

High Yield

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Banks Shift To Restructuring And Recovery

It may be safe to say that troubled banks view the enactment of the government bailout as Winston Churchill viewed the British victory over Rommel in the battle of El Alamein. "Now this is not the end. It is not even the beginning of the end," said Churchill. "But it is, perhaps, the end of the beginning."

As such, banks are presently working to regroup and rework their businesses to focus on those areas that can

bring in cash and add further liquidity to the market. "The real issue facing banks is establishing or resurrecting their workout groups," said **Anders Maxwell**, managing director with **P.J. Solomon Co.** "It's time to organize 'SWAT teams' to manage workouts. Having made lots of bad loans, it's time to try collecting. Given the shoddy underwriting

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Investors Turn To Pension Funds To Ease Liquidity Woes

An increasing number of loan investors have been seeking capital from pension funds to ease their liquidity squeeze. But while some pension funds have made the leap into the loan market, others have had cold feet as the credit crisis continues to worsen.

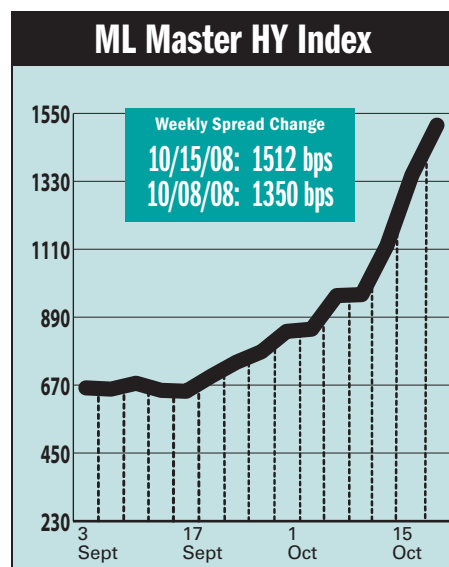
In order to sign pension funds on as new clients, investors have had to change their sales pitch to address the long-term needs of retirees, sources say.

The hardest thing, some investors say, is convincing pen-

sion funds that there is value in the loan market. Funds worry that if they buy a loan on the primary or the secondary, loan prices will fall further and the value of their portfolio will depreciate. To combat this fear, investors have to show that there are decent credits at bargain prices, and that those credits will rebound.

The pension funds that have come around to this asset

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Source: Merrill Lynch

THE SECONDARY

HY Market At Volatile Economy's Mercy

The high yield market is watching the economy and waiting for some stability. The U.S. government's bailout and equity stake plan for U.S. banks holds promise, but few want to invest until the fear of false bottoms dissipates.

"We're waiting to see all these new policies start to take effect," said **Stephen Carter**, a senior analyst with **Thomson Reuters**. "Hopefully there will start to be a slow thawing of the markets." The week began with a strong

rise in stocks, brought on by the government's plan to take an equity stake in banks, but economic indicators later in the week erased any hope of impending stability.

The Commerce Department reported that retail sales declined 1.2% in September. The New York Federal Reserve Bank's Empire State Manufacturing Index fell to -24.6 for October, a drop

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in many financings, there are going to be a lot of losses taken as the chickens come home to roost.”

Such workout groups have already been established at many major banks, according to several sources. In some cases, staff are being pooled from different groups within the bank to address certain classes of assets. It has become the chief focus for many banks' most talented staffers. “They're putting the brightest guys on this,” said **Armand Pastine**, head of **Maxim's** fixed income group and structured credit trading desk. “This isn't like bank workout 101. Now you've got some serious number crunchers looking to extract value however they can, as if their lives depended on it.”

With the economy experiencing the double whammy of frozen credit and the collapse in consumer spending, banks have to brace themselves for an onslaught of defaults, sources say. “The coming wave of corporate defaults will be beyond anything we've seen... The credit tsunami ahead is the corporate market,” Maxwell said. “The problems in subprime will be overshadowed in the next couple of years by corporate defaults.” He added that while, over the last several years, the credit markets were structured to put off defaults almost indefinitely, the amounts of leverage companies have added through covenant-lite loans and other loose lending practices will make it impossible not to default after a time.

Standard & Poor's expects the rate

of default in the U.S. speculative-grade segment to reach 7.6% by September 2009, the highest in nearly six years, according to an Oct. 15 report. Based on their estimates of a worst-case scenario, the three-year cumulative default rate among speculative-grade nonfinancial companies will rise to 23.2% between 2008 and 2010, S&P said last month (*HYR*, Sept. 29, 2008). This would be the worst on record since 1981.

“Most of the larger lending operations in the market will ramp up their internal restructuring practices—a lot of lenders have gone a number of years without dedicated workout groups because they didn't have a lot of things to work out,” said **Jeffrey Werbalowsky**, senior managing director with **Houlihan Lokey**.

Not Just For Behemoths

Meanwhile, smaller investment banks that don't have the burden of troubled balance sheets are jumping into the game as well, and beefing up their own restructuring businesses. Werbalowsky said that Houlihan Lokey has formed a special commercial real estate restructuring group to address the growing need for restructuring in the market. “Our challenge and our plan... is to reposition people internally into restructuring and restructuring-related projects as best we can so we can continue to avoid morale-sapping layoffs that have been and will

be effectuated by other banks,” he said. “We see a huge wave coming of commercial real estate restructuring.”

But the government's bailout plan could effectively throw a monkey wrench into banks' reworking and restructuring groups. “The problem is, now with the TARP era in place, that it's going to be very hard to decipher what guys are going to be doing with their troubled assets in light of what the government is going to do for them,” said Pastine, referring to the federal government's Troubled Asset Relief Program. He said that it would have been possible to unwind troubled assets without the government's help. “There's been an enormous amount of liquidity in the market, just not at prices people like,” he said. “This TARP throws a wrinkle into the whole thing. He said that banks will now structure and market their assets to the federal government, with a great danger of overvaluing bad assets at taxpayers' expense.

And market observers warn that unless banks lead the way in valuing assets, the government bailout plan could end up being an otiose exercise. “Our call is that banks must do even better,” said **Axel Merk**, manager of the **Merk Hard Currency Fund**. “If no leadership takes place on this front, the new Congress may spend trillions and create massive inflation in its effort to grow out of the problem. The market must be allowed to adjust; financial institutions must be strong enough to stomach the adjustment.” —MS

“They could easily convert,” said **Marc Franson**, a partner in the banking department of **Chapman & Cutler** in Chicago. “They are the next logical step. ... They're the other arm of financial services.”

Observers said that since the Gramm-Leach-Bliley Act of 1999 eliminated barriers between banking, insurance, and securities firms, conversion to a bank holding company would be relatively straightforward for

an insurance company.

Another much talked about, though more complicated, sector for potential converts is the auto industry. Automakers have been smarting for years under the weight of expensive pension plans, pricier supplies, and foreign competition. The credit crunch has dried up liquidity for car loans, further denting demand for some products.

Some observers said the automakers could argue that the credit crunch

is justification for a status change.

“If you look at what's going on with **GM**, **Ford**, and **Chrysler**, they would argue that the problem is credit with buyers,” said **Steve Dunlevie**, a partner at **Womble Carlyle Sandridge & Rice** in Atlanta. “The real impetus is to gain access, immediate access, to the traditional discount window, whereby they could borrow and use the same collateral as banks.” —Steven Sloan, *American Banker*