NCBJ | National Conference of Bankruptcy Judges

Evolution of the Capital Stack and the Tectonic Shift of the Players at the Table (Fundamental Changes)

October 10, 2017

Executive Summary

- In the past, commercial banks syndicated and held loans; investment banks underwrote and sold bonds
- Banks today originate and sell and rarely retain exposure to corporate credit. This is primarily due to increased regulation and increased capital requirements, but was also happening after mega-mergers between investment and commercial banks prior to the crisis
- As interest rates have compressed over the past 10 years, there has been an increased demand for yield and accordingly the markets for high yield bonds and levered loans have grown significantly
- At the same time, borrowers have used the proceeds to refinance debt at lower interest rates and for acquisitions to stimulate revenue and earnings growth

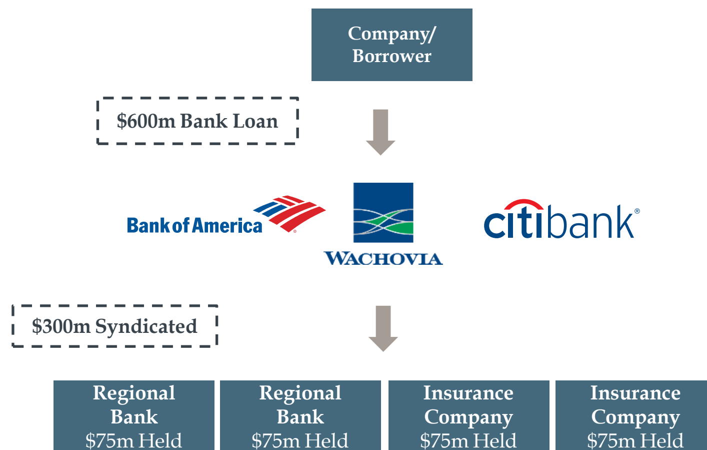
Executive Summary

- Firms like Blackrock, Fidelity and Pimco have grown assets, Collateralized Loan Obligations (CLOs) and Business Development Companies (BDCs) have emerged as significant originators, and large institutional asset management firms and hedge fund capital have grown
    - —These institutions have been the buyers of new credit issues
    - —They own credit through an economic cycle and are often now the largest constituencies in in-court and out-of-court balance sheet restructuring
    - —Their interests, regulatory and contractual restrictions, and time horizons on investments have changed the landscape in the restructuring and bankruptcy community along with the increased presence of distressed credit hedge funds in capital structures

Classic Model of Debt Origination / Issuance

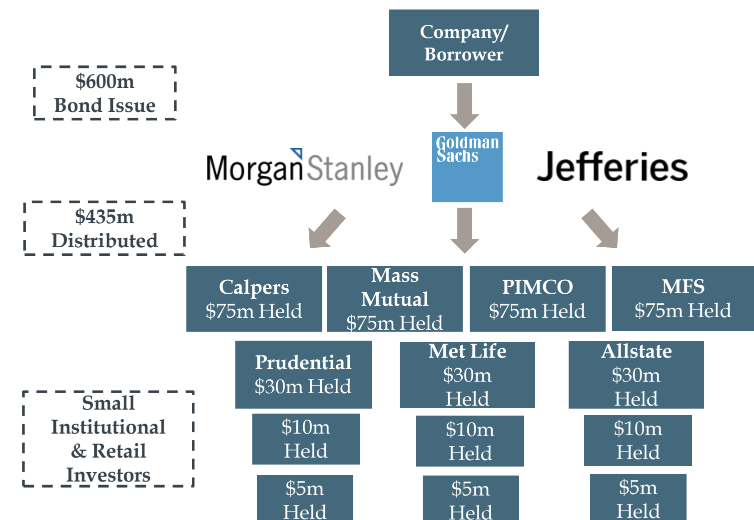
Classic Bank Loan Model – Commercial Bank Centric

- Banks underwrite and syndicate loans, retaining meaningful positions in the credit



Classic Bond Issuance Model – Investment Bank Centric

- Investment banks underwrite and distribute bonds and other securities

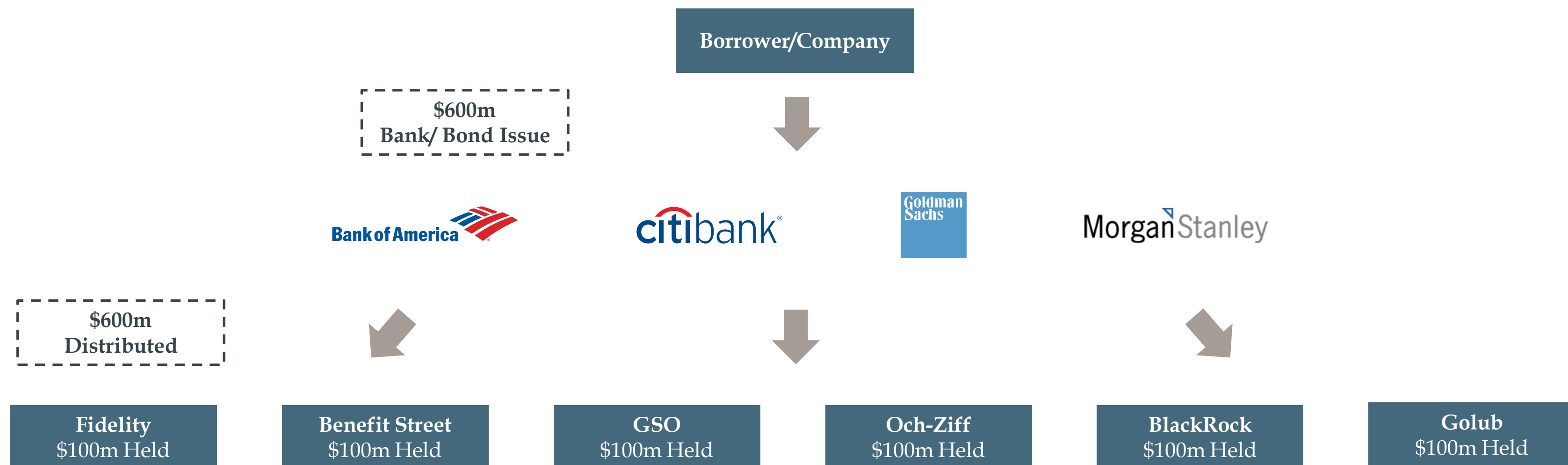


- Regulations, such as the Volcker rule, and capital requirements have caused a shift in the role of commercial and investment banks in the market place…

…Today the Structure has Transitioned to an "Originate and Sell" Model

- The role of banks in the market place has changed due to increased regulation and increased capital requirements. The "costs" of traditional banks continuing to own credit makes them less competitive to other credit investors

- Banks now originate and sell loans to a variety of traditional institutional holders and hedge funds



…Today the Structure has Transitioned to an "Originate and Sell" Model

- The owners of credit today:

  —Limited on what instruments they are allowed to own and could be forced sellers of securities if they must equitize

  —Face limitations on percentage ownership of non-accrual loans

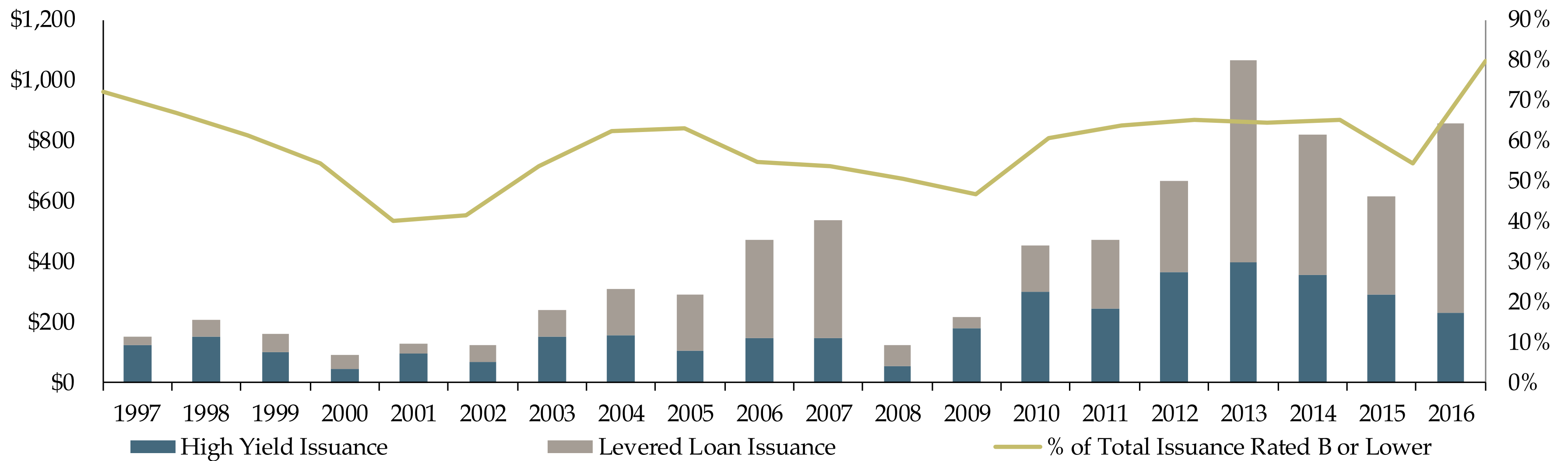
  —Confront a mismatch of assets and liabilities, often with daily, monthly or quarterly liquidity needs

  —Judged on short-term performance metrics making them sensitive to price volatility of the debt owned

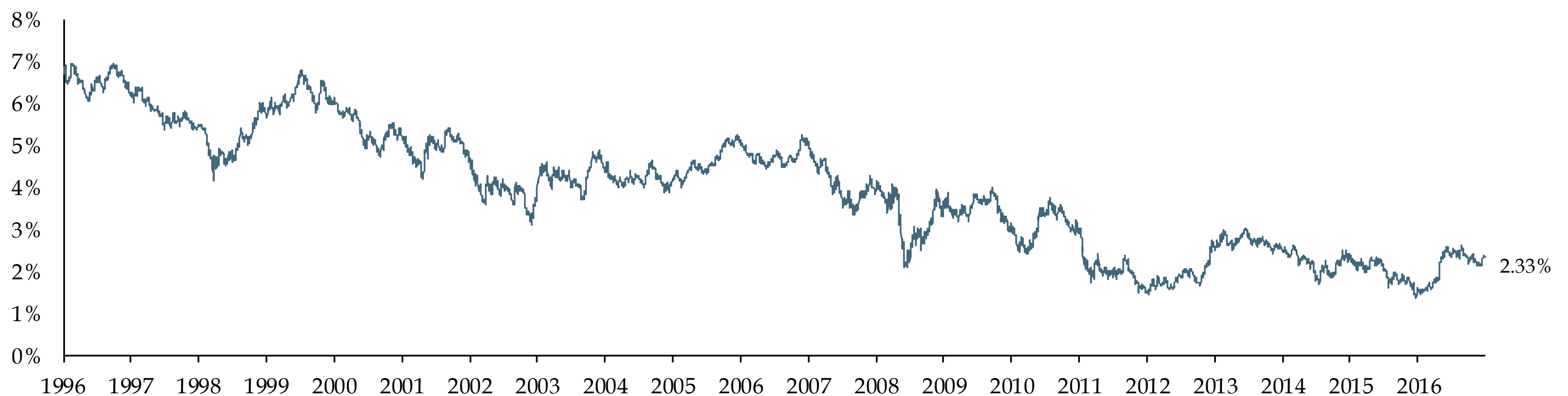
Drivers of Change - Growth of High Yield and Leveraged Loans

Size of the High Yield and Levered Loans Markets has Ballooned, particularly for Companies with Lower Credit Ratings

High Yield Issuance & Leveraged Loans ($BN / %)



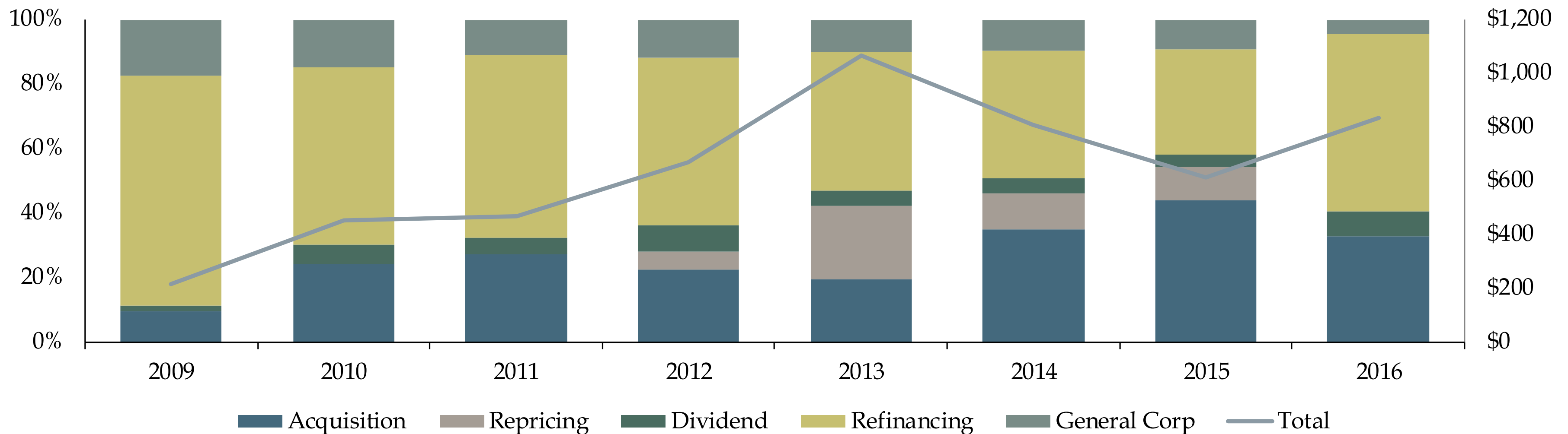
10 Year Treasury Yield (%)



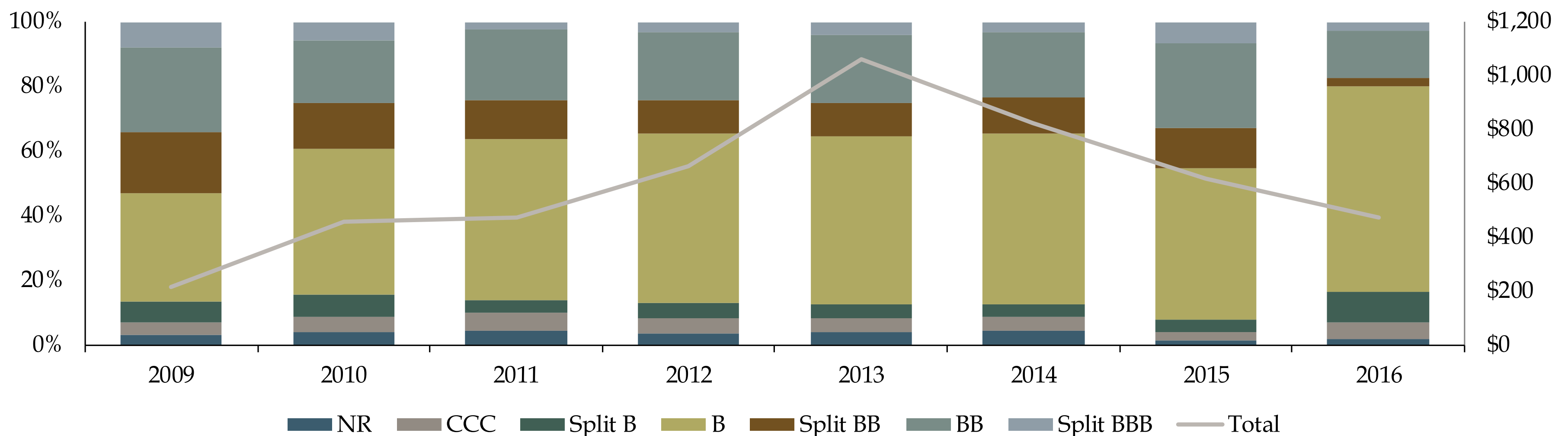
Source: LCD, FactSet, Cap IQ as of July 10, 2017

(cont'd) Drivers of Change - Growth of High Yield and Leverage Loans

Acquisitions are the Primary Use of Cash (% / $BN)



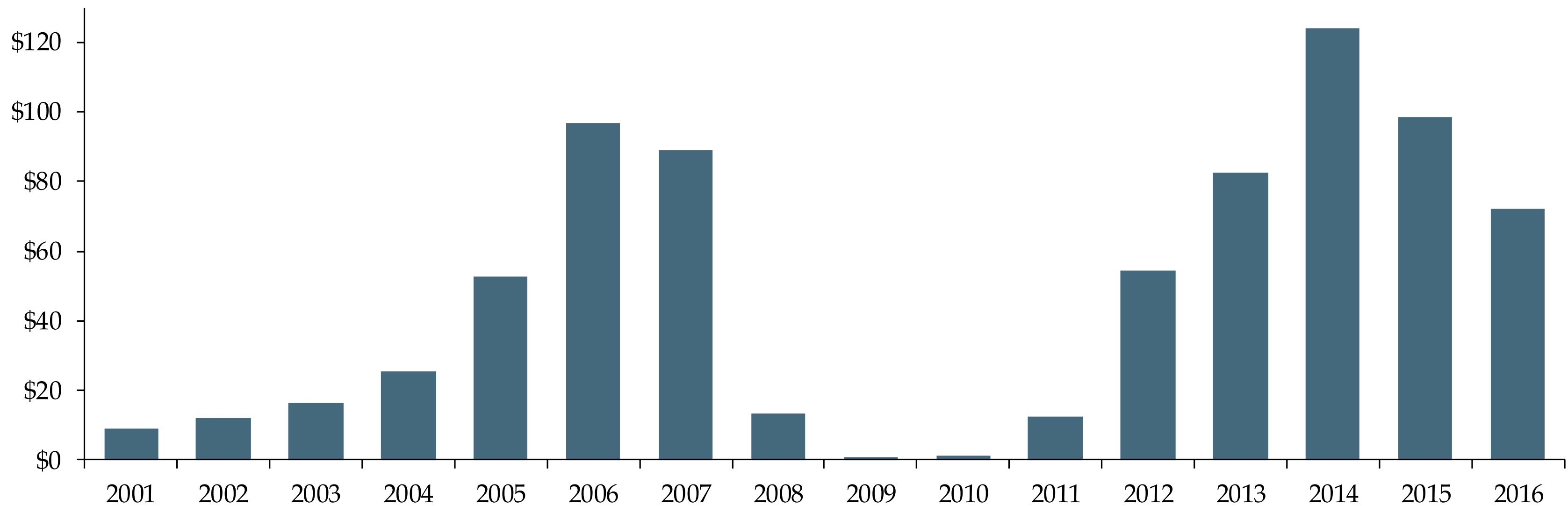
Lower Rated Borrowers have been Main Issuers (% / $BN)



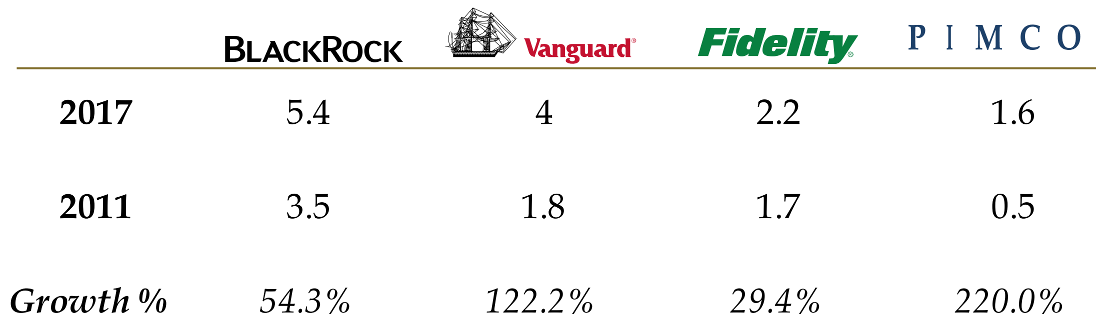
Source: LCD, FactSet, Cap IQ as of July 10, 2017

Drivers of Change – Growth in CLOs and Asset Managers

COLLATERALIZED LOAN OBLIGATIONS – ANNUAL ISSUANCE ($BN)



TRADITIONAL ASSET MANAGERS - TOTAL AUM ($TR)



	BLACKROCK	Vanguard	Fidelity	PIMCO
2017	5.4	4	2.2	1.6
2011	3.5	1.8	1.7	0.5
Growth %	*54.3%*	*122.2%*	*29.4%*	*220.0%*

Source: Cap IQ & S&P LCD, Bloomberg , as of June 15, 2017

Drivers of Change – Hedge Fund Capital has Exploded

Top hedge funds have grown in Assets Under Management, many of which were not top funds 13 Years ago

2004		
Fund	Rank	AUM ($MM)
Caxton Associates	1	11,500
GLG Partners	2	11,017
~~Citigroup Alternative Investments~~	~~3~~	~~9,900~~
Farallon Capital Management	4	9,856
Citadel Advisors	5	9,500
Angelo, Gordon & Co.	6	9,000
~~Vega Asset Mgmt~~	~~7~~	~~8,500~~
~~Andor Capital Mgmt~~	~~8~~	~~8,300~~
~~Soros Fund Mgmt~~	~~9~~	~~8,300~~
Bridgewater Associates	10	8,061
Och-Ziff Capital Management	11	8,000
Tudor Investment Corp.	12	7,800
Cerberus Capital Mgmt	13	7,500
Man Investments	14	7,400
Maverick Capital	15	7,200
~~Barclays Global Investors~~	~~16~~	~~6,900~~
Highbridge Capital Corp.	17	6,600
~~Pequot Capital Mgmt~~	~~18~~	~~6,500~~
Moore Capital Mgmt	19	6,100
Perry Capital	20	6,087
~~Campbell & Co.~~	~~21~~	~~6,062~~
Lone Pine Capital	22	6,000
D.E. Shaw & Co.	23	6,000
ESL Investments	24	6,000
~~Satellite Asset Mgmt~~	~~25~~	~~5,500~~
		193,583

2017		
Fund	Rank	AUM ($MM)
Bridgewater Associates	1	165,034
AQR Capital Management	2	96,000
Blackstone Alternative Asset Management	3	73,000
Renaissance Technologies	4	48,018
Millennium Management	5	35,070
UBS Hedge Fund Solutions	6	33,630
Och-Ziff Capital Management	7	32,400
Elliott Management	8	31,391
Two Sigma Investments	9	30,400
Baupost Group	10	30,000
Adage Capital Management	11	27,712
Goldman Sachs Asset Management	12	27,400
Davidson Kempner Capital Management	13	27,100
Citadel Advisors	14	27,000
BlackRock Alternative Investors	15	26,786
D.E. Shaw & Co.	16	26,000
Grosvenor Capital Management	17	25,900
EnTrustPermal	18	24,400
Morgan Stanley Alternative Investment	19	23,000
Farallon Capital Management	20	22,800
Viking Global Investors	21	19,900
Symphony Asset Management	22	19,562
King Street Capital Management	23	18,648
Brigade Capital Management	24	18,200
Third Point Management	25	18,000
		927,351

- Annual growth over last 13 years in assets for the top 25 Hedge Funds was 10.7 %
- There has been a consolidation of assets, many of the predominant players from a decade ago are noticeably different

KEY: The shaded rows show hedge funds that continue to be in the top 25, by assets under management from 13 years ago
Source: Preqin Hedge Fund Data

The Market Structure is Changing with a Shift in Ownership of Credit

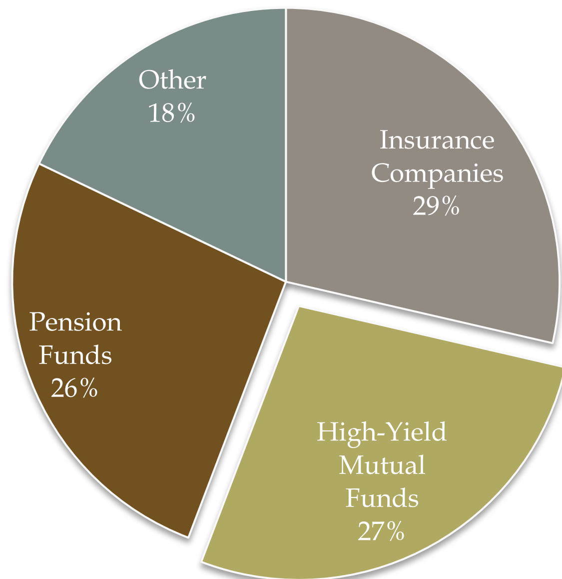
- Ownership of credit has transitioned to:
  - —Less stable hands more sensitive to the flow of funds and ratings downgrades
  - —Less flexibility to manage borrowers in financial stress/distress and going through financial restructuring/CH11
- Like the banks were in the 1980s and 1990s, current holders of credit, during times of market stress and corporate distress, may be forced sellers due to technical and structural reasons

Source: JPM Securities LLC, Public filings

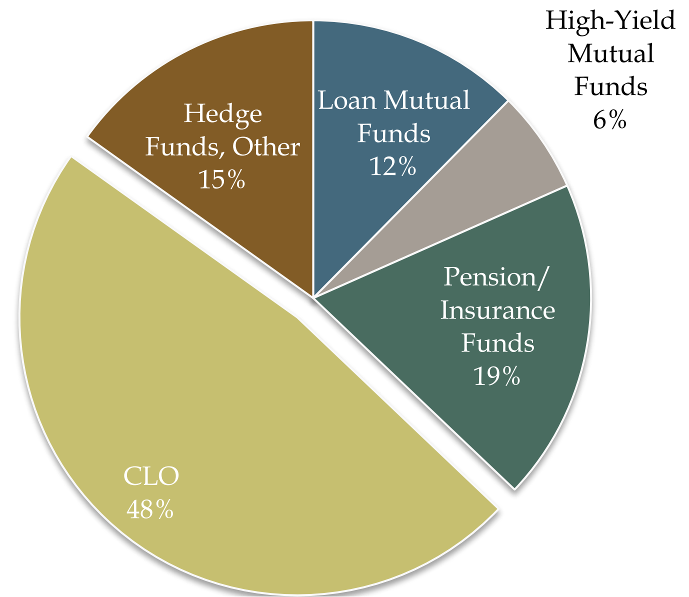
The Market Structure is Changing with a Shift in Ownership of Credit

Today

Who Owns High Yield?



Who Owns Levered Loans?



Source: JPM Securities LLC, Public filings

Current Observations

- Debtor-in-Possession financings (DIPs) were historically provided by 3rd party commercial / relationship banks
  - —Now, debtors' existing non-bank creditors typically provide DIPs in order to have some control over the timing and shape of the restructuring
- A more contentious inter-creditor and intra-creditor environment has become commonplace driven by:
  - —Greater limitations (CLOs and BDCs) and greater flexibility (hedge funds) on take-back securities
  - —Demand by CLOs/BDCs and hedge funds to realize near term returns
  - —Increasing use of 1 lien /2 lien and even 1 lien/1.5 lien/2 lien structures

Current Observations

- An increased number of pre-arranged and pre-packaged bankruptcy fillings to drive outcomes more quickly through the courts
  - —With the prevalence of prolonged disputes in court and the costs and risks assumed with extended bankruptcy, the preference is to come to agreement out-of-court and use the legal system to implement a reorganization
  - —However, the increase in creative in-court legal theories often gets in the way of pre-filing consensus

Current Observations

- Institutional asset managers and hedge funds have a preference for liquidity and are sensitive to limitations of trading. Therefore, creditors often try to remain public throughout negotiations and buy and sell positions during a restructuring
  - —The ability to negotiate amongst and across creditors has become challenged
  - —Increased trading before and during a Chapter 11 process often causes debtors and other creditors to change course mid-way through a process
  - —Credit investors may hold positions in multiple parts of a capital structure, may be "short" *vis-à-vis* their stated "long" position or otherwise have a "hedge" in place which can make opaque their true exposure
  - —It can be challenging to figure out with whom one should negotiate

Appendix

Types of Non – Traditional Lenders

Typical examples of Non- Traditional Lenders	
Type	Description
▪ BDCs	▪ A business development company (BDC) is an organization that invests in the debt of small- and medium-size companies. Many BDCs are set-up similar to closed-end investment funds and are typically public companies whose shares are traded on major stock exchanges
▪ CDS	▪ A credit default swap (CDS) is designed to transfer the credit exposure of fixed income products between two or more parties. In a CDS, the buyer of the swap makes payments to the swap's seller until the maturity date of a contract. In return, the seller agrees that, in the event that the debt issuer defaults or experiences another credit event, the seller will pay the buyer the security's premium as well as all interest payments that would have been paid between that time and the security's maturity date. It is in effect an insurance against non-payment
▪ CLOs	▪ A security backed by a pool of debt, often low-rated corporate loans, issued by a collateralized loan obligation (CLO) manager that raises numerous CLOs across different types of debt. With a CLO, the investor receives scheduled debt payments from the underlying loans, assuming most of the risk in the event borrowers default, but is offered greater diversity and the potential for higher-than-average returns