Owning Distressed Debt Outside of the United States: the Ying and the Yang of Risk and Reward

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The Case for Investing Abroad

Proponents of investing in distressed debt abroad can point to several advantages. First, foreign debt, especially in emerging markets, can have greater upside. Competition is less intense due to the higher level of research required. As a rule, buyers of debt exhibit a local country bias, preferring to buy issues of local companies that they know. This bias creates more liquidity in developed markets, which have deeper institutional markets. Foreign markets are much thinner, especially as credit quality declines. Local institutional buyers, such as pension funds, face legal restrictions that prevent them from investing in distressed debt. Hedge funds and absolute return investors are less plentiful. The shortage of investors results in a greater liquidity premium and more opportunities for adding value through research and exploiting the mispricing of debt. Second, covenants in bond indentures are often stronger. Investment banks demur from underwriting and investors balk at buying deals without extra protections, either in the form of additional security or restrictions on company behavior. Lastly, credit rating agencies penalize companies for country risk. An investor simply receives better credit quality for the same credit rating by investing abroad.

The Pitfalls

Detractors point to the complexities of investing abroad. Because markets are thin, liquidity dries up when markets are under duress and may not exist when an investor needs it. Currency risk necessitates knowing the denomination of a company's revenues, expenses, and liabilities, which may be in different currencies and lead to a deterioration of profitability when one currency appreciates. Understanding a foreign culture and the local market can be a challenge. Legal systems are slower and often favor the local debtor. Corruption is a concern, leading to the disappearance of funds and unpredictable legal outcomes. Insiders often dominate corporate boards, limiting independence and affecting the quality of corporate governance. Labor laws may guarantee wages, pensions, and severance payments, effectively subordinating creditor claims to the claims of workers. The bottom line is a more difficult decision with many more variables, many of which are unknowable, and greater uncertainty.

The Anecdotal Evidence of Credit Spreads

What does the evidence tell us about the relative value of foreign markets? Most evidence is recent and anecdotal. Relative credit spreads offer the best metrics. BCP Securities surveyed emerging market credit spreads relative to those of the United States in January 2010. In Mexico, Brazil, and Chile, BBB credits traded at slightly tighter credit spreads than did comparable issues in the United States. In Brazil and many other emerging markets, the same pattern of tighter credit spreads held true for BB issues. But

once credit quality deteriorated to B, emerging market issues traded wide of U.S. issues by 100 to 300 basis points, depending on the country. The conclusions are a lack of demand for distressed debt and investor concern about bankruptcy risk in emerging markets.

Two Models of Corporate Restructuring

The United States and foreign markets follow two different models of corporate restructuring. In the United States the restructuring process is well-defined. Bondholders and the debtor have the option of negotiating an out-of court restructuring or seeking resolution in bankruptcy court. An out-of-court restructuring usually takes the form of a distressed exchange, which grants the debtor extra time or reduces debt in exchange for additional collateral or equity. Bankruptcy filings are costly but prioritize debtor claims according to seniority in the capital structure and allow the debtor to operate under the protections of the bankruptcy court until the emergence from bankruptcy. In either case the outcome usually includes a reduction in debt, a rationalization of the capital structure, and a transfer of the equity ownership of the company from the shareholders to the debt holders.

In foreign markets, especially in emerging markets, the process is more opaque. Equity ownership rarely changes hands. Rather debt holders agree to extend or restructure debt, usually outside of bankruptcy, without gaining equity. Private ownership, especially by wealthy families, is much more common as opposed to public equity. Families are loath to surrender control or grant minority stakes. The bankruptcy process abroad is slower and more uncertain. From the creditor perspective, the poster child of the failed foreign bankruptcy is the case of Altos Hornos de Mexico, which has gone through three unsuccessful negotiations and ten years of bankruptcy. Three times the controlling shareholder reached a restructuring agreement with creditors and three times he withdrew his support at the last minute to continue operating the company as he pleased with negligible court supervision. As a result, negotiations occur outside of bankruptcy with the equity holder holding the advantage at the negotiating table. For the debtor, the reasons to resolve the default and restructure the debt are reputational and the desire to access the debt markets in the future.

The difference in process can lead to outcomes uncommon in the United States. Creditors may gain the right to appoint independent directors while the board is the exclusive preserve of shareholders for domestic companies. During tender offers foreign law often negates the right of smaller bond holders to hold out and demand payment of their bonds on the original terms, allowing debtors to cram down all debt holders at the same time. The concept of equitable subordination, which protects creditors against shareholders using debt purchases to manipulate the bankruptcy, does not exist. Holding company/subsidiary guarantees are less meaningful.

The Strategy of Successful Investors

Despite the minefield of potential issues, many investors succeed in investing abroad. What are their secrets? First, they ask the age-old questions about the viability of the business and the competence of management. No amount of financial engineering will rescue a business from bad management and poor execution while good management will take advantage of what opportunities exist. Next, successful investors evaluate the incentives and character of management and the controlling shareholders. Distressed companies fall into two groups: those with morally corrupt ownership and those with concerned, responsible owners going through a tough period. Successful investors spend a great deal of time shunning the former and seeking the latter. Country risk is another component. The objective is to find a good company when a country is in trouble. If the company is well-run, it should survive the hard times and appreciate in value once the economy recovers. The ability of the government to support the private sector is another factor. A country with deep foreign currency reserves has greater ability to support industry than a country that does not. Lastly, the successful investor prefers a just and efficient legal system in order to fairly balance the rights of creditors and shareholders.