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Reuters HedgeWorld & Dykema 2011 Insolvency Outlook Survey

March 2011

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Executive Summary

With an increasing preference for debt and growing appetite for risk, today's hedge fund managers are generating positive returns from financially troubled companies using a variety of strategies, according to the Reuters HedgeWorld & Dykema 2011 Insolvency Outlook Survey

Shrugging off the impact of the Dodd-Frank Act and several recent court decisions, hedge funds are focused on holding their debt positions in financially troubled companies in search of enhanced returns as the economic climate improves.

Highlights of the Reuters HedgeWorld & Dykema 2011 Insolvency Outlook Survey include:

- Marking a record high in the four-year history of the survey, 72 percent of hedge fund managers report having a portion of their portfolios invested in financially troubled companies, up from 65 percent in 2010.

- Financially troubled companies continue to generate positive returns for the majority of hedge funds: 62 percent of respondents who invested in financially troubled companies have seen these positions increase in value.

- Loan to own strategies bounced back: 29 percent of respondents report loaning money to a financially troubled company in pursuit of a loan to own strategy, up from 17 percent the previous year, and 50 percent of these hedge funds successfully acquired an ownership stake.

- For the second consecutive year, the majority of respondents (57 percent) expect lending activity to insolvent companies to increase as hedge funds look to capitalize on higher rates charged to "riskier" companies.

- 1 in 3 hedge funds reports that it is likely to invest in municipal debt in the next year.

- More hedge funds managers (56 percent) expect to hold debt in 2011 vs. sell debt (26 percent).

- Amid recent high-profile company failures, the bankruptcy of Lehman Brothers had the greatest negative impact on hedge fund portfolios.

- The majority of hedge fund managers (58 percent) believe that the Dodd-Frank Act will be ineffective in making the marketplace more transparent.

Q1. Do you expect that the availability of investment capital to financially troubled companies will increase or decrease in the next year?			
Responses	**Count**	**%**	**Percentage of total respondents**
Increase	69	68.32%	
Decrease	29	28.71%	
(Did not answer)	3	2.97%	
Total Responses	**101**		**20% 40% 60% 80% 100%**

- As the markets have recovered, so has the appetite for risk: 68 percent of respondents expect that the availability of capital to financially troubled companies will increase in 2011, up from 55 percent in 2010.

Q2. As potential investments, how will the risk profiles of financially troubled companies can change in the next 12 months?			
Responses	**Count**	**%**	**Percentage of total respondents**
Become riskier	50	49.50%	
No change	25	24.75%	
Become less risky	24	23.76%	
(Did not answer)	2	1.98%	
Total Responses	**101**		**20% 40% 60% 80% 100%**

- The risk profiles of financially troubled companies are expected to rise: 50 percent of respondents believe that financially troubled companies will become riskier investments in the next 12 months, up slightly from 47 percent of respondents in 2010.

Q3. Do you expect that lending activity to financially troubled companies will increase or decrease in the next 12 months?			
Responses	**Count**	**%**	**Percentage of total respondents**
Increase	58	57.43%	
Decrease	40	39.60%	
(Did not answer)	3	2.97%	
Total Responses	**101**		**20% 40% 60% 80% 100%**

- For the second consecutive year, the majority of respondents (57 percent) expect lending activity to insolvent companies to increase as hedge funds look to capitalize on higher rates charged to "riskier" companies.

Q4. What percentage of your portfolio is composed of debt or equity positions in financially troubled companies?			
Responses	**Count**	**%**	**Percentage of total respondents**
None	28	27.72%	
1-10%	38	37.62%	
11-20%	16	15.84%	
21-30%	3	2.97%	
31-40%	3	2.97%	
More than 40%	10	9.90%	
(Did not answer)	3	2.97%	
Total Responses	**101**		**20% 40% 60% 80% 100%**

- 72 percent of hedge fund managers report having a portion of their portfolios invested in financially troubled companies, up from 65 percent in 2010. This figure has risen steadily during the past three years, climbing to a new high from 53 percent in 2009.
  - Taking a closer look at this group of distressed investors, respondents have refocused their positions at the lower end of the scale: 3 out of 4 hedge fund managers now allocate less than 20 percent of their portfolios toward distressed debt or equity positions.

Q5. Have these positions increased or decreased in value during the past year?			
Responses	**Count**	**%**	**Percentage of total respondents**
Increased	43	62.32%	
Decreased	26	37.68%	
Total Responses	**69**		**20% 40% 60% 80% 100%**

- Financially troubled companies continue to generate positive returns for the majority of hedge funds: 62 percent of respondents who invested in financially troubled companies have seen these positions increase in value, up slightly from 59 percent in 2010.

Note: Question No. 5 was only made available to those respondents who reported that a percentage of their portfolio was composed of distressed debt or equity positions in financially troubled companies in Question No. 4.

Q6. Have you invested in distressed debt in the past 12 months?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	43	42.57%	
No	55	54.46%	
(Did not answer)	3	2.97%	
Total Responses	**101**		**20% 40% 60% 80% 100%**

- Distressed debt investing slipped slightly during the past year: 43 percent of respondents have invested in distressed debt in the past 12 months, down from 47 percent in 2010.

- Consistent with the results of our previous surveys, when the risk profiles of financially trouble companies rise as indicated in question No. 2, distressed debt investment activity falls accordingly.

Q7. In what type of distressed debt vehicle are you primarily investing?			
Responses	**Count**	**%**	**Percentage of total respondents**
Senior secured loans	14	32.56%	
Junior liens	3	6.98%	
Subordinated debt	7	16.28%	
Mezzanine loans	8	18.60%	
Unsecured debt	11	25.58%	
Total Responses	**43**		**20% 40% 60% 80% 100%**

- While senior secured loans remain the preferred distressed debt investment vehicle for the third consecutive year, hedge fund managers have dramatically redistributed their positions in the capital ladder to more closely resemble a barbell:
    - On the top rung of the capital structure, 33 percent of respondents have invested in senior secure loans, down from 57 percent in 2010.

- On the bottom rung of the capital structure, 26 percent of respondents have invested in unsecured debt.

- We believe the interest in unsecured debt is has been drive by two factors:

  1) Increased bankruptcy claims trading by hedge funds

  2) Hedge funds which are taking positions on all rungs of the capital ladder.

Q8. What was the aggregate amount in this investment?			
Responses	**Count**	**%**	**Percentage of total respondents**
0-$5 million	16	37.21%	
$6-10 million	14	32.56%	
$11-20 million	6	13.95%	
$21-50 million	4	9.30%	
$50 million or greater	3	6.98%	
Total Responses	**43**		**20% 40% 60% 80% 100%**

- The majority of hedge funds (70 percent) have invested $10 million or less in distressed debt with investments in the $6 – 10 million range experiencing the largest jump, more than doubling since last year.

- This migration represents a calculated shift from hedge funds which, consistent with the responses to Question No. 2, have begun embracing risk again in search of greater returns by opting for small, incremental increases in their distressed debt investments.

- To illustrate, distressed debt investments valued at $21 million or greater dropped to 16 percent, down from 24 percent last year.

Note: Questions Nos. 7 and 8 were only made available to those respondents who answered “yes” when asked if they had invested in distressed debt in the past 12 months in question No. 6.

Q9. In the coming year, which of the following will have the greatest impact on distressed debt investments purchased by hedge funds? Please select one:			
Responses	**Count**	**%**	**Percentage of total respondents**
Availability of capital	29	28.71%	
Availability of debt in order to leverage portfolio	14	13.86%	
Interest rates	28	27.72%	
Investor pressure to deploy capital	4	3.96%	
Redemptions requests from investors	7	6.93%	
Stock market performance	9	8.91%	
US government intervention	8	7.92%	
(Did not answer)	2	1.98%	
Total Responses	**101**		**20% 40% 60% 80% 100%**

- For the second consecutive year, the availability of capital (29 percent) and interest rates (28 percent) are the top two concerns facing hedge funds over their distressed debt investments in 2011, followed by the availability of debt – which finished a distant third (14 percent).

Q10. Have you created a new investment vehicle(s) in the past 12 months to acquire debt or equity in distressed companies?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	18	17.82%	
No	78	77.23%	
(Did not answer)	5	4.95%	
Total Responses	**101**		**20% 40% 60% 80% 100%**

- Amid a crowded marketplace, only 18 percent of hedge fund managers created a new distressed investment vehicle, down slightly from 20 percent last year.

Q11. How much money have you raised for this vehicle(s)?			
Responses	**Count**	**%**	**Percentage of total respondents**
0-$5 million	6	33.33%	
$6-10 million	2	11.11%	
$11-20 million	5	27.78%	
$21-50 million	1	5.56%	
$50 million or greater	4	22.22%	
Total Responses	**18**		**20% 40% 60% 80% 100%**

- Hedge fund managers who created new distressed investment vehicles indicate that the majority of this money (72 percent) was raised for smaller to mid-sized funds valued at $20 million or less. This represents a noticeable downsizing from last year when 1 out of 3 respondents raised $50 million or greater for new distressed vehicles.

Note: Question No. 11 was only made available to those respondents who answered "yes" when asked if they had created a new investment vehicle to take advantage of opportunities in distressed companies in the past 12 months in question No. 10.

Q12. Have you loaned money to a financially troubled company or purchased the debt of a financially troubled company in pursuit of a loan to own strategy in the past 12 months?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	29	28.71%	
No	68	67.33%	
(Did not answer)	4	3.96%	
Total Responses	**101**		**20% 40% 60% 80% 100%**

- Loan to own strategies bounced back in 2010: 29 percent of respondents report loaning money to a financially troubled company in pursuit of a loan to own strategy, up from 17 percent the previous year but well off the high of 43 percent we reported from 2008.

- As prepackaged bankruptcies became more popular in 2010, we believe this represents an expectation among hedge fund managers that loan to own strategies will be successful not withstanding the *In re DBSD North America* decision.

Q13. Have you successfully acquired an ownership stake in any of these companies?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	14	48.28%	
No	15	51.72%	
Total Responses	**29**		**20% 40% 60% 80% 100%**

- Among those respondents implementing a loan to own strategy in the past year, nearly 50 percent were successful in acquiring ownership in a financially troubled company.

- Notably, this success rate also likely helped fuel the rebound in loan to own strategies reported in Question No. 12.

Note: Question No. 13 was only made available to those respondents who answered “yes” when asked if they had loaned money to a financially troubled company in pursuit of a loan to own strategy in the past 12 months in question No. 12.

Q14. Are you aware of the Chapter 11 case, In re DBSD North America, Inc., in which the bankruptcy court disqualified the votes of a creditor pursuing a loan to own strategy due to "ulterior motive"?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	27	26.73%	
No	58	57.43%	
(Did not answer)	16	15.84%	
Total Responses	**101**		**20% 40% 60% 80% 100%**

- The percentage of hedge funds aware of the impact of *In re DBSD North America, Inc.* on creditors (27 percent) is generally limited to those pursuing a specific loan to own strategy (29 percent) in Question No. 12.

Q15. Are you likely to sell debt in financially troubled companies in the next 12 months?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	26	25.74%	
No	57	56.44%	
(Did not answer)	18	17.82%	
Total Responses	**101**		**20% 40% 60% 80% 100%**

- More hedge funds managers expect to hold debt in 2011. Only 26 percent of respondents report they are likely to sell debt in financially troubled companies in 2011, down significantly from 39 percent in 2010.

- Consistent with the responses to Question Nos. 1 and 3, we believe that this reflects a growing perception among hedge fund managers that there is additional upside as increased investment capital and lending resources will bolster financially troubled companies in 2011 and net better offers down the line.

Q16. Have you made any equity investments in financially troubled companies in the past 12 months?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	35	34.65%	
No	50	49.50%	
(Did not answer)	16	15.84%	
Total Responses	**101**		**20% 40% 60% 80% 100%**

- Expecting better returns on the debt side, hedge fund managers trimmed the rate of their equity investments in financially troubled companies: 35 percent of hedge funds made an equity investment in a financially troubled company in the past 12 months, down from 49 percent in 2010.

- Facing asset values that continue to decline amid leveraged balance sheets, equity positions in financially troubled companies are no longer as attractive to hedge funds which could find themselves too far “out of the money” in a bankruptcy proceeding.

Q17. How large was this investment(s)?			
Responses	**Count**	**%**	**Percentage of total respondents**
0-$1 million	24	48.98%	
$1-5 million	14	28.57%	
$5-10 million	6	12.24%	
$10-50 million	4	8.16%	
Over $50 million	1	2.04%	
Total Responses	**49**		**20% 40% 60% 80% 100%**

- The majority of hedge funds (49 percent) are making small equity investments less than $1 million. Given the small amounts, these investments likely serve as a primary hedge against their debt positions in the same financially troubled companies because the vast majority of equity positions will be wiped out in a bankruptcy proceeding.

Q18. Were you involved in a prepackaged bankruptcy in 2010?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	8	7.92%	
No	91	90.10%	
(Did not answer)	2	1.98%	
Total Responses	**101**		**20% 40% 60% 80% 100%**

Q19. Under this prepackaged bankruptcy, did you exchange debt for equity?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	7	87.50%	
No	1	12.50%	
Total Responses	**8**		**20% 40% 60% 80% 100%**

- Only 8 percent of hedge funds participated in a prepackaged bankruptcy in the past year and of these respondents, nearly 9 out of 10 swapped debt for equity.

Note: Question No. 19 was only made available to those respondents who answered "yes" when asked if they were involved in a prepackaged bankruptcy in 2010 in Question No. 18.

Q20. Which of the following recent company failures had the most significant impact on your portfolio?			
Responses	**Count**	**%**	**Percentage of total respondents**
Ambac Financial Group	6	5.94%	
American Media	1	0.99%	
A&P	1	0.99%	
Blockbuster	7	6.93%	
Extended Stay	3	2.97%	
General Growth Properties	4	3.96%	
Lehman Brothers	50	49.50%	
Metro-Goldwyn-Mayer	3	2.97%	
Tribune Co.	2	1.98%	
Washington Mutual	9	8.91%	
(Did not answer)	15	14.85%	
Total Responses	**101**		**20% 40% 60% 80% 100%**

- By a wide margin, the failure of Lehman Brothers had the greatest impact on respondents' portfolios.

Q21. Was this "impact" positive or negative?			
Responses	**Count**	**%**	**Percentage of total respondents**
Positive	20	23.26%	
Negative	66	76.74%	
Total Responses	**86**		**20% 40% 60% 80% 100%**

- Led by the bankruptcy of Lehman Brothers, company failures had an overwhelmingly negative impact (77 percent) on hedge fund portfolios.

Note: Question No. 21 was only made available to those respondents who answered Question No. 20.

Q22. Which of the following represent the most attractive distressed debt investment opportunity during the next 12 months? Please rank in order of importance with 1 being most important:															
Responses / Ranks															**Weighted Rank (Score)**
Banking	15	15	9	7	6	3	6	4	4	1	2	2	0	3	1 (799)
Energy	13	13	5	6	4	5	3	7	7	1	1	7	0	5	2 (712)
Housing	10	9	3	10	10	7	2	4	4	4	4	4	1	5	3 (689)
Automotive	5	4	6	13	4	10	6	6	2	5	4	2	8	2	4 (634)
Healthcare	5	4	7	7	8	8	5	3	8	7	3	7	5	0	5 (622)
Office buildings	3	6	11	4	7	3	4	6	5	10	7	4	6	1	6 (600)
Hotel/hospitality	2	6	4	6	5	7	10	6	8	8	6	3	4	2	7 (586)
Airline	8	4	4	2	9	3	7	9	3	5	6	5	4	8	8 (568)
Gaming/casino	1	2	8	4	5	6	6	8	10	7	5	6	6	3	9 (536)
Retail	2	1	7	3	8	6	7	8	5	7	7	7	6	3	10 (533)
Public/municipal debt	6	3	5	4	2	5	4	7	4	11	8	5	6	7	11 (518)
Subprime lenders	5	6	5	3	4	2	3	3	8	3	4	8	18	5	12 (488)
Restaurant	1	2	0	4	2	8	10	2	5	6	15	12	5	5	13 (441)
Other	1	2	3	4	3	4	4	4	4	2	5	5	8	28	14 (359)
(Did not answer)															24
Total Responses															**101**

- For the third consecutive year, respondents rank the banking and energy industries as the two most attractive distressed debt investment opportunities in 2011.

- Notably, the housing industry posted the biggest move, jumping up three spots to No. 3 from No. 6 last year as the hedge fund industry seems to expect housing to finally bottom in 2011.

- Ranked near the bottom, concerns over public/municipal debt (No. 11) have not made it an attractive target for hedge fund investment – yet.

Note: To calculate the weighted rank (score), selections were ranked 1-10 using an inverse weighted scale that valued each response as follows:

- 1 – 10 points
- 2 – 9 points
- 3 – 8 points
- 4 – 7 points
- 5 – 6 points
- 6 – 5 points
- 7 – 4 points
- 8 – 3 points
- 9 – 2 points
- 10 – 1 points

Q23. Do you think heightened hedge fund regulation under the Dodd-Frank Act will be effective in creating a more transparent marketplace?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	39	38.61%	
No	59	58.42%	
(Did not answer)	3	2.97%	
Total Responses	**101**		**20% 40% 60% 80% 100%**

- Facing further regulation, the majority of hedge fund managers (58 percent) believe the Dodd-Frank Act will be ineffective in making the marketplace more transparent.

Q24. Will the much-publicized decisions in the Philadelphia Newspapers and Pacific Lumber cases influence your decision to purchase senior secured positions in the future?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	23	22.77%	
No	73	72.28%	
(Did not answer)	5	4.95%	
Total Responses	**101**		**20% 40% 60% 80% 100%**

- In the wake of these decisions which deny secured creditors the right to credit bid, the majority of respondents remains undeterred (72 percent) and appears prepared to bid cash with the expectation that the cash will be used to repay their secured debt.

Q25. Are you likely to invest in municipal debt during the next year?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	34	33.66%	
No	63	62.38%	
(Did not answer)	4	3.96%	
Total Responses	**101**		**20% 40% 60% 80% 100%**

- Despite highly publicized concerns among several bond market analysts, 1 in 3 hedge funds reports that it is likely to invest in municipal debt in the next year.
- We believe this suggests that the hedge fund industry does not expect widespread municipal defaults to occur in 2011.

Q26. Are you willing to make additional investments to stabilize or "bail out" your original position in a company experiencing financial instability?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	47	46.53%	
No	51	50.50%	
(Did not answer)	3	2.97%	
Total Responses	**101**		**20% 40% 60% 80% 100%**

- Unchanged from a year ago, the majority of respondents (51 percent) are still not willing to make additional "bail-out" investments in a company experiencing financial difficulty.

Q27. Do you have a strategy in place to address potential insolvency issues related to current investments?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	73	72.28%	
No	22	21.78%	
(Did not answer)	6	5.94%	
Total Responses	**101**		**20% 40% 60% 80% 100%**

- Rising steadily since the recession, 72 percent of hedge fund managers have a strategy in place to address potential insolvency issues related to current investments, up from 64 percent in 2009.

Q28. In the past 12 months, have you consulted a turnaround or workout professional regarding positions in your portfolio?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	26	25.74%	
No	72	71.29%	
(Did not answer)	3	2.97%	
Total Responses	**101**		**20% 40% 60% 80% 100%**

- In line with last year's results, 26 percent of hedge funds have consulted a turnaround or workout professional regarding positions in their portfolios during the past 12 months.

Q29. Which of the following options best describes your attitude toward the potential for insolvency issues to affect assets in your investment portfolio?			
Responses	**Count**	**%**	**Percentage of total respondents**
Strongly concerned	17	16.83%	
Somewhat concerned	64	63.37%	
Not concerned at all	13	12.87%	
Not applicable	4	3.96%	
(Did not answer)	3	2.97%	
Total Responses	**101**		**20% 40% 60% 80% 100%**

- Concern has moderated slightly, but the majority of respondents (80 percent) still express some level of apprehension regarding the impact of insolvency on their portfolios:
  - Down from 22 percent last year, 17 percent of hedge fund managers report being "strongly concerned" about the potential for insolvency issues to affect assets in their investments portfolios.

Methodology

Between January and February of this year, Reuters HedgeWorld and Dykema distributed a survey via email to hedge fund managers which was completed by 101 respondents. Due to rounding, all percentages used in all questions may not add up to 100 percent.