Reuters HedgeWorld & Dykema 2010 Insolvency Outlook Survey

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Executive Summary

Signaling a reversal in how financially troubled companies are perceived as the economy emerges from recession, the majority of today's hedge fund managers have embraced a more opportunistic approach toward insolvency-related investments, according to the Reuters HedgeWorld & Dykema 2010 Insolvency Outlook Survey.

Armed with war chests of capital to deploy and greater comfort levels dealing with financially troubled companies, hedge funds are once again positioning themselves to capitalize on higher returns generated by financially troubled companies as interest rates and other yields remain stagnant.

Highlights of the Reuters HedgeWorld & Dykema 2010 Insolvency Outlook Survey include:

- Loan to own strategies have fallen out of favor with hedge fund managers: 17 percent of respondents report loaning money to a financially troubled company in pursuit of a loan to own strategy, down sharply from 43 percent in 2009.
- Surprisingly, while secured loans remained the preferred distressed debt investment vehicle, hedge fund managers reported that the rate of subordinated debt investments tripled from 7 to 21 percent in 2010.
- 70 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.
- 59 percent of respondents who invested in financially troubled companies have seen these positions increase in value in the past year.
- 56 percent of respondents expect that the availability of capital to financially troubled companies will increase in 2010, up from 37 percent in 2009.
- The majority of respondents (52 percent) expect that the risk profiles of financially troubled companies will remain unchanged or will improve in 2010.
- 65 percent of hedge fund managers report having a portion of their portfolios invested in financially troubled companies, up from 53 percent in 2009.
- 1 in 5 hedge fund managers has created a new investment vehicle to take advantage of opportunities in distressed companies in the past 12 months.
- Only 21 percent of hedge funds are party to an intercreditor agreement but nearly half of these respondents (44 percent) reported a dispute with another party in their agreement.

1. 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	67	55.83%	
Decrease	50	41.67%	
(Did not answer)	3	2.50%	
Total Responses	**120**		**20% 40% 60% 80% 100%**

- Experiencing greater levels of comfort from dealing with financially troubled companies during the past three years – and an increased willingness to put capital to work – 56 percent of respondents expect that the availability of capital to financially troubled companies will increase in 2010, compared with 37 percent in 2009.

2. As potential investments, how will the risk profiles of financially troubled companies change in the next 12 months?			
Responses	**Count**	**%**	**Percentage of total respondents**
Become riskier	56	46.67%	
No change	34	28.33%	
Become less risky	28	23.33%	
(Did not answer)	2	1.67%	
Total Responses	**120**		**20% 40% 60% 80% 100%**

- After peaking in 2007, the risk profiles of financially troubled companies continue to decline: 47 percent of respondents believe that financially troubled companies will become riskier investments in the next 12 months, down from 58 percent of respondents in 2009 and 84 percent of respondents in 2007.

- For the first time in the three-year history of the Reuters HedgeWorld Insolvency Outlook Survey, the majority of respondents (52 percent) expect that the risk profiles of financially troubled companies will remain unchanged or improve (i.e., “become less risky”) in 2010.

3. 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	67	55.83%	
Decrease	49	40.83%	
(Did not answer)	4	3.33%	
Total Responses	**120**		**20% 40% 60% 80% 100%**

- Consistent with their improved risk assessment of financially troubled companies, 56 percent of respondents expect lending activity to insolvent companies to increase, up from 41 percent in 2009.

4. What percentage of your portfolio is composed of distressed debt or equity positions in financially troubled companies?			
Responses	**Count**	**%**	**Percentage of total respondents**
None	39	32.50%	
1-10%	40	33.33%	
11-20%	12	10.00%	
21-30%	14	11.67%	
31-40%	2	1.67%	
More than 40%	10	8.33%	
(Did not answer)	3	2.50%	
Total Responses	**120**		**20% 40% 60% 80% 100%**

- 65 percent of hedge fund managers report having a portion of their portfolios invested in financially troubled companies, up from 53 percent in 2009.
    - This is clear evidence that as the financial markets have stabilized hedge fund managers have become more comfortable increasing their exposure to financially troubled companies.
- The percentage of distressed positions within hedge fund portfolios has also increased noticeably: 1 in 3 respondents has more than 20 percent of its portfolio in distressed debt or equity positions, compared with only 1 in 10 respondents in 2009.

5. Have these positions increased or decreased in value during the past year?			
Responses	**Count**	**%**	**Percentage of total respondents**
Increased	46	58.97%	
Decreased	32	41.03%	
Total Responses	**78**		**20% 40% 60% 80% 100%**

- 59 percent of respondents who invested in financially troubled companies have seen these positions increase in value in the past year.

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.

6. 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	32	26.67%	
Availability of debt in order to leverage portfolio	14	11.67%	
Interest rates	20	16.67%	
Investor pressure to deploy capital	15	12.50%	
Redemptions requests from investors	13	10.83%	
Stock market performance	11	9.17%	
U.S. government intervention	13	10.83%	
(Did not answer)	2	1.67%	
Total Responses	**120**		**20% 40% 60% 80% 100%**

- For the second consecutive year, respondents believe that the availability of capital will have the greatest impact on distressed debt purchase by hedge funds.

- Notably, interest rates have spiked as a major concern for hedge fund managers, trailing only the availability of capital in 2010 after finishing as an afterthought in 2009 (seventh overall).

7. Have you invested in distressed debt in the past 12 months?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	56	46.67%	
No	61	50.83%	
(Did not answer)	3	2.50%	
Total Responses	**120**		**20% 40% 60% 80% 100%**

- Hedge fund managers reported an uptick in distressed debt investing: 46 percent of respondents have invested in distressed debt in the past 12 months, up from 36 percent in 2009.

8. In what type of distressed debt vehicle are you primarily investing?			
Responses	**Count**	**%**	**Percentage of total respondents**
Secured loans	32	57.14%	
Unsecured loans	7	12.50%	
Subordinated debt	12	21.43%	
Mezzanine debt	5	8.93%	
Total Responses	**56**		**20% 40% 60% 80% 100%**

- While secured loans remain the preferred distressed debt investment vehicle for the second consecutive year, hedge fund managers reported that the rate of subordinated debt investments tripled from 7 to 21 percent in 2010.
  - This shift came at the expense of secured loans, which were selected as the primary investments vehicle by 57 percent of respondents in 2010, down from 78 percent last year.
  - It is surprising that hedge fund manages are moving down in the capital structure but we believe this represents a better understanding of the fulcrum points for financially troubled companies where debt may be converted to equity, as well as a search for higher returns on invested capital.
  - As part of this search for greater returns, we also believe hedge funds may be investing at a lower level as part of a more "hands-off" approach, knowing that they can now generate strong returns without focusing on secured loans or the ownership opportunities that secured loans can create in an insolvency proceeding.

9. What was the aggregate amount in this investment?			
Responses	**Count**	**%**	**Percentage of total respondents**
0-$5 million	25	44.64%	
$6-10 million	9	16.07%	
$11-20 million	9	16.07%	
$21-50 million	7	12.50%	
$50 million or greater	6	10.71%	
Total Responses	**56**		**20% 40% 60% 80% 100%**

- The majority of hedge funds (55 percent) are investing $6 million or more in distressed debt.
- Distressed debt investments made in the $21 - 50 million range have seen the largest jump, rising to 13 percent from 5 percent last year.

Note: Questions Nos. 8 and 9 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. 7.

10. Have you created a new investment vehicle(s) to take advantage of opportunities in distressed companies in the past 12 months?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	24	20.00%	
No	93	77.50%	
(Did not answer)	3	2.50%	
Total Responses	**120**		**20% 40% 60% 80% 100%**

- 1 in 5 hedge fund managers has created a new investment vehicle to take advantage of opportunities in distressed companies in the past 12 months.

11. How much money have you raised for this vehicle(s)?			
Responses	**Count**	**%**	**Percentage of total respondents**
0-$5 million	7	29.17%	
$6-10 million	3	12.50%	
$11-20 million	3	12.50%	
$21-50 million	3	12.50%	
$50 million or greater	8	33.33%	
Total Responses	**24**		**20% 40% 60% 80% 100%**

- Hedge fund managers who created new distressed investment vehicles indicate that the majority of this money was raised for mid- to larger-sized funds, led by 33 percent who raised $50 million or greater.

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.

12. Have you loaned money to a financially troubled company in pursuit of a loan to own strategy in the past 12 months?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	20	16.67%	
No	97	80.83%	
(Did not answer)	3	2.50%	
Total Responses	**120**		**20% 40% 60% 80% 100%**

- Loan to own strategies have lost their foothold with hedge fund managers: 17 percent of respondents report loaning money to a financially troubled company in pursuit of a loan to own strategy, down sharply from 43 percent in 2009.

- We also believe this represents a renewed confidence among hedge fund managers in the potential returns of financially troubled companies which has significantly weakened the need to pursue an ownership stake.

13. Have you successfully acquired ownership in any of these companies?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	4	20.00%	
No	16	80.00%	
Total Responses	**20**		**20% 40% 60% 80% 100%**

- Among those respondents implementing a loan to own strategy, only 20 percent ultimately acquired ownership in a financially troubled company during the past year.

<u>Note:</u> 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.

14. Which of the following industries 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	**Rank 1**	**Rank 2**	**Rank 3**	**Rank 4**	**Rank 5**	**Rank 6**	**Rank 7**	**Rank 8**	**Rank 9**	**Rank 10**	**Weighted Rank (Score)**
Banking	34	13	12	9	8	13	8	7	5	1	1 (793)
Energy	26	24	13	8	7	8	5	5	5	9	2 (772)
Healthcare	11	18	17	8	6	14	13	8	11	4	3 (672)
Other financial institutions	7	12	15	24	14	8	8	9	5	8	4 (667)
Commercial construction	6	13	16	13	11	13	11	12	12	3	5 (634)
Housing	10	6	9	15	18	9	18	10	11	4	6 (612)
Automotive	6	10	6	9	11	11	13	16	19	9	7 (529)
Airline	6	5	8	7	11	11	10	17	12	23	8 (477)
Restaurant	0	4	7	10	12	12	18	13	20	14	9 (459)
Subprime lenders	4	5	7	7	12	11	6	13	10	35	10 (435)
(Did not answer)											10
Total Responses											**120**

- For the second consecutive year, respondents rank the banking and energy industries as the two most attractive distressed debt investment opportunities in 2010.
  - In the banking industry, this likely reflects the expectation that investors will continue to purchase the banks, and portions of bank portfolios, which have been seized by the FDIC.
  - Meanwhile, with commodity prices stabilizing, hedge fund managers see opportunities in the energy industry which may include ethanol plants, oil trading firms or a variety of other assets levered to commodity prices.

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

15. Are you likely to sell debt in financially troubled companies in the next 12 months?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	47	39.17%	
No	68	56.67%	
(Did not answer)	5	4.17%	
Total Responses	**120**		**20% 40% 60% 80% 100%**

- Though the majority of respondents (57 percent) report they are unlikely to sell debt in financially troubled companies, a growing number of hedge fund managers do plan to sell debt in financially troubled companies in 2010.

- 39 percent of respondents are likely to sell debt in financially troubled companies in 2010, up from 23 percent last year.

16. Have you made any equity investments in financially troubled companies in the past 12 months?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	59	49.17%	
No	55	45.83%	
(Did not answer)	6	5.00%	
Total Responses	**120**		**20% 40% 60% 80% 100%**

- The rate of equity investments in financially troubled companies rose slightly: 49 percent of hedge funds have made an equity investment in a financially troubled company in the past 12 months, up 8 percent from 2009 (41 percent).

- Though a modest gain, we believe this growing preference for equity further reinforces the renewed sense of confidence hedge funds have investing in financially troubled companies.

17. How large was this equity investment(s)?			
Responses	**Count**	**%**	**Percentage of total respondents**
0-$1 million	20	33.90%	
$1-5 million	19	32.20%	
$5-10 million	11	18.64%	
$10-50 million	6	10.17%	
Over $50 million	3	5.08%	
Total Responses	**59**		**20% 40% 60% 80% 100%**

- More comfortable with financially troubled companies in today's marketplace, hedge funds put greater amounts of equity to work without making "big bets."
    - The percentage of funds investing in both the $1-5 million (32 percent) and $5-10 million (19 percent) ranges doubled from 2009.
    - Meanwhile, the small group of specialist hedge funds making larger, outsized investments of $50 million or greater in financially troubled companies shrank from 13 percent in 2009 to 5 percent in 2010.

Note: Question No. 17 was only made available to those respondents who answered "yes" when asked if they had made any equity investments in financially troubled companies in the past 12 months in question No. 16.

18. Which of the following recent company failures had the most significant impact on your portfolio?			
Responses	**Count**	**%**	**Percentage of total respondents**
Chrysler	7	5.83%	
CIT	40	33.33%	
General Growth Properties	18	15.00%	
General Motors	38	31.67%	
(Did not answer)	17	14.17%	
Total Responses	**120**		**20% 40% 60% 80% 100%**

- The failure of CIT slightly edged General Motors as the company with the greatest impact on respondents' portfolios.

19. Do you expect there will be greater U.S. government regulation of hedge funds in the next 12 months?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	107	89.17%	
No	9	7.50%	
(Did not answer)	4	3.33%	
Total Responses	**120**		**20% 40% 60% 80% 100%**

- For the third straight year, the overwhelming majority of hedge fund managers (9 out of 10) are bracing themselves for greater U.S. government regulation.

20. Are you party to an intercreditor agreement?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	25	20.83%	
No	91	75.83%	
(Did not answer)	4	3.33%	
Total Responses	**120**		**20% 40% 60% 80% 100%**

21. Has any dispute arisen with the other party or parties to the agreement?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	11	44.00%	
No	14	56.00%	
Total Responses	**25**		**20% 40% 60% 80% 100%**

22. How would you describe its resolution?			
Responses	**Count**	**%**	**Percentage of total respondents**
Favorable	2	18.18%	
Unfavorable	1	9.09%	
Unresolved	8	72.73%	
Total Responses	**11**		**20% 40% 60% 80% 100%**

- 21 percent of hedge funds are party to an intercreditor agreement.
    - Among these respondents, nearly half (44 percent) reported a dispute with another party in their agreement. Taking a closer look at these disputes, the overwhelming majority of respondents (82 percent) described their resolution as unresolved or unfavorable.

Note: Questions Nos. 21 and 22 were only made available to those respondents who reported that they were party to an intercreditor agreement in Question No. 20.

23. Were you a participant in a senior lending facility?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	22	18.33%	
No	95	79.17%	
(Did not answer)	3	2.50%	
Total Responses	**120**		**20% 40% 60% 80% 100%**

24. Has any dispute arisen about actions the agent should take in a bankruptcy?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	7	31.82%	
No	15	68.18%	
Total Responses	**22**		**20% 40% 60% 80% 100%**

25. How would you describe its resolution?			
Responses	**Count**	**%**	**Percentage of total respondents**
Favorable	2	28.57%	
Unfavorable	1	14.29%	
Unresolved	4	57.14%	
Total Responses	**7**		**20% 40% 60% 80% 100%**

- Only 18 percent of hedge funds participated in a senior lending facility.
    - Among these respondents, 32 percent reported a dispute concerning actions the agent should take in a bankruptcy and the majority of these disputes (57 percent) remain unresolved.

Note: Questions Nos. 24 and 25 were only made available to those respondents who reported that they were a participant in a senior lending facility in Question No. 23.

26. Which of the following best describes your familiarity with your legal rights should a company in your portfolio experience bankruptcy or face a similar insolvency issue?			
Responses	**Count**	**%**	**Percentage of total respondents**
I am aware of my legal rights and have fully assessed potential insolvency issues related to my assets and portfolio	58	48.33%	
I am aware of my legal rights but am not concerned about insolvency issues related to assets in my portfolio	36	30.00%	
I am relatively unaware of my legal rights in an insolvency situation	21	17.50%	
(Did not answer)	5	4.17%	
Total Responses	**120**		**20% 40% 60% 80% 100%**

- ➢ 78 percent of hedge fund managers are aware of their legal rights in the event of a bankruptcy or insolvency situation involving assets in their portfolios.

27. 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	52	43.33%	
No	61	50.83%	
(Did not answer)	7	5.83%	
Total Responses	**120**		**20% 40% 60% 80% 100%**

- ➢ Down slightly from 58 percent in 2009, the majority of respondents (51 percent) are still not willing to make additional “bail-out” investments in a company experiencing financial difficulty.

28. Do you have a strategy in place to address potential insolvency issues related to current investments?			
Responses	**Count**	**%**	**Percentage of total respondents**
Yes	84	70.00%	
No	32	26.67%	
(Did not answer)	4	3.33%	
Total Responses	**120**		**20% 40% 60% 80% 100%**

- ➢ Battle-tested by the recession, 70 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.

29. 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	29	24.17%	
No	85	70.83%	
(Did not answer)	6	5.00%	
Total Responses	**120**		**20% 40% 60% 80% 100%**

- Despite the recession, only 24 percent of hedge funds have consulted a turnaround or workout professional regarding positions in their portfolios during the past 12 months.

30. 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	26	21.67%	
Somewhat concerned	64	53.33%	
Not concerned at all	11	9.17%	
Not applicable	15	12.50%	
(Did not answer)	4	3.33%	
Total Responses	**120**		**20% 40% 60% 80% 100%**

- Unchanged from a year ago, the overwhelming majority of respondents (75 percent) report being concerned about the potential for insolvency issues to affect assets in their investments portfolios.

- Interestingly, hedge fund managers have put aside these concerns and increased the amount of their portfolios allocated to financially troubled companies in 2010.

Methodology

Between December 2009 and January 2010, Reuters HedgeWorld and Dykema distributed a survey via e-mail to hedge fund managers which was completed by 120 respondents.

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.

Questions Nos. 8 and 9 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. 7.

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.

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.

Question No. 17 was only made available to those respondents who answered "yes" when asked if they had made any equity investments in financially troubled companies in the past 12 months in question No. 16.

Questions Nos. 21 and 22 were only made available to those respondents who reported that they were party to an intercreditor agreement in Question No. 20.

Questions Nos. 24 and 25 were only made available to those respondents who reported that they were a participant in a senior lending facility in Question No. 23.

Due to rounding, all percentages used in all questions may not add up to 100 percent.