# Alpha Opportunities in Event Investing


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## Executive Summary

The purpose of this paper is to present a framework for event investing and to identify attractive event investing opportunities in the aftermath of the 2008 crisis. We view the event investing cycle in four stages: economic slowdown, corporate restructuring, recovery, and expansion. These stages provide a framework to dynamically allocate capital throughout an economic cycle. Each stage has characteristics that justify a specific portfolio positioning in the capital structure (i.e., senior debt during economic slowdown, distressed debt during corporate restructuring and recovery, equities during recovery and expansion). We believe that most event managers typically do not have the skill set to invest in all four stages of the event investing cycle. Therefore, an investor needs to dynamically allocate capital to the best-suited managers for specific event investing cycle stages. Based on our assessment of the current economic cycle, we believe the event investing cycle is between stage 2 (corporate restructuring) and stage 3 (recovery).

The corporate distressed market currently presents the best opportunities within the event strategy and has the ability to generate significant returns over the next three to four years. Over the previous two cycles, distressed investment opportunities remained robust for multi-year periods, and we anticipate a similar pattern during this cycle. Despite the recent decline in the default rate, there will be significant opportunities in distressed debt. The size of the opportunity set during this cycle has created a supply imbalance for distressed and defaulted debt. This imbalance combined with an uncertain economic outlook could lead to a multi-year restructuring period.

Another area of opportunity is in post-bankruptcy reorganized equities. Reorganized equities usually lack Wall Street analyst coverage, are underfollowed by traditional firms, and often trade at a substantial valuation discount versus peers. Based on the experience of prior economic cycles, as the economic recovery evolves, a portfolio of reorganized equities is expected to outperform the broader equity market. Managers that focus on restructured equities should be a portion of an institution's overall long equity exposure, as a source of potential alpha. Currently there is not a robust opportunity set for other equity event investing strategies (i.e., mergers, spin-offs). Investors need to be flexible to allocate capital to other equity event strategies as the recovery evolves.

Investcorp[1] has been active in equity investing since 1996 and uses its proprietary data and research to aid in the dynamic portfolio allocation process needed for successful event investing.

1. Unless otherwise noted, 'Investcorp' refers to Investcorp Investment Advisers Limited, Investcorp Investment Advisers LLC, N.A. Investcorp LLC, and its affiliates.

# Contents

| | | |
|---|---|---|
| Section 1 | Introduction | 1 |
| Section 2 | Event Investing | 2 |
| | 2.1 Stage 1 – Economic Slowdown | 3 |
| | 2.2 Stage 2 – Corporate Restructuring | 5 |
| | 2.3 Stage 3 – Recovery | 6 |
| | 2.4 Stage 4 – Expansion | 7 |
| Section 3 | Event Strategy Outlook | 8 |
| Section 4 | Conclusion | 10 |

# Section One
# Introduction

The recent market crisis in 2008 can be traced to the benign credit environment of 2003 to 2007. This environment was highlighted by low default rates, tight corporate spreads, low volatility, and lax underwriting/lending standards. The aforementioned factors led to significant asset price appreciation (especially housing), heightened LBO activity, and exponential growth in complex/levered debt structures. The first sign of the crisis occurred in February 2007 when the subprime residential mortgage market significantly declined. The next signal occurred in August 2007 when Structured Investment Vehicles (SIVs) had difficulty rolling over their commercial paper. These events highlighted the excessive leverage in the banking system and started the chain of events that led to the financial collapse in the fourth quarter of 2008. The collapse was marked by the failure of several marquee US financial institutions including: Bear Stearns, Fannie Mae, Freddie Mac, Lehman Brothers, Washington Mutual, American International Group, and Wachovia.

The lack of confidence in the banking system led to massive de-leveraging, which had a significant negative effect on the worldwide macroeconomic environment. As a result, high yield and leveraged loan spreads increased to record levels (high yield traded to 2,000 bps+ over treasuries). World governments took extraordinary intervention measures during the first half of 2009 to stave off a global financial meltdown. Many of these actions served to mitigate further economic and financial damage and bring confidence to the markets. As a result, most risk asset prices rallied significantly during the last three quarters of 2009.

The purpose of this paper is to present a framework for event investing and to identify attractive event investing opportunities in the aftermath of the 2008 crisis.

# Section Two
# Event Investing

We define the event investing universe as including any corporation experiencing a significant corporate action. Examples of corporate actions include: mergers and acquisitions, spin-offs, and Chapter 11 bankruptcy filings. The different stages of the economic cycle present various event investing opportunities. These various stages give an investor a framework to allocate capital.

We view the event investing cycle in four distinct stages. Each stage has different characteristics that are identified by the macroeconomic/business cycle. We define these stages as the following:

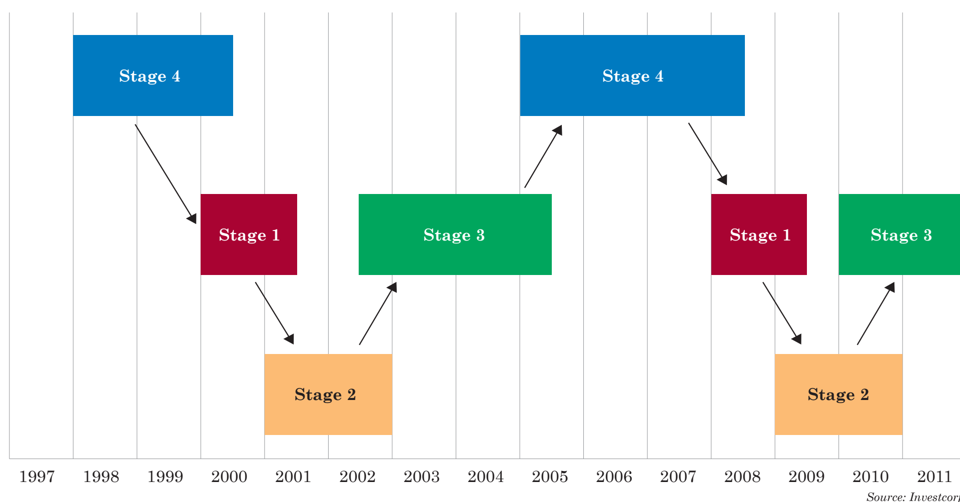
Stage 1 – Economic Slowdown

Stage 2 – Corporate Restructuring

Stage 3 – Recovery

Stage 4 – Expansion

### Chart 1: The Event Investing Cycle




*Source: Investcorp*

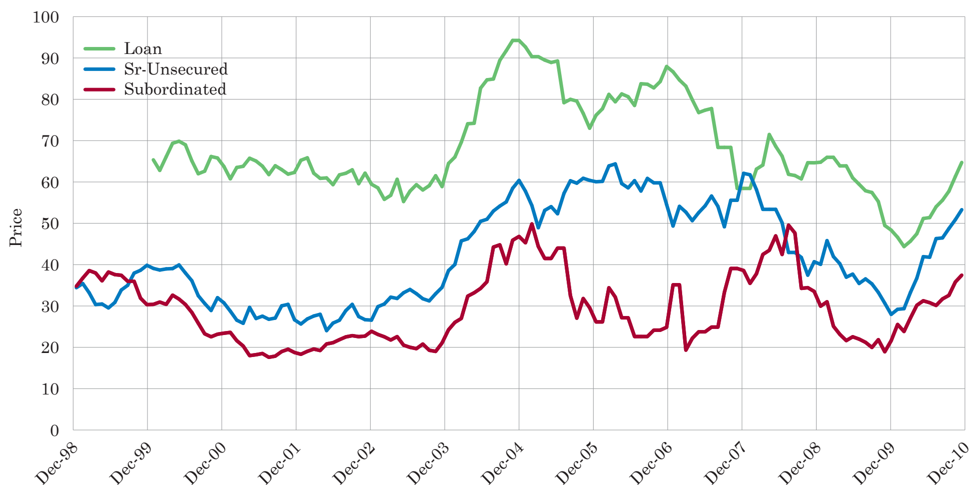
An investor should use a multi-disciplined, multi-manager approach by adjusting allocations dynamically as the cycle evolves in an effort to profit throughout the different stages. Many event managers do not have the ability to invest in all four stages. Therefore, investors need to be dynamic in their allocations as the cycle evolves. Each cycle can vary in length and severity. **Based on our assessment of the current status of the economic cycle, we believe the current event investing cycle is between stage 2 and stage 3 (Chart 1).**

## 2.1 Stage 1 – Economic Slowdown

Stage 1 is highlighted by a general deceleration in the economy which, in turn, puts pressure on corporate profitability. This hinders the ability of corporations to pay down and refinance existing debt obligations. As a result, corporations begin to aggressively cut costs and reduce capital expenditures. During this stage, market dislocations are prevalent. High-yield spreads and corporate defaults increase as the market re-prices risk and weak companies are unable to service their debt.

During this time, many corporations' debt ratings are downgraded by the rating agencies (i.e., Moody's, S&P). These ratings downgrades can trigger forced selling by investors that are mandated not to hold below investment grade paper. This forced selling creates an opportunity for distressed hedge fund managers to acquire attractively priced debt.

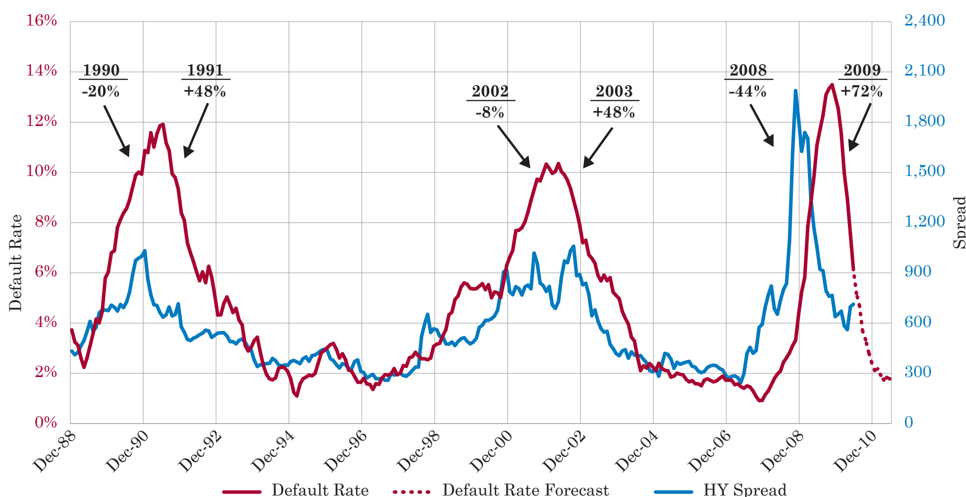
**Chart 2: Debt Recovery Rates**




*Source: Moody's. Recovery prices measured one month after default. Average in previous 12 months. Through 6/2010.*

During stage 1, an investor should either be under allocated to the strategy or be invested within the senior parts of the capital structure and hedged. Being senior in the capital structure offers the best risk/reward relative to the junior portion of the capital structure due to the fact that senior debt will typically have higher recovery rates in periods of uncertainty (Chart 2). The use of credit default swaps (CDS) allows fund managers to hedge or profit from negative views on corporations and countries. CDS were not available during the previous event investing cycles.

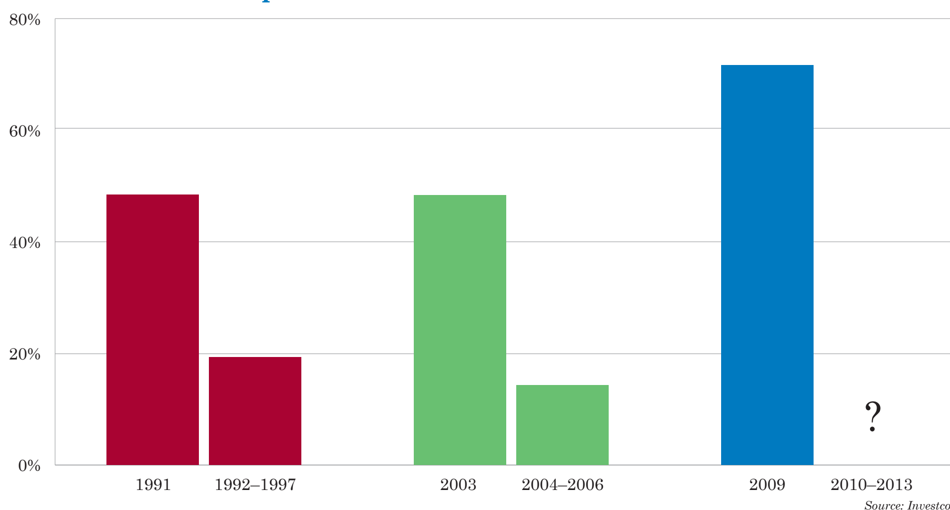
## Chart 3: Historical Spreads and Defaults vs. Defaulted Debt Returns




*Source: Investcorp returns. Default rates and forecasts (dotted) from Moody's. HY spreads from Merrill Lynch.*

As stage 1 continues, both the default rate and the supply of defaulted debt increase substantially. The pricing of debt typically comes under pressure during this stage. Chart 3 illustrates the fluctuations in default rates and spreads over the past three economic cycles. Investcorp's proprietary database illustrates the vast difference in defaulted debt returns between investing before and after the peak in default rates. The data shows that, historically, the best time to invest in distressed debt is after the peak in the default rate (Chart 3). Historically, returns have been the highest in the first year. However, Investcorp's Defaulted Debt Index[2] (Chart 4) highlights that over the past two cycles there were subsequent three to five year periods that generated strong returns (14% and 19% annualized)[3]. **Based on this research, we believe that defaulted debt has the ability to generate significant returns over the next three to four years.**

## Chart 4: Investcorp Defaulted Debt Index Historical Performance




*Source: Investcorp*

2 The Investcorp Defaulted Debt Index is a trade-based index that measures the monthly price performance of defaulted corporate debt. It includes the bonds and loans of global companies that have missed payment, exchanged debt at discount prices, and/or have filed for bankruptcy. It excludes municipal and sovereign issuer defaults. The index excludes companies with less than $200 million of debt, and issues trading at less than 10 cents on the dollar or without a price.

3 As noted here and throughout this report, past performance is not a guarantee of future performance.

## 2.2 Stage 2 – Corporate Restructuring

During stage 2, the economy begins to stabilize and economic visibility increases. At this stage, many corporations have defaulted and filed for Chapter 11 bankruptcy protection. Corporations will typically use the bankruptcy process to fix overleveraged balance sheets. Distressed hedge fund managers acquire defaulted debt and work with corporate management to implement changes during the restructuring process. Some corporate changes in bankruptcy include: capital structure restructuring, operational changes, vendor/supplier contract negotiations, union arrangements, and rent adjustments. These changes can serve to vastly improve a given corporation's business model and earnings prospects.

**Chart 5: Hypothetical Restructuring Example**

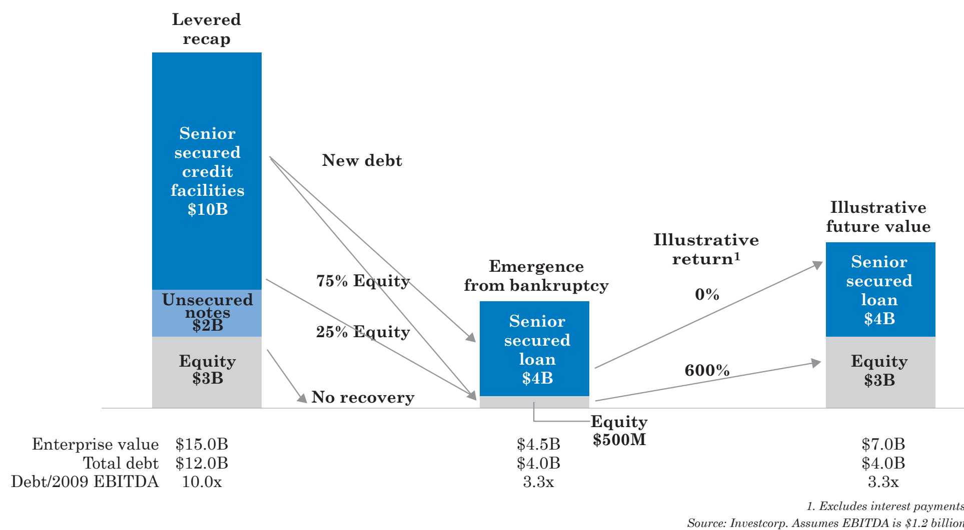



Chart 5 illustrates the changes in a hypothetical corporation's capital structure as it goes through the bankruptcy process. The pre-bankruptcy capital structure has a substantial amount of debt that would be difficult to service (10x Debt/EBITDA). The corporation has the ability to make significant capital structure changes when it enters bankruptcy protection. The senior secured lenders will most likely drive the restructuring process because they will not be paid in full. As a result, the senior secured lenders receive the majority interest (75% of the reorganized equity and 100% of the new secured debt) in the reorganized corporation. The subordinated debt holders receive a piece of the equity (25%), while the equity investors receive no compensation. The reorganized corporation has a substantially lower debt burden (3.3x Debt/EBITDA) upon exiting bankruptcy. The new equity has significant upside potential due to a healthier capital structure and positive operational changes.

During this stage, an investor should position with managers that have the ability to move lower in the capital structure as the cycle progresses. Typically, the manager's goal at this point is to identify the debt tranche that will receive the majority of the equity in the reorganized corporation. This gives the manager the ability to benefit from any additional upside as the corporation re-emerges from bankruptcy. Investors should increase exposure to multi-disciplined distressed managers at this time.

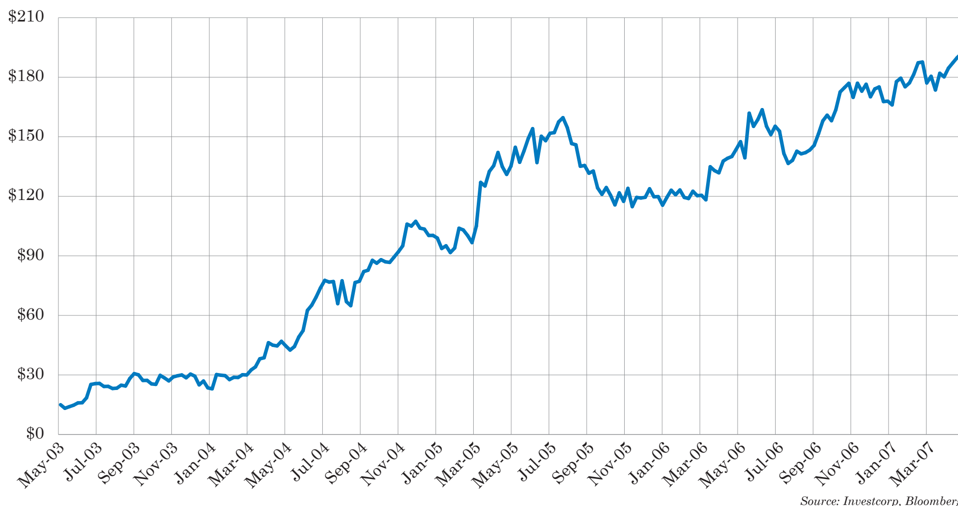
The bankruptcy and restructuring process is very complicated. A legal background, jurisdictional knowledge, valuation expertise, and creditor committee experience are important criteria when selecting a hedge fund manager. Capital should be allocated to managers that have the critical expertise and experience to succeed in the restructuring process.

## 2.3 Stage 3 – Recovery

In stage 3, the macroeconomic environment continues to improve. Corporations begin to focus on business reinvestment and growth rather than cost cutting. Previously failed corporations start to re-emerge from bankruptcy protection. Upon re-emergence, these corporations typically have a more balanced capital structure, fewer or no legacy liabilities, a lean cost base, and improved operations. As a result, many reorganized corporations can operate more efficiently and maintain a competitive advantage.

Reorganized corporations can have either private or public equity. Reorganized public equities are typically re-listed after the corporation emerges from bankruptcy protection. Reorganized public equities usually lack Wall Street analyst coverage and are underfollowed by traditional long-only institutions. The financial complexity and the stigma associated with a bankruptcy filing are headwinds to research coverage. However, investors should realize that these corporations are often misunderstood and represent a significant investment opportunity. Reorganized equities can have a distinct competitive advantage and often trade at a substantial valuation discount versus peers. Investors can benefit from this opportunity by identifying hedge fund managers with the ability and expertise to invest in reorganized equities.

**Chart 6: Post-Bankruptcy Reorganization Equity Example**




*Source: Investcorp, Bloomberg.*

For example, during the last cycle Sears Holdings entered bankruptcy protection (Chart 6). It emerged from bankruptcy as a stronger and more viable corporation. The stock appreciated 15x at its peak since it re-emerged from bankruptcy in 2003. While this is an extraordinary example, it highlights the potential upside in post bankruptcy reorganized equities. Many of these corporations have unique characteristics (clean balance sheet, lower cost structure) versus peers. **We believe managers that focus on reorganized equities should be a portion of an institution's overall long equity exposure, as a source of potential alpha.**

## 2.4 Stage 4 – Expansion

During stage 4, the economy is healthy and corporations are focused on growth. Typically, corporations' cash levels increase significantly as previous cost cuts have improved margins and enhanced profitability. Corporations need to decide on how to deploy excess cash levels. This can lead to various corporate events – M&A, increased dividends, one-time cash distributions, and share buybacks. During this time, corporations may also decide to divest or spin-off non-core businesses. These actions are typically complex and present opportunities for skilled equity event managers. Investors will need to position themselves accordingly as the event equity opportunity set increases.

**Chart 7: Historical M&A Deal Volume**

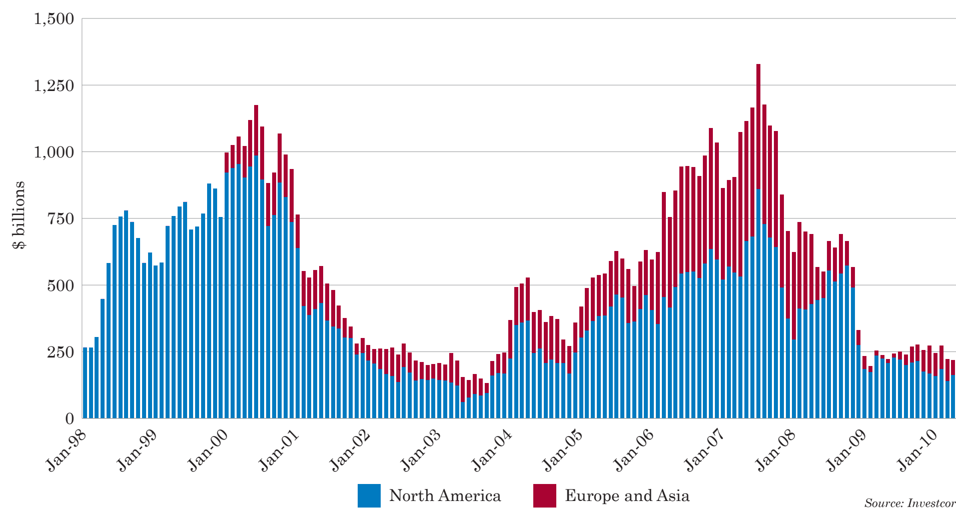


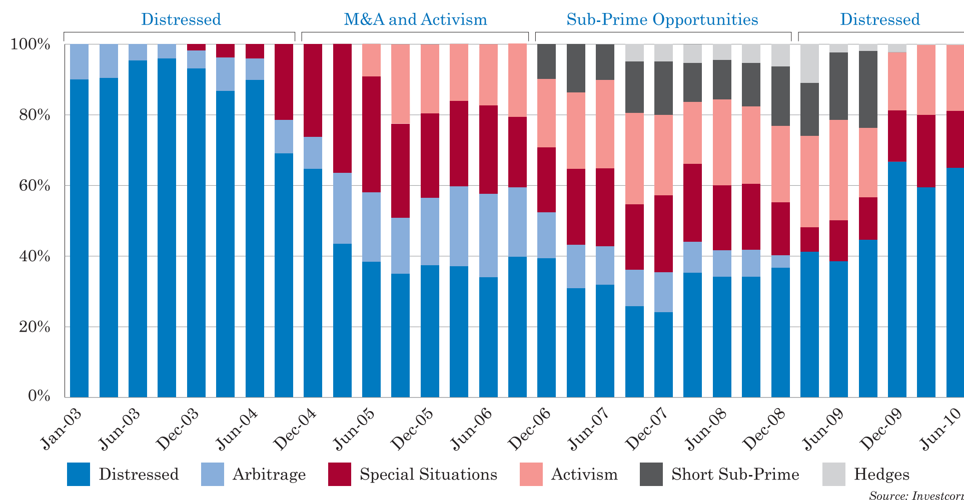

Chart 7 shows the historical M&A dollar volume by region from 1998 to the present. The rapid increase in M&A dollar volume coincides with expansionary economic time periods. The 1998 M&A cycle was predominately US mergers, while the 2005 cycle was a mix between domestic and foreign deals. An investor needs to have the ability to dynamically allocate to equities from credit during this stage. The focus should be the managers that have the ability to be opportunistic across the different equity event strategies (i.e., arbitrage, special situations, activism).

## Section Three

# Event Strategy Outlook

We believe that the current and upcoming stages of the event investing cycle are attractive and have the potential for strong returns over multiple years. We have been active in the event investing space since 1996 and have dynamically allocated to the opportunity set throughout the cycle (Chart 8).

### Chart 8: Investcorp's Allocation to Event Driven Managers

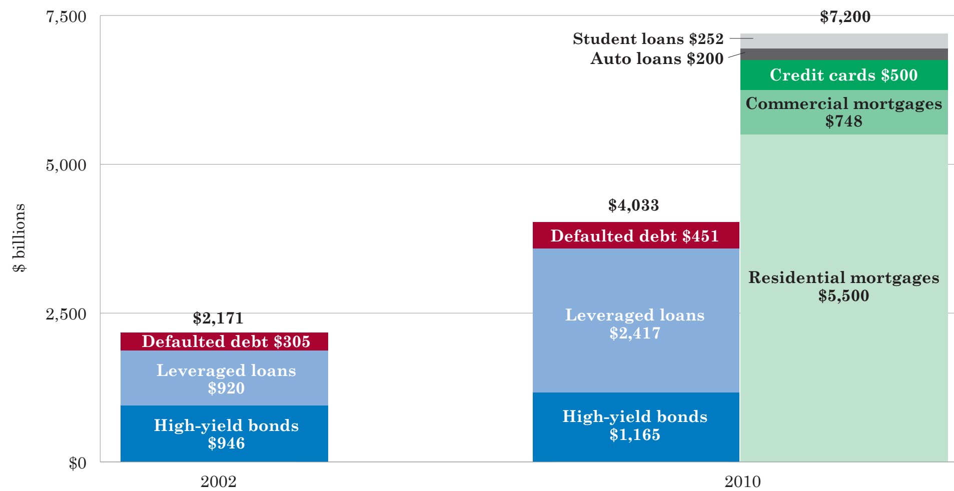



*Source: Investcorp*

The corporate distressed market currently has the best opportunities within the event strategy. Despite the recent decline in the default rate, there will be significant opportunities in distressed debt and reorganized equities. Distressed investment opportunities remained robust for a multi-year period over the previous two cycles and we anticipate a similar pattern during this cycle. The size of the opportunity set during this cycle has created a significant supply imbalance of distressed and defaulted debt (Chart 9). This imbalance combined with an uneven economic outlook could lead to a multi-year restructuring period.

In 2008 and 2009, a combined 410 corporations defaulted on $640 billion of debt, which exceeds the total from the last cycle (2001 to 2002), when a combined 500 corporations defaulted on $407 billion of debt. The overall opportunity set in high-yield bonds, leveraged loans and defaulted debt is significantly larger this cycle than in the previous cycle (approximately double the last cycle). Additionally, the structured credit market is a new opportunity set – residential mortgages (Chart 9) alone are $11 trillion (approximately $5.5 trillion securitized). An investor should focus on opportunities in the US and Western Europe because the legal framework and market liquidity in these regions are the most robust for distressed investing.

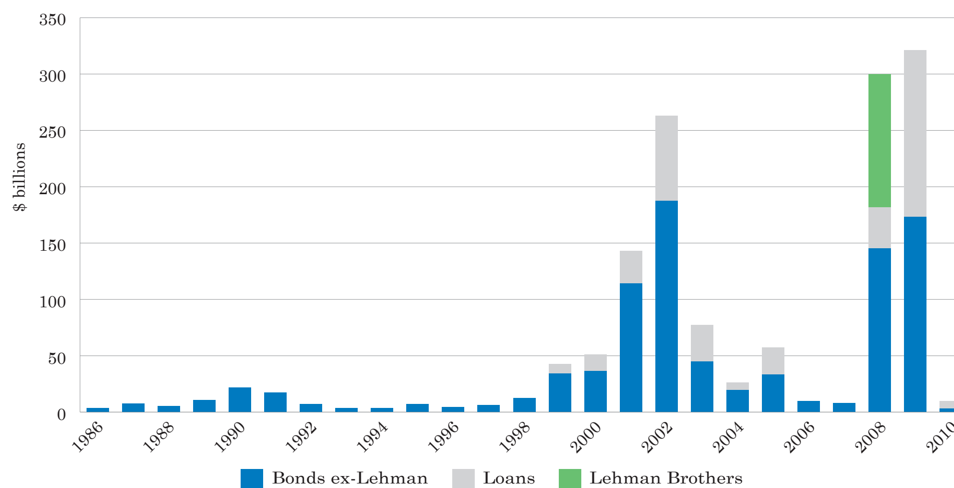
## Chart 9: The Distressed Universe – 2002 vs. the Current Cycle




*Source: Investcorp, Credit Suisse, Waterfall Asset Management. Based on securitized amounts outstanding.*

Investcorp will allocate to event equities as the cycle progresses. However, currently there is not a robust opportunity set (Chart 7). We were able to dynamically allocate to event equities during the last cycle (Chart 8) and anticipate a similar change in positioning in this cycle as the recovery evolves. Investcorp uses its proprietary research database to track current and historical defaulted corporate debt. Chart 10 illustrates the dollar amount of defaulted debt over the past three cycles. Dollar denominated debt has increased significantly during the past two cycles in conjunction with the proliferation in both the high yield and leveraged loan markets. The amount of defaulted debt outstanding (Chart 9) has increased by 50% ($451 billion) during this cycle versus the previous cycle ($305 billion).

## Chart 10: Amount of Defaulted Debt




*Source: Investcorp, Moody's. Through 06/30/2010 - revised.*

## Section Four

# Conclusion

The four stages of the event investing cycle (economic slowdown, corporate restructuring, recovery, and expansion) give an investor a framework to allocate capital. Each stage has characteristics that justify a specific portfolio positioning (i.e., senior secured debt, subordinated debt, equities). An investor should use a multi-manager, multi-strategy approach to investing throughout the cycle. Most hedge fund managers typically do not have the skill set to invest in all four stages of the event investing cycle. Investors need to have the ability to dynamically allocate capital to managers that are best suited for different stages within the event investing cycle. Investcorp uses its proprietary data to aid its investment research and portfolio allocation process.