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Trending Topics from J.P. Morgan Corp Fin Advisory | Week of May 28, 2018

4. The CDS and financing markets are intertwined, afterall

Key Takeaways

- Through credit default swaps (CDS), investors can replicate synthetic corporate credit positions with low upfront capital.
- Recently some of these investors have become true capital providers to firms (depending on incentives and willingness to lend).
- Firms have taken these financing lifelines while regulators and market participants are working to better understand the potential legal implications and impact to the CDS market.

Several precedents of this fact pattern have emerged, however each has a different flavor. In each case the party offering financing would protect its CDS position - for a CDS seller, ensuring continued receipt of premia payments, and CDS buyer, a more beneficial/likely payout on contractual default. RadioShack and Sears (reportedly) have had CDS sellers offer financing that would help stave off a default. McClatchy had a CDS seller offer financing along with a reorganization of debt structure, resulting in "orphaned" CDS contracts, significantly reducing any chance of a contractual default. Additionally, Codere and Hovnanian had CDS buyers who offered financing that also involved a technical default on CDS contracts.

These transactions are prevalent in situations where there are sizeable CDS positions relative to debt. When the stars align these third party contracts appear to result in one winner: firms in need of a lifeline.

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