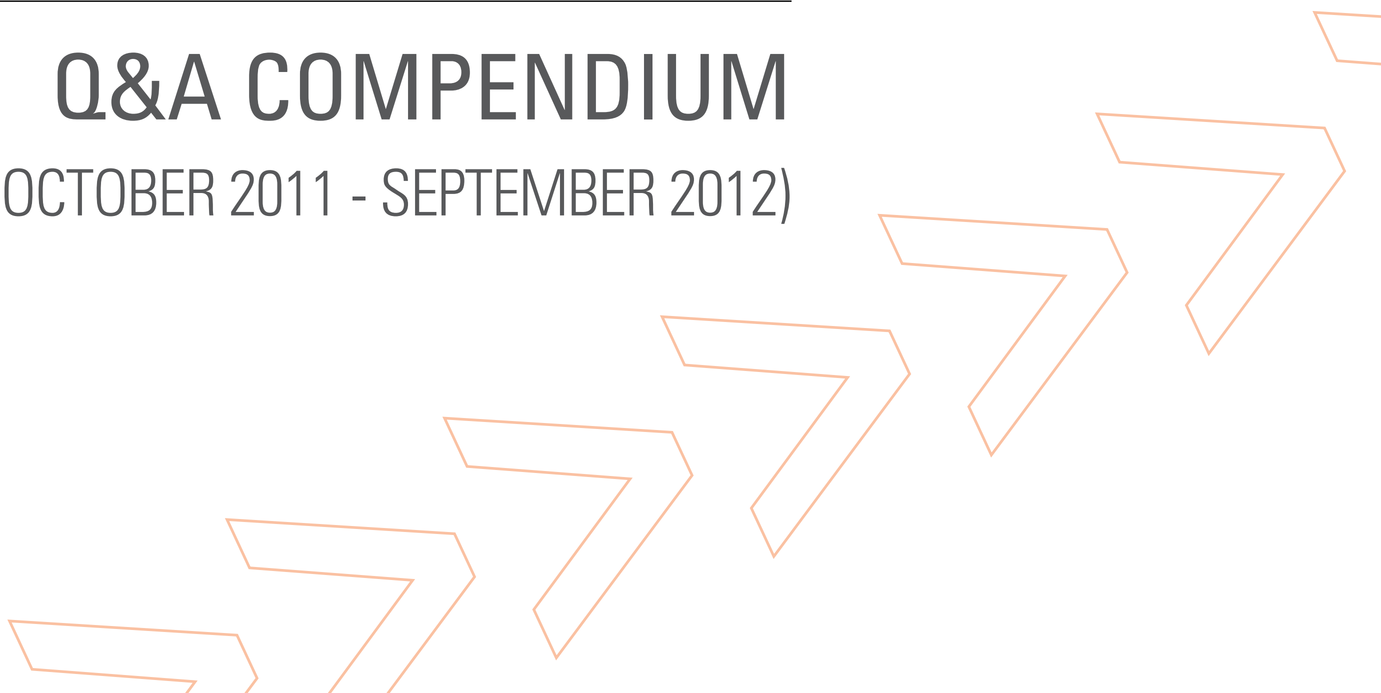
BANKRUPTCY AND RESTRUCTURING

Q&A COMPENDIUM

(OCTOBER 2011 - SEPTEMBER 2012)



INTRODUCTION

One year ago, on Oct. 12, Bloomberg LP's Bloomberg Brief newsletter team published its first daily newsletter focused on corporate and municipal bankruptcies and restructurings. Scan the headlines of that first issue and you will find that little has changed. Municipalities are under stress. Alternative energy businesses and retailers are struggling to make debt payments and some of the largest Chapter 11 petitions involve businesses within the financial services industry. We wanted to thank our readers for their interest and support. To celebrate that one year anniversary we are offering a collection of previously published interviews with leading industry specialists and restructuring practitioners.

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Q&A

Buckfire Sees More Restructurings Out Of Court Amid Anemic Economy

Slower-than-expected economic growth likely will force many companies to restructure their balance sheets and much of that will be done outside of a bankruptcy court, according to **Ken Buckfire**, chief executive of **Miller Buckfire**, and **Harvey Golub**, the restructuring firm's chairman. The Miller Buckfire executives said this next wave of restructurings likely will occur in the next year. Both executives were interview by Bloomberg Television on Wednesday. The following are excerpts from that interview.

Q: In which industry sectors would you see some restructuring?

A: We'll see this process of adjustment playing out across every sector of the economy where leverage has been employed to facilitate the growth of a business, but growth has not materialized. There will have to be an adjustment from the balance sheet that supported the model that people thought they had when the economy was growing to the one that we actually will have, which is zero to no growth for the foreseeable future. It's a process of adjustment. Financial restructuring is always there to help strategic restructuring, not the other way around.

Q: If you were expecting more of this restructuring, we're going to see more stresses then in the economy?

A: It is our expectation. Many companies were built on balance sheets assuming normal economic growth, two or three percent a year. But, in a world where economic growth is zero to one or one-and-a-half those balance sheets simply don't work. That puts a lot of stress on company operations. Revenues don't grow at the rate expected. They can't service the debt or pay down debt the way they expected, and therefore they're going to have to restructure to reposition their strategies.

Q: What would those restructurings look like? Are we talking about spinoffs?

A: They may involve spinoffs. They may involve reduction in capacity, sale of units of the business that cannot support themselves. They may involve separating good and bad assets and doing different things with the good and bad assets.

Q: One of the things that may arise from all of these restructurings is more layoffs, right? Are we going to see that increase in the months to come?

A: I think you are going to see that because companies are going to get more conservative about their own economic prospects. They are, therefore, not going to invest as much in projects which might require more labor. And, they're going to continue to reduce costs because they can control that. You'll see more and more of that over the next few years.

Q: You'll see restructurings, but not outright bankruptcies?

A: The culture of restructuring has changed. In past years, past decades restructuring a company was the last thing that a company wanted to do. They fiddled around the edges and they postponed tough decisions until they absolutely had to do a restructuring. And that was normally then done in Chapter 11 or in a dissolution of the company. Companies are realizing more and more that engaging in a restructuring activity prior to bankruptcy – prior to the necessity for bankruptcy – is often a better way to go. A better restructuring can take place, better arrangements with debtors and with other constituents can be made so that the company doesn't have to actually go into default. Or, if it does all the agreements were laid out ahead of time. So, they will be engaged in advisors earlier in the process before the necessity to actually file.

Q: Is that what we're seeing with Kodak?

A: Yes. In the case of Kodak they are quite correctly trying to buy more time to establish their turnaround plan. And if they can find the financing that allows them to do that, that's a logical thing to do. Again, no bankruptcy, no default and in fact many of the largest transactions that we've been involved in over the last 15 years did not go to bankruptcy and did not have a default. They were financially-driven restructurings that got no attention because, by definition, they didn't go bankrupt. So we're going to see that become a very dominant trend in the next cycle which will begin probably in the next year where the capital markets are much more understanding of these kind of circumstances and will finance companies that have balance sheet issues, but are fundamentally good companies. That's a very important factor underlying what we think will happen in the next few years.

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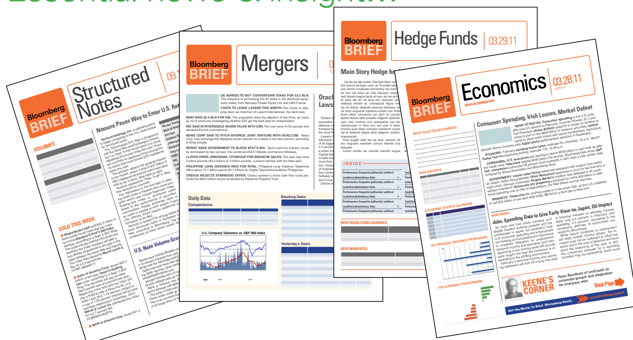

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Q&A

Weil's Harvey Miller Expects Pickup in Chapter 15s If European Credit Market Remains Tight

Harvey Miller, a partner at Weil Gotshal & Manges and co-founder of its restructuring group, said he expects a pickup in Chapter 15 because of tightening credit conditions in Europe. He also said in an interview with Bloomberg's Aleksandrs Rozens that more troubled companies will use Chapter 11 as a way to sell off assets as part of an effort to avoid litigation. Miller said banks have increased their participation in the DIP market as they try to generate better returns, leading in some cases to lower borrowing costs for debtors.

Q: The credit environment today has gotten more difficult for companies. Does this mean we expect an uptick in Chapter 11 filings?

A: The issue is getting down to the ability to refinance. People have been talking about the maturity cliff for a couple of years now. Every time there has been a suggestion there is a maturity cliff and it's going precipitate either restructurings or Chapter 11 cases, it hasn't happened because the market either opened up. Or, the companies were able to refinance through new investors. There is no question credit is tightening. There was an article the other day in some publication that the banks are loaded with cash. They are not lending. They are certainly not lending to midcap companies. And, that's where you are beginning to see some cracks with a very slight increase in Chapter 11 filings. There is a great reservation about actually seeking bankruptcy relief. If you look at bankruptcy cases of the last five years, less than five years, they are not what we would call the classic reorganization cases. They are primarily sale cases.

Q: These days we go to bankruptcy court to sell assets, either all of the debtor's assets or some portion of them?

A: Or, an orderly wind down of the assets. The issue is that the world has changed in the last 20 years. In addition to getting smaller, more inter-connected, more global, the whole dynamic of finance has changed. In 1978 when the Bankruptcy Reform Act was enacted the great bulk of credit was unsecured. And most of the provisions of the bankruptcy code were geared to dealing with unsecured creditors. It is universally accepted that secured creditors have more rights than unsecured creditors because they have rights to the collateral, property. And, property rights are protected in the U.S. Constitution. We now see in most companies all the assets are encumbered. There are very few commercial enterprises in which the assets are not encumbered. We've modernized all of our laws so that it is relatively easy to get security interests and liens. When companies get in trouble they need more financing. If they have any unencumbered assets, they will lien up those unencumbered assets. So when the moment of truth – if you want to call it that – occurs, there is no unencumbered base to use as a foundation for doing a reorganization or a restructuring. Essentially, the secured creditor or creditors moves into the control position and they are able to dictate what the process should be, whether it is a sale, a liquidation or a pre-arranged or prepackaged Chapter 11 case. The leverage of control has moved to the creditor sphere whereas in the concept of 1978 it would be evenly balanced. The debtor would have almost equal rights as the creditors because you had all of the provisions of bankruptcy code about the automatic stay which stopped everybody from doing anything and then the debtor in possession could borrow money. Today you can't borrow as a debtor in possession unless you can adequately protect the secured creditors and by the time these companies get to a restructuring stage or bankruptcy there's no equity. In other words the secured creditor is under-secured. That means you cannot borrow any money. You cannot do a restructuring unless you have cash flow.

Q: My understanding of bankruptcy law was that its ideal was to have the estate intact and alive after the 11 process.

A: In 1978 when the bankruptcy code was enacted, one of the underlying main principals was rehabilitation. Take a distressed entity, rehabilitate it during the Chapter 11 process so that at the end of the Chapter 11 it would come out as an economically viable unit that could compete in its industry. So, you are absolutely right, rehabilitation was a prime objective. Post-1979 when the code became effective and as we progressed another principle began to arise. And that other principle was maximization of creditor recoveries. Over the years that principle has subsumed rehabilitation. Creditor recoveries has become the theme of Chapter 11. When people talk about Chapter 11, they talk about creditor recoveries. You combine that with the fact that the secured creditors are in control and the rehabilitation scheme has sort of died.

Q: So, there are tweaks to the 2005 law that we could use.

A: The 2005 law is definitely anti-rehabilitation. If you start in 1978, you had a code that was intended to encourage rehabilitation. Unfortunately, post-1979 when it became effective the debtors don't have a lobby. There is no debtor's lobby in Washington. There is no office building in Washington that says the 'Organization of American Debtors' or something like that. Banks and financial institutions have very strong lobbies. Every amendment to the bankruptcy code since 1979 has basically included clawbacks against the debtor, taking away some of the debtor's power, exempting certain industries from the restrictions on preferences and so on. After 1979 more special interest legislation came into place to protect fisheries, granaries. Once you open that crack, the special interest legislation will start going through.

Q: Moody's recently warned that many high-yield companies in Europe will have a tougher time refinancing their debt. Should we expect to see an increase in Chapter 15s?

A: Yes, absolutely. Because these non-U.S. entities will have some assets here that they want to protect. They will use chapter 15. Even in the Lehman case, we have the German administrator for a

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Lehman subsidiary in Berlin, **Lehman Bankhaus**, who thought it was necessary to protect what he calls Bankhaus assets in the U.S. There will be more of them. The European situation is very very sensitive. It's a real powder keg over there. Its like a never-ending Greek tragedy and Greece is not the big problem. Italy is the big problem. There is so much exposure to Italy. Banks who bought sovereign debt in Europe finance themselves by selling commercial paper which is sold in the U.S. as well as Europe.

Q: Manufacturers facing asbestos claims filed for bankruptcy to mitigate claims. Could you see a way that top U.S. banks with a mortgage lending arm may try to mitigate litigation risk the same way?

A: The asbestos companies were unsuccessful. Initially, what they tried to do is move tainted assets to a subsidiary and then try to spin out that subsidiary or file a petition for that subsidiary and say 'That's not our responsibility.' It didn't work. All the efforts to isolate those assets did not work. That's why you have all of these major companies – **WR Grace**, **Owens Corning** – that ended up in bankruptcy because they could not hive off the asbestos problem. Trying to eliminate liability by either a spin off or a sale to a subsidiary leads to a lot of litigation.

Q: So for someone looking to mitigate risks of all the litigation of being a mortgage lender ...

A: It's a very difficult subject. It requires a great deal of analysis. It can be done in some situations. The asbestos cases are not good precedents for that.

Q: Some years ago you said it is very difficult to prove a fraudulent transfer.

A: Yes.

Q: But I get the feeling that a lot of people are cautious about that these days when they restructure out of court.

A: I'll tell you why. In many respects it's subjective. You can get a financial or an investment banker to testify on values over a wide range. It's not hard to get experts because its not a science. Valuation is not a science. Valuation is key to fraudulent transfers. If you name a firm I can tell you generally where they will be: high, low or in between. So, that's a big problem. The second problem is it's extraordinarily expensive litigation. It goes on for a long time.

Q: Fighting it or waging it?

A: Waging it. Discovery in today's litigation world is expensive. And with the world of computers and Internet and so on, discovery is broadened out because you can get everything. The demands for production of documents including emails are extraordinary. So, if you have a choice, you don't want to do that. If you are buying assets from a company that you don't know may or may not be insolvent or looks like its in distressed circumstances – you don't want to take a chance. Many purchasers will take the position 'I'm willing to buy but I'm not going to buy it and also buy a lawsuit. If you want me to buy, you put it into Chapter 11 and I'll buy it. We'll make it like a **General Motors**, **Chrysler**, etc.' That precipitates Chapter 11. Why is that good? Because you get a court order that absolves you from all this litigation.

Q: How is DIP money these days? Is it still readily available?

A: Generally DIP money comes from the existing secured creditors. But in the last six or eight months, because the financial institutions have a lot of cash there's been more competition. An institution like **JP Morgan,** which has got a lot of cash and which is looking for returns, is willing to get into the DIP market. If you look at **A&P** the old lenders were going to do the DIP. JP Morgan came along and said 'No, we'll do the DIP and well do it on better terms than the old one.' But their DIP also included taking out the old DIP. I think JP Morgan also may have done the DIP in **NewPage**. Again this was a new lender. Part of the DIP was paying off the old lender. There is a little bit more competition. Not generally for the benefit of the debtor, but financial institutions searching for some kind of better return than one percent.

Q: Does the savings for the debtor come in the form of lower fees or a lower interest rate?

A: I think in both the A&P and Newpage they got a lower interest rate.

Q: Daniel Erhmann said he believes Lehman Brothers Holdings has enough support to implement the payout plan. Do you share his optimism?

A: Yes. We are very hopeful that before the year is over it will be confirmed.

Q: Away from bankruptcy, I assume you still have season's tickets for the Metropolitan Opera.

A: Anna Bolena was very good. That's the Donizetti with **Anna Netrebko** who sang the first four or five performances. The singing was glorious. What the MET is doing, which I think is very important, is they are making Anna Netrebko an icon. When Pavarotti died or went into his later years, the Met lost an icon. Domingo to some extent was there, but he was also sort of fading out. It needs an icon. So she's done that.

Q: Years ago you stepped away to be an investment banker. Could you ever see yourself stepping away from bankruptcy law again?

A: Not anymore. I like being a lawyer. I like the challenges in a legal framework solving problems. I find it very exciting. I always have found it exciting. I'm very appreciative I fell into this by accident. It is, I think, an enormously interesting field because you are not dealing with a piece of paper. You are dealing with real people. You are dealing with real situations. And, fortunately, they have a beginning, a middle and an end within your lifespan and you can see the whole picture. If it's successful, if you are person who likes gratification, it's wonderful.

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Q&A

Alvarez & Marsal's Europe Head: $1 Trillion of Debt Has To Be Refinanced By 2015

Antonio Alvarez

Spyros Martsekis

Antonio Alvarez III and Spyros Martsekis

Alvarez & Marsal's new office in Athens likely will advise troubled companies and government entities, according to Antonio Alvarez, managing director and head of A&M Europe, and Spyros Martsekis, the firm's newly-hired head of its Greece office. Alvarez said he expects some $1 trillion worth of debt will need to be refinanced by 2015. Not all companies will readily find new lenders to extend their credit, he told Bloomberg's Aleksandrs Rozens.

Q: What spurred the move to open an office in Athens?

Alvarez: We happen to have been fortunate to win and perform a major restructuring engagement in Greece, which was **Wind Hellas** [**Telecommunications SA**]. It allowed us to see the market first hand and, at the same time, we began to see the strains on the Greek market and economy. We got interested in the Greek market, and when the broader sovereign crisis started to break out it made a lot of sense for us to be there given that we tended to do well in setting up shop in times of crisis.

Q: Do you expect to work more on behalf of creditors or debtors in Athens?

Alvarez: In Europe what we are known for is advising the companies, the debtors, and serving in officer, advisory roles for the debtor. We usually are on the company side. We expect it to be the same in Greece; we are targeting being of service and help to the Greek banks on their internal issues and financing issues and overall structural issues as well as Greek companies which we've already started to do. In addition to that, there have been announced privatization efforts. We think improving those businesses before sales or improving them after sales – those are things we like to think we do well and think we can be of value to the marketplace.

Q: In the U.S. you have advised municipalities. I was wondering if you would apply the same ideas to the Greek government, cities or municipal entities. Is there work for you there as well?

Alvarez: We think we can add a lot of value and we'd be delighted to take up that kind of work. We'll see how things progress.

Q: How many people do expect to bring into your Athens office?

Alvarez: We plan to, initially, have at least five locals; at any given point in time we should have at least ten people working in Greece. We can ramp that up, leveraging from the European practice. As of yesterday we probably had over 15 people in Greece doing work on some related matters. While it's our most recent office opening, it seems to be one of our more busiest and most active.

Q: Is there a bankruptcy law or legislation in place?

Martsekis: We had a Greek bankruptcy code which was for over a hundred years in Greece. This code has been replaced by a new law in 2007 which is called the Greek Bankruptcy Act and dubbed Law 3588. Basically, in Greece all restructurings are undertaken in the form and context of formal bankruptcy proceedings regulated by this new law and these are all court proceedings. The court actually appoints a bankruptcy administrator who supervises the whole process. We also have the term COMI, which is the center of main interest. There is no intervention from other authorities outside of Greece; if you have a restructuring case in Greece it's the local court which is taking care of it.

Q: If I'm a U.S. institution and I have a claim in a Greek bankruptcy court, would I expect the same sort of process as I would in a U.S. court?

Martsekis: You should expect the same process. There is also the European regulation from 2000, dubbed Regulation 1346, which basically allows European courts to intervene in case you have some Greek assets under question. But the main court remains the Greek one.

Q: What industries in Greece are in most need of a workout?

Martsekis: The banking sector is a very important one in terms of restructuring. Retail, media, shipping and construction and some manufacturing as well.

Q: When Greece has to sell off some assets as part of a privatization do you think the market will be there?

Alvarez: You need to balance your immediate liquidity needs and satisfy creditors while preserving the underlying future asset that you have got. In a micro restructuring parlance, you don't want to chop off your arms and legs and be left with a body that cannot survive. You can sell all of this stuff and raise some capital but you have just sold off your jewels and any potential long-term viability. If you look at **Lehman,** that's what we ultimately did. We didn't fire sale everything when we were under a lot of pressure. We were able to convince with the help of many professionals and many terrific people within Lehman that we can preserve and protect the most value for the estate by waiting.

Q: In terms of the bulk of the debt you will be working with - is it in the form of loans or bonds?

Alvarez: It's case specific. For corporates, if you look at capital structures there will be a lot of bank lending. There will be some international bank lending. In some of the situations we have seen like in Wind Hellas, there have been more complex capital structures where you'll have different tranches of debt. If you are talking about working for financial institutions, then you have more structured products and international lending including government bodies, the ECB and various institutions. Obviously, the

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government itself has borrowed money from other sovereigns, the EU and other banks.

Q: When we talk about Greece's credit issue, how much of a haircut are investors facing?

Alvarez: Our mission and our reason to be is to help corporates reduce their costs, improve their organization, increase their value over time.

Q: What does your gut tell as far as that haircut? I'd imagine that will shape what creditors could expect on claims for corporations in Greece.

Alvarez: You're right there is a lot of uncertainty that's tied up – waiting and seeing what the final verdict is. The challenge here is that all of the normal ways you look at this are thrown out because this is really political. It's really at that level it's being addressed. There's been no precedent on that. This is all new territory. The key message from the market and what we'd like to see is 'let's get a decision one way or the other and move forward.' The longer it takes to opine and make a decision, it just holds up the time it takes to address the underlying issues that will actually improve the situation.

Q: When you look at Greek companies, do you see them emerging from the equivalent of a Chapter 11 as a whole entity. Or will they have to resort to asset sales?

Alvarez: There's been no specific pattern. It's a myriad of different restructuring solutions.

Martsekis: It's very much case by case.

Q: There was a recent Moody's report predicting that $325 billion worth of bonds will come due by 2015. The rating agency raised concerns about high-yield companies that may have trouble accessing the markets.

Alvarez: I think it is $1 trillion. In the next three or five years the number we have been looking at, that's in our head, $1 trillion has got to resurface or reshape or reshuffle and refinance. Probably a good number of that will get refinanced somehow, but there's going to be a piece of that that will no longer be extended and pretended – if you will – which is going to create opportunities for people to buy into those situations. There is a growing wall of debt that's going to have to be reckoned with.

Q: That $1 trillion – is it all high-yield, or does it include high grade? Is it a mix of industries?

Alvarez: Everything. It's all industries.

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Q&A Scrapping Ships Not Always The Answer For Owners, Says Etheredge

Elliott Etheredge

Shipping companies bought too many vessels in the second half of the last decade and this has hurt companies that counted on a steady rise in freight rates to pay for the new ships, according to Elliott Etheredge, head of marine transportation investment banking at Dahlman Rose."I'd say almost every ship owner out there has had a conversation with its bank to waive covenants and amend loan profiles," he said in an interview with Bloomberg's Aleksandrs Rozens.

Q: You have a joint venture with Blackstone's workout group. Is a bulk of your activity related to restructurings of shipping companies?

A: That is certainly a growing part of it. The other part is working with people to raise money to take advantage of distressed opportunities. In all forms it centers around distress. There are people that are trying to work through the distress and there are people trying to raise money to take advantage of the distress.

Q: Private equity had an interest in some of the shipping and logistics companies. Does that extend to maritime as well?

A: It is growing, yes.

Q: How would they get involved?

A: We have seen a lot of people looking at coming in through second-lien structures where the use of proceeds of that second lien goes to repay a fair amount of bank debt. The other way we've seen people get involved is just buying ships. Going out and buying ships and trying to build up their own book of business and their own fleets without dealing with any existing corporate infrastructure.

Q: Is there a big secondary market for cargo vessels not being used? There is that famous photograph of unused vessels off the coast of Singapore.

A: I would say that things aren't as bad. That was taken during the 2008-2009 recession. Things are not that bad, but the freight rates are certainly under a lot of pressure. There is a secondary market that is very liquid for ships. So, if people do want to get in and build up a stake, then they certainly can.

Q: Are you getting involved with this secondary market for ships?

A: We'll get involved with some larger fleet type transactions, but we don't get involved in the traditional role of ship brokerage.

Q: Global container shipping trade fell in August from July, according to a Macquarie report. That was the worst in 11 years. Does this portend more in the way of restructurings or bankruptcies?

A: Yes. I'd say so. The container ship side is a little bit different. That slowdown is driven by a slowdown in demand which is consumer demand. For commodity-based shipping — dry bulk commodities, oil, fuel, — the demand side of things has been pretty good. Where the real problem has been is there's just too many ships.

Q: How do you deal with a surplus of vessels? Do you cut them up?

A: Scrapping is certainly one way of dealing with it. Scrapping is a big business. Steel prices right now are very high so that certainly helps push more ships to the scrap yard. From a restructuring perspective it does not necessarily play into the restructuring decisions but for the fact that you have some collateral value that you can look to from a scrapping perspective. Frankly, if you are having to look at scrap value to preserve some of your collateral coverage, then you have a much bigger problem as a company. The issue that we have is that so much debt was put on companies in the 2005 to 2008 time frame. Those ships today are pretty young. Ships have, generally speaking, a useful life of about 25 years. So, those ships you bought in 2005 and 2008 — from a scrap perspective you would only get a fractional amount of that value or the debt that's outstanding. The scrapping is really going to come from ships that are towards the end of their life cycle — ships that are 15 to 25 years old.

Q: You can't mothball vessels until demand comes back because you still need to make debt payments. So does the best bet involve selling vessels?

A: Yes, that's something we see a lot of people do. We see a lot of people selling ships to de-lever.

Q: Can you get a 100 percent recovery on the purchase price of a vessel?

A: It depends on what you paid for it. If you bought it 15 years ago and you sell it today, you might get pretty close to what you paid for it. But, if you bought it in 2007 and you are selling it today, you are certainly not getting anywhere near what you paid for it.

Q: Who holds most of the debt used to finance the purchases of ships?

A: Traditional European shipping lenders. The biggest lenders are Nordea [Bank AB], HSH [Nordbank AG], RBS, DnB [ASA]. Commerzbank, Deutsche Bank. The vast majority of it is bank debt. There are some bonds, but very little.

Q: Is most of the restructuring work you are doing these days out of court?

A: Most of the restructurings certainly are being done out of court. I'd say almost every ship owner out there has had a conversation with its bank to waive covenants and amend loan profiles.

Q: Has the Greek crisis affected Greek shipping companies?

A: The Greek shipping companies are more influenced by what's happening in the global shipping market than what's happening in Greece. Greece itself is not a big transporter of stuff. There happen to be a lot of Greeks who own ships. But, the Greek crisis itself doesn't necessarily impact shipping.

Q&A

European Sovereign Debt Crisis Sends Bankrupt Company Borrowing Costs Higher: Decker

James Decker

The European sovereign debt crisis has increased borrowing costs for bankrupt companies, James Decker, head of the financial restructuring group at Morgan Joseph TriArtisan, told Bloomberg's Aleksandrs Rozens. He said smaller bankrupt companies are paying a full percentage point more for a debtor in posession, or DIP, loan than they did a year ago. Much of the actual increase came this summer when Europe's fiscal problems became more accute, Decker said.

Q: What's behind the 100 basis points increase in the rate for DIP loans of up to $500 million? Some would argue that DIP loans are the most secure loans out there so there's no need to ask for a high rate.

A: You can argue that. Even though you get a DIP loan approved and you have therefore a super-priority lien, lots of things happen in bankruptcy. Just because you have a super-priority lien doesn't mean people don't argue over it or you get dragged along longer than you thought you might have. So, there is risk involved in spite of the fact that you might have that super-priority lien. The larger DIP credits are, generally cheaper, just as they are for similar credit facilities in the non-distressed world; there is more liquidity and there is greater certainty of information. If you are a company with $50 million EBITDA, you have greater access to the capital markets than a company that has $20 million EBITDA. The reason for the backup in the DIP market is the same reason that credits across the board — both large and small — have backed up in terms of costs. The whole European fiasco has put a damper on the markets. We're seeing credit markets that tend to move more like bond markets. If you watch the bond market, high yield has largely shut down while Europe sorts its problems out.

Q: Year over year, is that 100 basis points a large change for companies that need DIP financing?

A: We are just picking a point in time – the end of the third quarter of '10 versus the end of the third quarter of this year. I would say the reason for that 100 basis point increase has probably all occurred in the last couple of months of the quarter. This summer has just not been kind to debt capital markets.

Q: Does a lot of DIP paper get syndicated?

A: Very little. Most DIP loans nowadays are going to be provided by the pre-petition lenders. It's a defensive measure. You just don't see very often a priming DIP loan, particularly where that DIP loan is pushing the existing secureds further out of the money. If a company has a $100 million senior facility and it is viewed as worth $50 million and needs a DIP, that $100 million lender will not let a new provider of a DIP in front of them. They'll do it themselves.

Q: On syndication, I'm wondering if the rise in DIP loan costs also has any ties to the decline in the creation of collateralized loan obligations.

A: CLOs are generally not buyers of DIP facilities. They do not have the capacity. A CLO is basically a fund with a mandate to invest that capital in bank loans of such and such a metric, of such and such a quality and such and such a size. They don't have the capacity to undertake the hands-on work that's required of making a DIP loan. Never say never, but I'd be shocked. Most DIP facilities that are multi-bank facilities are an existing bank group. If it's a priming facility, generally those are either one-bank deals or club deals.

Q: You noted in a report that DIP loan sizes are falling. What's behind that?

A: It's because there are fewer large bankruptcies out there.

Q: In recent weeks we saw large filings from AMR Corp. and MF Global. What's your outlook on large bankruptcies? Do you expect more in the future?

A: Not in the near-term future. It really depends on where the economy goes, but we are still in a world where year-over-year EBITDA growth among borrowers is holding up in the teens to the low 20s. In both of those situations, they are not the result of macroeconomic trends as much as they are company specific. AMR probably should have gone through bankruptcy when **United (Air Lines Inc.)** and **Delta (Air Lines Inc.)** did. It had all the same legacy problems – unions, low margin business, a lot of volatility in fuel.

Q: What happens if Europe cannot get its fiscal act together?

A: Then you have some real issues. It all depends on how it all unwinds itself. I saw some studies where people were predicting what would happen to dollar-euro exchange rates under various scenarios; if Italy left the EU I think there was one estimate that the euro would move toward parity with the dollar. That would be good for American buyers of European goods, however the loss in trade from Europe would be pretty damaging overall to the economy. Plus, you would have a lot of euro losses amongst financial institutions and amongst parties engaged in trade across border.

Q: We're seeing more in the way of asset sales or outright sales of bankrupt companies; is that tied to the fact that many pre-petition lenders are doing the DIP loan?

A: I don't think that's right. It may accelerate towards a sale because pre-petition lenders are in there and as a condition of providing you with a DIP facility they put you on a clock for a sale. But I don't think you can link the causality of a sale to the fact that more pre-petition lenders are providing the DIPs. You saw – in the aftermath of the financial crisis of 2008 and well into 2009 – very few sales other than something that was just so completely broken that keeping the company alive would have cost the lenders more than they could expect to recover. As the market stabilized by the middle of 2009 and going into 2010 you saw more of the

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Q&A...
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whole kick-the-can phenomenon. Companies that kicked the can had the ability to generate enough liquidity to continue to pay interest and run their operations. We didn't see that many, relatively speaking, situations go into an 11 and either result in restructuring or sale. I'm not saying we didn't have them in the overall scheme of things but as we have gotten into the later part of 2010 and even 2011 we have seen an increase in the number of companies that have gotten in trouble in or out of court, largely because lenders have reached a point in direct opposition to where they were in 2008 and 2009. They could not afford to take the hit to balance sheets. They were all under severe regulatory pressure to increase equity balances and writing off a particular loan wasn't something they wanted to do in that environment. They have gotten stronger now. Moving into 2011 we see a greater willingness among lenders to flush a given credit through a sale and take a loss if there is indeed one versus what we saw in 2008 and 2009 and early in 2010.

Q: Are you doing more out-of-court work these days?

A: I'd say kind of like always, we are half in and half out. Probably at this moment we have more stuff that's in (bankruptcy) than what's out of court. Every one of our clients is a middle-market company.

Q: You say in a recent report that the credit market for middle-market issuers is a lot more like the bond market for larger issuers.

A: Right. Although larger issuers, all things being equal, will have much greater access to the credit markets than a smaller issuer will.

Q: Does that volatility push more middle-market people into an out-of-court restructuring because they don't have the ready access?

A: Yes. A lot of companies will struggle to get access to the capital markets to deal with a maturity, for example. They will have to go through some sort of restructuring or worse.

Q: You mention HR 2533 in that recent report. Do you expect this bill to pass? I'm not sure Vice President Biden would allow this to happen to his economy in Wilmington.

A: I think that there will be a lot of pressure from Biden. The Delaware Court is very important to the state. I think that it will depend – this is one of the things I don't really have a feel for – on the political pressure that is to brought to bear in that. In a vast majority of states that are not Delaware or NY – a lot of those bankruptcy judges would like to see their cases stay put. I think a lot of the Senators would like to see that. It really depends on who the creditors are. Creditors really get hurt by the party that goes to Delaware even though it doesn't have much business being in Delaware other than being incorporated there; creditors of that company who are hurt by that are more localized as opposed a large institution who won't care where you file. But, a small community bank or small trade creditor may well care and that becomes an expensive proposition for them.

Q: If this bill becomes law, it could be difficult for global companies. Somebody like Coca Cola, does that mean they have to automatically file down in Atlanta? They sell soda all over the country.

A: I think they can make a pretty compelling argument to file in Delaware or the Southern District of N.Y. because most of their creditors are there. It is a global firm. Yes, their headquarters are in Atlanta, Georgia, but it's probably easier for international creditors to get to New York than it is to Atlanta. I don't think that's what people are really worried about. This is more about the $100 million debtor in Southern Mississippi that goes to Delaware to file as opposed to the Southern District of Mississippi.

BANKRUPTCY ASSET SALES (DIVESTITURES COMPLETED OVER LAST THREE MONTHS) *MA BNKF SALE <GO>*

ANNOUNCE DATE	TARGET NAME	ACQUIRER NAME	SELLER NAME	ANNOUNCED TOTAL VALUE (MIL.)	PAYMENT TYPE	DEAL STATUS
11/18/11	Substantially all assets	Medicis Pharmaceutical Corp	Graceway Pharmaceuticals LLC	455	Cash	Complete
12/5/11	DTZ Trading Operations	UGL Ltd	DTZ Holdings PLC	121.45	Cash	Complete
10/27/11	Production Facilities of Izah-Auto OJSC	AvtoVAZ OAO	Izh-Auto OJSC	56.94	Cash	Complete
11/1/11	Substantially all assets	N21 Acquisition Corp	Nutrition 21 Inc	7.33	Cash	Complete
9/30/11	Substantially all assets	Brand Directions Pty Ltd	B Sug Australia Pty Ltd	N/A	Cash	Complete
11/9/11	Substantially all assets	Ningbo Huaxiang Electronic Co Ltd	Sellner GmbH	N/A	Cash	Complete

Source: *Bloomberg*

Q&A

Companies With Debt Due in 12 to 18 Months Looking To Avoid 'Liquidity Bind,' Peko Says

James A. Peko

More volatility in European financial markets and paltry economic growth in the U.S. could fuel corporate restructuring activity, says James Peko, a principal at Grant Thornton LLP's corporate advisory and restructuring services group in New York. Peko told Bloomberg Brief's Aleksandrs Rozens that his firm has seen a pickup in demand for advisory services from companies that are facing debt refinancings in the next 12 to 18 months. "These are clients that are very forward looking, not waiting until they hit a liquidity wall."

Q: Given where we are in the economy and the volatility of the credit markets, are you seeing an uptick in bankruptcies or out-of-court restructurings?

A: You had the refinancing cliff coming in 2012 and 2013. The issuance of 2010, going into 2011, has probably smoothed out that curve a little bit and moved that refinancing cliff further out. A lot of folks who were tapping into the high-yield market more recently were probably doing it more on an opportunistic basis and less out of necessity. If we see an extended period of volatility, and markets shut down already tight access to capital, you will begin to see a bit of a pickup. In terms of formal bankruptcy filings there really has not been all that much activity in the middle and large markets, aside from the recent **AMR [Corp.]** Chapter 11 filing. We have had a couple of clients come to us looking at their liquidity position 12, 15 18 months forward and saying 'Can you come in and help us?' These are clients that are very forward looking, not waiting until they hit a liquidity wall where there has to be an event.

Q: What's the common denominator to their concerns? Are they seeing a decline in sales and then worry about having to service their debt? Or do they have debt that is due to be refinanced in the next 12 to 18 months?

A: It's more of the latter where they have some debt coming due in 12 to 18 months. They want to be well-positioned to either refinance that or make sure they are not in a liquidity bind. Their businesses seem to be performing pretty well. I would not call that the classic "restructuring" client, but one that wants to be prepared so they are able to take advantage of opportunities. This requires more efficient management of capital. If we had more clients like that we probably would be able to keep more clients out of bankruptcy.

Q: How long does the high-yield market have to be closed to impact companies?

A: I suspect if it was some prolonged period of time, six months or longer. That's a complete guess. Assuming that there is a lack of financing available then you have got some issues that companies are going to have to deal with. That also assumes we continue in the economic state we have been in. We have been sort of bumping along the bottom with really not all that much growth in the economy; companies have done a wonderful job over the last 24 months or so, right-sizing cost structures, reducing costs. But cost reduction is not going to get you to prosperity. To the extent we continue to get volatility out of Europe, we continue to bump along the bottom here in the U.S., particularly with companies with international operations and focus – I think then that's going to lead to greater restructuring activity down the road.

Q: Our last bankruptcy wave was the most active when it comes to 363 sales. Do you expect more of that?

A: Certain factors drove that activity. Some of those factors may be unique to this particular cycle. I don't think you'll see an increased level of 363 sales but I think you'll see continued sales activity. Two of the main drivers were: there was so much free credit around and you had a lot of covenant-lite and no-covenant deals out there. It didn't provide the lenders a basis to monitor any of the deals. When the deals went south, they went south at a point in time where there was no way to come back. Predominantly, all the assets were already impaired and there was nothing to finance a bankruptcy process that results in a reorganization of the entity. Therefore, senior lenders are looking to get out and maximize their recovery as soon as they can. To a certain degree, some of that activity happened out of court. But where you have a disparate group of bond holders and other creditors that can't be done – it gets done in court. A lot of the DIPs have been defensive DIPs where the incumbent lenders are funding the entity; that's so they can fund a sale and get a recovery on their credit.

Q: When it comes to liquidation sales like Borders, given the overall economic environment today, I'd imagine they are getting less than they would five or six years ago. You can't count on those consumers being lured in by a Chapter 11 sale as much.

A: I would agree with that. The other thing that hurt Borders, frankly, was this last phase of the sale. They were just in a terrible time. You don't want to have a liquidation sale over the summer. It's the seasonality. You are just not going to get the same kind of value. You don't want to conduct a liquidation sale in mid-June or July. You want it in October, November and December.

Q: How does Europe's sovereign debt crisis impact U.S. bankruptcies?

A: It's company-specific and, to a certain degree, industry-specific. Company-specific, meaning how much exposure do I have to Europe and how does that translate into my financial performance? How much of a drag do I really get? If I'm a U.S.- based company and five or ten percent of my revenue is in Europe, it probably does not impact me that much. If I'm a U.S.-based company and my main lending relationship has lots of exposure to Europe and it's going to cause them to tighten up their lending standards – even if I don't have exposure on the revenue side – it might hurt my liquidity position. It may cause the bank to tighten up. There are some direct and indirect factors that will impact companies.

Q&A

Diminished Brand Value May Limit A&P's Future, Says Author of Company's History

Marc Levinson

A&P, which will have a confirmation hearing on Feb. 6 for approval of its Chapter 11 reorganization plan, aims to complete its court-supervised bankruptcy this year. Marc Levinson, author of a history of the company entitled "The Great A&P and The Struggle For Small Business In America," says A&P may not have a future as a food retailer because its brand has depreciated "very significantly." In an interview with Aleksandrs Rozens, Levinson says A&P's most valuable asset is its store locations, especially those in New York City.

Q: Any thoughts on where the current A&P goes?

A: I don't think the current A&P has a future as a food retailer.

Q: Why?

A: A&P used to be one of the most valuable brands in all of American business. This brand has been depreciated very significantly. A&P itself does most of its business under brand names other than A&P which tells you that it does not think consumers attach value to the A&P brand. I don't think that this company has much of a future as a retailer. What I think is going to happen is that it will be sold for its store leases, some of which are in very attractive locations in the New York area.

(Marcy Connor, a spokeswoman for A&P responds: While Mr. Levinson has a thorough and detailed perspective of A&P's history, the company has made significant improvements over the last year. Today, A&P is positioned for a bright future with an entirely new management team and a strong business plan supported by sophisticated investors who know our company and industry well, and who also share in the vision for A&P's future.)

Q: Do you think another food retailer comes in and takes that space?

A: A&P has a number of very attractive store locations in a part of the country where store locations are very hard to come by. If one were a chain that wanted to establish itself in New York, A&P offers perhaps the only opportunity to get a bunch of good locations in one transaction. I would think it might be attractive for a potential purchaser for that reason. I would not expect A&P to last for a long time as an independent supermarket operator.

Q: Does that mean the name totally disappears?

A: I think the name would probably disappear. Someone may resurrect it in the future for nostalgia purposes but anyone who would buy the company would not want to use the A&P name. A&P itself tries to avoid using the A&P name.

Q: Which is pretty remarkable because they spent a lot of time building that brand up through advertising and special events.

A: They had very valuable brand names in their stores. They sold Jane Parker baked goods. They had Ann Page packaged goods. They had Eight O'Clock Coffee. All of those were extremely powerful brand names. They are not that powerful anymore. Eight O'Clock Coffee has been sold off and someone is trying to resurrect the brand. But these were once some of the most powerful names in American business.

Q: What do you think the Hartford Brothers and the very earliest founder of A&P, George Gilman, would have thought about the company's bankruptcy?

A: I don't know what they would have thought about the filing. George Allan and John Hartford dramatically changed their company at least four times. They were very, very sensitive to the need to constantly re-make your company to keep up with changing consumer tastes and changing economic conditions. They were not afraid to do it. When the Hartfords died the folks who took their places had a much more conservative attitude. Their attitude was 'We want to keep things as they are because we are very successful' and the alternative to change is death. That's what has happened here.

Q: In an earlier book, 'The Box,' you examined container shipping. What's your outlook on the shipping industry?

A: The box totally changed the economics of running a shipping line. Prior to containerization, the ships didn't cost very much because they were very old. If business was bad you simply tied your ship up. Most of your cost was labor and this cost would go away when you tied your ship up. Now, this is a very, very capital intensive business. Some of the new container ships cost as much as $150 million, not counting the containers. If you are an owner of one of those vessels, you have got this enormous mortgage. You have no alternative but to keep the vessel operating no matter how low rates are. This leads to enormous rate volatility because this capacity simply has to stay in operation. They have to carry containers at any price above marginal cost to bring in some revenue in order to help service the mortgage. Since the beginning of container shipping that has meant that companies that are more heavily leveraged die. If the cycle turns against you and you don't have the cash to make it through the cycle, it's curtains.

Q:What happens now?

A: What we have seen over many years is consolidation in this industry. You have the companies with stronger balance sheets prepared for this kind of situation. They are able to acquire ships and acquire, in some cases, port facilities. The weaker ones merge or go bankrupt. That is repeating itself in this cycle. This is also, by the way, the reason that most of the very large container ship lines are in private ownership rather than widely-traded corporations. Public stock holders don't have the stomach for this sort of thing. If you are a private company you can think long-term and you can prepare for these kind of risks. You can use a period of bad rates like this one as an opportunity to expand, to gain market share. If you are a stock holder-owned corporation in an environment like this shareholders are going to want to bail out. It's very hard to run a business for the long term with that kind of situation. The industry has been quite cyclical since it became an international industry. There's no reason that's going to end now.

Q&A

Edelstein: Credit Conditions Push Smaller Hotels Over Edge, Lender Portfolios Are Brittle

A decline in business travel and consumer spending has pushed smaller hotel owners into bankruptcy because they have fewer sources of credit, says Robert Edelstein, co-editor of "Global Housing Markets: Crises, Policies, Institutions." (Wiley Pub.) He tells Aleksandrs Rozens that if many lenders marked to market their real estate portfolios the institutions would likely be considered insolvent.

Q: What's your outlook on Europe?

A: There is too much political capital right now invested to let the euro fold. Maybe they'll find a solution by letting some leave and letting some stay. That's going to be very, very difficult. It looks like – for the moment – they are kicking the can down the road and they are looking to get a solution that will keep the euro together.

Q: What happens to their housing market if the euro collapses?

A:The housing market will collapse with it.

Q: In your book you list various casualties of the housing crisis — lenders and mortgage insurers. Who is next?

A: If we were to mark to market the portfolios of many of the lenders in residential and commercial real estate, there is sufficient evidence that many of those loans would be marked substandard. Many of them would become insolvent. That's not in the public interest to expedite that because, quite frankly, it would require that the regulators take them over and put in an enormous amount of money. They don't have the resources that are required in terms of manpower or money.

Q: One of the dominant sources of new bankruptcy filings has been the single asset real estate category.

A: These are special purpose vehicles, investment vehicles. Typically they have a building or a portfolio of homes. Either the property is not performing at the rate it was supposed to – or properties – and therefore cash flows are insufficient to pay bond holders or other owners. Then you declare bankruptcy.

Q: A lot of hospitality companies are filing for an 11. What is behind that?

A: Hotels have been under enormous pressure. Hotels are very sensitive to market conditions. When the economy goes bad the first thing a company says is, 'No more travel.' And consumers say, 'I can't travel.' The hotel goes from being highly occupied one week to sort of vacant a few months later. So cash flow just disappears. It's not like having a tenant where if the company is having problems, it still pays its rent to the extent it can. Hotels are very good indicators of what's happening currently in the economy.

Q: In many of these bankruptcy cases it was mom and pop hotels, smaller motel or hotel businesses.

A: They have less resources to protect them. If you are Hilton or Marriott you have access to capital in ways that these guys don't.

Q: One of the things I noticed in your book is how the housing crisis bled into other parts of the economy. Are servicers next in line?

A: Servicers may be in the best position. Depending on the particular vehicle that's being serviced, the servicer works for the company so it gets paid first. It has rights to its fees. It also makes or it can make advances on payments that are due. If it does that, it goes to the front of the line. They go to the front of the waterfall for money.

Q: Do you expect more builder bankruptcies?

A: All these guys are under constant pressure. How long they can hold out depends on the circumstances. If you are a developer they try to just hold on. There are land funds that tried to be vultures and that has not worked. In part that has to do with complications; while everything is not performing well – in a broad sense we are in a down market – things have not come on to market nearly as quickly as you'd think, like REO [real estate owned properties] from financial institutions.

Q: A table in your book tracks subprime lending and problem mortgages by state. What's interesting is that some of these areas of subprime concentration have municipal bankruptcies. Is there a connection between states where subprime lending accounted for a large part of the housing stock and troubles for municipal finance?

A: Clearly, as real estate markets decline the property tax revenues decline. Also, many municipalities focused on fees associated with development. Development slows down, their budgets just disappear. There are also these district bond financings in Florida and California which are based on the household owners financing bond issues for schools and roads; as new development slows down and projects are half developed, those are very susceptible to additional bankruptcies. Those are definitely the high risk places.

Q: So there is a link between markets with a lot of subprime and Chapter 9s by municipalities.

A: That's where the enormous expansion occurred in real estate development and financing. Any place where the government depended on development fees or on property taxes, they are very susceptible to not being able to perform as they hoped.

Q: What is your outlook on housing?

A: Housing depends on economic growth. If you can't get economic growth going, we will not get housing to be buoyant. If we don't create access to capital or home financing that will also work against housing. But most important we need economic growth.

Q: Is there an alternative to securitization?

A: Its like saying morphine is bad. Morphine used in the right places when you have someone with enormous pain is not a bad thing. This has to be a controlled substance. It hasn't been a controlled substance. Whenever a mortgage-backed security is issued the sponsor has to have money at risk. So you just don't get a fee for the deal and run away.

Q&A

Acquisition of McGladrey Complete, D.A. Davidson Eyes Restructuring, Banking Chief Says

D.A. Davidson, which this week acquired **McGladrey Capital Markets**, may build up a presence in corporate restructurings, says **Brad Gevurtz**, managing director and head of investment banking for D.A. Davidson. Gevurtz tells Aleksandrs Rozens that he was not sure whether he will hire a corporate restructuring team en masse or if he will hire one professional to build a team from scratch. "It's an area we would like to explore," he said.

Q: Do you plan to get into corporate restructurings?

A: We are not experts on restructuring but I am interviewing senior restructuring bankers as we speak.

Q: So, there is a plan to get into that world.

A: Well, I want to be careful with my phraseology here. I am interviewing restructuring bankers. If I don't find the right one and I say to the market I plan to enter, I kind of look foolish. It is fair to say it is an area we would like to explore.

Q: Are you looking for something specific – such as a specialist that represents creditors or one that has more background with representing debtors?

A: I have actually done some restructuring and I have represented both creditors and debtors. What I'm really looking for is the best guy who will fit in our culture. It's a good question – am I looking for a creditor guy or a debtor or this guy or that guy? I'm looking for a guy who is really good at what he does and who will fit in our culture.

Q: Are you looking for just one person or more than one? Where would they be based – New York or West Coast?

A: That's the debate. Do we buy a group or do we get an individual and have him build the group? And, it really depends on the people we meet. If we find a guy who is good and has a track record at building a group, we might go with that. I'm not going in with pre-conceived notions. I'm looking for the best bankers who fit us the best way and then we'll make a decision as to whether one is better than another. A lot of times that happens in investment banking. If you make the search too narrow, you might get a guy who fits your criteria but he's not the best banker. We are a little more open minded on the universe of what they do and looking more for the best banker and the best fit. I don't want to say we have a plan to do it because if I don't find the right people we're not going to go ahead.

Q: Is there any industry vertical your firm specializes in?

A: We are very good in industrial. We are good in consumer. We are good at community banks. By getting McGladrey we added health care and energy. We are good at tech. We always used to say that we do everything except for health care and energy; we just got health care and energy and aerospace by acquiring McGladrey.

Q: Often when people consider getting into restructuring they have a pool of existing clients that need advice on corporate workouts or debt issues. What's spurring your interest in this? Is it from looking at the economy or was it one of the outlooks from rating agencies?

A: Two things. We have all of the products in terms of M&A, public and private equity, capital raising. But the one product area we don't have is the restructuring. Secondly, I know some individuals who are really good.

Q: Often people move into it because they see a lot of stress in the markets.

A: I don't want to go there and I'll tell you why. The problem with that is I know people who say 'I want to do X Y or Z because interest rates will go lower.' Really? Are interest rates going to go lower? Or, they'll say interest rates are going to go higher. I am not trying to time the market. Guys who time the market – good luck to them. We have a lot of things we can offer our clients. Restructuring is an area that we are not deep in right now. I know some good bankers so it's an area we are exploring. And, I'd love to tell you like other bankers will tell you that we know for a fact that a lot of distressed companies need help. I'm not smart enough to tell you there are going to be a lot more distressed companies a year from now.

Q: I'm just drawing from what I see in rating agency reports.

A: The problem with that is – it's like the recession. There are so many people who said this is going to be a one-year recession or the recession is over or interest rates can't go higher. If there is one thing I've noticed in the last four years it is that most everything people projected has been wrong. Four years ago they said interest rates can't go lower and the U.S. government is spending so much money that there is going to be an inflationary period. I don't want to out-think the Federal Reserve. We offer a lot of products to our clients. This is an area that would fill out our portfolio.

Q: You mentioned you had experience in corporate workouts.

A: When I was at **KeyBanc Capital Markets** I'd often pair with our head of restructuring because I was head of the tech/telecom group. I had two or three deals with tech/telecom companies that needed restructuring and in one of them I represented creditors. That does not make me an expert.

Q: Are you looking for someone with an investment banking background or someone with a legal background?

A: I like both. It's nice if you have both.

WHAT COMPANIES HAVE THE GREATEST DEBT OBLIGATIONS?
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Q&A

Distressed Investors May Find Opportunities as Banks Shed Non-Core Assets: Bryan Marsal

Bryan Marsal, co-founder of restructuring advisory firm **Alvarez & Marsal**, says assets shed by banks looking to meet Basle III requirements by year end will provide opportunities for distressed investors. Also, Marsal tells Aleksandrs Rozens that he has no plans to take his three-decade-old business public.

Q: What's your outlook on bankruptcies?

A: Bankruptcies are going to trend upward in the U.S. very gradually. We are seeing increased activity, but not a flood. Companies that were able to extend and pretend are not able to extend and pretend. Private equity firms that thought three years ago that there's a crack at things coming back are now throwing in the towel. There is more of an inventory of problems than a year ago. In Europe we see a stronger market; maybe there's a willingness to accelerate and not just extend and pretend because of Basle III. The restructuring activity in Europe is brisker.

Q: What is the common denominator to problems faced by these companies? Is any one industry facing more issues?

A: Shipping is clearly a problem. Commercial real estate is clearly a problem.

Q: Is the problem with commercial real estate related to the fact that the CMBS market is not really there anymore?

A: In MSAs like New York, Boston or San Francisco it is strong. But in other markets you have some more weakness. You have opportunities on the commercial real estate side. In Europe clearly you have significant overbuild situations in real estate in countries like Ireland and Spain. Iceland has invested all across America. We have had assignments working with Icelandic banks, Irish banks, Eastern European banks. We are working for Greek banks now. Our specialty is pretty much in financial institutions.

Q: What do you think about the future of the European Union?

A: I think that the Greeks will agree to the austerity measures begrudgingly. I think the Germans want the matter to be solved much more quickly. I think the Greeks want to be it slower and they want the pain to be less; I think the answer is going to be somewhere in the middle. Greece will be fine long term and Europe is going to be fine long term. They are going to have forge – over the next couple of years – a fiscal union.

Q: Is the era of extend and pretend over?

A: I think it's slowed dramatically in the U.S. It's still going on in Europe. Extend and pretend does not solve your problem with credibility. If you are extending something really under water then you are just BS-ing me on your reserves. If you do that, that prevents you as a bank from raising capital; people don't believe in your balance sheet. If you don't raise that equity capital then you have to shrink your asset base even further. Extend and pretend by itself is not bad. It's just really 'Am I extending something that is under water or am I extending something that is stable and is going to be improving and I have to be more patient?' Or, 'Am I extending something because it is really under water and somebody overpaid badly for this asset?' The Europeans have a problem with their portfolios; they have not written them down to where they have to. I think that is what is being addressed by the ECB. They are saying 'We are giving you a chance to get it off your chest. We need you to be cleaned up so you can raise capital and we need investor confidence that you have dealt with your problems in a forthright way.'

Q: For the distressed investor funds this is the opportunity to go out and buy some distressed credit.

A: If in fact there was a liquidity crisis there is a huge opportunity. The ECB took away the liquidity crisis. Now, the next wave of opportunity is in order to meet the mandates of Basle III, banks are taking their assets and putting them into two baskets: core - businesses I want to absolutely be in - and non core - businesses I want to shed. So they sell those business; the opportunity for distressed funds will be to purchase those non core assets. Those are being offered; the opportunity will be between now and over the next year. Basle III has to be implemented by December 31.

Q: Is there any industry under greater stress? Where are you getting the most calls from?

A: There's the obvious industries which would be shipping and commercial real estate. Beyond that you have what you have in a baseball league. You have those guys who are year in and year out stronger organizations - the Yankees and the Boston Red Sox - who seem to win every other year. Then you have a bunch of wannabees who convince some banker that if they make this acquisition they'll be propelled from number eight to number one. As long as there is hope like that and as long as there are people who can make other financiers believe, there are going to distressed opportunities. You'll always have two guys who are strong, you'll have two guys who are weak and four or five guys in the middle. Whether its baseball or its packaged goods you are going to find there are two strong players and two weak players. And those two weak players are going to try and become something that they have not been. When that occurs that tends to stress a company out; some succeed and some fail and become inventory for us. Even the strongest industries have that happen to them.

Q: Is there a common denominator to what's hurting them - higher costs for raw goods or is credit just not there for them?

A: It varies industry by industry. Like **Western Union** the telex went away. You have **Blockbuster** built in obsolescence; **Netflix** came about. Look at what's happened to Yahoo! Technology is just passing it by or competitors are passing it by. Sometimes it's that. In the case

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Q&A

Petroleum Capital's Donell: Gas Station Property Defaults to Increase as Much as 20 Percent

Defaults on loans made to gas station owners could climb as much as 20 percent in the next two to three years, says **Stephen J. Donell**, co-founder of Los Angeles Advisory firm **Petroleum Capital Advisors**. In an interview with Aleksandrs Rozens he says the defaults are tied to a decline in consumer spending amid higher gas prices and tighter credit conditions.

Q: Gas prices are up. So, why are gas station owners running into trouble?

A: There are two types of defaults. One is a default where it's a cash flow issue and the owner does not make, for example, a February 2012 payment. Another is a maturity default. Back in 2006, 2007 and 2008 the lending criteria was much looser than it is now. Often, the gas station owners got an SBA loan that had a five- to seven-year maturity and it was easy to get the loan. The underwriting guidelines were very loose. Those loans are now maturing and they don't have ability to pay off the mortgage.

Q: So it's a refinance issue that's coming up?

A: That's one of the issues.

Q: Is that refinance issue coming up because the SBA lenders have pulled back or is it that all lenders, generally, have pulled back?

A: It is really because all lenders have pulled back. There are a lot of different issues that come into play with respect to getting new loans. For example, in some cases the lenders are requiring Phase II environmental reports before they will offer a loan. The overall terms of the loans are much much more stringent, making it much more difficult to get a new loan. Indemnification agreements are much more stringent today than they were five to seven years ago. Although interest rates are lower you are going to get lower loan to values and the terms are much much tighter than they were before. The other type of default we have is one that is pure cash flow. To answer your question 'Gas prices are up so how can gas station owners be failing?' Generally speaking the margins on gas are very slim. As prices rise, the margins stay the same. So the higher gas prices do not correspond to higher profit for the gas station operator. It may correspond to an increase in profit for the gas station provider, Shell Oil for example. The real profit margin on gas station properties includes the sale of goods at convenience stores as well as mechanics working at the gas stations and car washes. People have less disposable income. They are spending less, getting their cars washed less. They are spending less on getting cars repaired. And, they are spending less buying gum, Coke, and those spontaneous purchases in the convenience stores.

Q: Broadly, we are all traveling less.

A: People are actually buying less gas. They are being more conscientious which means they have less occasion to stop at the gas station in the first place. Not only do people have less disposable income to spend money on those high profit items, they are actually visiting the gas stations less as gas prices increase. It's two areas: maturity defaults because the owners cannot refinance their way out of their existing loan. And, it is cash flow defaults. What lenders very often do is they will have a receiver appointed. A lender does not want to foreclose on a gas station because the process of foreclosing means the lender becomes the owner and they can be subject to environmental claims or any other type of remediation issues or other types of liability an owner would have. Lenders are loathe to cross that line in certain circumstances. What they do is have a receiver sell the property through a court-ordered process.

Q: Have lenders tried to duck the issue and extend the loan for a gas station?

A: It depends on whether this is a loan that is a CMBS loan being serviced by a master servicer and what the REMIC guidelines are or if it is a direct lender. It's not blanket that no lenders ever do the extend and pretend route. Sometimes the lenders are involved in active negotiations with their borrowers to try to achieve some sort of resolution that would involve either a restructuring of a loan or an extension of a loan.

Q: When that happens, does the lender incur a loss? And, how much of a loss is incurred?

A: The lenders are taking losses. In the last four or five sales that I have personally been involved with as receiver, the losses have been anywhere from a high of almost 50 percent to a sale where the lender took only a 15 percent loss. The lender will agree to take less than the principle loan amount or the principle loan balance. So, in that way it is somewhat similar to a short sale although you don't ever hear the term short sale for a commercial property.

Q: What's your outlook on the gas station industry?

A: I would expect that for the next 24 to 36 months we are going to continue to see an increase in defaults of gas stations, probably in the 10 to 20 percent range for a couple of reasons. Number one, we have got a relatively jobless recovery and income levels are not right. We've got a lot of volatility in the financial market and the lenders are still tightening their belts with respect to underwriting criteria. I don't see that the qualification process for loans is going to get any easier any time soon. We obviously have a lot of national and international issues going on with gas that are going to have upward pressure on gas prices. All of those trickle down together on a cumulative basis to not make it a really pretty picture for gas station operators on the edge.

Q: How many gas stations are there in the U.S. market? When you say 10 to 20 percent, is that a percent of that total that are in hot water?

A: I'd say that we'll see a 10 percent or 20 percent increase in the number of stations that are in default. I don't have a specific statistic on the gross number of stations across the country.

Q&A

Evercore's Ying: Banks Aim to Shore Up Net Interest Margins With Higher Yielding Debt

Banks are looking to bolster their net interest margins with higher yielding assets such as auto loans, **David Ying**, senior managing director and co-founder and head of **Evercore Partners's** restructuring and debt capital markets group, tells **Aleksandrs Rozens**. He also said strong demand for junk debt from investors hungry for more generous yields has served as a lifeline for some distressed companies.

Q: What is keeping you and your restructuring team busy? Is it more out of court or more in court?

A: It is mostly out of court. It's a reflection of what is going on in the capital markets.

Q: And that's tied to the improved conditions in the high-yield market?

A: Yes. The average default rate is still about one percent even though the long-term average is about four percent. After the last credit crisis, which started in July 2007 and the markets really reopened in the spring of 2009, default rates went from double-digit rates down to one percent. People don't see a massive wave of defaults happening in the next 12 months. Our business just reflects what's happening in the capital markets.

Q: What industries are seeing the most stress?

A: I don't see that much of a systemic problem in the global financial and business markets that you can say, 'Oh, specific industries are imploding.' I think it's much more spread out and situation specific. The U.S. economy is growing again. Obviously some industries are lagging. You are always going to find an industry where commodity prices might be rising and they can't pass them along. But I don't think you can generalize on any of the situations these days.

Q: Is improvement in the credit markets long-lived or more temporary with Europe still in the backdrop?

A: In the U.S. we have very easy money. The economy seems to be growing; employment is improving. The general business tone is okay. From a long-term fundamentals standpoint, the leveraged credit markets are much better. I think the underpinnings of that market are still very much driven by - on the margin - fund flows into retail mutual funds. A lot of that money is hot; it comes and goes. Right now people are feeling good if you can get 8 or 9 percent versus 1 or 2 percent on Treasuries. The high yield asset class was up 13 percent last year, better than the stock market, and it's very attractive. If you think long rates are going to stay low, the spreads for high yield are at 500 or 600 basis points. That's still, historically, a very attractive premium for the incremental risk you are taking. When you start looking more carefully at the high-yield market, I still think it is a bit of a tale of two cities.

For the bigger, established companies with a good business model, good positive earnings momentum – the markets are very eager to finance them whether it's for expansion, or acquisition or refinancing. For smaller companies with a weaker business model or those who have a lot of leverage or a weaker business model, they have a harder time raising capital. You are seeing companies that are extremely leveraged, where debt may actually equal or come close to total enterprise value. They can still refinance at a senior secured level because – even in a calamitous credit market or negative GDP environment – those senior secured pieces do very well. I remember when people were complaining adamantly about covenant lite not making any sense. Yet the experience, I think, for covenant lite through the last credit cycle was actually not bad at all; in fact it was quite good because being at the very top of the capital structure, secured by assets is a very safe and attractive place to be unless there is a truly calamitous change in business fundamentals.

Q: So the last downturn validated these covenant-lite loans?

A: Sure. As long as your loan-to-value ratio on your covenant-lite loan is not excessive relative to a diminished enterprise value in a recession, you are going to get all of your money back. Given how first-lien senior secured loans are treated in a workout process or a bankruptcy process you still come first. Distressed investors – if they want to take a conservative posture – will buy the first-lien because they know the same credit fundamentals I just described. Even if the world looks like it's coming to an end, they know they rank first and the value of the business is going to come back.

Q: So, investors are moving much lower into distressed paper?

A: All these capital structures have layers like a layer cake. Depending on your risk-and-return tolerance and your view of the business fundamentals, you can pick your risk and appropriate return level by picking layers in capital structure. So, when the market is improving, you take a little more risk. Obviously, the performance of the lower rated credits has been much better; when you look today and say, 'Now, how am I going to earn a double-digit rate of return?' Hedge funds don't raise money by saying I'm going to get you 7 percent. They tell investors 'I'm going to get you high teens, 20 percent.' The only place they can get that is by looking at bigger credits that are more risky or in the really small credits where there is risk because there's no liquidity.

Q: Is the high-yield market too rich? Dollar prices of loans have gone up pretty quickly.

A: If you are living in a world where the 10-year is trading at 2 percent and you can buy single-B rated bonds at 8 percent, that is a 600 basis point premium. If you assume the average default rate is 4 (percent) and even if a bond defaults you are not going to get zero, you are going to get something back. You are still being paid a premium over riskless paper that should more than offset any loss you might expect over a long full, credit cycle. When you look at the high-yield bond market historically, when credit spreads have gone closer to 400 basis points that's when the market is probably over-

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Q&A...
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priced. But if it is 500, 600 or 700, I think it is average. When you see the credit market is 1,000 over that's when you know the psychology of the market is horrible.

Q: In recent weeks bond inflows on a weekly basis are now at record levels.

A: Which is another reason why I'm saying the bond market is doing very well because you have this big influx of capital.

Q: Have these bond market conditions bought time for companies to refinance debt? We heard a lot about a refinancing cliff this year and next.

A: Even companies that are very leveraged, to the extent their maturities are populated in the more senior debt levels of their capital structure, they have the ability to go out and pay extra interest and extend the duration of their capital structure. You are seeing people do that quite aggressively. Look at **Realogy**, the big **Apollo** real estate brokerage business that is suffering from what is happening in the U.S. housing market. Everybody thinks it's a great franchise; it's number one or two in the country. They keep extending out the duration of the top end of the capital structure. Another company is **First Data**, the **KKR** LBO - very leveraged. But they keep refinancing the senior end of the capital structure to extend the maturity profile of their debt capitalization and to buy more time so they can continue to improve their business.

Q: What are you involved with in Europe?

A: We haven't done any sovereign work. So it's strictly on the corporate side. Europe - given their fiscal issues - is undergoing a pretty traumatic change from the ability of governments to continue to spend, support the population, and maintain social services. It's having an adverse affect on business confidence. So GDP growth is much more in question and that has a big impact on how businesses plan for the future. You have seen some European credits come to the U.S. to try and sell dollar-denominated debt because they believe they can get better execution in the U.S. than they can get it Europe.

Q: Given the hunger for yield, they are probably getting these done.

A: Yes, even though you are potentially taking on some additional exchange rate risk.

Q: With all of the assets being put up for sale in Europe and the U.S. are you working with investors to guide them through that process?

A: What's happened here is that the yield curve is so low that the net interest margin a bank can earn has been very challenged. So the U.S. banks, which are by and large better capitalized and therefore can take on more assets, they are actually very challenged in terms of obtaining higher yielding assets. We are helping companies sell high-yielding portfolios to banks that can finance them at very attractive rates. Or help banks try to acquire higher yielding asset portfolios. In Europe there is a fair amount of cross-border activity going on where the better financed U.S. financial institutions are looking for higher yielding assets. Some of the bigger ones are very comfortable going and looking for more globally diversified asset bases. When you localize your question to hedge funds or the high octane private investors I think it is a much more difficult question; what I've noticed is the portfolios I've seen for sale out of Europe - they are selling their better assets. It's very hard for a bank to improve its capital ratio by selling off assets at a price lower than their carrying value. It's much easier for a bank to improve its capital ratio by selling assets they can sell at their marked value.

Q: What kind of assets are the banks buying to improve their net interest margin?

A: When you think about big asset classes one is automotive loans. The car industry is doing much better, the SAAR (the seasonally adjusted annualized rate) of car sales is now coming back to the norm. The norm used to be about 14 million cars in North America per year. Back in 2008 and 2009, it dropped to 9 million which was catastrophic for the big auto companies. It's now back up to 13, 13-1/2 (million). The car loan market has proved to be an excellent asset class. The loan losses even to people with lower credit ratings have been very modest because, let's face it - we live in America.

Even if you are not a rich person or you are in between jobs or whatever your circumstances if you don't have a car, how are you going to handle many day-to-day tasks? The auto loan market has proved to be extraordinarily resilient. It's still a market where you can earn a very good spread. So, you see a lot of big banks who love that asset class and are trying to get into it and expand their portfolio. **Toronto Dominion** bought a part of the **Chrysler Finance** business that originates auto loans because they like the asset class.

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Q&A

High Yield Corporate Default Rates May Rise to 3 Percent This Year, Deutsche's Cohen Says

The Supreme Court likely will uphold the right of senior creditors to credit bid, but if it does not the cost of debtor in possession loans will increase, **Mark Cohen**, global head of restructuring and workouts at **Deutsche Bank,** tells Aleksandrs Rozens. Cohen also said he expects default rates to rise to 3 percent this year.

Q: The Supreme Court is examining the issue of credit bidding. Does this have any impact on the cost of money for DIPs?

A: Well, first I believe the Supreme Court is more likely to uphold the right of senior creditors to credit bid. And, I don't believe we have yet seen a negative impact under the assumption that rights are going to be terminated. However, if we did see the Supreme Court rule in a way that weakened senior creditor rights, that may increase the cost of borrowing for corporates in this country. One of the benefits we have right now is that we have the world's most refined and sophisticated bankruptcy code allowing the lenders to understand that the rule of law is going to apply in a certain orderly fashion. If we change that – and I don't mean to suggest that we will – I think that may impair liquidity and, therefore, pricing.

Q: I'd imagine everybody would have to recalibrate their assumptions as to what their returns would be as lender.

A: Yes, although I don't want to overstate it because number one, I don't expect it to happen. And number two, most restructurings and bankruptcies are consummated through a plan of reorganization and only some through a credit bidding process.Third, lenders have the option to raise new capital for the purchase price, become the winning bidder and then recycle the proceeds to pay their prepetition debt.

Q: Whenever an outside force has an impact on how people perceive credit, then down the road it has to cost more.

A: That's true. But what can sometimes get lost in this debate is that it comes down to valuation as opposed to process. If the senior creditors believe that they are impaired, then they may be looking to restructure the company and take back equity. However, if the junior creditors believe the senior creditors are money good, then the responsibility falls on the junior creditors to either craft a plan that's acceptable to the senior creditors or to pay off the senior creditors because they come first in the waterfall. So, the point on valuation is more significant than the process point.

Q: What's your outlook on credit defaults this year?

A: Credit defaults will rise slightly from the mid-twos where they have been for a while and I think you could see it at around 3 percent. I don't predict the beginning of a full credit cycle. I see this really as a normalization of the long-term average default rates of around 4 percent. Again, the defaults we will see in 2012 are the secular defaults. This is not the beginning of a new cycle yet. I do not expect a new credit cycle in 2012 or the first half of 2013.

Q: So do we expect an uptick in defaults in the latter half of 2013?

A: I think it is hard to predict what happens when some of the previous tax cuts expire. Some of the fiscal, long-term fiscal problems may emerge to create some friction in the economy.

Q: Is there any industry that likely will see an uptick in defaults?

A: The industries I think we should keep an eye on include old media or businesses impacted by new technology. For instance, retail can be impacted by new technology; **Borders Books** is an easy example. I'd say we still have a cycle to occur with regard to the low natural gas prices. On the one hand there are winners – including the American consumer – with low natural gas prices. But where there are winners there are sometimes losers; those businesses could sometimes struggle under those low natural gas prices.

Q: Any expectations for European credit defaults?

A: We do not have the same quality of data. But I would point out the following. In the U.S. right now we have a highly liquid market and we have a more institutional market, more institutional investors. We see the economy improving as you saw with the ISM manufacturing data that came out [last week] and the Dow trading at a four-year high. And, we have the jobless rate creeping down. So, in the U.S. you are clearly on the upward trajectory. In Europe, I think it is healing but I think you still have a more bank-centric model. And that will come under some stress as they continue to implement new capital rules across the European market. The U.S. lending markets have a greater percentage [of credit] supplied by institutional investors and less by banks. That's an intrinsic design benefit that we have that Europe does not have yet. Europe is evolving in that direction. But, right now, because our institutionalization has occurred in advance we are more insulated from moves in bank philosophy.

Q: Has the cost of DIP money changed?

A: DIPs are less expensive than they were at the depths of the financial crisis in 2008 and 2009 but more expensive than they were during the period of 2005 and 2006. It has to do with the quality of the companies. It's a tale of two cities. If you look at the better companies, they have ABLs pricing at 325-350, the ABL portion of the DIP. And they might have a term loan at 600 to 800 over Libor. If you look at the weaker companies, the tougher credit stories, their DIPs might be LIBOR plus 1,150 to 1,250. That's where the DIPs were on **Harry & Davids** and Borders, for example. So, it has to do with the lower-quality nature of some of the bankruptcy filings as opposed to the DIP market in general. If you had a really great company that needed to file and de-lever, I think they would find an adequate supply of DIP financing at competitive rates.

Q&A

Lashine: Specialty Funds May Buy Assets From Servicers, Rent Single-Family Residences

Funds raising capital may buy distressed residential properties and rent them out or they may buy non-performing commercial real estate assets from servicers, **Nancy Lashine**, managing partner and founder of placement agent **Park Madison** tells Aleksandrs Rozens. She said 800 funds are trying to raise $250 billion.

Q: What is the most common strategy right now for a fund raising money?

A: There are something like 800 funds in the market right now. Probably 40 percent of them are focused on investing in North America, 25 percent are focused on investing in Europe, 15 percent in Asia. With respect to return targets, roughly a third would be core investments, a third would be value-add and a third would be opportunistic. Distressed real estate generally would fall under opportunistic. Core real estate has an 8 to ten percent total return target with no or very little leverage. Value add has a 10 to 15 percent total return target with up to 50 percent leverage; and opportunistic offers north of 15 percent total returns with 65 to 70 percent leverage. As a placement agent we tend to get hired for the higher return funds that don't have large in-house marketing teams.

Q: How much money are they trying to raise in total?

A: About $250 billion, which is completely unrealistic. In 2011, about $45 billion of funds closed and the amount was similar for 2010. If you look at the peak year, which was 2008, $140 billion was raised.

Q: Are there distressed real estate funds raising money?

A: Typically investors are looking to buy distressed debt to get to the asset. Or it could be just buying debt at a discount and holding it and getting an above-market yield because they found a distressed seller, perhaps the original lender, who wanted to get out of holding the troubled loan. Or, it could be buying an asset from a bank at a foreclosure that nobody has paid attention to for a while. The other thing that differentiates a strategy from one fund to the next is geographic focus. We are definitely seeing a tale of two cities; there are markets where prices are back to 2007 pricing - NYC and San Francisco and Washington DC. You're seeing less interest and less price recovery in smaller assets and in markets that have not seen the same kind of high growth.

Q: Are funds looking at distressed residential real estate?

A: Multi-family in terms of residential is the most popular asset class by far because of demographics. That's the asset class that has performed the best. There are probably more multi-family funds out there than anything else. In terms of single-family residential there are now a number of people talking about buying up single-family residential developments from banks that are unoccupied and then fixing them up and renting them out. There are now people looking at a single-family rental strategy; you will see firms succeed at that because assets can be purchased at very cheap prices, especially when buying in bulk. There is going to be demand for people to come back and live in homes. People will want to live in homes, but they won't have the equity to buy a home, they won't be able to get the financing to buy a home, or they may not believe that they want to own a home again. There will be a trend towards home rental. I wouldn't be surprised to see a fund or two with a strategy like that over the next year.

Q: Are there any other commercial real estate assets that banks want to sell?

A: A lot of the problems are in the smaller banks; there are so many that have construction loans, land - investments that are just not institutional. It will take a lot longer to work through those loan portfolios, or they will eventually be sold "by the pound." The other place where there is an incredible buildup is special servicers. CMBS loans that have gone into default go to the special servicer; the special servicer is paid fees to fix them and lease them out, work the assets and then sell them. What's happened is the build-up on their books. What I hear anecdotally is these servicers had these assets for a while and they can't even begin to do the right job by the asset. A special servicer typically has 10 assets for every one professional. Some of these shops today are looking at 30 to one. They are just overwhelmed so they are also an important seller in the market.

Q: Are you seeing funds being created for European distressed real estate opportunities?

A: We saw fewer funds close for Europe last year, which isn't surprising but many managers are preparing to come back to market in 2012. Banks have not been selling in Europe, but we expect them to start to. Outside of real estate you are seeing lots of European corporate credit funds raised this year; there are probably six or seven. I think they have raised a few billion dollars, largely from the U.S. I think there is a view banks will start to sell the more liquid investments and eventually they'll have to start selling their real estate. The other consideration is when you make an investment in an illiquid asset like that you run currency risk; you cannot hedge it. It may be one thing to go out and buy European securities; you can hedge and if you make a mistake you can sell it the next day. If you buy real estate and the euro collapses, you have left yourself without options. I'm not saying people believe the euro is going to collapse but it's the incremental political risk of the Euro that is weighing on people now.

Q: How does today feel compared to the early 1990s?

A: There would be a lot more distress in the markets than there is now. Having a different interest rate policy makes this feel very different. The problem in the early 1990s was clearly a real estate and S&L crisis. But it wasn't a global debt crisis. We didn't have the fiscal issues we have here in the U.S. where we know we have an enormous debt overhang that we haven't figured out how to solve. We didn't have the issues of Europe and the fate of the euro.

Q&A

Unable to Pay for Chapter 11 Expenses, Small and Medium-Sized Businesses Liquidate Via 7s

An increasing number of small and medium-sized U.S. businesses cannot readily get credit from banks and are being forced to file for bankruptcy protection, says **Wayne Kitchens**, co-managing partner at **HughesWattersAskanase LLP** in Houston. Many of these businesses are unable to foot the high costs associated with a Chapter 11 so they end up liquidating via a Chapter 7, he said in an interview with Aleksandrs Rozens.

Q: Where is most of your activity? Chapter 7s or 11s?

A: People are using Chapter 11s to do a 363 sale, to get those assets moved from oldco to newco, free and clear of anybody's liens or other interests. That's kind of brought about a whole valuation industry to help facilitate those sales. I've used that process and I'm getting ready to use that on a case that hasn't filed yet; we are going to attempt to sell a company's valuable assets to an investor group and they will put some money into a liquidating plan so unsecured creditors can receive at least something. You've seen that structure a lot in the last 10 or 12 years.

Q: Should we expect more Chapter 7s from businesses?

A: In the small and mid-range (companies), the answer is yes. A couple of clients now who have long-time, established, once-very-successful small to mid-sized businesses with annual revenues of a couple of million to $70 million have just reached the end of the line. They don't even have the funds to pay for the administrative costs of an 11. They are just going out of business. We have an extensive trustee representation. Three of my colleagues are Chapter 7 trustees; so we do a whole bunch of Chapter 7 trustee and liquidation work. Ninety-five percent of Chapter 7 trustee cases are individuals and consumers, but you have that five to 10 percent that are businesses. Some of them can be quite large businesses.

Q: Do you think we will see an uptick in 15s given the lockup in credit markets in Europe?

A: I think we probably will. But one thing to keep in mind is that a 15 is not like an 11 where you have a flurry of activity here. The reorganization the 15 is designed to recognize is actually going on somewhere else. You are attempting to have the U.S. bankruptcy court recognize that foreign proceeding and extend the U.S. court's protection around U.S. assets of the foreign company. The last one I was involved in was a valve manufacturer in Seoul, South Korea.

Q: When we look at reasons behind the filings – what exactly is the cash flow problem? Is it the slowdown in the economy that brings about a drop in demand for a debtor's services or are lenders pulling back?

A: It is both. In a lot of cases the problem is in commercial lending; lines of credit have dried up and people don't have the working capital without those lines of credit to be able to continue. One of the larger banks here in town wanted a credit moved. A multi-million dollar operating capital loan and they wanted it out of the bank. Not because it was in default. They just don't want that type of credit anymore.

Q: Is it that they don't like the industry the business is involved in or is it the geographic location of the business?

A: It is not the region because they bought into the region. It's a Texas-based large regional bank that came into the Houston market and bought one of our larger local banks. It is a recurring theme: either the line of credit is completely used up and the bank will not extend further credit or they want the credit out of the bank. I've seen that on multiple occasions. We represent a lot of banks and we're seeing it on the workout side as well.

Q: When a bank wants a credit off of its books how much of it is tied to the industry the borrower is involved with?

A: It seems to be on a case-by-case basis. This particular business is in the automotive field and they don't want to lend to that type of business anymore.

Q: What are other common denominators behind bankruptcies that you are involved with?

A: In my region of the country we've had a number of oil field service bankruptcies such as pipe manufacturers, rig manufacturers which you would be surprised at because we seem to be in an energy boom. But you also have to remember natural gas right now is about $2 per thousand cubic feet.

Q: Has the bankruptcy case load at your firm picked up? When did the uptick become evident?

A: 2009, 2010 and 2011 – the first half of 2011 – we were very busy. In the second half of 2011 we definitely had a downturn in our business on the commercial bankruptcy side of it. Starting in February my partners and I have been steadily busy on the creditor and debtor side of the ledger. Smaller business people will make the serious mistake of funding their cash flow by not paying their employment or sales taxes. I've seen that many times with small business bankruptcies. You have the IRS knocking on your door and you have penalties. Whoever is responsible for collecting those employment taxes - that liability sticks to them personally. If you withheld from your employees' paychecks but you didn't remit to the government, you can be held personally liable for that.

Q: As an adviser to creditors what's on their minds?

A: We do a lot of real estate work and so we have been involved with quite a few out-of-court restructurings and out-of-court workouts. We have been involved in a very large transportation company that we were able to successfully resolve outside of bankruptcy court. Unless things have gone completely to hell in a handbasket many of our lender clients are interested in doing out-of-court restructurings and out-of-court workouts because bankruptcy is just so expensive. That involves extending a loan, taking back part of the property, finding additional capital to put into the business.

Q&A

Phoenix Management's Howard Says Banks Holding on to Problem Credits Longer

Banks are holding on to problem loans for a longer period as part of an effort to allow borrowers more time to fix their businesses, says **Tony Howard**, who recently joined Phoenix Management Services as a managing director in its Atlanta office. "There's a bit of kicking the can down the road with the banks," he said in an interview with Aleksandrs Rozens.

Q: What are your plans at Phoenix?

A: Phoenix has been around 25 years or so. About 75 percent of what Phoenix does involves debtors where we represent troubled borrowers. The other 25 percent is banks, hedge funds or private equity groups that need someone to check on cash flows, management teams and operations.

Q: So, your role will be to build up the business in the U.S. Southeast?

A: That's the plan. It's a Philadelphia based firm. It's very strong in Philadelphia, New York and Boston markets. Prior to my coming on board, the firm hired a senior professional in Cleveland. The plan is to really focus on the Southeast.

Q: How does the U.S. Southeast economy feel like to you?

A: It's actually a little bit worse, particularly in Florida and Georgia. If you compare the unemployment rate in Georgia and Florida to the national rate it's actually a little worse. So much of the economy, particularly in Florida, is construction related, housing, commercial development. Overall the economy in the Southeast is worse off from what the national averages are.

Q: What industries do you expect most of your mandates to come from?

A: General manufacturing. I think 70 percent of the businesses in the Southeast are manufacturing companies. That's where the majority of our work is going to come from down here. There are also a lot of trade-related industries in the Southeast with the port at Savannah. You get into the trucking industry, warehousing and distribution.

Q: Any specific type of manufacturer that is more likely to get into trouble?

A: Anything tied to the housing and construction industry is going to be in trouble for a while. I think there is at least another 18 months or so of struggles in any industry that touches housing construction. The problems in Europe are going to be adding to that.

Q: Are most of your clients looking to do their restructurings out of court?

A: In the Southeast a majority of the companies try to deal with their problems outside of bankruptcy. I don't think that's going to change. They are being encouraged by their banks to look at their costs, gross margins, make sure their expenses are in line. The banks have helped them in some cases restructure their own balance sheets outside of bankruptcy (court).

Q: How do the banks help? Do they extend a loan or allow them to violate a covenant for a certain period of time?

A: I think you are seeing a lot of that. In the Southeast there's a little bit of kicking the can down the road with the banks. They know they have got a problematic borrower. The borrower has tripped some covenants. The difference in this cycle versus other cycles is they are ninety-day forbearance agreements. So, they'll say: 'Okay we'll go ninety days out if you do the following three things. We'll revisit things at the end of ninety days and decide if we want to continue another ninety days or whatever.' We are seeing a little more of that short-term forbearance arrangement in lending agreements once they have been in default. The other interesting thing that's happening is two or three years ago about 50 percent of what we were seeing came from banks where they actually had a problem. The other 40 percent would be coming from private equity groups. That's flip-flopping. Clearly the banks are holding on to their problem credits a little bit longer before they engage professionals.

Q: When a bank gives a borrower an extra ninety days how effective is that? Can a business turn itself around in ninety days?

A: I would say probably 70 percent of the time there's very little – if any – positive change that takes place. That's just my 30,000 foot observation of things. Banks have got regulators breathing down their throats so they are looking for ways to work with their borrowers.

Q: When it comes to the PE-owned firms, are they turning to you because they are trying to sell a business and they want to clean up its balance sheet before they put it out for bid?

A: I think there is a lot of just let's clean things up so we can either sell it or refinance or get rid of it somehow, maybe sell it to another investment group. A lot of times we will get involved and help them with a cleanup strategy plan on their cash flows and try to get the Ebitda numbers as solid as we can. Then they'll go out into the market and try to refinance it or sell.

Q: Can you turn around a business more readily that comes from a bank than a PE-owned business that may be more levered up?

A: I don't think there is distinction. I think it's the same in both bank deals and private equity deals. It's all about cash flow and what you can do as a management team to squeeze out as much costs from your company as you can and get as much cash flow as you can; whether its debt or equity it doesn't really matter. It's cash flow that matters.

Q: Is anyone talking about Europe and how it impacts their ability to turn a business around?

A: Right now in the Southeast there are closed door discussions taking place about Europe. Everybody knows that whatever happens in Europe it's going to create volatility in exchange rates and it's going to create volatility in the equity markets which means that could create volatility in debt markets. CEOs of middle market companies are watching the European situation very carefully.

Q&A

Individuals and Institutions Turn Single-Family Homes Into Rentals: Fannie Mae's Duncan

The housing market is drawing individual investors and hedge funds that buy distressed properties from banks and servicers and rent them out, **Douglas Duncan**, chief economist at Fannie Mae, tells Aleksandrs Rozens. Duncan says the credit crisis has changed how investors value mortgage securities because many assumptions about prepayments have changed.

Q: When it comes to distressed residential investments where is the bulk of the interest coming from? Is it private equity funds or individuals?

A: It's really a whole range. It's some private individuals, some of whom may not have been in the rental business before but see an opportunity in their community. There are others who have a longer history — a private person or an LLP — a small, one- or two-person shop that has had a long history in rentals. Then there are hedge funds and also institutional investors who are looking at rentals as an opportunity in distressed property. Some of them are traditional flippers who buy, repair and put back on the market — people who have a lot of market-specific knowledge. Some of them do the buy-and-hold strategy, anticipating getting a cap rate based on the rent, and ultimately, perhaps some capital gain. Some do both of those. The difference between them and the hedge funds is likely to be the amount of discount that they'll require to get their return on capital. The institutional investors have a higher return-on-capital target. Numbers I've heard are 18 to 22 percent, but I'm not sure what the average expectation would be. Somewhere around the 20 percent range is probably reasonable.

Q: Are they buying the properties from banks, servicers or lenders that have seized property?

A: All of the above. **Fannie** [**Mae**] has tried a pilot project in that area. I've talked to hedge funds that have called to try and understand the dynamics of the market. Not so much to talk about the Fannie issues because they know Fannie has a pilot going on, but more to try to make sure they understand how the market functions. They tend to be regionally focused. They have some knowledge of the regional market and they want to make sure they understand housing financials generally and then apply that to the market.

Q: A lot of people automatically assume a rental property is an apartment building.

A: Yes, and that's a mis-impression. The distribution of rental units goes as follows: 25 percent of all the rental units in the U.S. are in developments which have more than 50 units. Twenty percent of the rentals are in developments which have between five and 50 units. And, 55 percent of all the rental units in the country are in buildings that are either a single-family detached house or they are a duplex or a fourplex. The crisis revealed the fact that ownership rate had gone way past sustainability and this led to a lot of foreclosures in the single-family properties — single-family detached houses plus condominiums. What's happened is lots of those are being converted into rentals. So the share of rentals in the one- to four-unit category has risen one percentage point each of the last four years. Four years ago it was 51 percent. It's actually returning to more normal relationships. There have been a lot of headlines that we have become a renter society. We don't believe that at all. It's certainly borne out by consumer attitudes: the same 80 percent-plus say they want to own a home some day. The statistics over the long term are that over 80 percent of households will, at some point, own a house in their lifetime. So, what happened was the homeownership rate was in the 64 percent range. We got up to 69. That simply was not sustainable. Now you are seeing this 30 percent of the market that is cash sales at the present time. That's the money that's going to buy foreclosed or distressed single-family properties and converting them into rentals.

Q: Distressed investments also take place in conforming and nonconforming mortgage bonds. Many homeowners are paying down their debt. Why should these investors be concerned about that?

A: One thing in calculating the value of a security is the pace at which it is expected to prepay. To the extent people are paying above and beyond their monthly mortgage payments, that accelerates the prepayment speed. [Investors] get their money back sooner than they anticipated and have to reinvest in current market rates which may not be as advantageous. Some of the programs to accelerate [loan] modifications are encouraging refinances so that is obviously speeding up prepays on eligible loans.

Q: When you have people who can pay down their debt more quickly, you are left with a pool of loans in a bond that may not be as diverse.

A: There is no question that at some point you can get an adverse selection in the pool. There is sort of a bifurcation in the market now between securities which have legacy loans [from] before 2010, 2009. The loans which have been made after 2009 are going to have a much longer duration because they are made at interest rates which were historically low and it's very unlikely that prepay speeds due to refinancing will accelerate in those loans. It's hard to envision rates could go low enough to encourage those loans to refinance so they may actually have a much longer duration. You have the pre-2009 book which includes conforming and nonconforming where the [loan modification] programs have been altering the structure; then you have what we call the new book of business which is under very different underwriting criteria and originated at a time period when interest rates are historic low.

Q: So a lot of the assumptions either on Wall Street or the buy side have been turned upside-down — how we

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Q&A

Downturn in Global Economic Growth May Spur Chapter 11s by Middle Market Companies

While the number of U.S. Chapter 11 filings has declined this year, the downturn in global economic growth could push more middle market companies into bankruptcy, **Richard A. Chesley**, co-chair of DLA Piper's restructuring practice tells Aleksandrs Rozens. "These companies do not have access to capital markets and have continued to hang on with increasing head winds," he said. "The slightest macroeconomic change or business variance will put these companies into the range of insolvency."

Q: Bankruptcy filings are not only down from last year they are off from recent years. Will filings increase with a slowdown in the economy?

A: Many businesses in the middle market are just barely hanging on. They are holding on because interest rates remain at record lows and those that require inventory are keeping their stocks low. I am very concerned about the continued unemployment and under-employment in the U.S. which will continue to temper consumer demand. With a global economy we must keep an eye on Europe and industrial demand in China. All of these factors would seem to indicate the drop off in bankruptcy filings is temporary. This may well mean more "quick" Chapter 11 asset sales and liquidations and Chapter 7 sales.

Q: So we'll see an uptick in 7's?

A: You will see more Chapter 7 cases and Chapter 11 cases that convert to Chapter 7s following asset sales.

Q: Is that because the money is not being offered for debtor-in-possession financings?

A: That's certainly one reason, though DIP financing does remain available in limited situations, especially from incumbent lenders who may be seeking to take control of the company. New DIP lending is going to very difficult because there is little, if any unencumbered collateral and no DIP lender will come in junior to the existing debt. If the senior debt is going to provide a DIP, it is only going to be, generally, on a very short-term basis so as to get the assets sold. The tradition of putting on a long-term DIP to try and reorganize around the core business, sell ancillary assets – that traditional process is going to be very difficult to repeat.

Q: Is this tied to 2005 amendment limits on exclusivity? If you have a longer period of time to reorganize you could bring back the business.

A: I don't think the 2005 amendment is the be-all and end-all cause. The real issue is a lot of these companies don't have the ability to survive that long in bankruptcy. Bankruptcy is very expensive and it can be very disruptive, especially if the company has any significant non-U.S. assets. For a lot of these companies, if they are going to reorganize, they are going to do it very quickly or generally amongst existing constituencies. You may see, for example, conversions of debt to equity. I don't think the 2005 amendment and the limitation on exclusivity has a lot to do with this. It is really a function of the capital markets and the nature of the businesses that are in distress.

Q: So what businesses will see an uptick in bankruptcy activity?

A: The energy sector, some of the commodity sectors – especially commodity sectors that are very dependent on Chinese demand. I continue to see substantial issues in some of the consumer businesses. Obviously, retail is on everybody's list. Some of the businesses in the semiconductor space are on difficult footing because their R&D [costs] were outstripping demand. Some pharmaceutical companies. Real estate.

Q: What is driving commercial real estate bankruptcies?

A: Real estate values for most types of properties in most locations remain significantly depressed. And, while many lenders and servicers have continued with "extend and pretend," or "kick the can" lending, waiting for the markets to turn, this cannot continue unabated. Mezzanine lenders are willing to lend in many of these situations. However, the costs of this debt can be prohibitive, especially where the property values remain far below 2005-2007 levels. Owners run the risk of simply returning to the same leverage situation they find themselves in today. Finally, it is difficult to complete an out-of-court restructuring with many real estate assets because the loans that were pooled do not have the traditional lender/borrower relationship, which is critical for a consensual restructuring. These problems are not going away and for those assets that have escaped restructuring so far, there will come a day of reckoning where the lender says "I cannot extend this any further" or the borrower says "I cannot live under these types of terms."

Q: Have servicers been amenable to extending loans?

A: Typically, they have been willing to extend, recognizing that in a lot of these situations the other option is selling at distressed prices and realizing a loss. Taking a property over is fraught with risks for the special servicer especially in a lot of these commercial facilities which include multiple properties.

Q: We recently saw an increase in Chapter 11 filings from companies listing $1 billion worth of liabilities.

A: Many of the ten-figure filings came from era of financial fraud. In the financial sector, the liabilities are massive, and to the extent that displacement continues in this space, billion-dollar filings will continue to occur. While I think these cases will grab the headlines, they will remain the exception, not the rule due to a more stringent regulatory and governance environment and the availability of capital. More bankruptcy cases will arise in the middle market, especially those [businesses] with exposure to European and Asian markets. These companies do not have access to capital markets and have continued to hang on with increasing head winds. The slightest macroeconomic change or business variance will put these companies into the range of insolvency.

Q & A

Kinetic Partners' Varga on How to Dismantle a Zombie Fund

Geoff Varga, global head of the corporate recovery and restructuring group of advisory firm Kinetic Partners, spoke with Sabrina Willmer about the firm's new business to unwind "zombie funds." Kinetic Partners, started about eight years ago, provides tailored services to asset managers including private equity and hedge funds.

Q: What liquidation experience do you have?

A: Within the firm, our liquidation group has been appointed to wind down numerous funds that have failed due to fraud, mismanagement and/or economic turmoil. Specifically, we were appointed over the failed Bear Stearns funds, in additional to funds that lost billions of dollars in frauds like Madoff and Petters. While most of these funds have been domiciled in the Cayman Islands, we have also worked on funds from the U.S., Europe and other islands in the Caribbean.

Q: Have you liquidated zombie funds before?

A: We have and continue to act as liquidators to hedge funds that withheld investor capital through gates or suspended redemptions. While formal liquidation is an option for them, we decided to expand our services to include taking over these funds as the new manager to help release value to investors. There is no reason why this offering wouldn't apply to private equity funds that are also not prudently winding down. We purposely set up a new entity to take on these roles and are registering it with the SEC as a investment adviser. As we are a liquidation/restructuring shop we are not looking to raise money or make investments. Our mandate is simple – return value to investors.

Q: Why now?

A: Following the events of 2008 most people, investors and managers alike, took a "wait and see" attitude to closing out positions. Now that a number of years have passed, it has become somewhat clear as to which remaining problem funds need to be dealt with. Specific to private equity, there are many funds which launched many years ago, making acquisitions at too-high prices. Those funds are now required to wind down – making it difficult for them to exit at a profit. This is causing a rift between the manager and investors.

Q: Does the SEC's recent focus on PE valuations offer an opportunity?

A: There has been increasing concern by both regulators and investors over valuations, which is compounded when the manager claims that they cannot sell assets for prices at or near their marked levels. We believe that these ongoing valuation issues will increase opportunities for us to step in and sort out the matter, even if just in an oversight role.

Q: Why else is this attractive?

A: While liquidation has been the traditional route for extracting value, we believe that stepping in as a replacement manager provides investors with another option. Despite an increase in secondary market buyers, investors are not normally thrilled with the prices on offer for their interests. This is due to the buyers being overly conservative combined with their need to earn a healthy profit on the purchase.

Q: Isn't it challenging to get permission to wind down funds?

A: Investors need to review their documents to determine their rights, but generally they can get traction with a majority vote. The difficulty can be identifying co-investors as the manager will not normally give out this information, requiring investors to be creative to cede control. This is where we can provide guidance/options.

Q: What is the biggest challenge associated with dismantling zombie funds?

A: The biggest challenge is actually implementing change and getting someone like us implanted to initiate the realization process. This may be achieved consensually with the assistance of the manager but in many situations this is not so easy, requiring more aggressive actions potentially through legal remedies. I don't believe that selling the positions is the real challenge. Despite what the assets have been marked at historically, their true value will be determined by what someone is willing to pay under a normal sales process. No investment is really "illiquid" – people may just not like the prices being offered.

Q: How do you make money?

A: We are a consulting firm, as opposed to an asset manager, and thus are flexible on our fee structure, which could range from an AUM-based fee, to one based on realizations, to something based on our standard hourly rates (or a combination of any of these). Each mandate is different.

Q: What steps do you take to liquidate a fund?

A: Once engaged, we conduct a review of the fund's positions so that we can develop a defined divestiture strategy. This review will also assist us in determining whether we require any outside assistance, possibly from the former GP or from specialist brokers. Most investors also bring good financial acumen to the table and it makes sense for us to leverage it, particularly given it is their money at stake. For private equity investments, our review will also involve meetings with management of the underlying investments, as they may have ideas for realization (and value) given their direct knowledge of the business. The key is to be fully engaged with all parties so that a well-constructed divestiture plan can be developed and implemented.

AT A GLANCE

Hometown: Windsor, Ontario

Education: B.Comm Queen's University (Kingston, Ontario)

Professional Background: More than 17 years of restructuring/insolvency experience (New Zealand, Canada, Cayman Islands, U.S.)

Hobbies: Golf, fishing

Favorite Restaurant: Quality Meats, NYC

SPOTLIGHT

JGP's Fritsch on Navigating the Nascent Distressed Corporate Credit Market in Brazil

Rafael Fritsch, founding partner and CIO of Rio de Janeiro-based **JGP Credito Root Capital**, spoke to Nathaniel Baker, editor of Bloomberg's Hedge Funds Brief, about the distressed market in Brazil. Fritsch's firm, a partnership between JGP Credito and Root Capital LLP, launched a $250 million fund in June.

Q: Can you give our readers some quick background on the distressed market in Brazil?

A: The total credit market has grown by 20 percent over the last 10 years, which is unprecedented. Ten years ago, with a R$200 billion ($99 billion) credit market, 7 percent of which was distressed, we were talking about a R$14 million distressed market. Today the credit market is R$2 trillion.

Q: Sounds like there should be lots of opportunities for hedge funds and others?

A: Some people have tried in the past. The Brazilian legal and restructuring environment is way tougher than most countries I have experienced. I spent 10 years doing distressed in Europe. When you look at France, Italy and Spain, they're very complex places to restructure businesses. I would say Brazil is even tougher than those countries.

Q: That's pretty impressive.

A: This is why, of the foreign players that came to Brazil in the mid 2000s, most have left. They couldn't get the adequate infrastructure, the legal side of the business or credit analysts with experience in restructuring. It is not an easy place to play and that's why prices need to be less than other countries. Recoveries in Brazil are very low. Investors need to be very careful when they choose the asset class to invest and the asset manager to use. Hearing people say 'let's buy consumer loans at 2 cents on the dollar, you can't lose money,' well you can still lose the 2 cents, which is 100 percent of your investment.

Q: Why are they that cheap?

A: If you buy a Brazilian loan, not only do you not have the liquidity to trade in the secondary market, but recoveries are lower than other countries. Once you buy a loan you pretty much marry that loan.

Q: What sectors do you invest in?

A: Distressed usually comes in cycles and some industries get more affected than others. Right now we're looking at the beef industry. Sugar and ethanol is a classic one. Airlines, real estate and the mid-sized banks. We're generalists that become specialists. I probably never looked at a meatpacker in Europe. Twenty percent of the world's beef production is in Brazil, having their ups and downs so you're forced to look at it and after three years you become kind of a specialist.

Q: How do you plan to meet all these challenges?

A: The bottom line is, we have people who have played the Brazilian credit market for 10 years. One of the founders of JGP for example founded Banco Pactual in the 1980s. He has a lot of banking experience. I've been a PM in distressed for 10 years. While there was no distressed in Brazil I was doing distressed in Europe. We have four lawyers in house. That's something you need in Brazil. Our six credit analysts were not just brought from the equities world to do credit. We also have adequate liquidity. Most credit funds in Brazil are crazy enough to have 30 days to 90 days liquidity with an asset base that is very, very illiquid. So any sort of redemptions will kill the fund. We have a long-duration lockup structure that prevents us from having liability issues where people redeem money and we have to sell assets.

Q: Can you do that with local regulations?

A: Our fund is the very first, reasonably-sized onshore locked-up distressed fund. It's regulated by the CVM. All investors are onshore.

Q: Can offshore investors access it?

A: Credit funds are taxed 6 percent, so foreigners would need to pay 6 percent to get in. There are many distressed bonds that list offshore if they want to go direct or through offshore funds. Banco Cruzeiro do Sul is one example of an offshore bond. But again, people need to be careful when they play the high-yield and distressed market in Brazil. Recoveries in Brazil are painful and long and a lot of the products are new. There could be regulatory changes as well. We may launch an offshore fund. We need to allocate at least 75 percent of the cash of the local fund. Once we do that, and we have clarity on the taxation for foreign investors, it should happen. We have the infrastructure to do it.

Q: Where do you see the market going in the next year or two?

A: I think credit will continue to grow. You'll see more bankruptcies. You'll see new entrants and new exits. Most funds will come without hiring the adequate personnel. Unemployment is historically low so to get qualified people is very tough. You'll have to pay up. Or you'll end up with a lot of not very experienced people in a new environment. That's dangerous.

AT A GLANCE

Age: 35

Education: London Business School (MBA), Pontifical Catholic University of Rio de Janeiro

Professional Background: Arrowgrass Capital Partners (2008 to 2012), Deutsche Bank (2006 to 2008), Bank of America, JPMorgan.

Hobbies: Futevolei, a combination of soccer and beach volleyball.

2014 World Cup Winner Prediction: Spain

Q&A

Vlad Jelisavcic on Distressed Investing Through Corporate Bankruptcies

Vladimir Jelisavcic, founder of **Bowery Investment Management LLC**, spoke to Bloomberg's Nathaniel Baker about his fund's strategy of investing mostly in bankrupt companies. Jelisavcic's New York-based fund launched in 2011 and has $110 million under management.

Q: Your strategy is to invest primarily in bankruptcies. Why this particular part of the distressed universe?

A: I think bankruptcy investing is one of the classic hedge fund strategies. It's a source of persistent alpha throughout cycles and it's easy to explain why. Take the example of a high-yield bond fund manager. Eventually there will be credits in a portfolio each year that will default. Bond fund managers are not always in the business of holding distressed securities. There may be charter restrictions or it may simply be a matter of style that they don't want to show ownership of defaulted assets. So they are going to sell those defaulted securities rather quickly. That selling pressure can result in very inefficient pricing. When a security makes the inefficient transition from high-yield to non-performing, it creates a lot of value for distressed debt investors.

Q: That's your catalyst, then?

A: It's about the time when we begin to accumulate positions. Catalyst number two is when a bankruptcy court approves a plan of reorganization or liquidation, unlocking value. In between the two there's generally a two-year process of resolving liabilities, reorganizing, selling assets and cutting costs. One of the great things about bankruptcy investing is that much more information becomes publicly available relatively quickly.

Q: So how do you go about choosing the instruments that you invest in?

A: When a company files for bankruptcy, we spend a lot of time and resources examining its business, where comparable companies trade, the capital structure, how many different entities are involved. We spread out its org chart and try to understand the value of every separate legal entity in terms of its assets, its liabilities, its relationships. Certain affiliates might depend on inter-company relationships, borrowing from others or the other way around. Do these entities issue bonds? Do they guarantee bonds? Do they pledge any of their collateral? How much more unsecured debt might be created as a result of contracts being renegotiated or rejected?

Q: That's obviously a lot of analysis. How many companies are you invested in at one time?

A: I'd say 15 to 25 at a time.

Q: Do you specialize in any industries?

A: We really don't. We view ourselves as process specialists. Oftentimes entire industries will experience stress, so we develop experience based on which ones have gone through bankruptcy. Over the years we've invested in a number of financial bankruptcies, typically liquidations such as MF Global or Lehman Brothers. Occasionally financial reorganizations such as CIT. We've been active in a number of energy-related bankruptcies such as Mirant, NRG, Enron. We've been very active in airline bankruptcies, currently with American Airlines, previously with United Airlines, Northwest, Delta. We've been active in auto and auto-parts, most recently GM and Delphi.

Q: Do you ever take post-reorg equity?

A: Yes we do. In general, our base strategy is not to hold post-reorg equities for an extended period of time. When we receive those equities it is with the view of gradually or not so gradually exiting from the position. We don't want to be longterm holders. If we don't see much value, we might sell almost immediately. If we see value we might allow a few months or a quarters for more traditional investors to become familiar with the company on a post-reorg basis and move the price up. We've done that in the past. One recent example is LyondellBasell Industries.

Q: Bankruptcies may have slowed down the last year or two. Where do you see the flow and opportunities?

A: We're niche players. I certainly mentioned some larger bankruptcies but we don't need very large bankruptcies to make great returns. We're very happy and comfortable pursuing smaller cases. We've got some investments in Syms, Borders Books and Mervyns for example. The number of bankruptcies has declined since its peak in 2009 but there is probably a surprising number of new bankruptcies that are being created. Within the last nine months you had Kodak, American Airlines, MF Global, Peregrine Financial and just last week ATP Oil & Gas. Based on the sluggish nature of the recovery I think it's quite likely the default rate will increase from approximately 2.5 percent to 3.5 percent over the next 12 months. We are tracking a number of companies that have lower-priced bonds that I think might have to restructure in the future.

Q: Now I have to ask what companies?

A: If you had asked me last week I would have said ATP. I'm going to have to hold my firepower, although I think the energy sector will continue to provide us with new distressed opportunities.

AT A GLANCE

Age: 42

Hometown: Ossining, New York

Residence: Upper East Side, New York City

Education: B.S., New York University; J.D., University of Iowa College of Law

Professional Background: Bear Stearns (1993 to 1998), LongAcre Management LLC (1999 to 2011), Bowery Investment Management since 2011

Family: Married with four children

Recommended Recent Reading: The Fabric of Reality by David Deutsch

Q&A

Blackstone's Coleman: Libor Remains Key Pricing Tool for Debtor in Possession Finance

Libor remains a key pricing tool for loans to bankrupt companies despite an investigation of at least 12 banks for manipulating Libor, says **Timothy Coleman**, senior managing director and head of restructuring and reorganization at The Blackstone Group. Coleman said in an interview with Aleksandrs Rozens that he expects more Chapter 9 bankruptcy filings and restructurings within energy, media and healthcare industries. "Energy appears to have had a fundamental shift due to many issues including fracking," he said.

Q: Given the issues with Libor, does this change the mechanics of debtor-in-possession lending?

A: I have not seen any change in the DIP loan process as a consequence of all of this controversy surrounding Libor. Perhaps it will, but I haven't seen any difference to date. Everyone continues to use Libor as the key rate.

Q: Is there any other benchmark that we could use in the DIP market in place of Libor?

A: Historically, the market has used the prime rate and the commercial paper rate in addition to Libor. But Libor has been the key pricing tool in the DIP loan market for easily more than a decade. While what happened happened, as long as they continue to set the Libor rate, I don't see anything changing the useage of Libor as the primary method for pricing DIP loans.

Q: You started out at Citi in the late 1970s and this has allowed you to see the evolution of DIP lending. Will the largest commercial banks always be the largest source of DIP money? Could regional banks come in?

A: They usually get involved if it's a company they have been working with. I haven't seen as many of them jump into the DIP loan market just as a business. I would be surprised to see regional banks get involved with the riskier DIP loans. It would be logical to see them get more involved in the basic DIP loans. There are a lot of lenders in the DIP loan market. Many of those lenders occupy a certain risk level of DIP lending. The big commercial banks are the ones who are probably the most basic of lenders, the ones that cross the widest spectrum of DIP loan risk. As the risk gets higher, then you start to see hedge funds and some private equity funds that are willing to provide DIP loans at a significantly higher rate, maybe Libor priced plus components of equity or something like that.

Q: Hedge funds and private equity funds have something like $70 billion that is waiting to be put to work. When do we get that fire sale in Europe?

A: The question will be how the governments support the euro. So if it goes in a very negative direction we might see a lot of companies fail and, as a consequence, there would be a lot of restructuring work. If it goes the other direction with strong government support you will see a much smaller restructuring opportunity. It is very much driven by government intervention and political intervention. That will dictate what kinds of opportunities will exist.

Q: What's your outlook on Chapter 9s?

A: A lot of cities have very large liabilities and not an obvious way to meet those liabilities. It is all different. You do have to think in a different way with a municipal restructuring. A corporation is a corporation, but these cases involve real people with real issues.

Q: Does the U.S. high-yield market stay open for European issuers?

A: The U.S. has a highly developed high-yield market with a giant advantage. The advantage is that we have bankruptcy laws. When you are looking at high-yield investments you know there is a forum to deal with any issues you might face with a borrower. Europe is not set up that way. The bankruptcy laws vary widely and are not as uniform and not as user friendly. The use of our bankruptcy laws really has been fully vetted from a case perspective. People test the theories relatively regularly; theories on how to interpret the law have been seen in many cases and judges have ruled on them. Lenders can look at those rulings and say 'Okay, I need to think about my loan with that ruling in mind.' In Europe they don't have the history and case law to help interpret what the statute looks like. Lending [in the U.S. high-yield market] is open to anybody, depending on what the risk profile is. Somebody who lends money can lend to the most difficult company in the most difficult economy if they have the terms they need.

Q: Which industries in the U.S. are under the most pressure?

A: Energy appears to have had a fundamental shift due to many issues, including fracking. That's allowed for an opening up of U.S. gas fields that brought about lower gas prices which affects all competing markets and which is why you see coal companies experiencing some issues. That's an industry issue versus an economy issue. You are seeing a change in the industry. When you are looking at where the restructuring comes from it's a variety of places; a key source is just an industry going through a change.

Q: Any other industries?

A: Definitely healthcare. We continue to see media – anything being hurt by the switch to digital. We will continue to have real estate because that is going through a variety of issues. And the real question is 'Where does our economy go from here?' which is, of course, anybody's guess and I suppose the election will have some impact on it. If the euro really struggles it will have a major worldwide impact, including on the United States.

Q: You were involved with Mohegan Sun's restructuring. I noticed more of the Native American casinos are running into trouble, just like other casino businesses. But you have to contend with different rules. Can you apply the basics of Chapter 11 with Native American casino? It has to be a little trickier — no?

A: By definition the native American

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casinos are sitting on tribal lands and the tribal lands do not have the concept of bankruptcy. They are not subject to the U.S. bankruptcy code. Also nobody other than the Indian tribe can own the equity of a casino on tribal lands. So, you cannot have a debt conversion in the way we normally see in distressed situations. So, those two factors really drive a very different process. Creditors can't force anything; the tribe can be in default but creditors cannot seize anything. So, it puts the two on very equal footing in the negotiations. As a consequence the deals tend to take longer. Creditors get very frustrated by that. Creditors are used to saying to companies 'If you don't do this, you'll have to file for bankruptcy. And if you have to file for bankruptcy, the equity is wiped and I'll own it' — the typical distressed fund holders's comments. That doesn't work in an Indian casino. You end up having to have a negotiation where the equity will always be continuing in an equity position. Then, the question is what do you try to do to change the distressed situation? There are no rules. Now, with Mohegan they had very good cash flow. It's a very well-run casino, the management team is very strong. It was mostly about moving maturity dates.

Q: Do you expect more of these Native American casino restructurings?

A: Yes, it seems likely to continue.

Q: We've seen a couple of large Chapter 11s but the overall volume of filings is down. Do you expect it to keep trending lower?

A: Our business is up year over year. We are involved in **ResCap** and **Patriot Coal**, by example. I think our market will be as strong as it was last year but it just may not be in the bankruptcy courts. I don't measure whether the business is from Chapter 11 filings; there have been some gigantic out-of-court restructurings that never saw the light of day.

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Q&A

Houlihan's Burian: Hospitality, Healthcare and Coal Companies Top Restructuring Candidates

Commerical real estate restructurings likely will pick up because the commercial mortgage backed bond market does not have as much capacity to finance new loans and lenders are not as readily extending mortgages for commerical properties, **Saul Burian**, a managing director at Houlihan Lokey, tells Bloomberg Brief's Aleksandrs Rozens. Burian also said his firm is not actively seeking to rebuild its dedicated sovereign restructuring group.

Q: What are you seeing in terms of real estate restructurings?

A: Most of the CMBS deals had limitations on extensions, on average two years. Some had three-year extensions. What we're seeing now is these consensual restructurings that were done early in the cycle are reaching the end of their extension periods. We think hospitality and other assets will become available as we reach the end of the CMBS extensions. CMBS debt that is available for refinancing is relatively inexpensive, but the amount of CMBS debt is more constrained than it used to be.

Q: What other sectors are seeing restructurings?

A: We are not seeing an across-the-board restructuring wave. Debt is so inexpensive that companies are finding ways to get by, so to speak, and of course the high-yield market has been an actively employed resource to refinance debt. We're not seeing a global wave of restructurings that is systemic. We are seeing a much more episodic restructuring environment, often based on a company's particular issues combined with the inability for that business to refinance debt. It is a much more haphazard market.

Q: What are the common denominators for troubled companies?

A: We've been searching for that as well. Obviously, high leverage and a need for new capital are two common characteristics. A business may be cyclical and requires new investment or a new capital need can arise from regulatory or other issues. Let's take an obvious example - healthcare. We are seeing an uptick in the healthcare space, certainly in the middle market. People are struggling with the mandates on data storage and electronic record keeping. You are seeing people struggling with the costs and uncertainty in dealing with Obamacare and competing in the ever-decreasing reimbursement environment. It's the uncertainty about where reimbursement rates are going to be and what the new protocols will be. It's very hard to make significant investment in these areas without being uncomfortable. Think about radiology. It costs hundreds of millions of dollars to build some of these centers. How are you going to be reimbursed? And, what are these reimbursement rates going to be? Who will be your payor? Are your relationships with HMOs still good? I'm not saying there is a wave of healthcare restructuring coming, but what we are seeing is that middle market companies are more impacted and it's more difficult to get them the cash they need. Coal may be an area where there is an industry-wide shake-up if natural gas prices stay low and taking coal out of the ground becomes more expensive. We are also seeing more financial institutions work. Money managers are subject to faster swings in their assets under management [AUM]. Money is more hot these days so you have less stability. It can be ugly when the capital structure needs to shrink to accommodate the new AUM reality.

Q: What are other factors adding stress to the financial sector?

A: We're seeing greater regulatory scrutiny. It is a generally a more difficult environment to be doing business because of increased scrutiny and a lack of clarity.

Q: For money managers, a low rate environment can't be helping either.

A: They still get their fees on AUM. It does not help if they are not growing their assets. In the old days investors were stable and you could at least count on growth from the reinvestment of the interest on the bond portion portfolio. In today's environment, you have to stretch more for yield or not grow.

Q: Houlihan once had a sovereign restructuring group. Are you getting back in to that?

A: We don't see a huge opportunity in sovereign restructuring. It's relatively low margin, and high, high touch work that, in light of our lack of underwriting and distribution, has not been an attractive opportunity for us. We are active in situations that involve sovereigns etc., but we are not actively looking to rebuild a dedicated a sovereign group.

Q: If the appetite for high yield among investors stops, do you expect an uptick in restructurings?

A: If rates went up a little bit and the high-yield market stopped growing, there'd be a huge increase in restructuring work.

Q: How long will it take to see a complete wind down of the Lehman estate?

A: When you say complete – that will take years. It looks like they are moving aggressively on a number of items. I would say two to four years should be a safe estimate to be substantially completed.

AT A GLANCE

Education: B.A. Yeshiva University, J.D. Columbia University School of Law

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