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Will Distressed Debt Investments Boom?

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"Buy low - sell high". Financial investors have shown again and again how profitable this strategy can be. The main reason for this is that successful financial investors have the ability to invest in assets with a potential for high appreciation at the right time.

It is generally expected that in 2008 distressed debt investors could profit from the current volatility on financial markets and existing business conditions. Lucrative and "bargain" asset classes could particularly be leverage loans, i.e. loans extended to companies with a complex equity structure and high leverage, and some portfolios of structured securities which have been given much attention in the press since August 2007.

The reason given for the expected downturn of certain leverage loans is that the default rates of German and European borrowers, currently at a historically low point, could rise significantly as a result of the economic slowdown and ongoing volatility on financial markets. In particular, borrowers with high borrowings and complex financing structures consisting of short-term loans subject to early violations of covenants could be expected to run into financial difficulties in this environment and would thus be strongly exposed to the risk of insolvency. The relevant indicators will be lower ratings for these borrowers, which can be observed even now in some cases although the current general economic situation is probably not (yet) responsible for this. Another factor is that bridging and restructuring loans will no longer be available to the same extent as the financial crisis continues.

The expected appreciation of portfolios of structured securities is, however, dependent on the underlying assets of these securities. The default rates for securities based on US subprime loans for residences (residential mortgage backed securities) have significantly increased, and market observers believe that this trend will continue. The write-offs of several billions reported by the worldwide banking community to date must, based on a cautious evaluation, be seen as indicators in this direction. The situation for European residential mortgage backed securities in countries with strong price increases over the past years, such as the United Kingdom or Spain, could also become worse. As regards structured securities based on European commercial mortgage backed securities as underlying assets, it is likely that some of the (deeply indebted) borrowers will run into payment difficulties as a result of facing refinancing problems. The same considerations apply to structured securities which are based on leverage loans extended to German or European companies. The default rates for structured debt instruments based on other asset classes, such as car loans or leasing, are currently not higher than expected. As a result of the financial crisis these debt instruments are, however, also under pressure and cannot be traded on the secondary market or can only be traded at a discount.

It is likely that institutional investors, such as banks and insurers, holding substantial investments in these critical asset classes will think about divesting these positions so as to reduce their market risks and, consequently, their potential write-offs. At the same time, specialized distressed debt investors are able to generate above-average returns if attractive purchase prices can be realized.

Before starting to buy leverage loans, a commercial due diligence of the companies involved should be conducted to determine whether the prospects of the business of each of the borrowers are solid. A due diligence review of structured portfolios will focus on what asset classes are included in the portfolio and whether a positive forecast can be made for the performance of the portfolio.

An example for a spectacular deal is the investment by the hedge fund Citadel Investment Group and other investors in the online bank E*Trade Financial Corp. E*Trade ran into financial difficulties as a result of unfortunate investments made on the US subprime market. Following a report of a Citigroup analyst last October who estimated a 15 % likelihood of insolvency, customers terminated their investments which further aggravated the financial situation of the company.

On 29 November 2007 an investment agreement was made between the Citadel investor group and E*Trade. Citadel purchased from E*Trade a securities portfolio with a nominal value of three billion US dollar containing collateralized debt obligations and secondary collateral from mortgage investments on the US subprime market for a purchase price of 800 million US dollar (27 % of the nominal amount). In addition, the investors granted E*Trade capital in a total amount of 1,75 billion US dollar in consideration of common stock and unsecured bonds at an interest rate of 12.5%. Based on this agreement, the investors will hold 19.9% of the common stock of E*Trade and will be given a seat on the supervisory board. Additionally, E*Trade has agreed not to take up further debt higher or equal ranking or to enter into any other transactions affecting the interests of the bondholders. It was further agreed that the new bonds will be served with priority after certain old bonds have been repaid and that other old bonds will be subordinated. This example shows how distressed debt investors can successfully implement a purchase of a structured portfolio based on a combination of equity capital, debt capital and control through a seat on the board of directors of the company.

From a legal point of view it will have to be reviewed whether the restructuring strategies pursued by distressed debt investors can be implemented in the view of existing creditor rights against the assets. If for instance a hedge fund is not only interested in making a quick profit, without implementing any restructuring strategies, but intends to take an active or passive influence on the restructuring process or to convert debt into equity, the critical issue is whether the hedge fund can, as a distressed debt investor, exert any influence on the restructuring process based on the debt instruments or by taking accompanying measures or can block measures in such process.

In the context of frequently highly complex capital structures it is crucial for distressed debt investors to understand the position and rights of the holders of the debt instruments and their collateralization. For this purpose the legal relationships between these creditors will have to be reviewed on the basis of typically complex inter-creditor agreements and financing documentations strongly influenced by the Anglo-Saxon legal system. It is therefore recommended to conduct a review of the assets before starting the actual restructuring work. This is already standard practice when purchasing certain subordinated positions and also appropriate or even required for refinancing the purchase. It therefore appears likely that there will be a greater need for legal advice in the interface between structured finance and financial restructuring & insolvency in the future.

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