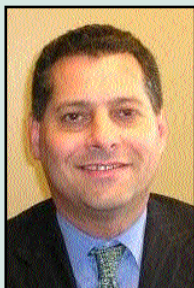


VIEWPOINT

Hedge Funds In Leveraged Finance: Are They Too Good To Be True?

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If something appears to be too good to be true, it probably is.

Deep-pocketed hedge funds have ostensibly been great friends to the leveraged-financing markets, supplying unprecedented liquidity. But what happens if these same hedge funds also pursue distressed investment strategies?

According to a recent Greenwich Associates survey, hedge funds control as much as 82 percent of trading volume in distressed debt, 30 percent of trading volume in high-yield bonds and credit derivatives, and 26 percent of leveraged loans. Before passing judgment on this new source of funding, we should better understand the motives involved.

A hedge fund is an investment pool, similar to a mutual fund but exempt from the Investment Act of 1940, in which ownership is limited to sophisticated "accredited" investors. Many hedge funds are focused on a particular investing strategy, with a few focused on leveraged finance. The typical hedge fund manager will charge a management fee of 1 percent to 2 percent of asset value, along with an administrative fee and a share of returns, usually over a specific hurdle rate.

With that type of return expectation, clearly these money managers are not buying corporate credit at LIBOR plus 2 percent to 3 percent. However, if the investment is made via a collateralized loan obligation, or CLO, structure, the numbers begin to look more promising. A CLO is a special-purpose vehicle that packages a portfolio of loans and sells the funding into the securitization market in different risk tranches. Fitch Ratings has coined the term "credit-oriented hedge funds" to describe those that invest in CLOs. While banks and other investors can control CLOs, credit-oriented hedge funds are the most aggressive.

A credit-oriented hedge fund can take a \$10 million investment and leverage it five times, allowing the fund to control a CLO pool of leveraged loans in excess of \$800 million. This pool might generate annual interest and fee income of \$20 million, or 2.5 percent. When the related cash flows - principal, interest and fees - are received, they are applied to the different layers of funding under a "waterfall of payments" formula to ensure that the highest-priority tranches get paid out first. After factoring in underwriting fees, administration, credit enhancement and borrowing costs, a credit-oriented hedge fund might expect an annual return on a CLO equity investment of more than 40 percent. However, this is a fairly simplistic model that does not incorporate prepayment risk or default risk into the equation, which could reduce the expected return to 20 percent or less.

CLOs appear to be the real source of liquidity in the leveraged loan market. What makes things really interesting is if a credit-oriented hedge fund also has a distressed-debt strategy. On top of these significant returns, the CLO portfolio might serve as an incubator for future potential distressed investments and, therefore, have the potential to generate even greater returns.

In this scenario, the hedge fund in question uses the private information it has gained as a member of the bank group to make an opportunistic, contrarian bet on the enterprise value of the company. There is an arbitrage opportunity tied to the tendency of

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One of a series of opinion columns by bankruptcy industry participants.

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regulated banks to sell problem loans in order to manage the level of disclosure to bank regulators and Wall Street. Typically, problem loans tend to trade down at the outset of distress, eventually trading up during the reorganization process.

In addition, by controlling the most senior claim in a capital structure, a distressed investor can more confidently purchase the “fulcrum security” - the highest priority of claim that would be expected to be impaired in a bankruptcy filing - and consequently control the reorganization process. This investment strategy is known as “loan to own” or “involuntary private equity.” There can be real value created if an overleveraged firm in an out-of-favor cyclical industry is purchased using this strategy. Some very successful high-profile examples of this strategy include Oaktree Capital Management LLC and Philip Anschutz’s investment in Regal Cinemas and Wilbur Ross’s in the steel industry.

Although there are rules about creditors with access to inside information trading in a company’s debt, much of today’s distressed debt trades under “big boy letters,” which insulate the inside party from liability tied to nondisclosure of private information. Thus, access to “private” bank reporting information, combined with exposure to signs of individual bank fatigue at bank meetings, can give credit-oriented hedge funds an advantage over third-party distressed investors.

This has the potential to become a self-fulfilling source of proprietary deal flow. By using CLOs to buy into healthy loan syndications, these distressed investors have positioned themselves as wolves in sheep’s clothing, with goals in direct conflict with those of management and ownership of the borrower. Once a borrower gets into trouble, CLOs may start demanding exorbitant compensation and other volatile actions, pushing the credit down a slippery slope toward a restructuring.

This behavior becomes especially problematic when a 100 percent vote is required for an amendment or waiver of the senior credit agreement. Distressed investors may argue against a decision that appears to be in the best interest of the senior lenders. This causes banks to cash out, allowing the hedge fund to increase its ownership and negotiating power while (usually) lowering its average cost.

By effectively controlling the bank facility, the distressed investor can also make more-informed purchases of the fulcrum security. Management and private equity are typically steamrolled in the process, with a change in ownership the likely outcome. In the best-case scenario for the hedge fund, the average discount from the debt purchases can be converted into equity through a debt-for-equity exchange, and the cash value of the related debt repaid from a refinancing or reinstated in an exit facility. This becomes a zero-cost investment with the potential for infinite investment returns.

So while the leveraged loan market is currently flush with liquidity, in part from this new funding source, private equity firms and management should remember that some of the players might have ulterior motives. If something sounds too good to be true...

(Opinions expressed are those of the author or authors, not of Dow Jones Newsletters.)

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