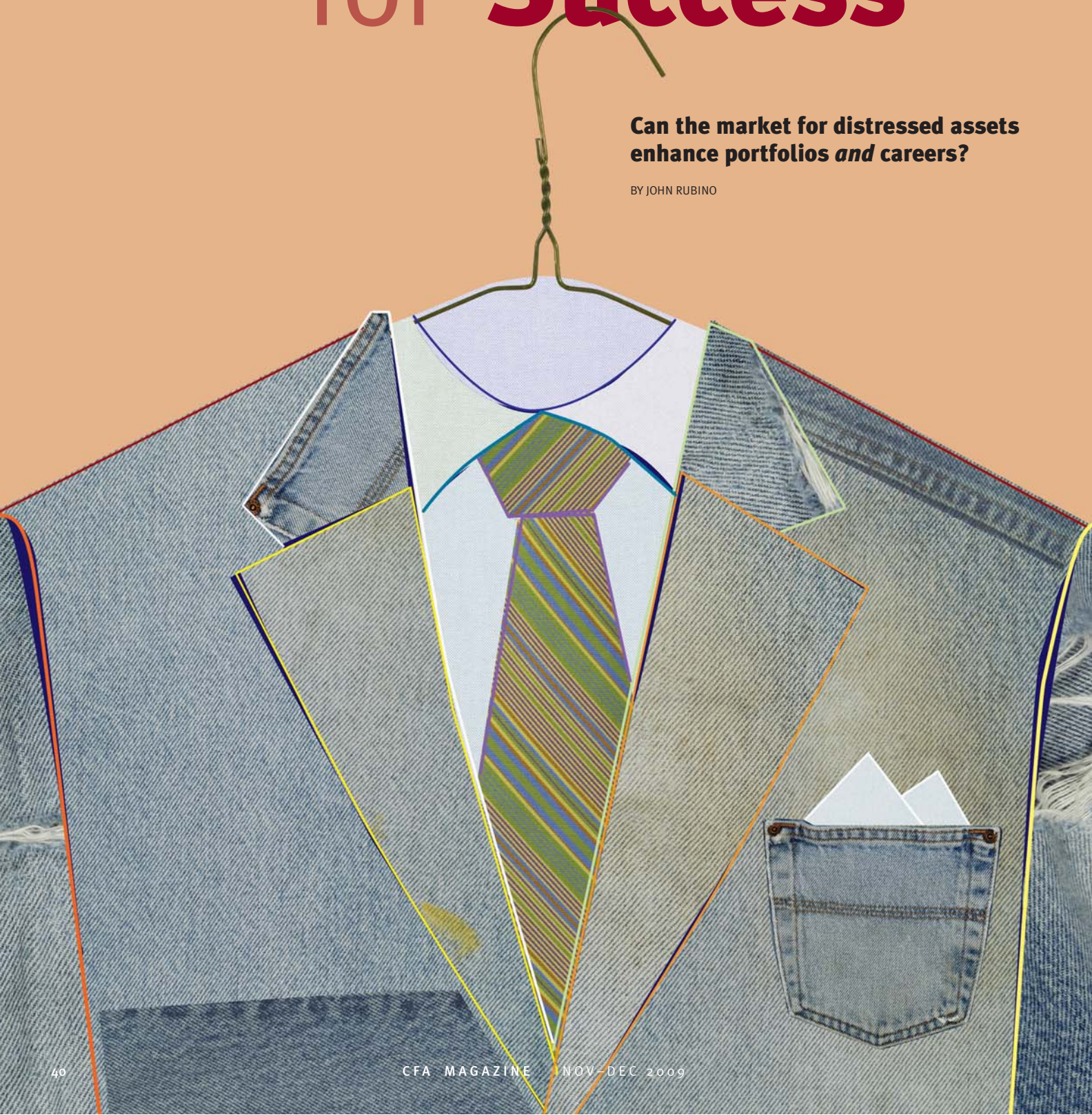


Distressed for Success

**Can the market for distressed assets
enhance portfolios *and* careers?**

BY JOHN RUBINO



Making money in real estate between 2001 and 2006 was easy. The same goes for derivatives, securitized debt, and any number of other credit bubble instruments. But holding on to those profits was a different matter, which is why Denver-based Colorado & Santa Fe Real Estate stands out. After riding the commercial property boom in the western United States to huge gains, company founder and CEO Marcel Arsenault sold near the top and used the proceeds to short bank and home builder stocks, which also worked out nicely. “Making a lot of money is not nearly as important as keeping it,” says Arsenault. “That turns out to have been monumental. We missed the whole flame-out.” [Editor’s note: An earlier CFA Magazine report examined Arsenault’s shorting strategy. See “Magic Kingdom” in the January/February 2007 issue.]

Now, armed with a ton of cash, Arsenault is bidding cents on the dollar for various distressed properties. And he’s in good company. The prescient few who raised cash—or who maintained their ability to raise cash—during the boom are now identifying undervalued assets and making offers to desperate owners. If history is any guide, they’ll reap outsized rewards for their patience.

Some of today’s distressed asset investors are veterans who have done this several times before. Some are former credit bubble players who are now scooping up undervalued versions of the assets they once created. And some are running consultancies and electronic exchanges that promise to clean up the mess on internet time.

In short, “distressed” is the new hot asset class. Capital is flowing in from cash-rich investors worldwide. Deal volumes are soaring, and funds are being raised at a record pace, which implies that 2010 will see an epic clean-up—and an epic hiring spree on the part of distressed investing funds.

DISTRESSED ASSET CLASSES

The sectors that soar in good times are generally the ones that experience the greatest collapse, thus producing the best bargains. The dynamic works like this: In the blow-off stage of a bubble, mainstream investors (banks, pension funds, and stockbrokers) finally succumb to the lure of easy money and load up on the hottest assets. When the bubble inevitably bursts, the mainstream players take whatever they can get in order to remove the toxic assets from their books before investors and regulators notice. By doing so, they create massive price distortions that, for a giddy couple of years, cause gems to be undervalued. The daring and perceptive who can see real value are able to pick up quality assets at bargain prices.

Today’s world is a classic example of this process at work. Here are a few snapshots of the busiest sectors.

REAL ESTATE

Despite liquidating his firm’s holdings, Marcel Arsenault kept the core of his team intact for the inevitable rebound. The

challenge now is to wait patiently. But that will change soon as various parts of the real estate market hit bottom.

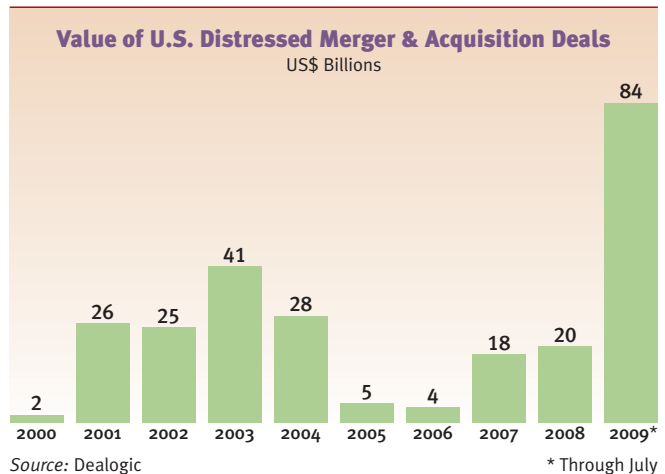
“Commercial real estate follows the economy with a lag,” he says. “You can’t catch a falling guillotine, and the guillotine is still coming down. So you want to stay away from most of it.”

Housing, however, has had its crash. “With land, standing inventory, and busted condos,” says Arsenault, “lenders are moving past the denial stage. The old appraisal said it was worth 30 [million dollars], but the new one says it’s 20 and descending fast. We offer 18, and they ask if we can close for cash. Yes, we can close for cash.” He explains a recent deal: “We bought a portfolio of properties from a national home builder and have sold most of it off. Our internal rate of return (IRR) will probably exceed 120 percent; we’re already over 100.”

Miami is an example of what the rest of the world’s formerly hot commercial real estate markets might look like in 2010, says Peter Zalewski, principal of Miami-based Condo Vultures, a broker of busted condominiums. “I got approached about two weeks ago by a [condo] developer whose lender decided to discount and sell the note on his tower.” The original asking price was \$450 a square foot, but demand had dried up in the bust. “He called me at 11 on a Friday night. I met with him on Saturday afternoon. I put out the word, got interest from 14 groups, showed it nine times, and now we have five offers.” The likely sale price will be around \$160 a square foot.

This deal wasn’t a fluke. “I’ve been approached by over 400 funds from all over the world,” says Zalewski. “They’re all looking to come here and buy distressed real estate with cash. Miami is about six months ahead of the curve compared to other formerly hot markets like Las Vegas and San Diego because of its appeal to Latin American and European investors.” The driving force, he adds, is “a movement by foreign nationals interested in wealth preservation. While the typical Wall Street fund is looking for a 20 percent annual return on distressed Florida real estate, “the foreign national is looking to just preserve their money and make sure they don’t lose anything—a 0–5 percent return.”

FIGURE 1



DISTRESSED COMPANIES

Wilbur Ross has been fixing broken companies for longer than many of today's money managers have been alive. This time around, his firm, WL Ross & Company (now a division of Atlanta-based Invesco), likes the financial sector. "It's been the hardest hit and is most essential for the overall recovery to take place," he notes. "We've bought the largest independent servicer of nonprime mortgages, American Home Mortgage. We're also in Assured Guaranty, the last standing monoline insurer with a AAA rating."

Ross is especially happy with his recent acquisition of Florida-based BankUnited. "We looked at probably 100 banks before deciding," he says. "The others, whether because of price or fundamentals, we didn't want to do. But BankUnited we very much wanted to do." His reasoning is that Florida, with no state income or estate tax, is a magnet for retirees, a very attractive bank demographic. And the state is home to approximately 65 other independent banks, "many of which are or will be insolvent," so the roll-up potential is enticing.

Hong Kong-based ADM Capital was established in 1998 during the Asian crisis. Since then, it has focused on "financial rescue as opposed to operational rescue," says Anthony Stalker, a partner with ADM's European arm. "We don't buy companies that are operationally problematic because we think we can run them better. We're not turnaround experts." Instead, ADM looks for solid companies with balance sheet problems—of which there are plenty. "The withdrawal of credit happened very quickly and left a huge vacuum in the space in which we operate," says Stalker.

This is especially true in Eastern Europe, a region that Western banks have largely abandoned. "We're looking at a [Eastern European] company with steady cash flow, but it has borrowed money on terms that allow the bank to convert the loan into a bullet payment," says Stalker. "Despite the fact that operations are looking better and better, the company can't make the payment. So we're going to step in and create that long-term cushion." The deal will include an equity kicker, offering ADM both a steady income stream and part ownership of a growing company.

FIGURE 2

Private Equity Distressed Asset Funds Raising Capital

	Number of funds	Aggregate Capital US\$ Billions
2001	11	7.9
2002	9	5.8
2003	17	5.9
2004	23	11.7
2005	21	10.9
2006	28	19.0
2007	38	47.5
2008	28	44.7
2009 *	59	52.5

* Includes funds in the process of raising capital as of 31 July 2009.

Source: Preqin

Electronic Exchanges: Liquidity and Transparency

One big difference between today's clean-up of toxic assets and those of the past is technology. Distressed-asset deals used to require arduous due diligence and bilateral negotiations between buyer and seller, but electronic exchanges have emerged to standardize the due diligence and aggregate buyers and sellers, creating vastly more transparency and liquidity.

Boston-based DebtX was founded in 2000 as an online market for banks to buy and sell loans. The service was "primarily for financial institutions to engage in active portfolio management to optimize returns and avoid excessive concentration in a given asset," says DebtX CEO Kingsley Greenland. If a regional bank,

for instance, was accumulating too many strip-mall loans, it could list them on DebtX's exchange where another bank or private equity firm looking for such loans might buy them.

Today, of course, it's all about moving distressed paper. "When the credit markets seized up, we were one of the only places where banks could go to create liquidity for toxic assets," says Greenland. "Our business is up many times in the past two years."

DebtX is structured a bit like a sell-side shop, with analysts who convert loan data into standardized formats and calculate a reasonable value and salespeople who convince potential buyers and sellers to participate. The resulting exchange "enables a pool of capital to

bid on 10 of our loans in the time it would have taken them to bid on one. If a buyer only wants to see office buildings over 20 stories in Boston or Dallas, they're matched to the product and can price them in one-tenth of the time," says Greenland.

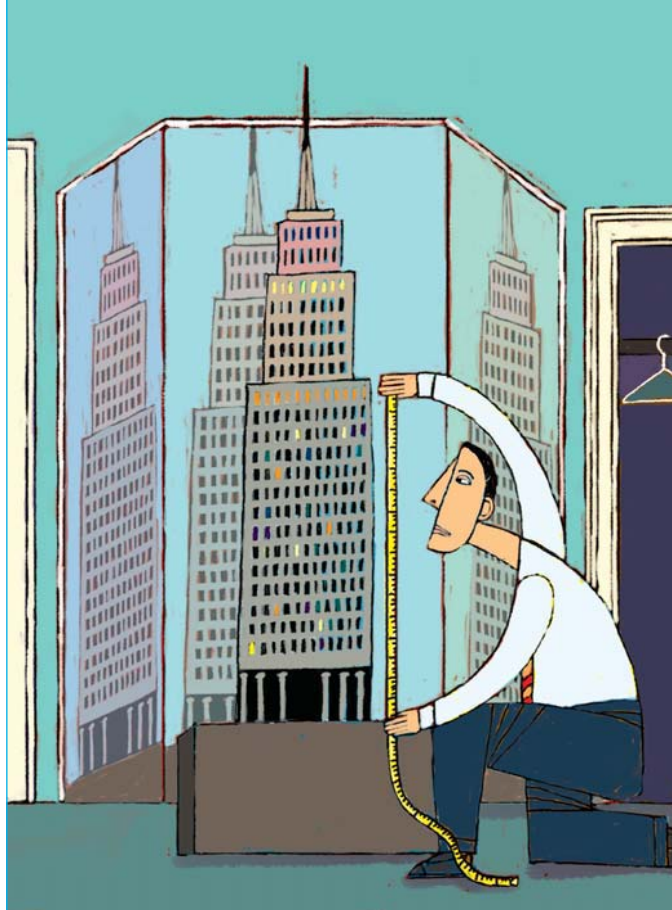
Oklahoma City-based First Financial Network got its start advising buyers and sellers of Resolution Trust Corporation (RTC) assets during the real estate bust of the early 1990s. "That's still our role," says executive vice president Jamie Hook. The firm's analysts still work with client banks to construct and price portfolios of loans for sale. And they still help potential buyers understand the value of the assets being offered. But the combination of technology and the soar-

BUSTED BONDS

Since the last bubble was debt driven, it's no surprise that the financial landscape is now littered with the bleached bones of credit instruments ranging from bank loans to credit default swaps. It's also no surprise that a variety of analytical tools and strategies are being brought to bear on this sector.

At Morgan Stanley's FrontPoint hedge fund arm, portfolio manager Marc Rosenthal's team is using proprietary models to categorize busted bonds and create long-short portfolios that take advantage of their mispricing. "The bonds we look at are generally trading anywhere from 30 to 90 cents on the dollar. They're formerly AAA securities with significant amounts of credit enhancement that will take more time to eat through and cause the bonds to take actual write-downs. The idea is to be able to predict the loss timing and severity," says Rosenthal. His model yields a profile for a given bond, ranging from "flat or stable," which should hold up in a variety of scenarios, to "steep," which does well in some scenarios and horrifically in others, to "cliff," which, as the name implies, "looks good in a variety of scenarios but then falls off the planet and has a massively negative return in a bunch of other scenarios. That's the bond we like to short," he says. The flats and steeps, meanwhile, "are all about the yield at which you can buy them."

Meanwhile, Minneapolis-based CarVal Investors is buying the loans. "We buy portfolios of whole loans, not securitizations, and we work out those loans on an asset-by-asset basis with the borrowers," says senior partner Tim Clark. Of CarVal's worldwide staff of 340, about 180 are "asset managers" who negotiate the terms of corporate restructurings,



debt-equity swaps, and the like. "We're highly involved in each deal," says Clark.

A typical deal might involve some loans from a failed bank being peddled by the Federal Deposit Insurance Corporation (FDIC). "We'll look at the loan files, value the collateral, and go through all the bank correspondence," says Clark.

ing number of loans for sale has sent the process into overdrive. "We're conducting more research on a bulk basis," says Merrie Duncan, First Financial Network's director of marketing. "Most of it is done with proprietary models we've built internally. In cases where there are hundreds or thousands of loans in a particular offering, there are sampling methodologies that you can use to extract results."

Once a portfolio is analyzed and priced, First Financial Network markets it to a prescreened list of buyers. "Potential bidders review the data and all the documentation in advance before bidding. Then we'll host a bid day online and collect sealed bids and handle all the closing functions as well," says Hook.

New York City-based SecondMarket was formed in 2004 as a marketplace for trading restricted securities in public companies. "For the first three and a half years, that was the only asset class we traded," says chief strategy officer Jeremy Smith. But in early 2008, the market for auction-rate securities imploded. "So, we launched a marketplace for those securities," says Smith. "We've done nearly 1,300 transactions and are the only marketplace for auction-rate securities."

Encouraged by the success of its first two innovations, SecondMarket has added seven new products in the past year, including bankruptcy claims (primarily vendor claims on bankrupt companies) and limited partnership interests in hedge funds and private equity funds.

Most have been well received. "Bankrupt claims generally start trading about nine months after bankruptcy," says Smith. "So in the past few weeks, we've seen a huge spike in listings, from US\$100 million to over US\$500 million."

With hundreds of hedge funds closing their redemption windows, a secondary market in limited partnership stakes fills a growing need. "The only people who get to see the information are preapproved buyers. The fund doesn't get the money, but it avoids having to cash out an LP who wants to leave," says Smith. In other words, weak hands can be replaced with strong hands—without the need to liquidate existing positions and create more distressed assets.

A CarVal asset manager will then put together a plan that maximizes the return on the loans, either through liquidation or by keeping them current for their duration.

EXPERIENCE IN DEMAND

Each busted bond, bankrupt company, and small business loan is unique, which is to say it has to be analyzed, valued, restructured, or explained to potential buyers. So, demand is soaring for people who can perform some or all of these tasks. Some of the best in the business were asked to share their insights on opportunities that currently exist:

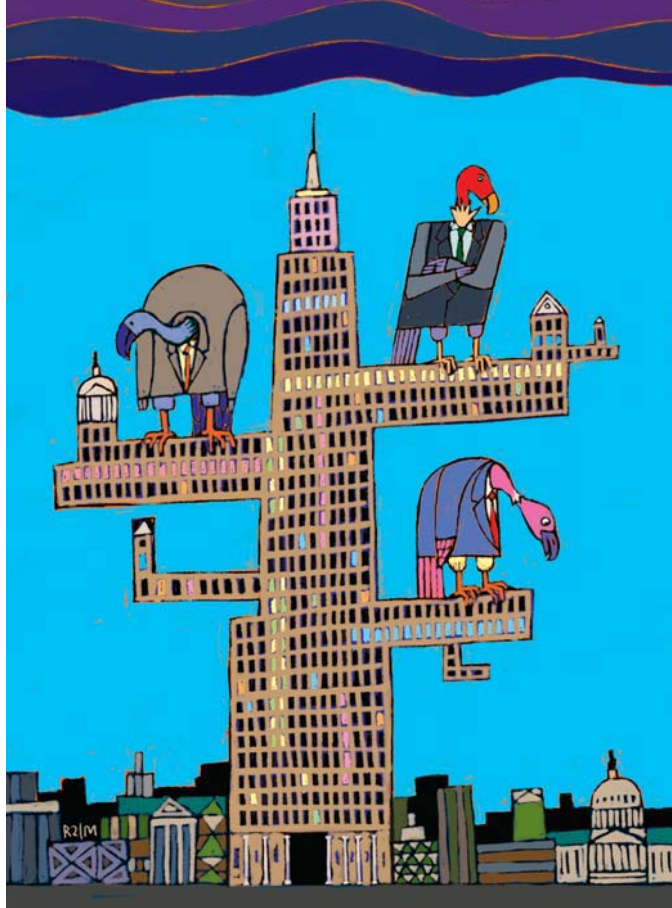
WL ROSS & CO.: “We hire people who have experience in investment banking, commercial banking credit, or research, generally with a graduate education, a CFA [charter], and 10 years or more of experience,” says Wilbur Ross. “Separately, when hiring managers for our businesses, we like people who understand that exact industry. We’re skeptical of the idea that if someone is a good manager, they can manage anything. Industry-specific knowledge is a very important thing.”

ADM CAPITAL: “One of the keys to doing distressed business in emerging markets is to be close to the market,” says Anthony Stalker. “You’re not buying a public equity. You’re investing in businesses and people, frequently families. So, I want our people on the ground rather than jetting in from London when they feel like it. We typically recruit people whom we’ve worked with on the other side of the table. The person now running our Turkey office approached us to take a look at his family company, and the guy who runs our India office worked with us on our first India deal.”

COLORADO & SANTA FE: “We went down to under 30 people and will probably be at over 100 in two or three years. We’ll be ratcheting up the back office, accountants, deal people,” says Marcel Arsenault. “We’re in the process of making an offer to a young lady who’s extremely exciting, a CPA/CFA [charterholder] who can help us with deal analysis.”

CARVAL: “The perfect resume is an MBA/CFA [charterholder] with specific asset-class expertise, either by origination, analysis, or business plan,” says Tim Clark. He’s also interested in people with insights into securitized products that can be broken up into individual loans: “Where is it, who owns it, and can you work it out with the servicer? Where are the skeletons?”

FIRST FINANCIAL NETWORK: “We bring in analysts, former mortgage people, or bankers on a contract basis with a clear understanding of the credits they’re analyzing. There’s a network of these underwriters that we tap into on a pretty regular basis,” says First Financial Network’s executive vice president Jamie Hook. The buyers of the loans the FDIC is selling are also hiring. “Some of the names of successful purchasers are published on the FDIC website,” says Merrie Duncan, director of marketing at First Financial. “These secondary



market purchasers are extremely busy right now, and they’re always looking for people with backgrounds in these areas.”

DEBTX: “Most of our traders are loan guys for asset-backed securities who have the ability to understand the asset underlying the loan and translate it for others,” says DebtX CEO Kingsley Greenland. According to the DebtX website, in early August, the company was “seeking senior sales candidates to establish, maintain and develop relationships with customers and qualified prospects for DebtX services. The ideal candidate will have established industry contacts and a willingness to prospect and cold call potential customers. The candidate will be responsible for evaluating, pricing and structuring potential transactions, negotiating engagement terms, and overseeing all aspects of the customer relationship. Significant travel required.”

The story is the same across the distressed asset spectrum. In a recent report entitled “2009 Leadership Outlook—A Global Perspective for the Private Equity Market,” executive search firm Russell Reynolds Associates found expertise with distressed debt and corporate workouts to be in huge demand. Even law firms stung by the fall-off in regular corporate business are recruiting associates with backgrounds in distressed assets. “There is a flight to experience,” the report concluded. ▀

John Rubino, a former financial analyst, is the author of several books on investing, including Clean Money: Picking Winners in the Green Tech Boom.