BANKRUPTCY LAW360

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Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | customerservice@portfoliomedia.com

Hedge Fund Addiction Could Prove Deadly: Report

Thursday, June 22, 2006 --- Credit markets have seen hedge funds increasing their presence in recent years, reflecting an institutional shift that doesn't show any signs of slowing as companies bid to avoid bankruptcy through quick cash infusions. But that trend may be headed for a showdown if interest rates rise, according to a report released this week.

The Turnaround Management Association's 2006 Trend Watch Poll on credit availability, which surveyed turnaround practitioners, lenders, attorneys, investors, and others in the turnaround profession, found that hedge funds have been playing a rising role in the restructuring landscape.

But the report also found that struggling companies betting their turnaround on hedge funds may be in for a rude awakening if the economy does an about-face.

The poll showed that 73% of respondents believe the expansion of nontraditional lending such as hedge funds has caused fundamental changes in the economic landscape.

In addition, nearly half of those surveyed said hedge funds—which are often willing to take on extra risks—are a significant factor in restructuring companies in late decline, although they do not play as prominent a role for companies in mid-term and early decline.

But according to the report, while an infusion of fast cash may currently be helping underperforming companies stay afloat, their ability to obtain credit could change dramatically as interest rates rise.

Nearly all of those surveyed in the report set the tipping point for some tightening of credit when the prime interest rate hits 9.5%, and at 10% and above, 65% thought a substantial credit tightening would occur.

That rapid escalation in defaults could happen as early as the end of 2007, portending a rude awakening that becomes more likely as the economy slows and interest rates rise, according to the report.

Hedge funds have changed the landscape of financing for companies that classically would have faced bankruptcy or liquidation, says Patrick Lagrange, member of the TMA Executive Committee and managing director of Carl Marks Advisory Group LLC.

“There are so many hedge funds with so much money looking for a home right now that companies that formerly would have endured the classic

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workout process are now able to delay the inevitable," Lagrange explains. "On top of current market liquidity, you've got a number of hedge funds with capital waiting on the sidelines for the opportunity to buy distressed debt at the 'right' price. This potential liquidity has dramatically changed the scene."

However, it remains to be seen whether this represents a seminal, lasting shift in the traditional workout world, says Lagrange.

"Going forward, there's a lot of uncertainty about what will happen in the next business down turn," he says. "Some hedge funds have hired trained lenders, giving them some infrastructure in terms of managing credits and a longer term focus regarding distressed investment."

But he says many hedge funds maintain their roots in the trading world and look to benefit primarily from selling positions at higher prices than they paid.

"We're still facing something of a dislocation of the dynamics of the classic market, particularly in the case of widely syndicated credit," he says. "It really is a brave new world for all of us in the turnaround business."

Lagrange adds that the credit markets are generally efficient in evaluating and pricing risk but market liquidity itself can be unpredictable, so forecasting the future of the lending market is difficult.

"Market liquidity really introduces something of a wild card," he says.

Indeed, although corporate bankruptcies plunged last year to the lowest level since 1997, a liquidity crunch could cause a sharp rise in bankruptcies in the future.

An important factor distinguishing 2005 from past years in which bankruptcies declined is the extreme liquidity of the capital markets, according to a survey released in February by bankruptcydata.com.

Last year, it was easier than ever before for companies to secure debt, thanks to the emergence of hedge funds as major players.

Some experts predict that turnaround activity will pick up within the next year as credit tightens due to a combination of high debt multiples and an expected increase in interest rates.

"We don't need to see the economy take a downturn for restructuring activity to increase, because many companies are already over-leveraged," says Colin Cross, TMA President and managing director for Crystal Capital in Chicago. "Even from three to six months ago, there has been a surge in restructuring and refinance activity. Companies have defaulted, but still have enough value to work out a refinancing with new lenders, including hedge fund lenders."

According to Cross, hedge funds are increasing their number of capital

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structures.

“Some hedge funds still act as investors who really just buy and sell paper, but many more are becoming interested in much more active involvement,” says Cross. “There is a trend in which hedge funds are starting to work more closely with turnaround consultants right after companies default.”

According to this week’s report, credit availability may already be leveling, with 43% of respondents saying more credit was available now than a year ago, down from 58% in the 2005 poll.

However, companies with relatively easy access to capital sources may be caught off guard if credit availability continues to decline, according to J. Scott Victor, managing director of SSG Capital Advisors LP and president of the Philadelphia TMA Chapter.

"The current drop in Chapter 11 filings can be primarily attributed to the unprecedented liquidity in the marketplace," said Victor in a statement. "When the cash dries up, these companies will be in such severe distress, they will have no choice but to prepare for a sale or a liquidation. A turnaround will no longer be an option."

Even though hedge funds may temporarily provide a quick fix for struggling companies, the long-term benefits may be less than desirable, agrees Ken Yager, consulting manager at Morris Anderson & Associates Ltd.

“There have always been investors tapping into underperforming companies, but hedge funds are a new breed of animal,” says Yager. “Some are lending money on a yield basis, looking for a way to get a 12% interest rate. Others rely on a loan-to-own strategy, giving companies money when they assume there is a high probability of default, a risk most hedge funds are set up to take. A third group makes equity investments in companies that have hit bottom, competing with equity firms.”

Yager says while the hedge fund trend has been building for at least a few years, pouring money into struggling companies doesn’t provide much of a solution.

“The trouble with hedge funds loading companies with cash is that it only papers over the real problem,” he says. “Hedge funds have created an addiction to capital, and there is a lot of money floating around. But underperforming companies still have to deal with the problems that got them into trouble in the first place, and those problems will ultimately have to be fixed.”

--By Erin Marie Daly, erin.daly@portfoliomedia.com

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