

BANKRUPTCY ALERT!!

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Here are the signs that our portfolio managers look out for that signal a potential bankruptcy.

SWAPS: The derivatives markets can be especially valuable as an early-warning signal particularly the credit-default swap market, where institutional investors seek financial protection against corporate bankruptcies. The default swap market is probably the most sensitive measure of how market participants view corporate prospects.

For example, the credit-derivatives market was far ahead of the rating agencies in suggesting that once-mighty energy trader Enron was a weak credit. Weeks before the company sought bankruptcy-court protection, pricing on Enron protection was far more expensive than it should have been, given Enron's then investment-grade rating. Essentially, these credit swaps are a form of insurance on Enron debt; if Enron defaults, the buyer of such a swap goes to the seller of the swap and receives 100 cents on the dollar, regardless of how worthless the debt may have become.

DEBT THAT DIVES IN VALUE: Often the secondary bond market can provide valuable clues about a troubled company's fate, as bond analysts are much more focused on a company's ability to repay its debts. They scour information pertinent to the sort of distress that leads to a filing.

BANKING TROUBLE: Another indication that a company may be about to seek bankruptcy-court protection is when it draws down all its credit or standby credit lines from its bankers.

CONSCIOUSNESS OF RATIOS: Financial distress quickly translates into a company violating its lending agreements with its bankers. Such violations allow the banks to pull their lending lines or even declare a company in default. While information about the relationship between bank and client usually isn't public, there are certain relevant financial ratios that can provide clues. For example, lending agreements oblige most companies across a wide range of industries to keep the debt level at no more than about seven or eight times earnings before interest payments, taxes and depreciation. If the amount of the debt is far greater, investors can assume the banks aren't happy. Unhappy bankers can even petition the courts to push their client into involuntary bankruptcy.

A DATE WITH DEBTHOLDERS: Figuring out the timing of a filing can be tricky, of course. Managers of these sophisticated investment pools assume that a troubled company would prefer to file before, rather than after, paying out large sums of precious cash.

FLASHING RED LIGHT: Some signals couldn't be more glaring. If a company retains bankruptcy counsel or calls in restructuring-advisory boutiques, it is reasonably certain a company is at least considering bankruptcy.