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Distressed Investors Keep Hunting for Yield

By Matthew Sheahan and Danielle Fugazy

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While deals abound for high yield bond and leveraged loan investors, distressed debt opportunities have fallen precipitously over the past year. This has left some distressed investors sitting on the sidelines and others taking bigger risks in their quest for yield.

Tightening spreads have created a big shift in distressed debt levels. According to **Standard & Poor's**—which defines distressed credits as speculative-grade-rated issues with option-adjusted spreads of more than 1,000 bps relative to Treasuries—as of December, the distress ratio is at 14.65%, below its long-term average of 16.2% and down from its all-time high of 85.2% in December 2008.

The distress ratio is nearly 25 percentage points lower than the 12-month average and at its lowest point in a year and a half, according to the rating agency. According to a Jan. 15 report issued by S&P, the composite speculative-grade spread was at 582 bps, down from 1,628 bps at the start of 2009.

Meanwhile, the average price of bonds on the high yield secondary market has jumped significantly, with bonds that were trading for 30 cents on the dollar at this point last year trading in 80 to 90 cent territory today. Bonds that are trading below the 50 cents on the dollar total \$8.9 billion, or 1.1% of the high yield market, according to a report issued last month by **JPMorgan**.

Stressed to Invest

“Now the average triple-C credit is trading at 90 cents on the dollar,” said **Margaret Patel**, a portfolio manager with **Evergreen Investments**. “The tremendous amount of money that poured in opportunistically has diminished,” she added. “Now the sector doesn’t look as attractive as it did a year ago, just because the prices are up so much.”

This means a lot of investors could be left with capital that was targeted for distressed debt investment now looking for somewhere else to put it. “Some big funds are sitting on a lot of commitments and just biding their time,” said **Anders Maxwell**, a managing director with **P.J.**

Solomon Co. “The smartest guys in the distressed business are being very careful in terms of new commitments, but at the same time, they are getting more confidence in the credit markets and the ability to trade, so they are stepping up and taking on more risk.”

The distressed funds, formed with the objective of getting larger-than-average yields on the high yield market, are now faced with climbing down the credit quality ladder in search of larger yields, since higher-rated companies are no longer in the distressed category. Therefore, while the distressed market has diminished, distressed investors are more likely to do riskier deals in their quest for yield.

“A lot of people, when they’re stuck with a style risk mandate, respond by taking more risk,” said Patel. “This may work over the shorter term, but over the longer term it is counterproductive. I’m sure this cycle won’t be any different. ... You’ve already starting to see more marginal credits come to the market.”

But this won’t stop investors from jumping into the market now. High yield issuance is at its strongest point yet—the week ending Jan. 15 was the biggest week on record for junk bond volume, with \$11.7 billion in new bonds priced, according to **Thomson Reuters**. And the distressed debt market provides the highest yields in high yield. “Distressed has been far and away the best part of the high yield market,” said Patel. “With that performance experience, this will continue to be an area that holds and attracts money, absent any negative surprises. ... With the liquidity and the huge rallies we’ve had, the risk appetite is extremely high.”

Meanwhile, the distressed M&A market is dealing with its own disappointing number of opportunities. The speculative-grade default rate, which was hovering around 11% as of the end of last November according to Standard & Poor’s, would seem to point to an inflow of opportunities for buyers of broken companies. These deals, however, haven’t materialized at the pace market watchers might expect.

“If lenders are forcing pay downs, then you are seeing sales, but the distressed market isn’t as frothy as people anticipated,” says **Duff Meyercord**, a partner with **Carl Marks Advisory Group**.

Extend and Pretend

The U.S. has seen an increase in the number of bankruptcies and distressed related M&A. As of December, 163 bankruptcies and distressed M&A deals had been completed in 2009, according to **Dealogic**—up from 83 in 2008. But considering the wild ride the economy has been on since mid-2007, the number might seem quite low.

‘Amend and extend’ is the ditty deal pros use to explain the shortfall, identifying that many companies that were on the verge of falling off the proverbial cliff have negotiated for themselves a second chance. Lenders may get better terms, while the companies live to see another day. Both sides, meanwhile, avoid the pain of a restructuring.

A typical situation might involve a company that has seen revenues decrease 20% to 30% over the past year. The return of revenues, though, is likely not enough to sustain companies that are saddled with too much debt. Distress investors were counting on these situations to provide the dramatic inflow of opportunities that have yet to materialize.

Justin Hillenbrand, a partner with **Monomoy Capital Partners**, notes that many companies that he sees simply extending their loans are not addressing the fundamental operating issues. "It's going to be a challenge for some of these companies to improve their businesses enough to afford their capital structure even when the economy does recover," he said.

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Margaret Patel

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