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Distressed-debt market bets on smaller companies; It might take longer for investors to profit.

WASHINGTON - The flood of filings for bankruptcy protection, such as those from Global Crossing Ltd. and WorldCom Inc., has subsided, leaving a market full of small to midsize companies. For distressed-debt investors, that means that profits might take longer to realize.

Firms in the business of buying and selling speculative-grade bonds - typically those rated double-B or lower by New York-based Standard & Poor's - are hunting for investors ready to bet even on the small, suffering entities.

Longroad Asset Management LLC in Stamford, Conn., recently raised \$183 million to be invested in the debt obligations of struggling companies valued at between \$50 million and \$500 million. The firm plans to add strategic and financial resources to operationally stable firms that suffer from debt obligations, its officials said.

Why smaller firms? "Supply and demand," said Steve Zambito, a director at Longroad, which previously raised \$109 million for its first group of partnership interests.

"There's been more of a shift towards small to medium-sized companies because you don't have the Adelphias and MCIs going bankrupt this year," he said, referring to Adelphia Communications Corp. and MCI Inc. (formerly WorldCom).

Although investments in smaller businesses can take longer to generate returns, they can be a greater value, dollar for dollar, Mr. Zambito said.

More potential "With a small company, you're basically buying the company indirectly to clean it up and sell it or refinance it with traditional loans," he said. "It's a lot more work, but the potential is bigger, too."

Hedge funds that invest in distressed debt may not be as interested in smaller companies, because the funds tend to focus on bigger, well-known companies that are generally more liquid, Mr. Zambito said. Often, hedge funds want to turn over their portfolios more quickly than investments in small, distressed companies would allow, he said.

Looking at current bankruptcy filings, small and midsize companies make up the bulk of the firms, according to the American Bankruptcy Institute in Alexandria, Va. One exception is U.S. Airways Group Inc. of Arlington, Va., which filed for bankruptcy protection Sept. 12, its second time in two years.

Edward Janger, the institute's resident scholar, said the United States witnessed the largest bankruptcy filings ever in 2001 and 2002.

In fact, half the nation's largest 24 bankruptcies ever were filed during those two years, according to New Generation Research Inc. in Boston.

The biggest three were WorldCom at \$103.9 billion, Houston-based Enron Corp. at \$63 billion and Carmel, Ind.-based Conseco Inc. at \$61 billion.

Some of the big cases are still working their way through the bankruptcy system, said Mr. Janger, who also is a professor at Brooklyn (N.Y.) Law School.

Attracting investors

But the distressed-debt market continues to attract investors.

At Longroad, which deals with institutional investors, the interest comes from a desire to fund alternative investments that don't depend on the U.S. stock market for a positive return, Mr. Zambito said.

Edward Altman, a finance professor at New York University's Leonard N. Stern School of Business, tracks the distressed- and defaulted-debt markets.

He estimated that the worldwide market was about \$600 billion as of Sept. 15, down from a high of \$942 billion at the end of 2002 though up from \$492 billion at the end of June.

There are both fewer firms and smaller firms in the market than there were in 2002, Mr. Altman said. One reason for this is the improving economy, and another is because a lot of "questionable firms were bailed out by the credit markets in 2003," he said.

The number of midsize firms heading for bankruptcy could increase along with interest rates, Mr. Altman said. Rising interest rates "potentially could cause a lot of marginal firms to go under, particularly in the middle market," he added.

Growing interest and increasing assets in the market over the past several years led The Bond Market Association in New York to create a distressed-debt committee a year ago. On Sept. 14, that committee said it had developed uniform-trading terms and voluntary guidelines for trading practices to standardize trading, clearing and settling of distressed bonds.

"As buyers and sellers adopt standardized trading practices, we believe that they will see improved efficiencies in the market," said Michele David, vice president and assistant general counsel at The Bond Market Association.

But this market "is not for kids," Mr. Janger said.

"The distressed-debt market is one where having information about the company and understanding the bankruptcy is unbelievably important," he said.