

In the Midst of a Major Storm... Global Credit Crisis Creates Financial Hurricane Leaving No Asset Class Unscathed

If the National Hurricane Center were to name a hurricane after the global credit crisis that has ravaged the markets over the last month, it would be called "Lester Leverage" — a storm so strong it wipes out billions of dollars of value and sends investors running for cash shelters only to find the doors locked.

By Ricardo S. Chance

The economic and psychological impact with this occurrence is different from financial storms of the past because contributors to the crisis are dispersed across thousands of companies from home appraisers, mortgage brokers and underwriters to credit rating agencies, investment banks and hedge funds. This time around, there is no one entity that the Federal Reserve can blame for the crisis or even bail out easily.

Tsunami of Mortgage Defaults

In early 2006, the first wave of mortgage defaults rolled onto U.S. shores and was a precursor to the much more serious and systemic credit crisis that is upon us today. People can no longer use their home as an ATM machine since the collapse of the subprime mortgage industry cut off possible high ratio refinancings. But we have not seen the end of the collapse. Market participants estimate there is still more than \$1.5 trillion of adjustable rate mortgage resets that will wash through the financial system between 2007 and 2010 and drive further waves of defaults. Home listings in many regions are at historical high levels.

The credit crunch has created an untenable situation for borrowers who are now faced with mortgage payments increasing 50% and greater, declining appraisal values, more stringent loan documentation requirements, which are coupled with higher interest rates and greater down payment requirements. Absent a government bailout or a dramatic decline in interest rates, all of this translates into a prolonged and painful recession for the real estate industry, which has been a major catalyst for consumer spending and economic growth over the past three to four years.

Blinding Visibility

Firms such as Moody's, Standard & Poor's and Fitch Ratings may have been blinded by billions in fees earned while performing their inherently conflicting role as both the public's watchdog in rating and monitoring the various tranches of collateralized debt obligations (CDOs) and also being paid handsomely for favorable ratings by the issuers of

these same CDO securities. CDOs are financial instruments derived from pools of mortgages and rated in various tranches of risk that are sold to investors as a bond.

According to Thomson Financial in 2005 and 2006 alone, more than \$1.2 trillion of subprime mortgage-backed CDOs were issued and are now held worldwide by pension plans, banks, insurance companies and private institutions in highly leveraged portfolios. *Bloomberg News* recently reported that even select U.S. money-market funds, a traditional safe haven for risk-averse investors, now hold approximately \$300 billion of these risky CDOs in their accounts. Even with the turmoil in the current mortgage and real estate markets, less than 3% of these CDOs have been downgraded by rating agencies since their original issuance.

There is no historical benchmark on which to accurately predict what percentage and to what degree the investment and non-investment grade CDO tranches will default. As the lower grade mortgage-backed tranches default, the value of the remaining tranches including investment grades have declined more rapidly than anticipated, and in some cases, the CDOs cannot even be valued due to the lack of investor demand in the current market. The lack of transparency inherent to the CDO rating process, whereby rating agencies collaborated with issuers on CDO deal structuring, contributes to the loss of confidence in the high-yield debt markets as investors struggle to understand the true value of the collateral allegedly supporting the CDO.

Leverage Storm Surge

Given the loosely regulated and opaque nature of the hedge fund industry, no regulator knows the holdings or how much leverage hedge funds have or how that leverage changes day to day. In the case of the two now debunked \$20 billion Bear Sterns hedge funds, leverage during the early origins of the funds was reported to be 5 to 1, but at the time of default, leverage levels surged to an astonishing 15 to 1 for one of the funds.

Under these extreme leverage levels, very small changes in a fund's value can wipe out the entire equity value of the fund as seen recently with Goldman Sachs flagship Global Alpha Fund, which lost a quarter of its

\$10 billion value within a few weeks. One has to wonder, of the approximately 10,000 existing hedge funds that now manage approximately \$2 trillion in assets, what percentage are excessively leveraged and on the brink of liquidation? Websites such as the Hedge Fund Implode-o-Meter (www.hf-implode.com), which track hedge fund implosions, demonstrate costly scenarios reminiscent of the dot-com era.

Improbable Global Linkages

Why is this credit crisis contagion spreading to asset classes that are not directly exposed to the subprime CDO market? When a highly leveraged hedge fund incurs a margin call, it must sell assets to cover its position. Naturally as assets sell, prices fall and so does the existing fund's collateral resulting in even more selling. A de-leveraged death spiral is now set in motion, and if enough hedge funds with toxic CDOs all start selling, there is nobody left to buy. As a result, the hedge funds have no choice but to look to their most liquid and highest grade assets held in other funds to sell. Amplify this scenario across thousands of hedge funds where each manages billions of dollars pursuing similar hedging strategies and there are linkages less than "six degrees of separation."

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The intensity and velocity of this spiraling force is analogous to the gravitational pull of a black hole created by a collapsing star; global equities, bonds and even traditional safe-haven asset classes, like money market funds such as Sentinel Management Group, which recently filed Chapter 11, are placed under severe liquidity pressures and sucked into the vortex as investors rush to raise cash by dumping any asset that someone else is willing to buy at whatever price.

The Federal Reserve Bank has intervened to date with an unprecedented \$135 billion cash injection into the banking system during the past two weeks in an attempt to restore liquidity and confidence in the financial system. A global reassessment of risk/return is now in process by investors, but it will take much more time to figure out a solution to the crisis that secure a soft landing.

Dark Clouds on the Horizon — Waiting Out the Storm

What a difference a month can make. The long awaited uptick in distressed debt opportunities that so many advisors and distressed investors have been preparing for has finally hit our shores. At the same time, the Federal Reserve implemented a one-half percent decrease of the discount rate to calm "disruptions" in the financial markets, saying that the financial market conditions have "deteriorated," and "tighter credit conditions and increased uncertainty have the potential to restrain economic growth going forward."

At the corporate level, the first tangible cracks appeared with the largest leveraged loans associated with pending buyouts. Beginning in June 2007, a slew of high profile LBO deals (e.g., Dollar Stores, Chrysler and Service Master) stalled as high-yield investors began closing up shop leaving investment banks holding the bag on their loan commitments. The market will next see highly leveraged companies with maturing debt begin a long overdue formal restructuring process of shedding costs

(including jobs) to increase cash flow and selling non-core assets to pay down debt. Many of these companies in the past few years avoided a formal restructuring by negotiating temporary forbearances or tapping low cost rescue refinancing, which have all but evaporated.

There may be further earnings restatements from corporations and large loan reserve announcements from financial institutions including an uncertain future for some of the remaining lending giants. Institutions with highly leveraged exposure to margin calls may also start to sell some of their better quality portfolios at attractive discounts in order to build up cash reserves. Even more, there is also the possibility of legislative reform to instill some accountability to those rating agencies and more transparency in the securities held by hedge funds.

For the LBO high-yield bond market, which is up more than 70% in issuance volume for this year at \$700 billion, anticipate the additional \$300 billion of pending issues (i.e., HD Supply, First Data etc.) to be either re-priced from a low risk premium of LIBOR+300 to a historically normal risk premium of LIBOR+600 or more or withdrawn altogether. As the LBO and stock buyback markets cool, this may remove one of the main catalysts that have been driving the overall stock markets.

For middle-market M&A, prices may compress as the cash-flow loan market dissipates and asset-based lenders tighten their underwriting criteria and bolster reporting requirements for existing credits. Anticipate the return of seller notes and earnout mechanisms that help bridge the gap in valuation between seller and buyer, and spreads the cost of the acquisition over later periods. Look for credit watch lists of banks to begin swelling as they take a much closer look under the hood of their most leveraged clients.

As the volatility in the market continues, monthly 401(k) statements hit consumer mailboxes and losses appear in print, the real psychological impact of this storm will take hold. Consumers will realize that in order to retire, they need to save more and spend much less unless they intend to continue working until age 85. Because consumer spending accounts for two-thirds of GDP growth, look for this barometer to compress and move closer to negative territory through 2008. Following the housing meltdown, other industries such as retail, automotive and hospitality will feel the next impact of this consumer spending retrenchment.

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When the eye of "Hurricane Lester Leverage" finally passes over us, the Federal Reserve will have taken all traditional emergency measures to calm the markets including lowering interest rates and injecting massive amounts of liquidity into the financial system. As the tail end of the storm rolls out, however, we'll need to watch our backs. If one of the immutable principles of economics still holds true, that everything eventually regresses to the mean, then this credit crisis is going to be a very mean regression for a lot of smart people who provided the key

ingredients to fuel this storm in addition to innocent individuals who have only their life jackets to hang on to throughout the balance of 2007 and 2008.

The silver lining, however, is that investment prospects continue to exist. The value investors who are looking to invest at distressed prices will likely have significantly more deals to review than in recent years. The strategy will need to be a buy, fix and hold until the economy cycles through the storm, although it will certainly be challenging to deliver the capital structures in a tighter credit environment. To be sure, those who do find the right opportunities will be well rewarded for their effort. **abfj**

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