Courting Distress

A systematic approach to distressed investing

European Credit Strategy

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Recent policy initiatives to recapitalise and clear-out the banking sector of legacy assets have sparked optimism that the global economy is moving closer towards stability, despite the large contraction in global GDP in 1Q09. Stock markets have rallied on the hope that banks will return to profitability and that monetary and fiscal stimulus provide a respective boost to credit creation and final demand.

One set of risky assets that have lagged during the current equity rally is low cash price high yield bonds. Of the 45 bonds we track that were priced at or below 40% of par at the recent low on stocks, the average gain is 2.4 points. Part of this may be down to the wide bid-offers and limited trading volumes on distressed bonds, which makes them less than ideal for trading sentiment or market directionality. It may also be because high yield investors are sceptical that (i) an economic recovery is on the cards, or (ii) that it will provide any assistance to the most leveraged credits, which tend to be valued as an expected coupon stream.

At present we hold 19.5% of our model portfolio (by notional) in bonds trading below 40% of par, compared with around a third of our index. We still believe that default rates are at least a year from peaking, making it premature to reallocate a substantial part of a high yield portfolio into distressed assets. However, the redistribution process has to start somewhere, and we intend to reduce the Underweight in distressed bonds over the course of 2Q09.

On the next page we have put some thoughts together on how to identify the potential winners and losers among the distressed bond community. We list the main attributes in order of their importance to us, and use these metrics along with our analysts' input to provide a systematic approach to tackling the distressed sector. The top and bottom 10 bonds are shown in Table 1.

Table 1: Top and Bottom Ranked Distressed Bonds

Scores run from strongest to weakest in ascending order

Top 10	Score	Price	Bottom 10	Score	Price
VNU 0%/11.125%	13.3	42.00[1]	GM 7.25%	30.0	14.50
EDCON E+5.5%	14.5	23.50	RESCAP E+3.45%	28.5	20.00[2]
EUROCA 8.125%	15.0	24.00	TREOFN 11%	27.0	18.50
HTZ 7.875%	16.0	35.50	MOMENT 9%	27.0	24.00
BCMAU E+5%	16.3	35.00	MESSA 7.25%	25.8	34.00
ECOBAT PIK	18.0	26.50	ONOFII 8%	25.5	18.00
CARWAG E+5.75%	18.3	15.50	INEGRP 7.875%	25.3	8.00
AVELN E+2.625%	18.5	35.00	ESCADA 7.5%	24.5	25.50
COGNIS PIK	18.5	30.00	SAFILO 9.625%	23.3	30.50
ARGID PIK	18.8	33.50	HELLAS E+6%	22.8	18.00

Source: J.P. Morgan. Mid-market opening prices on 6 April 2009. 1. Percentage of accreted. 2. Estimate

See page 4 for analyst certification and important disclosures.

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Key metrics to look for

1. Companies with sufficient liquidity to survive at least 18-24 months
There's no point thinking about recovery trades now without having the view that economic conditions will have begun to normalise by the end of 2010. In developed economies that may mean growth that is positive but sluggish, with the pay-back of earlier stimulus creating a fiscal drag on demand.

Such an environment would make it difficult for over-indebted corporates to de-lever, but would provide a more favourable backdrop for restructuring, helping issuers to either avoid default outright or aid recovery rates for creditors. Today's depressed equity valuations and a lack of capital to invest in struggling businesses, means that secured and unsecured creditors are being forced to accept low recoveries if companies need a cash infusion to survive.

That makes issuers with enough cash to survive a severe downturn for at least 1.5-2 years a potentially attractive prospect, from both the perspective of the future value of the debt being higher, and also the coupon income earned in the intervening period. We have also seen some companies use excess cash to repurchase debt at a discount to par, which could help boost pricing for investors and reduce the corporate interest burden. We estimate that €940mm has been spent by issuers repurchasing discounted debt since January 2008.

2. Firms with strong brand, business models or market positioning
Ask most distressed debt investors what they look for in a potential investment, and they invariably reply: "good companies with bad capital structures". These credits are more likely to attract bids from trade competitors or financial sponsors.

3. Bonds with high asset coverage
Recovery value has a large impact on whether distressed bonds look attractive: we target bonds where the value of the underlying business or assets exceeds the current price-adjusted leverage of the bond. A judgment call on how to value the business needs to be made; cash-constrained companies we consider more on a liquidation based valuation.

4. Firms with the greatest financial or operational flexibility
Companies can take action to negate the risk of default in two ways: improving the financial profile of the business, and tackling the operational side. The first could involve asset sales and the ability to secure additional funding either secured against unencumbered assets, or by selling equity or equity-linked debt. Operational flexibility includes the ability to efficiently manage costs and working capital during the downturn.

5. Companies with ample covenant headroom, or no maintenance covenants at all
Aside from a liquidity event, the other main trigger for default is a breach of financial covenants, typically under a bank facility since bonds tend to mainly include incurrence based financial covenants. Although loan syndicates may agree to some form of covenant waiver or amendment – a common feature of the European bank loan market – they may impose conditions that further harm bondholders, such as taking money out of the company in fees or a higher margin on the loan.

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Companies that may benefit from policy action

Another category to consider is the impact of policy action being taken by central banks and governments around the world. The most immediate beneficiaries of efforts to restart credit markets may be those that used to rely upon consumer credit securitisations, such as Car Rental and Auto Finance companies. Fiscal stimulus is likely to impact consumer facing sectors more immediately than manufacturing or capital goods related sectors, given the speed at which tax cuts can be implemented compared to infrastructure projects which tend to have a longer lead time.

Distressed Bond Scorecard

In Table 2 we present our scorecard for rating the various distressed bonds tracked by our analysts, along the lines of the attributes discussed above. Each attribute is assigned a score between 1 (strong) and 3 (weak), and the scores are combined by weighting the various attributes to reflect our view of their relative importance.

The scorecard is designed as a starting point for screening potential distressed investments, and we will use it when we rebalance our model portfolio later this month. Although we already own a number of low cash price bonds in our portfolio, many of those positions are Underweights versus the benchmark, leaving us plenty of room to add exposure. The bonds we own are: Edcon (senior not subs), Europcar, BCM, CWT, Cognis PIK, CMA CG, World Directories, PEPR, Codere, Safilo, Ineos, and Momentive (see *European Credit Outlook & Strategy*, 19 March 2009).

Table 2: Distressed Bond Scorecard

Each attribute scored out of 3: 1 = Strong, 3 = Weak. Ordered from strongest to weakest by Total Score

Analyst	Instrument	Liquidity	Business Model	Asset Coverage	Fin/Op Flexibility	Covenant Headroom	Total Score	Bond Price
	Weighting	3	2.5	2	1.5	1		
Andrew Webb	VNU 0%/11.125%	1.5	1	1.5	1.5	1	13.3	42.00[1]
Katie Ruci	EDCON E+5.5%	1	1	2	2	2	14.5	23.50
Stephanie Renegar	EUROCA 8.125%	1	1	3	1	2	15.0	24.00
Stephanie Renegar	HTZ 7.875%	2	1.5	1.5	1.5	1	16.0	35.50
David Caldana	BCMAU E+5%	1.5	1.5	1.5	2	2	16.3	35.00
Nachu Nachiappan	ECOBAT PIK	1.5	2	2	2	1.5	18.0	26.50
Nachu Nachiappan	CARWAG E+5.75%	1	2	2	2.5	2.5	18.3	15.50
Stephanie Renegar	AVELN E+2.625%	2	2	2	1	2	18.5	35.00
Nachu Nachiappan	COGNIS PIK	1.5	2	2	2	2	18.5	30.00
Nachu Nachiappan	ARGID PIK	2	1.5	2	2	2	18.8	33.50
Nachu Nachiappan	CMACG 5.5%	2	1.5	2	2	2	18.8	40.00
Nachu Nachiappan	IMPMET PIK	2	1.5	2.5	2	2	19.8	27.00
Katie Ruci	FAGEGA 7.5%	2	2	2	2	2	20.0	42.50
Nitin Dias	LECTA E+4%	1	3	3	2	1	20.5	26.00
Stephanie Renegar	TRW 6.375%	2	2	2	2	3	21.0	31.00
Andrew Webb	WDAC 8.5%	1.5	2	3	3	1	21.0	21.00
Olek Keenan	PEPR 5.875%	3	1	1	3	3	21.0	30.00
Andrew Webb	SEAT 8%	2	2	2.5	2.5	2	21.8	39.50
Nachu Nachiappan	GROHE 8.625%	2	2.5	2.5	2.5	1	22.0	40.00
Nachu Nachiappan	CODERE 8.25%	2	2.5	2.5	2	2.5	22.8	40.00
David Caldana	HELLAS E+6%	3	2	2	2.5	1	22.8	18.00
Katie Ruci	SAFILO 9.625%	3	2	2	1.5	3	23.3	30.50
Katie Ruci	ESCADA 7.5%	3	3	1.5	2	2	24.5	25.50
Nachu Nachiappan	INEGRP 7.875%	2.5	2	3	2.5	3	25.3	8.00
David Caldana	ONOFII 8%	3	2	2.5	3	2	25.5	18.00
Nitin Dias	MESSA 7.25%	3	3	2	2.5	1.5	25.8	34.00
Nachu Nachiappan	MOMENT 9%	3	2.5	2.5	2.5	3	27.0	24.00
Nachu Nachiappan	TREOFN 11%	3	2.5	2.5	2.5	3	27.0	18.50
Stephanie Renegar	RESCAP E+3.45%	3	3	3	2	3	28.5	20.00[2]
Stephanie Renegar	GM 7.25%	3	3	3	3	3	30.0	14.50

Source: J.P. Morgan. Mid-market opening prices on 6 April 2009. 1. Percentage of accreted. 2. Estimate

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