# Hedge Funds Poised For High Yield Opportunities

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While central banks have injected US$3 trillion into the global economy in the past two months, high yield corporate credit markets are still in a state of decline. Despite some signs of credit loosening in the commercial paper and other high-grade markets, banks and capital markets continue to clamp down on lending to companies further down the credit curve.

In the past few weeks there has been widespread liquidation of assets resulting from hedge fund redemptions. All of these factors are bringing severe leveraged loan and high yield bond price declines to unseen levels. Credits rated CCC fell 25.75% in the month of October and are off 37.83% for the year. Global credit losses and write-downs may reach as high as US$1.7 trillion, affecting high yield mutual funds, hedge funds and other investors. A negative feedback loop of selling begets redemptions that beget lower prices has lead to irrational pricing in leveraged loan and high yield bonds.

The sheer volume of debt trading at stressed levels begs the question, "Are these companies really that stressed or are market technicals driving bond prices lower?"

The answer is that technicals are overwhelmingly driving this market. There are currently hundreds of companies with debt trading at stressed prices that have no near term liquidity issues, are free cash-flow positive, and are fundamentally strong even at trough earnings in a weak economy. Companies for the most part have been able to continue to service their debt and maintain solid liquidity.

Now with credit markets closed, the real threat to credit issuers is not that they will not make their coupon payments, but that there will not be a high yield market to go to refinance their outstanding issuance once they come due. This has been one key factor causing investors to be wary of high yield and avoid allocation to the space.

**How Can an Investor Take Advantage of This Market Environment?**

The credit sell-off over the past year has created the most opportunistic time for stressed investing in the last decade, even as markets have experienced increased volatility in the past few weeks. Credit volatility will remain high for the remainder of 2008. The overall economy will likely remain weak in the near term and credit markets have not yet completely stabilised. However, federal government actions and falling commodity prices will begin to stabilise credit going forward. While this will surely come with some near-term volatility risks, this market environment has credit priced at values that significantly limit the downside potential from these levels for many securities.

With spreads as wide as they are currently, one does not even need to reach out to the riskiest segments of the high yield market for attractive yield. There is strong value in solid credits higher in the capital structure with yields equal to what riskier credits were offering just a few months ago. These credits are free cash-flow positive with the ability to pay down debt over time. Many of these companies do not have significant portions of their debt coming due for another five to ten years, which gives capital markets ample time to open again before these companies need refinancing. Purchasing debt higher in the capital structure also permits an investor to take advantage of a deleveraging opportunity if certain covenants only allow debt reduction higher in the capital structure prior to addressing subordinated structures.

An investor can also benefit from a strong current yield in this market environment, even if it takes the credit markets time to rebound. Spread stabilisation at this point with no price improvement would offer the portfolio an outsized return just based on the current yield of the credits in the portfolio.

Bondholder activism can achieve outsized performance in this environment. The rewards can be substantial for investors who can successfully negotiate a deal with a company that needs to right size its balance sheet in a difficult market environment. In addition to consent fees, these bonds typically offer a current yield of 15-25% because of the high coupon and price discount at which the bonds can be purchased.

The universe of names now trading at stressed levels will need to come up with capital structure initiatives once reserved for companies in much worse financial distress (ie recapitalisations, debt rescheduling, debt


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for equity exchanges etc). It will be easier for these fundamentally sound companies to complete capital structure initiatives than deals completed in the past since these companies are not "stressed" in the traditional sense but find themselves in a stressed situation due to the technical factors driving this market.

This scenario creates opportunity for activist investors to earn attractive current yield with a strong recovery value as well as upside potential from one-time fees for indenture waivers, add-on participation incentives, and equity stakes that can add immediate value to portfolios. While building coalitions amongst bondholder groups and advising company management teams on capital structure changes may be out of the realm of individual investor expertise, partnering with a manager that has experience in this segment of the market or purchasing debt where there may be a likelihood of these types of events occurring are options for investors looking for outsized performance.

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*This article first appeared in www.finalternatives.com on 19 November 2008.*


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