

Distressing times for distressed investors; access to easy money played spoiler in 2013 – Part 1
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By Reshmi Basu

We asked a host of buy-side and advisory sources in the distressed arena the same two questions: *What defined your 2013, and what sectors will you be focused on in 2014?*

Here is the first cross-section of their answers:

Alan Gover, partner at White & Case

I don't think there is much confidence that the overall flow of debt restructurings will be materially larger in 2014 than in 2013. I think it's been generally a slower time. In general, distressed opportunities are not as abundant as they were three years ago. Ironically, there is a lot of "anxiety" about the lack of trouble. The restructuring world – both the people who invest in it and the advisors that support it – is enormous and global. The need for deal flow is huge. I don't think the supply matches up with the scale of the industry anymore.

The restructuring world is made up of extremely shrewd and imaginative people. They may not see the opportunities in debt but indeed in equities.

People have broadly spoken about municipalities as a distressed sector. Every municipality is in some sense unique and therefore the rulings in Detroit may be very limited to the specific circumstances in that city. I don't think it will translate in simple fashion across other municipalities in other states. There are a lot of troubled municipalities but each of these municipalities will be troubled in their own specific way.

Marc Carmel, of counsel at Paul Hastings

This year (2013) was defined by continued slowness for in-court restructurings and the ability of companies to effectuate out-of-court restructurings. And I believe the pace of restructurings in 2014 will be at a similar level as 2013 – as long as there continues to be relative easy access to money.

Two of the biggest motivating factors are decreased spending from the federal government, which will impact healthcare and defense, and the continuing changing economy and technologies, which will impact media and publishing companies.

In the retail sector, you will see pockets of strength – similar to what you see in the US economy. There is strength in the top and the bottom of income earners. Retailers that cater to the middle generally don't have a compelling story to convince customers to shop.

Deirdre McGuinness, managing director of corporate restructuring services for KCC

In 2013, capital markets were providing liquidity to distressed/stressed companies supporting more out-of-court restructurings than Chapter 11 filings. Companies facing more complex operational issues such as leases, pensions, labor negotiations, etc., were looking to Chapter 11 as a strategic option to help right-size their capital structure, improve operations and emerge as a more profitable entity. For companies that did file Chapter 11 in 2013, we saw shortened timelines due to pre-packaged plans and asset disposition under Section 363.

We expect to continue to see historic low speculative grade corporate bond default rates for 2014. We expect to see more of the same level of activity for Chapter 11 filings in 2014. However, if interest rates go up or an event driven unforeseen situation occurs, the credit markets could constrict.

We'll continue to see certain industries face headwinds – including shipping, transportation infrastructure, retailers, municipalities and mining. These companies and entities face challenging balance sheets, complex operational issues and a drop in consumer spending/behavior. Chapter 9 is also becoming more common and we may continue to see a trend in those filings.

Saul Burian, managing director of financial restructuring, Houlihan Lokey

In 2013 we saw pockets of activity, both locally and internationally – primarily situations in which the low interest rate environment and easy credit were not enough to remedy the specific issues impacting the relevant company or its industry.

We are seeing significant activity in shipping and in some of the more challenged European nations. Aerospace and defense is another sector in which we're seeing a pickup in restructuring activity.

We think default rates will likely remain very low. Access to easy credit will allow companies to extend maturities, but that doesn't necessary translate into the creation of equity value. Many companies will just run in place.

Vladimir Jelisavcic, chief investment officer, Bowery Investment Management, LLC

One of the trends we observed that was, more emphatic than in prior periods, was the changing of the guard from the mega bankruptcies of 2009 and 2010 and a move toward middle market and niche opportunities.

For 2014, we've thought long and hard about this and expect the default rate to increase. We think the Fed tapering changes everything. The de-acceleration of monetary stimulus by the Federal Reserve will gradually tighten market liquidity over time and will cause interest rates to slowly rise. This is critical for the creation of distressed opportunities.

Based on S&P data, the default rate was projected at 2.3% at the end of September 30, 2013. We expect that will increase to 2.8% in 2014.

The high-yield market is vulnerable to a correction. The triggers are a potential spike in US rates, if the Fed gets it wrong or the market misinterprets the Fed.

Since the financial crisis, some corporate balance sheets have actually increased leverage. The overall leverage in the high yield market has actually risen by 0.5 from 3x to 3.5x.

We are also seeing some pockets of stress in industries such as TMT. **Hibu** in Europe is a great example. It's very inexpensive and misunderstood. Hibu's digital business is significant and is rapidly growing. Another name to watch is **NII Holdings**.

Shipping was a core sector in 2013 and remains important.

One thing to emphasize again is that the distressed market is an extremely strong performer. There are a lot of misconceptions that it is cyclical, but it is the second best performing strategy year-to-date, even given the perceived lack of opportunity. The longer deal cycle is key to a distressed manager's returns.

Jon Sablowsky, head of trading at Brownstone Investment Group

Brownstone expects default rates to remain at or near historical lows. We currently project a default rate of 2% for 2014 and do not see the rate rising above 2.5% into 2015. This rate remains well below the historical average of 4.4%.

Given our expectation of a 2% default rate in 2014, Brownstone would expect the needs for any large-scale restructurings to be minimal as well. Given the Federal Reserve's commitment to keep the Federal Funds rate at 0.25% through 2015, a continuance of vibrant capital markets, and moderate yet consistent economic growth, we see no real catalysts for the pace of restructurings to be out of line with 2013. The maturity wall through 2015 currently stands at only USD 149bn, which is down 60% from the beginning of 2013.

One of the troubled sectors in 2013 was defense, where the withdrawals and reductions in military activity and budget cuts led to some pockets of distress. Healthcare was also volatile in 2013 as investors jockeyed to locate the winners and losers per the effects of the Affordable Care Act. Finally, coal was a poor performer in 2013 due to pressures associated with environmental concerns as well as competition via lower natural gas prices.

Looking ahead into 2014, Brownstone believes the three sectors above, defense, healthcare and coal will remain on distressed investors' radar, principally due to the same lingering concerns that affected their 2013 performances. We also could see anxiety rise in certain areas that are related to consumer discretionary spending. These

would include the restaurant and retail sectors, which will need resurgence in consumer confidence and its by-product, consumer spending, in order to lift all boats.

Brownstone will also be closely monitoring the municipal asset class for pockets of opportunity. Given the issues affecting certain large issuers, principally, Puerto Rico and Detroit, we can see investors, including Brownstone, becoming much more involved in this fixed income asset class.