advanced

DISTRESSED DEBT

Here to stay

The trends of 2006 show how the market will adapt and grow over the coming years

In the middle of 2006, European distressed debt investors were feeling as if they had won tickets to the World Cup, but when they turned up in Frankfurt, they were then turned away at the gates. With European default rates almost non-existent in 2005 (save for Concordia, the Swedish bus company) Germany had promised to be the place to be in 2006. Banks began restructuring their debt by selling off non-performing loan (NPL) portfolios to comply with the Pillar 1 capital adequacy requirements of the Basel II Accord and estimates of the potential size of non-performing German assets were in excess of €300 billion ($394 billion), comprising 60% of Europe's total.

Why did some distressed debt investors in Germany feel like they only ever saw an empty stadium?

In addition, the German distressed market looked set to heat up as the small and medium-sized corporations known as the Mittelstand, often referred to as the backbone of the German economy, became financially unstable. This instability was caused by increasing costs and greater international competition, both of which had a negative impact on the German market as a whole, ultimately leaving the smaller banks feeling vulnerable. In 2006, Germany was the sick man of Europe and needed cash, and distressed investors were willing to provide it. With the German goal wide open, why did the distressed market provide returns only for the few rather than the many?

First, the large NPL opportunities, like the €3.6 billion Olympic portfolio sold by Hypo Real Estate, were mostly snapped up by Lone Star, leaving the rest trying to get exposure to single name credits in 2006.

Second, there were many barriers to entry, not least of which were the language and culture. German sellers of debt were cautious about trusting US investors and were

unfamiliar with market trading practices, making debt purchases a slow, lawyer intensive and costly process.

Third, the German regulatory regime required lenders to have a banking licence. This meant that hedge funds could only enter revolving or unfunded credits as participants behind banks such as Morgan Stanley, which ramped up its exposure to German credits in 2006 by acquiring a lot of the most liquid opportunities.

The Mittelstand corporations, often family-run businesses, traditionally enjoyed strong, long standing and friendly relationships with their local banks. The influx of US investment from unfamiliar vulture funds and banking heavyweights was therefore unsettling and communication proved difficult. To alleviate concerns, investors had to develop good relationships with the local banks. This was time consuming and required local knowledge, which led to investors partnering up to be cost efficient. Investors needed quickly to assess the variety of debt instruments and bonding facilities available, many of which were specific to Germany, written in German and governed by German law. Furthermore, the instruments and facilities in some cases (*Genußschein* for example) bore no direct relation to anything seen either in the US or the UK, which added to the complexity and made the market particularly illiquid.

Given these hurdles, some investors found Germany too troublesome and looked elsewhere, whilst others persevered and were able to purchase non-performing debt at bargain rates. The German auto industry, for example, provided many opportunities with bonds in Schefenacker (a German car parts supplier) trading at around 20% of the face value. Nonetheless, whilst Germany was full of promise and actually delivered for some, the end result did not live up to the expectations of the many.

The real winners in Europe in 2006 were probably the restructured energy, cable and airline businesses. Consistently high gas prices fuelled a resurgence of interest in coal-fired power generation. The European Trading Scheme (ETS) in respect of allowances for carbon emissions did nothing to dampen the interest in coal power plants as the market for allowances proved volatile and plants could purchase allowances at low rates. Eggborough for example, a UK coal-fired plant owned by British Energy and based in Yorkshire, saw its bonds trading at more than three times their face value in June 2006.

Since the European markets were generally flush with liquidity, and merger and acquisition activity in 2006 contributed to a record year for the profitability of investment banks, few opportunities for distressed investors materialized. In response, funds that typically invested in distressed opportunities adapted their strategies and became involved earlier in the restructuring process, not only in mezzanine and second lien debt, but increasingly at the senior tranche level.

Whilst investment banks were reporting stellar performances, the distressed debt traders could have been left idly twiddling their thumbs. However, undeterred by the slow distressed market, they set to developing a new product to further capitalize on secured credit exposure and created a synthetic loan market that is likely to boom in 2007 through the trading of loan-only credit default swaps (LCDS).

A North American LCDS document was published by the International Swaps and Derivatives Association (Isda) in June 2006 and a European version is expected to be

launched later this year. This North American product is non-cancelable (or non-callable) and continues so long as there are any "syndicated secured" loans outstanding in respect of a "reference entity". The contract is focused on the overall credit risk of the obligor and recovery rates for that obligor's secured loans, whilst the European contract is likely to be focused more closely on default risk tied to a specific secured loan obligation. The current European LCDS product, not yet approved by Isda, is considered a "cancelable" "reference obligation only" contract, in that the parties specify upfront the actual loan, or list of loans, that may be delivered to the protection seller in exchange for the par payment after a credit event occurs. It is cancelable because the LCDS contract terminates upon repayment of the reference obligation (although an alternative non-cancelable option for the European contract is under consideration by the Isda working group). This makes the European LCDS contract a good hedging product because, if you are long the underlying loan and you are a protection buyer, you have no risk that your loan will not be deliverable to the protection seller for par after a credit event.

The development of loan-only credit default swaps will undoubtedly result in more market participants gaining exposure to loans as an asset class in 2007 and ultimately engaging in the trading of loans as a means of physically settling derivative contracts, which in turn could lead to a price squeeze on the debt when a borrower defaults on a payment obligation or restructures (two of the so-called credit events under the proposed European LCDS contract). Credit protection buyers are required to deliver a certain loan to the protection seller to fulfill the LCDS contract by physical settlement. How this settlement mechanism will play out in practice and what the impact on the markets will be remains to be seen. The European LCDS contract is set to continue to be a topical subject of debate for the loan market and a final Isda-endorsed document is expected to be launched in May 2007.

Whatever the result, 2007 promises to be an interesting year as the synthetic market grows, the primary lending market is still booming, and with companies' debt at an average all time high of nearly six times Ebitda (Earnings Before Interest, Tax, Depreciation and Amortization), it is inevitable that some companies will end up in default. Views on exactly when this will happen however, vary widely due to the stability of the European economy. Some expect that only a major geopolitical event could change the market, and predict that liquidity in distressed trading may not return until 2008.

As for Germany, more of the same is expected in 2007 and investors will continue to pursue opportunities in the automotive industry and monitor the Mittlestand corporations that need capital. That said, the German economy appears to be performing better so far this year. The Financial Times reported (January 31 2007) that "Germany's hosting of the 2006 World Cup – and the strong showing of its youthful team – seemed to inject a renewed sense of optimism after years of post-unification blues".

Current German economic indicators point to recovery: reduced unemployment, higher exports and growth in private consumption (albeit gradual) looks set to continue, despite the sales tax increases at the start of 2007. The German market is stabilizing, which may reduce distressed opportunities and investors could be turning their attention to other areas of Europe in readiness for the next credit crunch. Spain, for example, is a possible contender for opportunities in 2007/2008 as wages are still rising at around twice the European average, well ahead of productivity growth, and Spanish demand has been driven by housing and credit booms that are vulnerable to higher interest rates.

The hunger for mezzanine and second lien debt in Europe from hedge funds, CDOs and CLOs will continue to create greater debt and higher leverage, but this is tempered by the large number of private equity funds that are still willing to pump money into financially unstable companies. Given the excess liquidity in the market, the amount of deeply discounted debt may be limited in the next downturn and supply of distressed opportunities is therefore likely to remain fairly low until late 2007 or even mid-2008.

Given that Europe's current economic stability does not bode well for an imminent flow of distressed opportunities, many are beginning to focus their sights on Asia's NPL market, whose current size (excluding Japan) is estimated at $885 billion, of which $480 billion is derived from China. Governments across Asia are putting pressure on banks to release this debt from their books and remove inefficiency from the banking system. In addition, the new Chinese bankruptcy law, based largely on US principles, is coming into force in June 2007, which may help to open up the market.

Regardless of when the next round of defaults kicks in, 2006 demonstrated that the distressed players are here to stay. In a year offering few new distressed opportunities, the market adapted to the buoyant economic environment, hedge funds became more accepted as a source of primary lending, banks developed the LCDS product and distressed investors proved that they have the ability to tackle what is thrown at them in readiness to score big in the next credit cycle, wherever and whenever that may be.

By Louisa Watt of Richards Kibbe & Orbe LLP