By Heather Lane

Distressed debt investors to the *rescue?*

Uncertainty about how big losses could get has left the market for mortgage loans, bonds and CDOs wracked by fear and illiquidity. Distressed debt investors may not be universally loved — they are, in fact, often regarded as sharks circling in the water. But they could hold the key to breaking the gridlock.

He's out to make a killing. But can he help as well?

Just how much are subprime mortgage securities worth? That has become the $64,000 question — or in the case of some financial institutions, one worth an exponentially larger amount. But it's exceptionally difficult to come up with an answer. Borrower defaults could reach unprecedented levels of 20%, or more. The ratings agencies are likely to continue downgrading subprime bonds and collateralized debt obligations at a fast clip — Standard & Poor's has already dropped ratings on a quarter of higher-quality subprime mortgage-backed bonds issued since 2005, and on 70% of the tranches rated triple-B or lower.

The derivatives market, as encapsulated by the ABX family of indices, paints a grim picture of current valuations. Triple-B bonds have lost as much as 80% of their value this year, and since the summer even the purportedly more robust triple-A tranches have dipped by a fifth. ABX is an imperfect market: it is dominated by short sellers, easily moved by relatively small trades, and with bid-offer spreads as wide as 10 points it can be hard to monetize positions. But it's one of the few touch points mortgage bondholders have. And it has helped generate fear, and left the market gridlocked.

But not everyone is shying away: this looks like the perfect stomping ground for distressed debt investors. They have always been quick to pounce on dislocations in the corporate credit market, turning them, for example, into one of the most successful hedge fund strategies in the wake of the corporate-led recession at the start of the decade. The strategy returned an average of almost 30% in 2003, according to Hedge Fund Research, beating the index of composite hedge funds returns by about 50%.

But that market didn't just allow a swathe of fast-moving investors to make a bundle. It also improved, if not created, price discovery and transparency. Even as default rates dropped and opportunities became more infrequent, a bankrupt company's debt would rapidly reflect distressed investors' expectations of recovery value. Take Dana, the auto-parts maker. A couple of weeks after it filed for Chapter 11 in March 2006, some of its bonds traded up from around 60 cents on the dollar to more than 90 cents. There is a growing hope that distressed investors can pull off a similar trick in the floundering market for mortgage securities.

There's certainly a big enough stage. The opportunities span distressed subprime and alt-A mortgage bonds, collateralized debt obligations (CDOs) and pools of mortgages. There is a lot to be had. Of the $10 trillion of mortgages in the U.S., subprime and alt-A mortgages total an estimated $2.4 trillion. According to analysis by FBR Investment Management, 5% of alt-A bonds and a fifth of subprime loans will default between August 2007 and August 2008.

Most of the overall total, some $1.9 trillion, is in the form of mortgage bonds. Tom Capasse, co-founder of Waterfall Asset Management, a firm that plans to buy distressed mortgage assets, estimates $500 billion is set to be downgraded or subject to credit impairment. Some analyst calculations put that figure nearer $750 billion.

Pricing is anybody's guess

E*Trade Financial provides one of the few recent examples of a sizable portfolio publicly changing hands. Citadel bought its $3 billion portfolio of mortgage-related securities for just $800 million, or an average of 27 cents on the dollar. But most potential sellers haven't yet been forced into offloading positions, and have been reluctant to enter into deals and accept huge losses when it's anyone's guess how to price a portfolio.

As an indication of valuations, the E*Trade deal is a red herring [see box]. But it's about the only evidence of a floor available to analysts. Credit Suisse described the pricing as the "best benchmark for a worst-case scenario." No one's expecting distressed investors to step in and magically save the U.S. mortgage market. "But," says, Jonathan Laredo, co-founder of credit asset manager, Solent Capital, "as buyers decide there is real value in ABS and maybe CDOs, prices will be provided in a market which hasn't had prices in many months. Buying distressed assets provides price discovery. That doesn't mean those prices are fair, but you need that demand side for the market to recover. That demand side is only just starting to appear."

Appear it is, and in force. Laredo believes some $10 billion has been raised by funds investing in distressed U.S. mortgages or mortgage-backed securities since July. Solent itself, which runs a $330 million credit opportunities fund out of London, launched a distressed structured credit fund towards the end of 2007.

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Goldman Sachs appears to account for almost half of that $10 billion estimate, but its $4.5 billion fund will invest in all manner of distressed credit, from leveraged loans to CDOs. Pimco is raising $2 billion for a distressed mortgage fund. TCW has snapped up more than $1.5 billion. The list goes on. And it's not just in the U.S., as Solent demonstrates. One senior banker to hedge fund clients in London reckons there are 100 such funds of various sizes opening up in the city, with as many as 20 in one hedge fund hotel in Mayfair.

Already, Laredo's $10 billion figure appears conservative. The actual buying power of the funds will vary. Wall Street and European banks have already cut sharply the leverage they are willing to extend, especially to the mortgage market, and are charging more for what they are providing. The likes of Pimco, TCW and Citadel carry more clout — and have deep pockets of their own. Smaller funds, and especially specialist funds, may find it much harder to gear up. There's also the question of timing and recruiting the right talent. One fund manager in New York who already specializes in mortgages and other asset-backed securities would love to set up a distressed fund. "We've already got most of the basic skills," he says. "But I still reckon we'd need about six months to set the desk up properly before we could go into the market as buyers."

The search begins

Where are the best opportunities? Capasse reckons most hedge fund buyers will jump into distressed CDOs and subprime mortgage securities rated double-A and below, with banks taking the higher-rated bonds.

"Triple-A and double-A securities account for about 80% of the $1.9 trillion of bonds outstanding," says Capasse. "Those were bought by asset-backed commercial paper vehicles and SIVs. The triple-A bond market now trades between 75 and 95 cents on the dollar, and we expect technical selling pressures to be consistent there up to the end of the first quarter of 2008, but we won't go back to par."

E*Trade's Red Herring

Don't get sidetracked by E*Trade's sale of its $3 billion asset-backed portfolio to Citadel last November. It's tempting to cite the price paid, $800 million, as a floor for distressed mortgage assets. That equates to around 27 cents on the dollar, which on first blush looks nicely in line with where some of the ABX tranches have been trading.

But it's misleading. First, the sale didn't happen in a vacuum. It was part of a broader $2.5 billion package designed to shore up the online broker's balance sheet and capital base — including a $1.6 billion infusion that bought Citadel, along with its co-investor BlackRock, an almost 20% stake in the company. That added an extra discount to the fire-sale price tag on the ABS portfolio.

Second, 60% of those assets were rated double-A or higher. Equating each tranche to the relevant subprime ABX indices would have yielded a price closer to 50 cents on the dollar. But it doesn't stop there. While the bundle included some ABS CDOs and second-lien mortgages, almost three-quarters of the holdings were in mortgages E*Trade described as of prime quality, although with some alt-A mixed in.

Prices for top-notch MBS have certainly declined, but not by this much. Voluntary sellers should bear that in mind in the coming months as they consider unloading their own mortgage assets. But the message to forced liquidators is clear: you are completely at the mercy of the buyer.

Even so, potential returns might not be too shabby. Buyers could make 20% on their investment buying a triple-A bond at 75 cents on the dollar that later traded up to or paid out at 90 cents. But that might not be enough to attract many hedge funds, believes Capasse, in part because the limited availability of leverage will restrict their ability to boost returns. This top tier of distressed assets is more likely to appeal to the likes of banks and insurance companies. In part it's a matter of capital: they don't have to set aside as much for triple-A paper even under current rules. That'll be even less onerous under Basel II, which the European banks have just adopted. Also, even though few investors will be enticed on ratings alone considering the shaky nature of so much subprime issuance, there is still a lot of downside protection here from the overcollateralization built into the deals.

It's the $350 billion or so of securities rated single-A or lower that will appeal to hedge funds. "They're trading from 15 to 50 cents on the dollar," says Capasse, who estimates that as many as three-quarters of them could default. That's bad news for current owners of CDOs, which by his reckoning gobbled up the vast majority of them.

While riskier investments, the opportunities for returns for managers are higher. Assume that 15-cent paper has been oversold and is actually worth 30 cents. That's a double-your-money play without even accounting for any interest payments, and gets even more lucrative with just a modest amount of leverage. If the seller is desperate, buyers might be able to strike an even better deal.

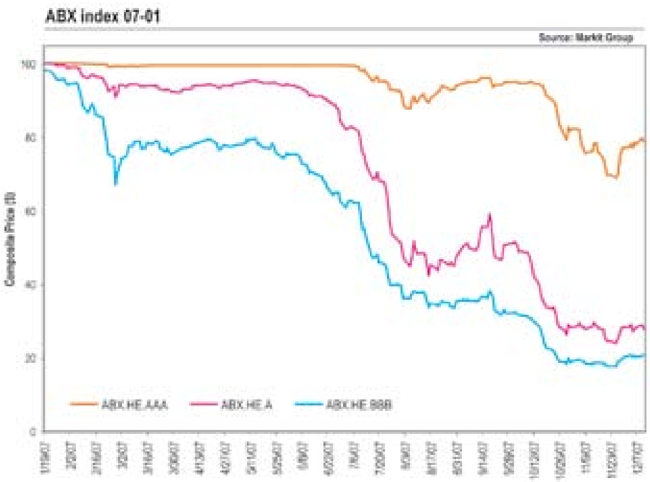
Of course, actual returns would depend on how long the new owners would have to hold on to the asset. They could also be crimped by the amount of capital tied up to satisfy prime brokers' more conservative margin requirements. There's another potential downside, too: since CDOs own so many of the bonds, getting hold of them would require many more of these complex products to be forced into liquidation by their investors than the handful so far seen in the market. On the other hand, distressed buyers could just try to buy struggling CDO tranches.

> *"You need detailed analysis on these loans as every property needs to be finely analyzed..."*
> *Shane Rodgers of Signal Capital Management*

Analyzing these securities is no mean feat, though. They are more complex than corporate bonds. Says Laredo: "Each deal needs to be analyzed down to its collateral. That means hundreds of ABS transactions because many CDOs also reference other CDOs which in turn reference other CDOs." The good news is that there are a lot more people with these skills coming onto the market now that sell-side banks are laying them off. [see story, page 62]

How far off price stability?

What does this mean for the broader market? "More buyers certainly provide liquidity, but it's not going to solve the pricing transparency problem," says Joseph Fichera, chief executive of financial advisory firm Saber Partners. "It's not ideal if sellers are relieved at last to have a buyer for their assets, but are left asking themselves: 'Did I sell that at the right price, did I get picked off?'" The current environment, he says, "is attracting buyers who believe there will be a broader disparity between price and actual value — it's a case of 'get in cheap before the issue gets settled'. That is capitalism, and fair enough. But for long-term stability, investors need to be brought in based on confidence in a level playing field — not just to reap short-term profits because the market is so severely depressed that no one can understand it." Fichera believes that price stability, and therefore confidence, will not return unless there is a more consistent regulatory scheme in place that will ensure price information is reported, widely disseminated and independently verified. "Selective disclosure of pricing information will simply lead to confusion."



Mortgage bond indices: pain for some, opportunity for others

It will take time for pricing to return to fair value. "It's not unlike what happened in the distressed ABS market of the late 1990s," says Capasse. "It took three or four years for the market to recover, but prices returned to fair value in the end."

Distressed players are also looking at buying loan portfolios as well as securities. Some loans changed hands earlier in the year, when hedge funds like Ellington Capital and Fortress paid just under par to take assets off the hands of defunct lenders like Fremont. Prices have dropped considerably since then.

Several of the new funds are focusing entirely on this sector. They're joining a busy market. "There has always been a healthy appetite for distressed mortgage pools," says David Tobin, co-founder of Mission Capital Advisors, a boutique investment bank that advises on residential and commercial loan portfolio sales and syndications. "But new buyers have been attracted as the prices are now dramatically lower. A year ago, a residential scratch and dent portfolio of mixed delinquency was trading between 75 and 85 cents on the dollar and today that same pool trades in the 55- to 65-cent range. This is reflective of continued housing price depreciation, longer foreclosure and other legal timelines, a glut of real estate on the market and higher rates of return required by investors to compensate for increased risk in this space."

It might not look like much, but it's a start Getty

Capasse says the supply of pools of non-performing loans (NPLs) will increase as deterioration continues. The biggest source, he estimates, will be Wall Street, where there were around 30 players purchasing subprime loans at the 2006 peak.

Price opacity, however, is an issue for non-performing and distressed mortgage loans, just as it is in the securities market. "A lot of what we're seeing these days are lenders to mortgage providers who have had to take back [the mortgage collateral from] these loans [when they defaulted] and now want to sell them, but have no idea where to price them," says Tobin. "It's not that difficult to value a portfolio of loans per se, but some of these pools contain a real hodge-podge of mortgages across the credit spectrum, in various stages of their lifecycle, and the lenders, such as repo and warehouse lenders, just do not know what they have on their hands."

Tobin says that new buyers are commercial banks, investment banks and hedge funds. "They're getting fairly decent deals, but this is not a market where everyone will make 30% to 40%. What will prevent such returns is a lack of end-buyers of the foreclosed houses, and the challenge for investors to borrow institutional money to buy non-performing loans."

Complexity is an issue

Unlike in subprime bonds, the wholesale mortgage market is not one that is likely to suffer over-crowding from hedge funds. As with investing in CDOs and mortgage-backed securities, a high level of analysis is required, and each loan has to be worked out in order to receive a payment. "Hedge funds love to sit on trading desks and look at NPLs as they would bonds, but they are very different. NPLs are not homogeneous financial units. They are labor-intensive micro investments and no two loans are the same. The complexity of these deals is lost on a big macro fund that would love to put $500 million to work," says Tobin.

Having a relationship with a mortgage servicer with expertise on default servicing is a must for investors buying wholesale mortgages. That's what Signal Capital Management is doing. Just under half its $250 million fund will be invested in non-performing real-estate loan portfolio acquisitions and workouts, and it has teamed up with a firm that researches, restructures and recovers underperforming and non-performing debt. Says Signal's Shane Rodgers: "You need detailed analysis on these loans as every property needs to be finely analyzed in order to determine liquidation or workout options, strategy and, most likely, recovery."

Waterfall and Solent similarly have relationships with mortgage servicers for their NPL investments. But are there enough to go around? A number of specialized mortgage servicers disappeared during the bull market as the NPL sector dried up. Others have already been snapped up by other investors. Carrington Capital Management won the bidding for bankrupt New Century's unit last spring. And several investment banks now own some of the larger servicers as a result of their foray into buying subprime lenders in the last couple of years.

While the potential for new buyers in the NPL market might be hampered by lack of expertise, Tobin believes the market will adjust to allow some extra capacity if needed which will inject liquidity, and potentially help the market recover. "New buyers won't make prices increase. Prices are where they are based on inflated property values. That said, liquidity is the precursor to recovery and market clearing. Special servicing capacity will ramp up to meet demand because of the large amount of displaced mortgage personnel. New loan production personnel will be retooled into special servicing personnel. By way of example, the new loan closer becomes the modification closer. As capacity ramps, any discount associated with this re-allocation of existing resources will eventually disappear."

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> *David Tobin, co-founder of Mission Capital Advisors*

Rodgers, however, is less optimistic about the subprime market. "Liquidity in the NPL sector will lead to liquidity in the securitized market, and greater liquidity should lead to a high purchase and workout rate, which should, in turn, lead to all these overvalued properties coming back into the market at more realistic prices and on better financing terms to better qualified buyers. It might uphold the subprime market, but I think the subprime market is all but finished for the foreseeable future," says Rodgers.

Servicing costs loom large

More buyers of distressed mortgage assets may potentially bolster market valuations and pricing. Ultimately, though, investors' success in this developing set of strategies depends on exactly how many borrowers default. Up to a point, fear of loss drives pricing down. But the worse it gets, the more concern arises about whether the underlying defaulted mortgages are properly serviced and collected. Some fear not. "If there are triggers and default mechanisms in CDOs which will collapse the CDO when 30% of a certain amount of its underlying assets are rendered worthless, what will happen to these bonds? The same is true of securitizations. Will we get to the point where there is not enough money generated from a securitization's servicing fee to service the loans?" ponders Tobin. "If 30% to 40% of a single securitization is in default, it will be far more costly to service its portfolio of loans."

The amount of money that could be spent servicing and modifying broken loans can severely eat into returns. "At a fully loaded special servicing cost of $150 to $200 per loan per month, you're looking at $2,000 to $2,500, a year just trying to get your money back from one loan. If you've got a $100,000 loan yielding 8% interest, that is half the meaningful part of your coupon right there," says Tobin. Distressed buyers should bear that in mind. And if defaults get too high, it risks putting servicers in peril, and that's bad news for everyone. "It will unduly burden the mortgage servicer and we will end up with a situation similar to that in 1999, when Green Tree's entire special servicing operation had to be rescued by Fortress through a complete restructuring of the securitization's pooling and servicing agreements. Only this time, we have the added complexity in that residuals and servicing rights have been sold into CDOs."

The challenges ahead in the residential mortgage-backed market indeed seem overwhelming, but the emergence of distressed investors should act as some comfort. "It's sort of like the market broke its legs and will require painful healing and physical therapy," says Tobin. This healing process will not be short-term. The level of expertise required to cope with the complexity and opacity of loans, mortgage-backed bonds and CDOs will keep otherwise opportunistic investors at bay in the short term. But over the next two years or so, the distressed MBS sector will become a substantial part of the bond market, believes Laredo. Those first to the trough stand the best chance of making the highest returns — and probably some of the most spectacular losses if they're not careful.

Current holders may not appreciate having to sell off their portfolios at such deep discounts. But the mortgage market, and perhaps other parts of the capital markets too, will only be able to start to move on once a proper clearing price is established. Like them or loathe them, distressed investors can serve a useful purpose.

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