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Energy Sector Draws Investors in Distressed Securities

Wilbur Ross, Blackstone's GSO Capital Raising Funds for Oil and Gas

By

Wilbur Ross *PHOTO: BLOOMBERG NEWS*

MATTWIRZ

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The oil slump is drawing interest from some of the savviest bargain hunters on Wall Street.

Veteran hedge-fund manager Wilbur Ross, Blackstone Group LP's GSO Capital Partners and Apollo Global Management LLC are among those raising funds to buy the battered stocks, bonds and loans of energy firms following a 54% decline in New York crude prices since June.

More traditional investors like Western Asset Management Co. and Seix Investment Advisors LLC also have started funds to help large clients such as endowments and pension funds to place bets on the ailing energy industry.

Oil's plunge to six-year lows has spurred an exodus from the securities of companies that explore for, produce, transport and refine oil and gas. The carnage is creating an opening for distressed investors, who snap up cheap stocks and bonds of troubled companies, seeking to profit when prices rebound or to use the investments to take the companies over in bankruptcy.

Mr. Ross has used the strategy to build businesses in the steel, automotive and textile industries and is now starting an energy-focused fund, a person familiar with the matter said.

Fueling the fundraising rush: Bargain investments have been hard to find in recent years, as low interest rates and a U.S. economic rebound have helped pump up many major stock indexes and bond prices to records. "We sold our last material private investment 18 months ago and we've been waiting for an opportunity ever since," said Clint Carlson, whose Carlson Capital LP hedge fund manages $9 billion in Dallas.

The oil-price plunge has hammered revenues for energy producers and the companies that work with them, as well as investor sentiment.

A quarter of bond investors polled by Bank of America last month held fewer energy bonds than the benchmark index they track, the largest proportion since the survey began in 2005.

Since June 30, 91U.S. energy companies with market capitalizations exceeding $100 million have lost more than half their stock-market value, said Howard Silverblatt, an analyst for S&P Dow Jones Indices.

In the junk-bond market, there were 111energy-company bonds that traded for less than 80 cents on the dollar in February, compared with six in July, according to data provider MarketAxess. Bonds typically trade close to 100 cents on the dollar-the face amount the company must pay at maturity-and prices below 80 cents reflect risk that the borrower may default. Bonds now trading below that threshold have a face value of $57 billion and market value of about $34 billion.

Investors are pursuing diverging strategies in the wake of the slump. Bearish fund managers are using a technique called short selling to profit from the drop in stock and bond prices. Some funds have started purchasing securities of higher-quality companies they believe have been unfairly beaten down and will survive the downturn.

Others are waiting for prices to fall further before buying bonds of firms that are likely to default, aiming to swap the debt for ownership stakes in a strategy called "loan-to-own."

GSO is targeting between $500 million and $1billion for its new fund focused on debt of distressed energy companies, and Seix is aiming for about $500 million for a comparable fund, people familiar with the matter said.

Ironically, the greatest worry for some fund managers is that too many other investors will jump on the energy trade, pushing prices back up before they can exploit the oil-related selloff.

"The sector traded down very quickly" and could bounce sharply, said Michael Buchanan, the head of global credit at Western Asset Management. "That's why we're looking to move quickly."

Western Asset, which manages about $134 billion of bond and loan investments, has launched a fund to buy debt of energy companies rated below investment grade in the next three to six months, he said.

Some investors, like Mr. Carlson and Halcyon Asset Management, are focusing on energy stocks for now because equity valuations of stronger companies have been hit harder than their bond prices. Jim McGinnis, manager of Halcyon's energy fund, said he saw a bargain in shares of Devon Energy Corp., for example, which fell32% from July to January. The company's bonds declined 6% over the same period.

Halcyon expects to build up its roughly $100 million energy fund to about $500 million by the end of 2015, as the firm's European clients have started clamoring to invest in the energy industry, a person familiar with the matter said.

Five years ago, Mr. Carlson's fund made a 39% return on a $1billion bet on distressed mortgage bonds. Now, the firm is launching three funds to bet on the securities of energy companies hit by falling oil prices.

One of the funds, which can buy energy-company securities or bet against them, has started investing, but Mr. Carlson is waiting to ramp up the other two, which will buy stocks and bonds for the long term, because he expects most prices to fall further.

The firm has 12 analysts and fund managers covering energy and power companies who are working full-bore assessing new investments, he said.

"The last time we made a big investment was in 2009 in [mortgage-backed] bonds," said Mr. Carlson. "This is the next opportunity."

Write to Matt Wirz at matthieu.wirz@wsj.com