



THE GREAT LIQUIDATION & GREAT LITIGATION

Investing through the Credit Cycle

Updated – June 2011



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In early 2010, we published our first paper on the Great Liquidation, entitled “Investing Through the Credit Cycle”. We outlined the three distinct phases of the Great Liquidation and Great Litigation, together with the investment approach best suited to each of the phases. The current phase is playing out as we previously described, but on an even greater scale. Within this environment of continuing economic uncertainty, the environment for distressed credit investors has never been better.

We continue to believe that the Great Liquidation is unprecedented in magnitude and will provide opportunities to acquire assets at attractive prices to generate attractive returns. In order to maximize returns, investors need the skills, experience, resources, and infrastructure to implement a distressed credit strategy over the long term. In this updated paper, we share our thoughts on where the credit cycle stands today. We describe a range of attractive investment opportunities that are appearing in the current phase, which

we have termed “Financial Services Garbage Collection”. Drawing on our experience over the last 25 years of navigating several credit cycles, we have developed a clear view on the timing and scale of the current cycle – as well as how best to invest in and profit from the opportunities we see evolving over the next several years.



OPPORTUNISTIC CREDIT INVESTING, DEFINED

Credit Spectrum

We view credit as a single, broad asset class covering a spectrum of narrow sectors across four distinct investment strategies. The inherent complexity of the asset class forces many managers to focus on only select sectors, geographies, or types of investments. We believe that the greatest return potential over time can be found with the most unconstrained managers, provided they have the experience, investment structure, and resources to move opportunistically and globally across the entire credit spectrum.

Experience

Outcomes in credit investing differ significantly depending on how proactively the end-to-end investment process is managed. To find the best risk/reward opportunities in the credit landscape, investors should not just buy low, but should also prioritize situations to find the most motivated sellers, actively negotiate transactions, and apply hands-on asset management (e.g., servicing loan portfolios) to ensure that maximum value is realized. Value is found in distressed assets, as well as distressed sellers. Less competitive, more inefficient situations are found in privately negotiated transactions. Sourcing these transactions requires a blend of creativity (how can we help solve that problem?), credibility (are we a reliable, resourced buyer?), and execution (do we have the skills, experience, and resources to move quickly?).



Creativity, credibility, and execution are developed through decades of experience, including having invested through multiple credit cycles. We believe that the investors best positioned for today's turbulent climate are those with the greatest volume of transactions through the Savings & Loan crisis, the Asian and Russian crises, and the post-internet bubble. Because no two credit cycles are identical, and because today's investment opportunities are idiosyncratic, a key measurement of a manager's skill is its depth and breadth of credit investing experience.

Structure

Experience has proven that "patient capital" is essential to maximizing returns. Liquid credit strategies are widely available, yet we believe truly opportunistic credit investing is best executed with a longer term horizon. Investors can demand a material return premium for illiquidity, as being a willing buyer of illiquid assets is a significant differentiator.

In order to execute this strategy successfully across the complex spectrum of credit opportunities, asset-liability matching is critical. Appropriately aligned investment and term financing structures are fundamental components of distressed credit investing and risk management. Given the longer term nature of many investments, portfolios should be structured to avoid asset-liability mismatches.

Resources

We believe that the single biggest risk in opportunistic credit investing is insufficient infrastructure. Distressed investing, particularly involving illiquid assets, requires a specialized, well-resourced team, with deep experience in each investment sector, industry sector, and type of transaction – everything from corporate restructuring, portfolio workouts, structured finance, bilateral lending, and sale leasebacks, to private equity. The investment team needs support from a robust infrastructure, including skilled legal and tax teams, government policy

specialists, proactive and disciplined asset managers, and strong accounting and finance/operating professionals. Speed of execution and certainty of closing are clear differentiators.

A broad investment mandate coupled with specialized capabilities allows an investor to move in and out of sectors in search of best relative value, rather than limiting the investor to a programmatic approach in a narrowly defined

investment sector. It also allows the investor to tackle opportunities requiring real specialization in more than one investment category. We believe that combining a broad mandate with a broad range of expertise positions an institutional investor to take advantage of opportunities that other, narrower managers may miss. Even more importantly, an unconstrained mandate combined with deep

expertise is essential to avoiding the risk of investing past the point of real opportunity.

Times of great economic uncertainty create opportunities for smart investors. Those who are willing to pursue value generated by distressed pricing on assets can realize returns while helping the system heal itself.

UNCERTAIN TIMES

We live in a time of great uncertainty. This tumultuous investment environment touches communities and businesses around the world, as it is driven by broad-reaching economic and geopolitical factors. The two are often intertwined. An obvious geopolitical example is the growing economic and military power of China and India. Other geopolitical factors increase uncertainty, such as emerging nuclear capabilities, social upheaval in the Middle East, and the on-going wars in Iraq and Afghanistan. Even historically stable countries are sources of uncertainty, for example, Ireland with its banking-dominated economy. The contentious debate about the U.S. budget and debt ceiling this year is another symptom of political uncertainty.

We are inundated by headlines about sovereign risk, potential breakdown of the Euro-zone, trade imbalances, quantitative easing, currency valuations, commodity prices, insider trading scandals and the inflation/deflation debate. The U.S. continues to be affected by long-term, systemic

unemployment, constraints on mortgage finance, ongoing delays in the foreclosure process, the effect of markets on savings and retirement accounts, municipal deficits and pressure on public debt. In this environment, investors and voters grasp at signs of improvement and retreat from negative headlines, creating volatility in the markets.

Times of great economic uncertainty create opportunities for smart investors. Those who are willing to pursue value generated by distressed pricing on assets can realize returns while helping the system heal itself. This search for value must be grounded in solid assets that ideally present visible cash flows. As we have observed, government intervention can influence market outcomes in unanticipated ways, so investors should stay attuned to the possibility of government action. Employing our 25 years of experience investing in numerous distressed credit cycles, we seek to outline in this paper how investors may navigate these challenges in order to profit in these uncertain times.

AN UNPRECEDENTED OPPORTUNITY

Eras of economic instability are often coupled with, if not driven by, a crisis in the credit markets. Uncertainty may lead to deleveraging, forced sales, and constrained growth. Investors who have experienced credit crises of the past two decades understand the pattern from bubble to crisis to healing. However, we have not seen anything of the scale that this current crisis will bring. We believe that even the seemingly large dislocations of recent history will ultimately equal only a fraction of the global opportunity we see today.

For example, the Savings and Loan (“S&L”) crisis, from 1988 to 1995, generated approximately \$260 billion in asset sales¹. Similar to the current situation, that crisis also received significant U.S. government attention, in the form of the Resolution Trust Corporation (“RTC”), which was established in 1989. However, unlike today’s



global crisis, the S&L collapse was U.S.-focused in its impact. What is often forgotten is that a year elapsed after the S&L collapse before the creation of the RTC, and that another six years passed before the crisis played itself out².

The Asian Currency crisis, which began in 1997 in Thailand and South Korea, was similar in size to the S&L crisis but with a much different geographic focus. The Asian crisis lasted into 2000 and generated approximately \$345 billion in asset sales³.

We anticipate that the current credit crisis will spawn asset sales far greater than either the Savings & Loan or Asian crises. In fact, more than two years into the crisis, we have identified over \$2 trillion in assets that are intended for sale⁴ – several times the size of the S&L and Asian crises combined. Some of the sellers are putting assets on the block equivalent to the total of one of the prior crises. These assets are coming from all around the world. We believe that the asset sales over the next five years will be several times the \$2 trillion already identified, far exceeding the total of all financial asset sales over the prior century.

Because of the scale of deleveraging that has already occurred and the sales that are yet to come, we feel like we are living through the Great Liquidation. Coupled with what we call the Great Litigation, the Great Liquidation will drive a supply-demand imbalance of distressed, illiquid assets that exceeds anything experienced before. Stressed borrowers – whether countries, banks, companies, or other investors – are trying to survive as long as possible before resorting to selling their assets. However, the inevitable can only be forestalled for so long – eventually gravity brings everyone back to earth. While this time of uncertainty may be marked by periods of optimism, we believe that the supply-demand imbalance will persist and create opportunities for years to come.

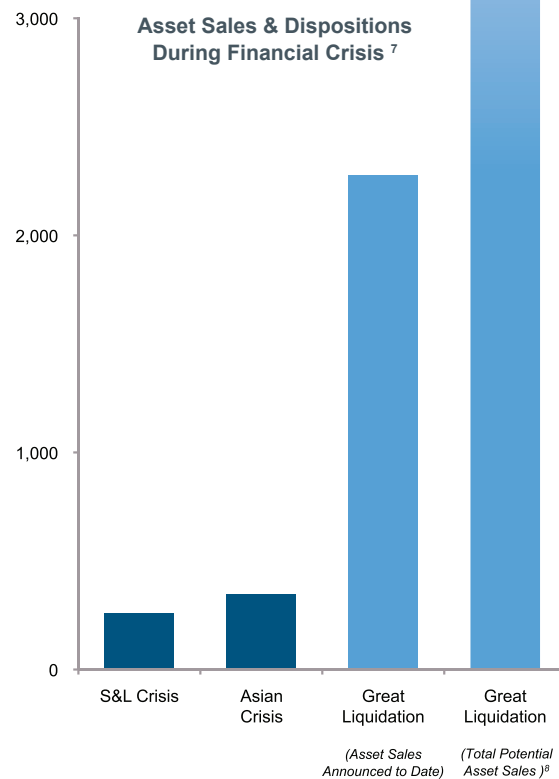
**THE GREAT LIQUIDATION:
A SUPPLY-DEMAND IMBALANCE**

The easy access to credit between 2005 and 2008 allowed governments, companies, and investors to lever their balance sheets, often combined with unnecessarily complex structuring. The current economic and financial market crisis has forced an unwinding of this leverage, a process that we call the Great Liquidation.

Certain factors drive the supply of assets for sale, and all are linked to the significant leverage employed by institutions across business sectors. These entities are now selling for a range of reasons:

- 1) Regulatory – they are being required to sell by their government supervisory agencies. (This reason is most prevalent among regulated financial institutions – investment banks, consumer banks, insurance companies);
- 2) Survival – many institutions need to sell assets, regardless of the price at which the assets were acquired, in order to reduce leverage and survive; and;
- 3) Business focus – certain institutions have decided to exit non-core businesses, even if they are able to sustain their non-core investment.

In the Great Liquidation, while supply is massive, demand for these illiquid, complex financial assets is limited. A hallmark of the bubble was the creation of structural complexity around otherwise straightforward assets.



Uncertain economic environments cause investors to seek liquidity, demand transparency and heavily discount unknowns. Investors avoid perceived risk, flocking instead to investments perceived as safe and where their money is easily accessible.

Thorough underwriting and due diligence can expose the *actual risk* of an opportunity while the general market's *perceived risk* of that same opportunity remains much greater.

We saw this demonstrated in late 2008, with panic selling of otherwise stable securities in a move to cash (e.g. heavily discounted senior bank debt on quality companies). A strong preference for liquidity remains among institutional and retail investors. Traditional buyers (e.g., investment banks, insurance companies, hedge funds) have become sellers. This has further limited

demand for more uncertain, more complicated, less liquid investments.

Experienced investors with the expertise to evaluate these more intricate situations have the potential to generate very attractive returns, as we spend the next several years seeking equilibrium in the supply-demand ratio for illiquid assets. Thorough underwriting and due diligence can expose the *actual risk* of an opportunity while the general market's *perceived risk* of that same opportunity remains much greater. The misperception among many investors that complexity always equals risk creates an opening for the few investors willing and able to assess the true intrinsic values and actual risks of the assets coming into the market today. We will further discuss some of these opportunities on pages 8 and 9, as well as provide examples of specific opportunities on pages 10 through 12.

**THE GREAT LITIGATION:
INCREASING COMPLEXITY**

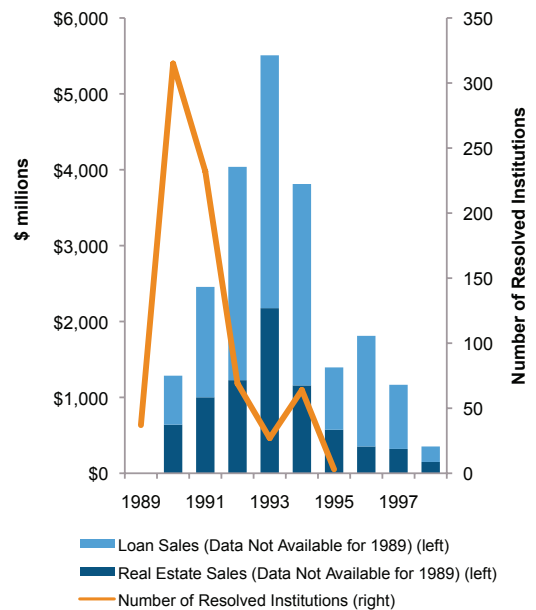
In conjunction with the expansion of the credit bubble, another investment dynamic developed: the financial world evolved extremely complicated capital structures, with many layers of debt and many associated creditors. This complexity, often built around otherwise simple assets, has led to increased litigation in all directions. Creditors are suing debtors, creditors are suing creditors, and, in several cases, debtors are suing creditors complaining they were allowed

to borrow too much. Within legal circles, this has been dubbed “tranche warfare”.⁵ We call this the Great Litigation, and see it as an exacerbating factor in the large scale of the Great Liquidation.

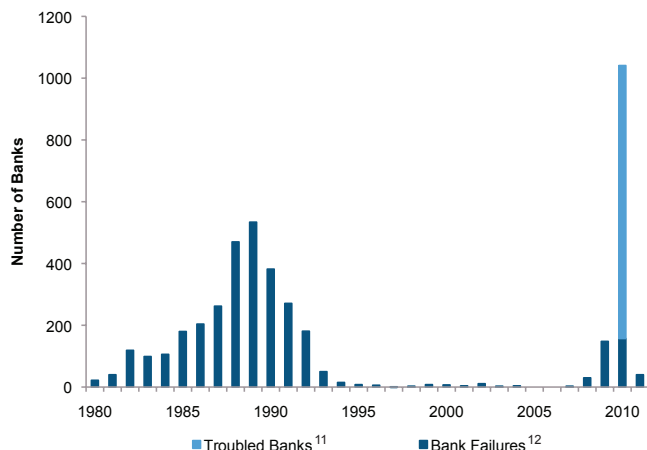
Broad litigation makes it difficult for many investors to assess the true value of prospective investments. Therefore, the Great Liquidation coupled with the Great Litigation may deter otherwise interested investors from participating in certain opportunities, thereby increasing the investment opportunity for those investors who understand litigation processes in various jurisdictions. Having the fortitude to persevere through potentially lengthy transactions, when others do not, can make asset sales involved with litigation quite interesting.

The Great Litigation is particularly evident in commercial real estate and the expanded CMBS market. Litigation is likely to develop in multiple lender situations, where conflicting lender interests often exist. In many cases, the owners of securities are not sufficiently capitalized to litigate or otherwise protect their interests.

FDIC Asset Sales and Number of Institutions Resolved by the Resolution Trust Corporation (RTC) ⁹



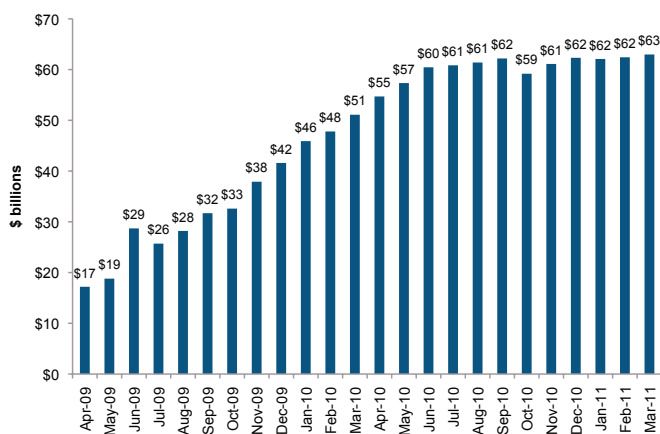
FDIC Troubled Banks ¹⁰



WHERE WE ARE NOW

We believe that we are in the most pronounced phase and best investment opportunity of this credit cycle. We have termed this second phase of the Great Liquidation, “Financial Services Garbage Collection”. As mentioned previously, we anticipate that the total amount of assets that will be sold in the Great Liquidation and Great Litigation will greatly exceed the currently announced intended dispositions. Most of those assets will be sold during the Garbage Collection phase. Some institutional investors wonder if the volume will be as great as we predict, given the measured pace to date and hopeful headlines that appear intermittently. We believe that some positive headlines are not based on fundamentals. Furthermore, financial institutions have built-in incentives to reflect an optimistic outlook, and in doing so may lull some investors into a sense of security that distress in the

Monthly Commercial Mortgage Backed Securities Delinquencies ¹³



THREE PHASES OF THE GREAT LIQUIDATION AND GREAT LITIGATION

We have identified three distinct phases within the Great Liquidation and Great Litigation. Different investment strategies are best suited to each of the phases. We believe that we are currently in the second phase of the cycle, having transitioned from the first phase.

PHASE 1: BROKEN PLUMBING

The first phase, “Broken Plumbing”, began immediately after the failure of Lehman Brothers. Fear of a major financial system failure following that event caused widespread panic. The rapid de-leveraging of both the regulated banking system and the shadow banking system, together with the market’s perception of credit risk, was the first leg of the supply-demand imbalance that triggered sizable realized and unrealized losses and panic selling. Senior securities traded at mid- to high- teens spreads above the risk free rate. Purchasing senior securities at those levels provided upside opportunity with very limited downside risk.

During the Broken Plumbing phase, all types of entities with a need for liquidity were selling. Savvy investors purchased substantial amounts of senior residential mortgage-backed securities, as those represented the best combination of yield, safety, and duration. Investors with liquidity also opportunistically purchased senior secured bank debt and high yield debt in the secondary market at significant discounts to par.

The Broken Plumbing opportunity faded in early 2009 as comfort returned that the financial system would survive. At this point, liquid debt securities have been picked over by mutual fund managers and governments, leaving few compelling investments in the public credit markets. The potential for outsized returns in public, liquid investments was unique to the dislocation of the first phase of the Great Liquidation. Beginning with the second phase of the cycle, privately-negotiated transactions offer the best return potential.

PHASE 2: FINANCIAL SERVICES GARBAGE COLLECTION

Uncertainty remains a central factor in today’s markets. We are no longer at the brink of disaster, but neither is the system fixed yet. This next phase is about cleaning up the mess coming out of the credit bubble – the financial services “garbage” being thrown out in great volume, which is why we call the second phase “Financial Services Garbage Collection”. The garbage includes liquidating finance companies, hedge

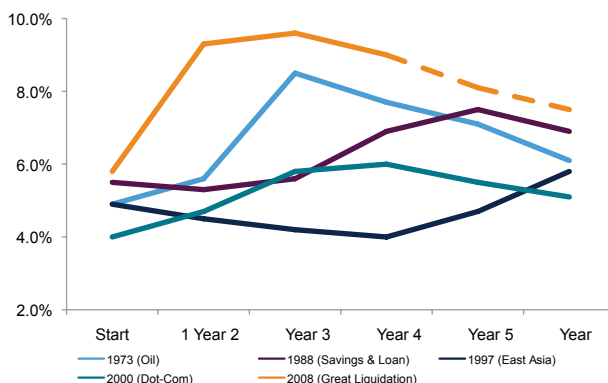
market has passed. For example, comments from the Federal Reserve, both positive and negative, can directly affect market behavior. That may lead the Fed to highlight data that may encourage the market to move in the desired direction. Even if certain positive statements are temporarily self-fulfilling, we believe the underlying dynamics remain grim.

The FDIC list of troubled banks continues to grow. We believe smaller banks in the U.S. (under \$1 billion in assets) are particularly challenged. They have received little government support, and commercial real estate (“CRE”) debt represents 44% of their total loans.⁶ Many CRE loans currently have a negative loan-to-value ratio, given the sell-off in CRE from the peak.

Many, if not most, community banks will be unable to earn their way back to capital adequacy, resulting in a large number being taken over. We believe the FDIC continues to understate the number of banks that will meet this fate in the next five years. Bank closure is necessarily a methodical process made slower by the government’s interest in deferring realized losses for as long as possible. Even in the S&L crisis, which affected a narrower segment of the economy, asset sales did not peak until more than four years into the crisis, in 1993.

Beyond the banking sector, other sources of structural stress have yet to be resolved. The “wall” of debt maturities, discussed since the beginning of the crisis, has not gone away. When these maturities are reached, the associated borrowers may not be able to refinance. “Extend and pretend” works only as long as extending the financing is possible. The recalibration of securitization markets and the disappearance of most of the shadow banking system may increase bankruptcies significantly above current levels.

Unemployment Rates in Financial Crises ¹⁴



funds being driven out of business by asset-liability mismatches, and investments identified as non-core by their current owners.

Phase 2 started in mid-2009 and will likely endure for several years, based on our experience with prior credit cycles. We have also referred to this stage as a “dog’s breakfast”, given the sloppy, unknown situations presenting themselves in the market today. In this environment, opportunistic credit investors can realize attractive returns by cleaning up the mess through acquisitions of businesses with intrinsic value. The same approach benefits the broader industry by supporting an orderly, timely resolution for severely impaired businesses that would otherwise clog the system. Given the idiosyncratic nature of these opportunities, the investor must dive deep to understand the true value of the assets in a variety of stressed scenarios. Exerting control of the process, through negotiating private transactions and actively managing the assets, yields the most positive outcomes.

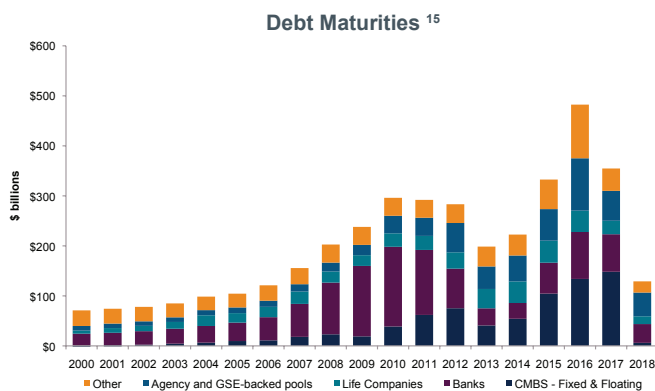
When governments and regulators reduce the amount of support they are providing financial institutions, these institutions will be forced to recognize losses on distressed assets. This is already in process across the shadow banking system where government support did not exist. Regulated banks are waiting for enforcement and hoping they will heal in the meantime. When action is finally taken, banks will sell assets at prices that we expect will generate attractive returns.

PHASE 3: RESTRUCTURING AND CONTROL

With over \$2 trillion of leveraged loans, high yield bonds, and commercial real estate debt coming due in the next few years, we believe many companies will be unable to refinance their debt and will ultimately default. The final phase of the Great Liquidation, “Restructuring and Control”, will provide opportunities to take control of assets and companies. The refinancing void will provide a wealth of opportunities to acquire companies with bad balance sheets at a significant discount to replacement cost or fair market value. The range of strategies employed will vary according to the particular situation, and will include holding senior securities as a means to control restructuring, as well as buying the layer of a company’s capital structure that is likely to be the fulcrum security.

We have entered the early part of this phase. Isolated situations are emerging, but the tidal wave of opportunities that should come from this Restructuring and Refinancing phase will take several years to play out.





Finally, persistent unemployment is a symptom and cause of increasing default rates across a range of assets, including student loans, small business loans, limited partnership investments, commercial real estate, and of course residential real estate. In the U.S., employment created by the bubble economy in housing construction and related sectors masked much of the continued hollowing out of America’s manufacturing core.

The unprecedented level of systemic unemployment in the Great Liquidation will likely extend the duration of this crisis longer than past crises. At the April 2011 Federal Open Market Committee meeting, the governors indicated that U.S. unemployment rates are expected to remain at elevated levels through at least 2013.

Outside of the U.S., the environment is perhaps even more uncertain. Europe’s sovereign crisis has severely strained the euro and intra-European relationships. Problems in Greece, Portugal, Ireland, and Spain, together with increased regulation of financial institutions, will lead to ongoing asset liquidations. Japan is likely to be another user of global capital as it rebuilds following the March 2011 earthquake. Recent reports indicate that the Japanese economy has slipped into recession, in contrast to growth across much of the rest of Asia.

While these factors continue to paint a difficult picture for consumers, home owners, business owners, property developers, and their lenders, the same factors create an extremely rich environment for distressed credit investors. In fact, for those investors able to make long-term commitments and do the hard work, the opportunity is better than it has been in our lifetimes. The challenge is prioritizing prospective

investments quickly to focus resources on those opportunities with highest likelihood of attractive returns.

PRIORITIZING DISTRESSED CREDIT OPPORTUNITIES

For investors in the business of Financial Services Garbage Collection, today’s opportunity remains very significant. Many people will make money during the Great Liquidation; however, returns will differ significantly between “average” and “best” investors. The unprecedented volume of opportunities has made prioritizing more critical than sourcing to date. Now, with more entrants pursuing investments, sourcing should grow in importance. We consider the following factors when sourcing and prioritizing our own investments. The same considerations may be relevant to readers of this paper.

Investors need to find opportunities where they will be paid for having the skills and persistence to work through the situation.

Quickly diagnosing the urgency of the seller and the fundamentals of the assets is essential to maximizing value. Investors can think about any opportunity in terms of where the distress lies, with the seller or with the asset:

| SELLERS | NON-DISTRESSED ASSETS | DISTRESSED ASSETS |
|-------------------------------|---|---|
| Non-distressed sellers | Patient sellers with high-quality assets High demand Highest prices | Patient sellers with messy assets Limited demand Higher prices, longer to close |
| | NOT TYPICALLY INTERESTING | POTENTIALLY INTERESTING |
| Distressed sellers | Impatient sellers with high-quality assets High demand Price driven by urgency of seller POTENTIALLY INTERESTING | Impatient sellers with messy assets Limited demand Lowest prices, can move fastest OFTEN INTERESTING |

Complex capital structures and complicated situations generally attract few buyers.

Limited competition should increase the chance of an attractive price. Therefore, seeking complex assets and stressed sellers can provide an immediate pricing advantage. Complicated situations exist in both large and small deal sizes. Few investors have sufficient long-

term capital to pursue very large deals, resulting in less competition. On the other hand, few investors have sufficient human resources to pursue the volume of small deals now coming out of banks, meaning

Seeking complex assets and stressed sellers can provide an immediate pricing advantage.

that attractive opportunities can also be found at smaller commitment levels.

Investors should prioritize opportunities where they have a competitive advantage in terms of knowledge or relationships.

Superior knowledge of a particular class of assets should enable an investor to more quickly assess value. Similarly, established relationships with a seller may enable the transaction to move more quickly. Trust between buyer and seller is important in any transaction, but all the more so when the seller requires a fast resolution and certainty of closing. Smaller deals, which may be more accessible and therefore more competitive, can be truly attractive if the investor has such an information advantage.

Privately-negotiated transactions, while rare, may create unique opportunities.

In these situations, the investor will have to demonstrate creativity in developing solutions. For example, while this paper focuses on asset acquisition, it may become clear during a private negotiation that a loan better meets the objectives of both parties. Understanding the seller's (or borrower's) priorities, constraints, and level of urgency are keys to a successful private negotiation.

With the highly idiosyncratic investment opportunities coming out of the Great Liquidation, investors need to be able to assess actual risk, versus perceived risk.

Risk can be significantly mitigated by paying a price that allows for additional value deterioration. We recommend focusing on the forward-looking cash flows of the underlying assets, as certainty of cash flows can compensate for complexity of the investment. We believe that investors should prefer investments where principal is preserved even under stressed scenarios, along with related cash flows.

Credit investors should place a priority on situations where the cash flows demonstrate a “self-amortizing, self-liquidating” investment.

This reduces risk by allowing investors to realize returns in the case that the debt capital markets do not provide a reliable exit. Investors can take the value assessment a step further, looking for those investments that may perform well in either deteriorating or improving market conditions. For example, acquisitions focused on special servicing, i.e., collection of defaulted debt, may actually increase in portfolio value during difficult economic conditions. The same business in more positive economic conditions may be able to improve collection outcomes.

Finally, we advise well-resourced investors to source transactions across sectors and from all types of sellers,

rather than concentrate in a few sectors via a programmatic approach. In this way, it is possible to pick the most attractive low-hanging fruit, in terms of relative value across all opportunities, while waiting for dynamics to appear within a sector that warrant a deep dive and more concentrated attention. A word of caution: this approach can yield great rewards, but requires significant experience and resources to be able to analyze and structure investments across the credit spectrum. Less-resourced investors may need to limit themselves to a sub-set of the broad opportunity set.



FINANCIAL SERVICES GARBAGE COLLECTION: WHAT'S APPEALING

During the credit bubble, assets were acquired somewhat indiscriminately and in some cases without regard to pre-existing expertise in a given investment sector. As a result, investors may see similar assets coming out of different types of entities, for example: consumer finance companies being sold by public pension plans; and portfolios of esoteric insurance investments being sold by regulated banks. These assets can have significant intrinsic value. They are “garbage” only to their sellers, not to the investor who is able to see through the static and pay the right price. Certain characteristics make opportunities particularly attractive, regardless of the source of the asset or the nature of the asset. In the next few paragraphs, we summarize categories of opportunities that we see coming out of the Financial Services Garbage Collection phase of the Great Liquidation and Great Litigation, together with mini-case studies providing actual examples of each of these categories.

Information Platforms

Periodically, credit investments appear that offer material value beyond the current portfolio and future cash flows. We think of these as “information platforms” and expect that investors lucky enough to find them will benefit from new credit opportunities throughout the Great Liquidation. Information platforms yield new information on a pool of borrowers, due to the composition of the existing portfolio. For example, a portfolio of commercial loans will contain information about the underlying entities and their capital structures, providing insight into market dynamics and borrower needs. Third parties may discount some of this information, but the owner of an information platform may have a better context within which to compare opportunities. While the economics of an information platform transaction should stand on their own, the intangible benefits of such related information may be substantial.

Information Platform Case Study 1:

Commercial real estate debt servicing and origination business

Situation:

Seller decided to exit its U.S. real estate business to concentrate investments in its home country.

Investment Approach:

Buyer had experience both in developing servicing companies and in realizing value in mortgage securitizations, which supported the win in a competitive process. Platform was acquired via private equity, valued on servicing revenues, potential to grow servicing portfolio, make servicing acquisitions, and grow existing fund management and real estate lending businesses. The business offers insight into a significant portion of the commercial real estate market.

Information Platform Case Study 2:

TruPS CDO Manager

Situation:

TruPS CDO manager chose to wind down business and use cash to delever balance sheet.

Investment Summary:

The TruPS CDOs comprised over 500 unique issuers, primarily trust preferred securities of banks and insurance companies. Management fees are the most senior payment in the capital structure, assuring a long, reliable revenue stream. Sellers needed to raise cash, creating an opportunity to purchase the CDO management contracts at a significant discount. Management of TruPS CDOs provides insight into the financials of the underlying issuers and the potential to participate in restructurings.

Recapitalization Case Study 1:

High-quality, multi-family complex with 3200+ units

Situation:

Commercial real estate recapitalization precipitated by over-leverage, decline in rental income and imminent debt maturities.

Investment Approach:

Investor's ability to navigate a complex capital structure allowed purchase of a core asset at significant discount to market value. Investor negotiated simplified capital structure and implemented sales strategy to increase occupancy and cash flow. The investment offers potential additional upside through re-entitlement and development of additional units, and hands-on asset management.

Notwithstanding any analysis above, the investments described in the case studies could result in a total loss of invested capital.

Recapitalizations

By definition, any credit crisis presents a dearth of willing creditors. In the Great Liquidation and Great Litigation, the gap is particularly large, due to looming refinancing needs combined with the reluctance of regulated and unregulated finance companies to actively offer credit. As a result, many businesses seeking to recapitalize or restructure are seeking investors with long-term capital to put to work.

Some of these cases may fall into the “rescue finance” category, where the borrower is in significant distress and the investor needs to act quickly to fill the financing gap. In other cases, the borrower is simply trying to move its business forward, yet cannot secure the credit necessary to do so. Regardless, we advise that an investor focus on those opportunities where the collateral is highest quality, ideally with guaranteed cash flows. We also advise developing a loan agreement that includes several layers of protection for the investor, along with potential for upside. For example, interest payments combined with a revenue-share and/or a make-whole provision can mitigate risk and deliver a more certain outcome for investors.

Multi-Asset Entities

Many opportunities during the Great Liquidation have complex financial structures wrapped around them. Some opportunities have added complexity, in the form of different types of assets rolled together. We believe that these multi-asset entities require the investor to have expertise in different types of investments, in order to accurately assess the overall opportunity. Because few investors have the tolerance to pursue the deep level of analysis, these opportunities often generate less competition. Investors willing to make the effort and take a challenging set of assets off the seller’s balance sheet may be rewarded by significantly discounted prices.

Recapitalization Case Study 2:

Major motion picture production and financing corporation

Situation:

Corporate recapitalization driven by debt maturities and desire to raise cash.

Investment Approach:

Investor’s relationship with company through a prior investment provided an opportunity to participate in their recapitalization. Significant existing collateral and priority access to a strong global distribution networks on favorable economic terms provided an opportunity to participate with positive upside potential and downside protection. The recapitalization was structured with equity participation, collateral that can be put to a solid credit, and a make-whole provision.

Multi-Asset Entity Case Study:

Portfolio of 4,000 residential whole loans and three servicing platforms located throughout Europe

Situation:

Seller decided to exit its mortgage operations in Europe and the U.K., including an under-serviced loan portfolio, three separate mortgage servicers, and over 15 different legal entities.

Investment Approach:

Expertise in mortgage and other consumer servicing businesses and demonstrated ability to close complex transactions allowed the purchase of this multi-asset business at 29% of face value of the whole loan portfolios. Approximately 60% of the loans are delinquent, requiring the investor to strengthen servicing processes.

Liquidations Case Study 1:

Private Student Loan Portfolio

Situation:

Portfolio of over 58,000 student loans being sold by a consumer finance company that chose to exit this non-core business.

Investment Approach:

The portfolio included performing, sub-performing and charged off loans, from graduate, undergraduate, and professional education. Several bidders were interested in portions of the portfolio, but the winning investor was the only party willing to purchase the entire set of loans. Experience in servicing consumer receivables allowed the investor to evaluate the risk/reward profile of the portfolio in an asset class that has recently been out of favour.

Notwithstanding any analysis above, the investments described in the case studies could result in a total loss of invested capital.



Liquidations

Several of the investment opportunities coming out of the Great Liquidation are themselves liquidations. In these cases, the assets being sold do not constitute “going concern” businesses that are desirable to preserve or build. The seller may need to delever, or simply may have decided to exit a non-core business. Also in the Liquidation category are broken fund structures. These are often hedge funds that found themselves with an untenable asset-liability mismatch. Closing and liquidating the fund may be the only way to return investors’ capital in a reasonable timeframe. Common to both is a business model or capital structure that can no longer be sustained. We believe that the solution is to liquidate the remaining assets, which requires a strong asset management capability and a hands-on approach to winding down the portfolio. Investors pursuing these opportunities will need to have the expertise to truly understand the underlying assets, in order to price the portfolios correctly and execute a wind-down strategy that generates the maximum return.

Different Geographies

We have already discussed seeking less-efficient, lower competition arenas. Investors based in the U.S. who have the resources to source opportunities around the world should make an active effort to do so. The United States is, arguably, the most competitive market for credit opportunities. Most experienced investors in the distressed credit space are U.S.-based. The market is much more fragmented in Europe, and even more so in Asia. Few investors, even very sophisticated ones, have direct experience working through regulatory and bankruptcy proceedings outside of their home countries. Globally experienced and flexible investors have a significant competitive advantage.

As we outline in the mini-case studies above, these investments are idiosyncratic – no two are alike – and complex. Having the resources, experience, and perseverance to develop the optimum solution, weather possible litigation, and manage the asset through to value realization should significantly improve the investor’s potential for attractive returns. But it requires a lot of old-fashioned hard work.

Liquidations Case Study 2:

Portfolio of 600 small balance sub-performing commercial and residential loans

Situation:

Regional bank recapitalization precipitated the sale of its sub-performing portfolio.

Investment Approach:

The bank engaged a loan sales advisor to solicit bids for the portfolio. The ability of the investor to purchase the entire portfolio in an all or none bid and to analyze, price and close the transaction in a tight timeframe allowed the investor to purchase the portfolio at a discount to market value. The investor plans to implement a loan servicing and asset management plan to maximize return on the portfolio.

Different Geographies Case Study 1:

Global aircraft leasing portfolio

Situation:

Portfolio of 130+ regional jets leased in Europe and Australia acquired from an aircraft manufacturer.

Investment Approach:

Investor was approached by operating partner interested in acquiring the portfolio when seller decided to exit non-core business. The investor was a favored prospective partner due to prior experience with aircraft leasing, skill in assessing market potential in Europe, Africa, South America, and Asia, and ability to close. The in-place, high-quality leases cover the purchase price, with upside potential from the residual value of the aircraft.

Different Geographies Case Study 2:

European Bank Assets

Situation:

European bank filed for insolvency and needed to dispose of assets rapidly.

Investment Approach:

Investor was required to navigate the country-specific regulatory process for disposing of bank assets. Purchased unsecured bonds at significant discount, including loans to customers and credit institutions, and corporate and government bond holdings. Analysis of liquidation values showed limited downside and material upside from reflation of financial assets and improving economic conditions in the countries in which the assets are based.

Notwithstanding any analysis above, the investments described in the case studies could result in a total loss of invested capital.

CONCLUSION: KEY SUCCESS FACTORS FOR OPPORTUNISTIC CREDIT INVESTING

Regardless of the exact timing of the phases discussed in this paper or the relative pace of economic recovery, the sheer scale of impaired assets and their unlikely recovery to pre-crisis levels for a considerable time make us confident that more financial assets will be sold in the next three to five years than in the previous 100 years. Furthermore, even if the recovery is more rapid than expected, banks and other entities will still shed troubled assets in order to focus on more profitable new business.

We believe that sourcing, prioritization, and execution are critical during the Financial Services Garbage Collection phase. These types of investments are operationally complex and require intensive asset management to maximize value. To summarize, we believe investors can participate in the Great Liquidation and Great Litigation by following these guidelines:

- Seek opportunities that reward the knowledge, skills and persistence needed to work through the situation.
- Focus on complex capital structures and complicated investments, which attract fewer buyers.
- Prioritize idiosyncratic opportunities where perceived risk is high relative to actual risk.
- Focus on self-liquidating investments and those where over-collateralization provides solid credit protection.
- Source investments broadly and opportunistically, seeking the best relative value as market dynamics shift throughout the Great Liquidation.

Our team of investment, asset management, and operating professionals is available to discuss the concepts and strategies presented in this paper in greater detail. We also stand ready to review specific opportunities to participate in and profit from the Great Liquidation and Great Litigation.

Endnotes

¹ Represents book value. Source: FDIC publication titled “Managing the Crisis: The FDIC and RTC Experience”, February 2003

² Source: FDIC Research and Analysis, October 2006

³ Represents book value. Source: Federal Reserve Bank of St. Louis publication titled “Corporate Response to Distress: Evidence from the Asian Financial Crisis”, July 2006

⁴ Represents announced asset sales to date. Compiled by Fortress from the following sources: FDIC, Federal Reserve Bank of St. Louis, Bloomberg, Company Filings and Public Press Releases.

⁵ Source: Bloomberg, January 2010

⁶ Source: Deutsche Bank, Intex, SNL Financial, December 2009

⁷ Represents announced asset sales to date. Sources: FDIC, Federal Reserve Bank of St. Louis, Bloomberg, Company Filings and Public Press Releases. As of May 2011.

⁸ Fortress estimates.

⁹ Source: Maximus Advisors, FDIC

¹⁰ Source: FDIC.

¹¹ As of December 31, 2010.

¹² As of May 19, 2011.

¹³ Source: Realpoint Research, March 2011

¹⁴ Sources: U.S. Bureau of Labor Statistics, Bloomberg Consensus Forecasts, May 19, 2011.

¹⁵ Source: Maximus Advisors, April 2011.



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