Life Ltd. (K.K.) INVESTMENT CASE STUDY

Life Ltd. (K.K.) – A Japanese credit card company

In this case the company had filed for an insolvency procedure although it continued to operate. The main assets in question were credit card receivables in respect of which there was no real uncertainty regarding their value given a long history of well documented default rates that fell within a narrow band.

The bulk of the financing to the company was secured on the receivables. There was a small tranche of unsecured debt at the bottom of the capital structure. In Japan there is no concept of a floating charge and the creditors did not have security over cash. As soon as a receivable is repaid the secured creditor's collateral is reduced which in the case of credit card receivables happens very rapidly. The standard practice for dealing with this issue is to renew the collateral at the start of every month. The effect is that the value of assets secured fluctuates materially over the course of a month, reducing as the month progresses. The company had filed for liquidation on the 10^{th} of the month but the market was valuing the security based on the balance sheet value of receivables at the start of the month. The result was a significant mispricing of the unsecured piece.

The non discounted return in this case was approximately 100% on a 5 million USD cash investment.

Commentary

The above is an example of a common situation where the securities of a company subject to restructuring with a multi layered capital structure are often mispriced with respect to one another.

Another example and a recurring theme is the situation where a junior unsecured debt piece appears to be out of the money but retains an insolvency trigger. These junior pieces often get paid more than their intrinsic value on a strict priority basis. This occurs because the secured debt will accept some transfer of value to more junior pieces to avoid a formal procedure where those procedures create uncertainty or impair collateral value.

These kinds of opportunities in my experience are much more prevalent outside the US. This is caused by three factors.

1] The types of collateral available and their application in standard debt documentation is more advanced in the US in the sense that they are more effective at achieving priority for senior creditors without leaving gaps in the assets covered.

2] Chapter 11 is much more robust in maintaining the value of secured creditor's interest during the process and ensuring priority vs. unsecured creditors by for example allowing the court in certain situations to encumber assets that were not part of the original collateral package to maintain "adequate protection".

3] Chapter 11 has been tried and tested many more times than say the new French Sauvegarde procedure so there is a lot less doubt on its application.