with the developed world's unprecedented build-up and unwinding of leverage. At the same time, that mountain of debt may create historic investment opportunities as many lenders become forced sellers at depressed valuations during this protracted distressed cycle. Investment professionals from Siguler Guff have been investing in private equity markets for two decades and believe they are well positioned to discuss the current opportunity in the market. BNY Mellon Asset Management recently spoke with them about the distinctive distressed debt investment opportunities the current environment offers.

What makes this cycle in distressed debt opportunities different from previous cycles?

What makes this moment unique is the sheer scale and breadth of the opportunities. There will always be pockets of distress and opportunities for those who can provide solutions. But the huge build-up of leverage in the global financial system over many years probably means it will likewise take many years to unwind; and those bumps in maturities will likely create opportunities. The inexpensive price of debt in the first half of the 2000s contributed to that enormous expansion. The massive amount of leverage in the system and search for yield created more demand for structured products. According to Standard & Poor's LCD, the institutional leveraged loan market grew 5.1 fold between 2000 and 2008 from approximately $117 billion to $591 billion. Banks and traditional lenders accounted for approximately 60% of the demand for leveraged loans in 1997, but constituted only approximately 18% as of 2007. The balance of demand came from collateralized loan obligations (CLOs) and hedge funds, which grew from 42% of demand in 1997 to 84% in 2007. It should be noted that hedge funds were an immaterial component of leveraged loan demand in 1997 but grew to represent 27% by 2007. With the advent of CLOs, what was a nascent market in 2000 became a growth engine of demand by 2007. Therefore, approximately $450 billion in loans now needs to be refinanced or repaid.

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In the current environment, we don't believe the bond market or the equity markets can handle the sheer size of the refinancing necessary. Accordingly, we expect to see a great deal of forced deleveraging across a variety of asset classes. The current situation is unique because the distress is global and spans many asset classes and strategies. The inter-connected nature of today's markets across geographies, legal structures, and political systems has created greater complexity and decreased the effectiveness of diversification in periods of significant dislocation, as we experienced in the fall of 2008. As a result, there is a lot more to work with than in previous cycles but portfolio construction requires a greater level of care.

"Distressed" describes a market in which economic, structural, social or other forces lead to selling decisions that are made for non-economic reasons. As a result, the pricing of investments typically declines significantly below the intrinsic value of the asset.

Distressed cycles tend to be idiosyncratic and episodic. In our view, this one can be broken into two coincident stages. The first stage happened between 2008 and 2009; the second began in 2010 and continues today. The first stage was driven by very large fallen angels like Lehman Brothers, Washington Mutual, IndyMac, and others. The second stage has been more persistent: less about bankruptcy and largely concentrated in the financial industry. Historically, the banking industry has been fairly stable (excluding the Great Depression and the Savings and Loan Crisis), but we have seen distress across all forms of lending, across multiple jurisdictions, and across multiple loan categories. In the first stage, we saw extremely high default rates, which were addressed by an increase in liquidity provided primarily by government entities. Since then, default rates have declined rapidly in the second stage, and long-term solvency risk has replaced short-term liquidity issues. The pervasiveness of this cycle is being felt beyond the U.S. and is lingering much longer than the corporate distressed cycle of 2008-2009. Additionally, we are experiencing significant distress across sovereign borrowers, which in turn impacts global growth prospects.

How do you define the distressed market?

"Distressed" describes a market in which economic, structural, social or other forces lead to selling decisions that are made for non-economic reasons. As a result, the pricing of investments typically declines significantly below the intrinsic value of the asset. A significant factor influencing distress is bankruptcy risk or credit rating risk. As a company's risk of bankruptcy increases and ratings decline, investors' selling pressure increases due to many institutional investors' contractual limitations on holding riskier investments.

Overall, default risk in the market has been declining since 2009. In response, the broader markets have responded through rising prices (and declining yields). However, many small- to middle-market companies remain in distress because they are largely loan-financed, more heavily tied to U.S. GDP growth, and highly leveraged. The loan financing concentration and lack of access to the current broader public market refinancing wave is a serious obstacle, since the availability of lending to these small- to mid-sized companies has declined substantially as banks, CLOs, and other lending institutions have migrated away from riskier and less liquid investments.

Compounding the difficulty to access financing markets, the revenue of smaller U.S. companies tends to be much more dependent on the domestic economy, which has experienced a period of low to zero growth since 2007, as opposed to exporting to faster-growing markets abroad. Without substantial U.S. growth, smaller companies will likely struggle under the substantial leverage that they acquired in the prior cycle.

How have historically low interest rates affected the opportunity set?

Low rates have had a meaningful impact on distressed debt opportunities, as the cost of funding has declined for high yield issuers and LIBOR-based borrowers. The market's ever present search for yield has driven newer buyers into riskier assets. This increase in broad market demand for liquid high yield debt has further driven down yields and interest rates, and provided a long life-line to riskier borrowers. This kind of "kicking the can down the road" can persist for only so long. Without very high global and, more particularly, U.S. growth, we believe the market will re-price lower and there will be more distressed opportunities in the broader market.

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The second phase of this cycle has been characterized by struggling financial companies. These financial institutions generate earnings by borrowing at low rates and lending at higher rates. The steep curve of the last couple of years has been extremely beneficial to lending institutions. Recent comments from the Federal Reserve have indicated a desire to flatten the curve, which could have negative implications to financial institutions as net interest margins collapse.

How do distressed opportunities in private markets differ from those in public markets?

Public markets typically provide greater transparency and liquidity. As such, demand for public debt is generally greater and more consistent. Private market demand increases as yield buyers migrate away from lower-returning investments. In addition, because of these factors, volatility in private markets tends to be greater in down markets. However, because private markets generally involve floating-rate obligations, private markets tend to have less rate sensitivity and are therefore less volatile in stable markets. Today, distress is more prevalent in private markets due to the nature of borrowing by the small and middle-market borrower and the tighter lending standards applied. Supply and demand imbalances in these submarkets are driven by declining demand for the product by traditional and structured credit markets. Increasing supply (i.e., the demand for borrowing) is driven by the expanding wall of maturing leveraged loans.

What are the sectors and industries that are particularly appealing? What about specific regions?

We believe there are attractive opportunities in the corporate distressed market in the U.S., particularly in the small- and middle-markets as previously mentioned. Our research has also identified attractive opportunities in financial companies, hard assets like shipping and real estate, and other more niche oriented strategies such as drug royalties and non-performing loan pools. We believe a market catalyst in Europe will likely provide attractive opportunities in the near future. Finally, the structured credit markets have provided, and we believe will continue to provide, episodic opportunities.

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All eyes were originally on 2012 when a huge volume of corporate debt was set to mature. How does the coming refinancing wave affect the opportunity set?

Due to the significant issuance of corporate bonds since September 2009, the wall of maturities has been extended beyond the 2012 target that people originally referenced. As you can see from Exhibit 1, bond debt has been pushed out to a more even maturity profile through 2016. Leveraged loan debt, however, has a significant wall beginning in 2013/2014 with a second bump in 2016. Unless the high yield market can nearly double over the next year to 18 months, the leveraged loan market will begin to face significant structural challenges in 2013.

A key difference between high yield bond debt and loans is that bonds can have very long maturities, whereas loans typically have much shorter maturities. Leveraged loans generally pay interest on a floating basis linked to LIBOR, which has been historically low for the better part of 2010 through today, whereas high yield bonds typically pay on a fixed basis. This low base rate has lowered cash financing costs, which has helped provide a lifeline to highly levered capital structures. Furthermore, loans generally have scheduled amortization payments that shorten the average life of the loan substantially. Further complicating this maturity wall is the role of collateralized loan obligations (CLOs) in the securitized market. CLO demand has waned as structures transition to harvesting from investing, and issuance has been almost nonexistent over the past couple of years.

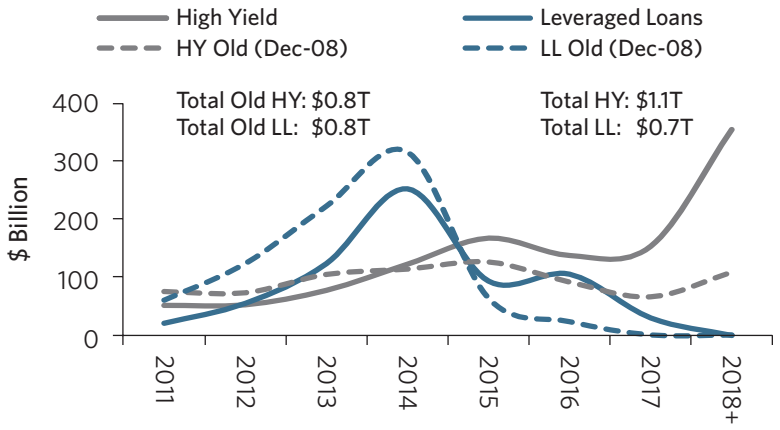
Leveraged loans generally require greater lender controls in the form of covenants and collateral packages, whereas high yield bonds generally do not. These controls generally de-risk the loans relative to the bonds. It should be noted that the initial stage of high yield issuance in the second half of 2009 required more loan-like characteristics. As the market improved and fear subsided, these control provisions relaxed and the purpose of the issuance changed from nearly 100 percent refinancing to a blend of refinancing, general corporate purposes, acquisitions and dividends. A result is that companies swapped near-term unsecured debt with limited, if any, covenants for longer-term secured debt with strong covenant protections, which limits managements' ability to run the business and puts greater emphasis on the top of the capital structure.

We expect idiosyncratic opportunities to continue in the public and private markets with broader near-term opportunities in the small- and middle-market loan-based borrowers. Longer-term, we expect the opportunity set to expand as companies struggle to grow into their bloated capital structures.

The shift of emphasis to the top of the capital structure is due in part to the large amount of secured debt residing on the company's balance sheet. Investors are willingly or unwillingly taking equity risk in the debt instruments they are holding. A strategy in this environment is the "loan-to-own" strategy, which is a longer-term strategy of creating the equity position through an exchange of debt instruments either through a bankruptcy process or in an out of court resolution. Certain managers excel at operational turnarounds which, when coupled with a financial restructuring, can be a powerful tool for value creation. A drawback to this strategy is that it is highly illiquid and very long duration.

We expect idiosyncratic opportunities to continue in the public and private markets with broader near-term opportunities in the small- and middle-market loan-based borrowers. Longer-term, we expect the opportunity set to expand as companies struggle to grow into their bloated capital structures. We believe the next default cycle will likely be characterized by riskier borrowers with significant recapitalization needs. Exhibit 1 shows that not only has the maturity profile of the leveraged markets been extended, the size of the overall market has also grown by more than 10% over the past few years. In other words, the market has not de-levered through this default cycle, which is what usually happens in a classic distressed cycle. Instead, we have experienced fallen angels that liquidated, and stressed companies that have extended their maturities. Because of this, our view is that the next default cycle, a more classic cycle, will be a continuation of those events that began in 2008.

Exhibit 1 – Growth and Maturities of Leveraged Loan and High Yield Markets



Source: JP Morgan Credit Research, as of July, 2011.

As an episodic and highly cyclical strategy, distressed investing carries many risks, all of which are of primary importance at different points in time.

Finally, as we have discussed, the refinancing of the 2012 maturity wall was driven in part by the reallocation of capital into the fixed income market and, in particular, into high yield as the impact on yields by U.S. government stimulus programs drove buyers into more risky asset classes. As these stimulus programs recede, and assuming no new programs, we expect market yields to normalize at levels higher than they are today. This will likely draw buyers back to their natural markets and bring supply-demand back into balance. The impact should be a rising yield environment. Due to the low interest rates and long durations on the recent issuances, we believe these products are at particular risk of high fluctuations in pricing to the downside, which may create an episodic buying opportunity.

What are the particular risks associated with investing in distressed debt, and what are the distinctive capabilities managers need to approach these markets intelligently?

As an episodic and highly cyclical strategy, distressed investing carries many risks, all of which are of primary importance at different points in time. We look at a number of different distressed strategies, each of which has different risks. More liquid strategies, such as trading, rely on timely execution. So this naturally raises execution risk, counterparty risk, and liquidity risk. Execution risk and counterparty risk are extremely important, given the long settlement procedures related to bank loans.

Although documents state a trade must close 7 or 19 days past the trade date, the actual settlement date could be months after the trade date because of the non-specific nature of the agreements and highly customized legal procedures surrounding these agreements. During September 2008, counterparty risk was probably the greatest risk in the market as banks, funds, and other vehicles were at risk of failure.

Less liquid strategies, such as control or ownership, bear more asset selection, enterprise/operational, or process risk. From an investment perspective, one has to be concerned with enterprise risk and whether the investment bears more equity or credit risk. As reflected in their ratings, distressed companies carry a high risk of failure. In addition, the bankruptcy process requires a deep analysis of all obligations to determine the ultimate distribution methodology and a third-party valuation to determine the size of the pool of assets which will be distributed using that methodology. Although all of this is based in contract law, there is a significant amount of interpretation that can lead to a drawn-out debate over recoveries. So in general, we would say that investors need to be able to assess all of these risks, as well as others, to plan for a large number of potential contingencies.

In such an uncertain landscape, we believe portfolio construction requires even greater care than historically presumed. We also believe, however, that another economic downturn is likely to expand the distressed opportunity set even further and prolong the cycle.

What macroeconomic changes could affect the opportunity set?

In the U.S., we still have a substantial housing debt overhang that is weighing on growth. Any significant improvement or decline will likely contribute to a shortening or lengthening and easing or deepening of this financial crisis and distressed cycle. Policy choices are also having a significant effect on the current market. Low interest rates help prop up problem institutions and delay real resolutions. The upcoming elections and potential policy shifts in their wake could also have a significant impact on domestic markets. We've already seen how the downgrading of U.S. government credit combined with deteriorating fundamentals in the U.S. and Europe has rattled investors and undermined confidence. Consumption remains a disproportionately large driver of U.S. GDP growth, yet many U.S. consumers remain highly leveraged, underemployed, or are rapidly approaching their retirement years with inadequate savings due to recent market fluctuations and a severe and protracted decline in the housing market, thus making them less likely to spend in the future. Beyond the U.S., we believe the fiscal instability in Europe, the political unrest in North Africa and the Middle East and the impact of China on global growth all contribute to an environment of great macroeconomic uncertainty. As we mentioned above, globalization has had a negative impact on diversification due to increasing political and economic interconnectedness. In such an uncertain landscape, we believe portfolio construction requires even greater care than historically presumed. We also believe, however, that another economic downturn is likely to expand the distressed opportunity set even further and prolong the cycle.

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