

Argyle Conversations

by ARGYLE EXECUTIVE FORUMSM

featuring

Bruce Richards

Co-Managing Partner and
Chief Executive Officer
Marathon Asset Management

&

Louis Hanover

Co-Managing Partner and
Chief Investment Officer
Marathon Asset Management

&

Perry Mandarino

Partner
PricewaterhouseCoopers

On September 29, 2010, Bruce Richards and Louis Hanover, Marathon Asset Management's CEO and CIO, respectively, spoke with Perry Mandarino, a partner at PricewaterhouseCoopers, about bankruptcy and restructuring.

Bruce Richards Bruce Richards is a co-managing partner and the chief executive officer of Marathon Asset Management, and is responsible for general oversight of the firm's capital across its funds and managed accounts. Mr. Richards leads Marathon's executive committee, which manages the firm's operational initiatives and its strategic direction, and he is also a member of Marathon's investment committee.

Mr. Richards' day-to-day presence is critical in maximizing the firm's synergies and leveraging the intellectual capital throughout the firm. Prior to founding Marathon, Mr. Richards worked on Wall Street for 15 years, including 10 years as a managing director in the fixed income divisions of Smith Barney and Donaldson, Lufkin & Jenrette, where he was head of a trading desk responsible for principal investments and market making. Mr. Richards also worked at Shearson Lehman Hutton ("Lehman Brothers") as a trader in its fixed income division, after starting his career with Paine Webber. Mr. Richards received his BA in economics, summa cum laude, from Tulane University in 1982 and is a member of Phi Beta Kappa.

Louis Hanover Louis Hanover is a co-managing partner and the chief investment officer of Marathon Asset Management. Mr. Hanover oversees Marathon's portfolio managers and their investment activities. Mr. Hanover's responsibilities also include managing risk on a firm-wide basis, as well as serving as senior portfolio manager for the firm's corporate credit investments, including funds and managed accounts. Additionally, Mr. Hanover serves on Marathon's investment committee and executive committee.

Mr. Hanover has extensive trading experience and expertise as an asset manager, arbitrageur and risk manager in both the equity and fixed income markets on a global basis. Prior to co-founding Marathon in 1998, Mr. Hanover was a managing director at Smith Barney, where he was responsible for all trading and risk management in the global emerging markets debt trading division. Earlier, Mr. Hanover was a director of the global emerging markets debt and foreign exchange derivatives trading division at Merrill Lynch. In 1991, he pioneered the use of warrants on a basket of Latin American equities at Nomura Securities. Mr. Hanover previously traded European sovereign debt futures at First Chicago Capital Markets and was a floor trader at the Chicago Board of Trade. Mr. Hanover received a BA degree in economic history from the University of Chicago and an MBA from the Graduate School of Business at the University of Chicago.

Perry Mandarino Perry Mandarino has provided assistance to clients in the areas of strategic planning, complex debt restructurings, preparation of turnaround and business plans, cash flow analyses, preference investigations, fraud and fraudulent conveyance investigations, collateral evaluation and claims resolution. He has assisted numerous clients in the negotiation, development and implementation of Plans of Reorganization. He has a broad range of restructuring and bankruptcy industry experience, including retail, distribution, communications, business services, manufacturing, healthcare, construction and real estate companies.

Mr. Mandarino served as the chief restructuring officer (CRO) of Hoop Holdings, Inc. d/b/a/The Disney Stores. He also served as the examiner in the Polaroid, Inc. and Summit Global Logistics chapter 11 cases and as the CRO of Kara Homes, Inc. and the MIIX Group, Inc. Mr. Mandarino has represented several lending institutions including D.E. Shaw, BNP Paribas, Wachovia Bank and Lampe, Conway & Co. He has extensive experience in the bankruptcy courts in the districts of Delaware, New Jersey and New York, where he has testified and been qualified as an expert in matters related to financial viability, valuation, general reorganization matters and financing. Mr. Mandarino has assisted clients in raising over \$700 million in debt and equity financings. Mr. Mandarino has represented over 300 clients during his career.

Prior to joining PwC, Mr. Mandarino was a senior managing director of Traxi, LLC. Before Traxi, Mr. Mandarino spent 14 years at Arthur Andersen LLP, where he was a partner in the firm's global corporate finance, corporate restructuring group. Mr. Mandarino also was managing director, restructuring in the investment banking firm of Berenson Minella & Co.

Mr. Mandarino received a bachelor of science from Seton Hall University. He is a Certified Public Accountant, and a member of the American Institute of Certified Public Accountants, the New Jersey Society of Certified Public Accountants, the New York Society of Certified Public Accountants, and the American Bankruptcy Institute. Mr. Mandarino has lectured to various groups on bankruptcy issues and the reorganization process.

PERRY MANDARINO: In the past few years we've witnessed bankruptcies of companies like General Motors and Chrysler, institutions that no one could have envisioned would ever go through a filing; banks are still reeling from the liquidity crisis of 2008 and 2009. What's the effect of all this on the market today?

LOUIS HANOVER: There are two paths in answering that question: One is tight credit conditions and what that means for companies that are currently being restructured, and then the second path would be those that need to deal with their debt maturities going forward. There's plenty of capital for companies that are in need of exit financing after they diligently work through their restructuring. There's plenty of capital for the debt structure of viable companies that are efficiently priced in the market. So if a company went through a bankruptcy and took all the necessary steps afforded a company in bankruptcy such as cutting leases that were not necessary and restructuring the company to focus it in the right direction—then there's plenty of capital for them to do their DIP financing and their exit financing.

BRUCE RICHARDS: The markets are open; the markets are liquid. We just crossed a \$200 billion mark for high-yield issuance this year—that's a record and there are still 4 months to go; last year set the previous record of \$170 billion. So when you look at the bank debt and bond market in the high-yield sector in the U.S. and Europe, it's a \$3.7 trillion universe. What we're seeing is a remarkably vibrant market, where companies are able to extend and amend and push their maturities down the road. We believe there will be continued restructuring opportunities for many years to come as high yield issuers continue to delever their balance sheets.

When management teams and boards have the opportunity to fix the problem or extend the liquidity constraints, what are some of the most common mistakes?

RICHARDS: Common mistakes with respect to restructuring a company are multifaceted. Number one is underestimating the complexity of the restructuring process itself. There is deep knowledge required in assessing the bankruptcy, determining the plan of reorganization, and evaluating how that may affect the company's operations. There are also complexities regarding the parties involved, from secured to unsecured creditors to employees to stakeholders to former stakeholders. Our job is to assess these dynamics and moving variables to ultimately derive what will be the fulcrum security. Identifying the security that has the greatest upside relative to risk is how we butter our bread. We spend substantial time upfront understanding the roadmap of company in terms of creditor arrangements, bond indentures, reorganization documents, and restructuring advisors. At the end of the day, it's about figuring out what the recovery value is vs. today's price and an expectation of how long it's going to take to get there.

“One of the most important things, once you figure out who is on the chessboard with you, is to make sure management is aligned so that when you do exit, you know everyone's rowing in the same direction”

HANOVER: There are some other pitfalls. There are companies that span multiple jurisdictions or countries. That can create mistakes. One of the most important things, once you figure out who is

on the chessboard with you—creditors, labor management, etc.—is to make sure management is aligned so that when you do exit, you know everyone’s rowing in the same direction.

Has the process of evaluation, of determining what the enterprise is, gotten so complex and difficult that it’s slowing down deals?

HANOVER: I don’t believe it’s any more complex than it has been in the past. You have a bad apple, and the core of that is something that you can grow the company from. Sometimes the apple has one bruise and sometimes the whole apple is bruised. With financial alchemy and too much chemistry, there might be too many things to deal with—different layers of debt, different subsidiaries that are encumbered, that are not encumbered, etc. But in the end, you’re peeling it back to that core to determine the value. It might take more work to get there now, but I don’t think it’s any harder to assess.

Are there certain industries that you stay away from because they are too tough to value?

“We think the government actually did a pretty reasonable job in how they went about dealing with the crisis”

RICHARDS: Marathon has a very deep team that covers all industry groups, with industry analysts, restructuring experts, bankruptcy lawyers, and bank debt analysts. At any point in time there are industries that are out of fa-

vor. Back in 2002, there were three industries that were predominantly hit: independent power producers, telecom and cable, and the travel industry, particularly the airlines. We were involved in the all those sectors back then and today. I can’t think of a sector that we don’t have an analyst assigned to. It’s a function of the opportunity set as opposed to thinking, “This is an industry we can’t address.” Restructuring is about opportunity, being nimble and flexible, and having the experience and knowledge to evaluate complex restructurings.

What do you think about government involvement in restructurings?

RICHARDS: We think the government actually did a pretty reasonable job in how they went about dealing with the crisis. It was heavy handed, but the situation called for a very heavy-handed approach. The banking system was on the verge of collapse and there were certain industries that were on the verge of collapse. Companies couldn’t rollover commercial paper, for instance; banks couldn’t issue short-term debt. So the government developed programs to guarantee debt out to three years, to backstop commercial debt, and to slow down the run on money-market funds. Under TARP, banks were required to take capital, so strong banks such as JP Morgan—who had argued that they didn’t need capital—were required to take \$25 billion. So although heavy handed in the process, the government did a valiant job in addressing what was a very critical time for this country.

HANOVER: As far as throwing out the safety net, having that net under the trapeze artist—the artist being the financial system—they did a great job. When it comes to the auto industry and the restructurings around that, it was difficult having government involved. People weren’t sure if rules were going to change as they were going through the process. The government isn’t economically

motivated; they're politically motivated. So you do have to wonder, will Chrysler and GM use the benefits of going through a bankruptcy and restructuring properly so they come out strong on the back end? We'll have to wait and see.

People have used the term “economic Darwinism,” or survival of the fittest, to suggest that we have reached a point where certain companies just can't survive. Do you like bankruptcy or is staying out of court preferable?

HANOVER: If you can avoid a bankruptcy and restructure out of court or in a pre-pack, where you're quickly in and out of court, you save a lot of time and money. There's less uncertainty with suppliers and other vendors, so net/net, it can be better for a company to do a fully out-of-court restructuring, where you equalize the bottom part of your bloated capital structure. With respect to a pre-pack, it uses the bankruptcy rules in a highly efficient manner to get a Company in and out, so that's fine. But sometimes you need a full term bankruptcy to properly restructure the company. In the airline industry, there were a lot of excesses that had built up over the years, so a full bankruptcy was necessary to fix the companies, to peel them back to where they needed to be.

What's your outlook on investment opportunities in emerging-market debt? What are some best practices for investing there?

“Emerging markets are in a lot better shape than developed markets”

HANOVER: In a lot of places, the emerging markets are in a lot better shape than developed markets. They're commodity driven markets, so their economies have been able to ride the updraft of commodity prices rallying. And their banking system for the most part didn't have the excesses that the developed markets did. You can't just walk into a bank in Brazil and borrow as easily as you could in the U.S. The banks primarily hold government securities, so the banking system's healthier. These countries have been doing the right things—they've gotten a little bit of commodity prices being strong, their economies are vibrant, the populations are younger and growing faster than in the U.S. 75%, 80% of the market is now investment grade.

RICHARDS: When one talks about the emerging markets, you start by talking about the BRICs. Look at Brazil, Russia, India and China and identify their sovereign spreads. Then compare this to the spread for European countries such as Portugal, Ireland and Greece. The Western economies—the recent contraction of growth, expanding deficits, the increase in leverage, and the trade deficits—look much different than the fastest growing countries in the world. With the fast-growing countries, they are strong currencies, with a strong fiscal position and little-to-no net debt when you calculate reserves minus debt outstanding. When you add in the trade surpluses, natural resources, and the cheap labor, it's no wonder the debt levels of the BRICs are trading tighter than certain developed countries.

You can't paint all the emerging markets with the same brush because there are emerging-market countries that don't have this dynamic, ones with weak economies, weak leadership and weak fiscal positions. But certainly it is Marathon's objective to identify the winners from the losers, with

respect to corporate credit and sovereign credit, and to capitalize on what we believe are the more interesting opportunities around the globe. Marathon has offices in London and Singapore. As a firm focused on credit, we focus on three main segments of the marketplace: The high-yield and distressed marketplace; the structured credit marketplace; and the sovereign and emerging marketplace.

Do you view sovereign debt as riskier than emerging-market debt?

HANOVER: In days of old, you had two camps: developed markets and emerging markets. There was some hierarchy of who was stronger and weaker in emerging markets, and you didn't really think about that much in developed markets. There was just a difference between Greece and Ireland and France and Italy. Well now, a lot of the emerging-market countries have done the right things in the last 10 years—they've run trade surpluses; foreign direct investment has been consistently positive; and the banking system hasn't had the excesses. Whereas in the developed markets, you've had trade deficits, foreign direct investment going the other way, and too much debt. If I compare Greece and Peru, I'll take Peru. There are more shades of gray, more layers of who's strong and who's not in the developed markets.

What can the U.S. learn from what's gone on overseas, particularly in regard to the deleveraging process?

RICHARDS: The deleveraging process is one that we've spent a lot of time studying. It impacts consumers who are going through a very large deleveraging process, investors who have already

“Consumers have a new religion now—they're saving”

gone through the deleveraging process, as well as companies with many that have gone through a deleveraging process and others that are just beginning to delever. The U.S. government on the other hand has been leveraging up its balance sheet to offset the deleveraging going on in the private sector. When you focus on the companies, you can break it out into the haves and have-nots. For example, we can talk about investment-grade companies and non-investment-grade companies, or the high-yield companies. Investment-grade companies are sitting on nearly \$3 trillion in cash, which represents about 7% of their balance sheet. This is the greatest amount of cash as a percentage of balance sheet that they've ever had. So U.S. companies that are investment-grade are significantly deleveraged. When you look at the highly leveraged companies with non-investment grade credit ratings, they have gone through an enormous leveraging process. If you looked at the high-yield cohorts back in 2002, at the peak they had \$1.9 trillion in debt, bank debt and high yield bonds. Coming into the 2008 crisis, their debt loads had expanded to \$3.7 trillion. So the amount of debt outstanding on high-yield companies' balance sheets was the greatest ever in absolute size, and is still too elevated when evaluating on a debt-to-cash flow or debt-to-EBITDA basis. These companies are going through an enormous deleveraging process that will last for some time.

The deleveraging process that we saw in the '91, '92 recession, and after the 2002 recession, lasted around four-to-five years. Since the recession ended 18 months ago, if this deleveraging process

was the same as the past deleveraging processes, we'd have two-to-three years more to go. But because the capital markets have been so extended, so open to new issuance, where bank debt has been extended to longer-term bonds, we think the timeframe is more like three-to-four years.

In terms of the consumer drag, it's tremendous. Consumer debt-to-GDP, looking back at the last many decades, has always been around 100%. That number in the mid-2000s, leading up to the 2008 crisis, extended to 130% consumer debt-to-GDP. Consumers have a new religion now—they're saving, and certain consumers are defaulting on debt, causing the debt loads to come down as they pay off or reduce debt. So consumer debt-to-GDP has now dropped to 118% from a peak of 130%. We believe consumers still have about two-to-three more years to deleverage. Saving and debt reduction, while it might be good for the consumer household, is not very positive for GDP growth rates.

This drag on the economy results in lower expected GDP growth. We believe with the new normal, we get an anemic 1-2% GDP growth rate. As consumers, companies, and the banking system deleverage, the U.S. government has its hands tied.

“As consumers, companies, and the banking system deleverage, the U.S. government has its hands tied”

On the monetary side, the Fed funds rate is already at zero. The Fed has very few tools to deploy. And in regard to fiscal policy, given the deficits we're now running, the U.S. government is not in a very strong position to put forth future stimulus packages. Undoubtedly, they have the ability to do so, but they're just not in good position to do so.

There was a recent editorial in The Wall Street Journal that said the Fed fund rate should be raised. Any thoughts on that topic?

RICHARDS: The Fed fund rate being at zero results in money-market rates being zero, which means that individuals are getting zero for our money—in essence, it's a tax on us as savers and investors. What that does is it forces the marginal saver to move out on the risk curve, which is why long-term yields have shifted down and credit spreads have huge support and continue to tighten. Fed funds were at 5.5% back in '06 and '07, and this rate was not inconsistent with GDP growth rates of 3%. Having said that, U.S. companies and U.S. consumers who own homes will marginally benefit from this lower rates environment. The Fed is very, very concerned with a double-dip recession. Ultimately, if a double-dip were to occur, the inflation rate could potentially turn negative or result in a deflationary cycle. So the Fed is very focused on inflating our way out, and the best hopes they have for inflating our way out is to leave rates low.

We believe we're going to be stuck in this very low rate environment for some time. With that, one of the greater risks is duration risk. Here's a very interesting fact: Going into the crisis, the amount of commercial paper outstanding was \$2.4 trillion. Today it's \$1.1 trillion. That reduction of \$1.3 trillion of commercial paper outstanding in this low rate environment has allowed these companies to extend and issue debt five years, seven years, 10 years and 30 years. Today, the duration of the corporate bond market in entirety is 6.6 years. It's the longest duration in the history of the bond market. If you look at data going all the way back to 1960, the duration of the bond market has never been this long.

In the marketplace, there are three types of risk: interest-rate risk, spread risk and default risk. Default risk has been coming down—the default rates have fallen from 12% to 4%. We think it will stabilize in the 2-4% range. Spread risk has been substantially reduced because the demand for high-yielding assets is strong at the present time. We think that will continue to be a very, very powerful force. The risk that has increased is the interest-rate risk. It's a very interesting dynamic that's begun to shift in the

“If you look at data going all the way back to 1960, the duration of the bond market has never been this long”

credit and fixed-income markets. Our risk management team spends an inordinate amount of time working with the chief investment officer and our portfolio management team to identify these risks and to hedge accordingly.

What do you think of the recent stress test put forth by European banking regulators?

HANOVER: I don't think any stress test is ever perfect. The European banks have a larger portion of government bonds on their balance sheets than is typical of a U.S. bank. So there's been some argument and some controversy over how those stress tests dealt with sovereign debt holdings in various parts of the bank. Absent that, I think the stress test did a good job of calming people's fears and shedding some light. Light was a good disinfectant on the situation. They're not out of the woods but they're partially out.

RICHARDS: I agree. It calmed nerves for many in the marketplace. At the end of the day, the stress tests were applied to the largest 91 banks in Europe and seven failed. That required a capital injection of just under \$5 billion—in the long run, we'll see how healthy these banks are. For now, credit spreads in Portugal, Ireland and Greece are pushing out wider. The stress in Ireland is due to the stress that they see first and foremost in the calculation of \$30 billion—potentially \$50 billion—to be injected into their banks by Ireland. The latest round of stress that we've seen in CDS is the result of a rather large capital commitment for Ireland to underwrite. The stress test was a useful exercise as it helped identify outlier institutions. But it was not very transparent. It could have drilled down deeper in terms of the actual risk in the portfolio that the banks have as a result of sovereign exposure. For us, it didn't adequately answer certain questions. It raises the bar for us to do deeper fundamental analysis on the individual European banks.

“The Volcker Rule will force banks to take less risk with their own portfolios due to the effective elimination of the big proprietary trading desks. As an investment manager, that's a positive thing”

How will Dodd-Frank affect us in the U.S.?

RICHARDS: This measure was a great outcome to a horrible series of events. With the systemic bank regulator that's going to be put in place, hopefully we won't have another Lehman freefall that is so disruptive to not only the markets but also the overall economy. Also, securitization laws are in the process of being rewritten. We know that the flaws in the underwriting and ratings were so pervasive that they resulted in tens of billions of dollars lost. As it relates to the Volcker Rule, we

believe that this will force banks to take less risk with their own portfolios due to the effective elimination of the big proprietary desks that they were running in the past. As an investment manager, that's a positive thing. The Volcker Rule itself puts in place a mechanism to transfer risks out of the banking system and more toward the marketplace. The investment banks will focus more on client flow as opposed to proprietary trading. So we're a big fan of the bill and think the banking system will be sounder as a result.

HANOVER: Any kind of regulation that leads to banks having more capital will provide for a safer system. It's not wonderful for bank stocks because their return on equity will be lower, but it will be fortified and be able to provide services that the economy needs.

Are there any potentially hot sectors for distressed investors in 2011?

HANOVER: Commercial real estate's going to be very, very fertile ground. We have approximately \$1 trillion-\$1.2 trillion of debt that's coming due in the next two-to-four years. It's taken some time for the banks to be in a strong enough position to sell their impaired loans, but we're seeing more and more blocks of loans being marketed in secondary sales between \$.15 and \$.75 on the dollar.

RICHARDS: Look at the structured credit market—it's \$4.1 trillion. It's bigger than the high-yield and leveraged loan market, which stands at \$3.7 trillion. We're seeing great value in the structured credit marketplace, being able to select a securitization that represents an attractive rate of return relative to risk. Marathon has purchased over \$2 billion of these securities already this calendar year, and we don't anticipate our pace slowing down in the next 12 months.

On the commercial real estate side, being able to buy first-mortgage notes from banks at deep discounts puts the buyer in the position to negotiate with the borrower, or take possession of the property—this represents a fairly large opportunity. Finally there is opportunity across industry because the amount of debt, especially in the high-yield market, is high relative to companies' cash flow and EBITDA. There are dozens and dozens of companies with very large capital structures, \$5 billion and up, which have debt-to-EBITDA ratios that are simply unsustainable. Identifying these companies and identifying what the outcome is going to be in terms of potential restructuring, represents an opportunity for us. There is about \$300 billion worth of debt of companies that have gone through bankruptcy or been recently restructured. Stay tuned. ■