GLADLY TURNING THE PAGE ON 2008; DRESSING FOR DISTRESS IN 2009

TRENDWATCH

By Anuj Bahal and John Yozzo

ONE LAST LOOK BACK AT 2008

We knew that 2008 would be tough sledding for buyouts and other credit market dependent activity but we never remotely envisioned a year like the one that just finished. It was absolutely unprecedented in the modern investing era. With the exception of a brief respite from late-March through May following the Bear Stearns rescue, corporate credit markets were inhospitable for most of the year until they finally slammed the door shut on virtually all leveraged lending activity following the Lehman Brothers bankruptcy in mid-September. The fourth quarter of 2008 witnessed a near cessation of speculative-grade borrowing of any kind and turned what had been just a bad year until that point into a disaster for many high-yield and distressed investors. Margin calls, events of default, forced unwinds and redemptions experienced by various clientele in fixed income markets only served to reinforce the downward spiral and resulted in the following lowlights by year-end:

- Reuters LPC reported a return of -29% for leveraged loans in 2008, the first time the asset class experienced any net loss in a year.
- Junk bond returns were close behind leveraged loans at -26%, according to the Merrill Lynch U.S. High Yield Index.
- Performing senior term loans of speculative-grade borrowers fell in secondary market trading into the mid-to-high sixties price range, producing yields-to-maturity (YTM) in the mid-teens or higher.
- Corporate high-yield bonds rated within the single-B range were typically yielding 20% or more, while CCC rated or worse produced YTMs of around 30%.

As for lending activity, leveraged loan volume was down nearly 60% in 2008 to its lowest level since 2002. Lending to finance domestic LBO transactions tumbled 80% from its all-time high of $210 billion in 2007. A tiny $2.2 billion of LBO-related loans were made in 4Q08 according to Reuters LPC. New high-yield bond issuance fared no better; falling nearly 70%, to a mere $45 billion, in 2008. Within little more than a year's time the global credit system had fallen into complete disarray.

WHAT MIGHT 2009 BRING?

A couple of insights have already hit us in early 2009 as investors search intently for any sign of credit market stability. The vicious sell-offs experienced in 4Q08 were probably less technically driven than we would have liked to believe. Yes, there certainly were idiosyncratic factors driving some of the selling pressure in late 2008 but we now know that the underlying fundamentals were also weakening quickly in most cases—more so than we thought at the time. Expected corporate default rates are now predicted to exceed previous cyclical peaks following extraordinary default forecast revisions by the two preeminent rating agencies in January 2009:

- S&P upped its U.S. speculative-grade corporate default rate forecast to 13.9% by year-end from its previous forecast of 7.6%, a huge revision from just one quarter earlier. Under its pessimistic scenario S&P's projected speculative-grade default rate is now 18.5%.
- Moody's hiked its global speculative-grade corporate default rate forecast to 15.1% (15.3% in the U.S.) from 10.4% in December and an actual default rate of close to 4.0% in 2008.

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— Moody's baseline forecast is in the vicinity of corporate default rates experienced during the Great Depression, and suggests that almost 300 rated corporate issuers will default in 2009 compared to 105 last year. The S&P baseline default forecast is an all-time high and implies well over 200 corporate defaults in 2009.

We cannot recall revisions of this magnitude coming from the rating agencies, which they largely attribute to the deepening global economic slump, the growing proportion of "deep junk" (B- and worse) rated issues relative to all speculative-grade issues, and the recognition that highly discriminating credit markets will be impacting corporate liquidity, defaults and recovery prospects for many of these deep junk issuers if credit doesn't start flowing soon.

> "The default rate in 2009 could be as high as 11% to 15%. The best time to buy distressed securities is after default rates have peaked, so the best opportunities probably won't arrive until later this year or even 2010." —Dr. Edward Altman

A second insight that we take away from the disastrous final quarter of 2008 is the sobering recognition that the list of "known unknowns" (to quote a former Defense Secretary) that will ultimately determine how and when this financial crisis plays out is too complex and interrelated to be estimable with any high degree of certainty.

How close are we to a housing market bottom? It depends on which expert you ask—and the range of answers is huge with respect to its potential wealth impact on U.S. households. Some say we are now approaching a bottom, others have said that housing prices nationally have another 20% to fall before a recovery can begin. The difference between these two estimates is nearly $4 trillion of household wealth.

How much further do bank and institutional write-downs and loan losses have to go? Another $1 trillion? $2 trillion? More than $2 trillion? We have seen all three answers given by various experts. It depends on default and loss rate assumptions for enormous pools of diverse assets such as commercial real estate loans, home mortgages, small business loans, consumer credit card loans and auto loans. NYU professor Nouriel Roubini believes we are barely halfway through the process and that total losses on loans and securities originated by the U.S. financial system will eventually total some $3.6 trillion. He argues that the U.S. banking system is borderline insolvent and will need to be re-liquefied to the tune of at least $1 trillion. Not everyone agrees with Roubini's dire forecast but he has been closer to the mark than most over the last couple of years and his once "outrageous" predictions now seem plausible.

Will corporate default rates creep closer to the high or low end of S&P's 2009 range of 10.0%-18.5%? It depends partly on whether banks begin lending again to risky borrowers which, in turn, depends on their capital adequacy, which depends on the extent of additional write-downs and charge-offs to be taken. In many respects it is a circular phenomenon; if banks don't start lending again there will be a subsequent spike in business bankruptcies, which will further discourage (or disable) banks from lending. The looming unknown at the moment—and the one that can potentially stop this spiral in its tracks—is the extent to which the Federal government will commit to absorb, guarantee or backstop these private sector losses. Stay tuned for that one.

Much of the pessimism that has gripped financial markets for the last few months derives from the collective realization by investors that there is still much we don't fully understand and cannot estimate with any degree of confidence as it pertains to the resolution of this unique financial episode. What began in 2007 as a seemingly containable crisis in a corner of the structured finance market has morphed into a global financial pandemic despite our nation's best efforts to avoid this very outcome. The full panoply of monetary policy tools has failed to tame it. As unsettling as this realization may be, it has finally put to rest any notion of a silver bullet solution and the complacency that slowly began to return to markets in the weeks following the Bear Stearns rescue.

> "We remain bearish on the outlook for the U.S. economy and believe that the recession will extend into late 2009 and likely 2010. The sharp contraction in the global economy, the instability of the global financial system and the ongoing credit contraction are unlikely to be resolved in the first half of 2009."
> —John Paulson, The Paulson Funds

Ultimately, the calamitous events of late 2008 served to convert optimists into realists and investors into traders or spectators. Few pundits and market strategists are willing to hazard anything more than an educated guess as to where financial markets will be a year from now. Conviction is sorely lacking. Historical experience provides some but limited guidance. It was a humbling year for everyone but we finally seem to know what we don't know. Eighteen months after it all began we are still navigating through uncharted territory.

DISTRESS IN 2009

We at FTI Consulting, together with Debtwire North America, Bingham McCutchen LLP and Macquarie Capital USA recently released the results of the 2009 North American Distressed Debt Market Outlook, consisting of a survey of mostly hedge funds, institutional investors and prop traders. (A copy of the report can be accessed below.) Some highlights of the survey include:

— Respondents believe this restructuring cycle will take longer to work itself out than previous cycles.

— Two-thirds of respondents are increasing their capital allocations to distressed debt.

— A solid majority is targeting returns in excess of 20% for this year.

— More than three-quarters see the best opportunities at the very top of the capital structure in senior secured loans—a strategy that backfired last year. However, with many performing senior secured loans trading near historical recovery values it's hard to imagine anything close to a repeat performance in 2009—the downside seems quite limited while the upside potential is substantial.

> "There are some really extraordinary opportunities in the credit world. You want to make sure you're with companies that have the ability to survive in a really tough economic environment." —David Swenson, Yale Endowment Fund

NO SHORTAGE OF DISTRESSED M&A OPPORTUNITIES

Of particular interest to buyout sponsors, survey respondents were nearly unanimous in their belief that distressed M&A transactions will rise sharply in 2009. We at FTI are also seeing that early trend in many of our recent assignments. The dearth of financing options for bankrupt and nearly bankrupt enterprises will continue to spur opportunistic purchases of businesses and assets, and strategic buyers will surely have their chances to engage in consolidation on the cheap and make a deal happen quickly. But why stop there? We believe the distressed debt tent is big enough to accommodate many other players. With the buyout boom likely to remain subdued in 2009, private equity money will likely migrate over to the arena of distressed investing and they too will have ample opportunities to invest in or control distressed businesses via direct lending and loan-to-own strategies that some traditional distressed investors tend to avoid. Moreover, the opportunity to repurchase existing debt of portfolio companies at deep discounts, a strategy that really took off in late 2007 when banks were trying to offload hung loans, is still viable.

Acting alone or in concert with other distressed investors, buyout shops are capable of bringing not only financial resources but deep industry expertise and C-suite executives to situations that will require operating and resuscitating a business in an extremely challenging economic environment. Investors will need to pay special attention to rigorous business plan due diligence and to assessing the validity of turnaround plans and synergy forecasts being put forward by management teams.

> "Restructuring is really just M&A where you are being hired to negotiate control back from your creditors," —Ken Moelis, Moelis & Co

> "That means all of us have to adapt. We have to change the way we'll do business. If we don't, we'll be left out." —Henry Kravis, discussing KKR's focus on alternative investment opportunities instead of buyouts—including distressed debt, mezzanine financing and infrastructure.

Corporate credit markets may remain unsettled and the big buyout era may be dormant for now but that doesn't mean it will be a quiet year for private equity sponsors. It's just time to refocus on where the opportunities are.

This article was written by Anuj Bahal, Senior Managing Director and John Yozzo, Managing Director of the Corporate Finance Group of FTI Consulting. The opinions, facts, and conclusions contained herein are those of the authors or the sources cited and not those of FTI Consulting, Inc.

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