Private Debt Investor

September 2020 • privatedebtinvestor.com

EXTRA
The asset class's most popular sectors

Ten views on how covid-19 will change private debt

The distortion of distress

The part of the distressed market that can generate the highest returns may be under threat from central bank intervention

The distressed and special situations opportunity set is one of the most exciting areas for clients to invest in. Our clients were already prepared for distress and had a variety of new funds investing in or pivoting towards distress in March. However, the distressed cycle may be different this time around, in large part because of the unprecedented amount of central bank and government fiscal support that has been provided to offset the economic impact of covid-19.

A typical distressed cycle usually involves three separate phases.

Phase one involves traded credit, where high-quality companies trade down for technical reasons. This phase is already over in the current cycle, having existed in March and April before the speedy snapback in yields.

Phase two is the stressed and distressed phase we are in now. It involves corporate distress and impaired balance sheets owing to leverage levels being unsuitable for covid revenue stress. It typically lasts around four months to a year, and has been particularly acute in covid-affected sectors such as airlines and hotels. I believe this second phase started in May and will continue until around mid-2021, when we expect fiscal stimulus will be slowly unwound.

Phase three is usually the 'main event' for distressed. It involves more traditional forms such as bankruptcies, restructurings, and non-performing loans. This is where the returns are typically highest (20 percent-plus) and where investors benefit from investing via locked-up capital vehicles. This phase normally takes place from around 1.5 to five years after the dislocation event. If events follows the normal cycle it will not start until the second half of 2021, when stressed companies will have exhausted all other credit sources and start to default in larger numbers.

"This excess liquidity, combined with what has been promised by central banks as years of very low interest rates, may lead to 'zombie capitalism'"

BEV DURSTON
Managing director
Edgehaven

However, a decade of intervention by central banks has trained them to believe they can consistently support markets. The US Federal Reserve's unprecedented intrusion into new credit market sectors – such as collateralised loan obligations, real estate investment trusts, high yield debt and bond exchange-traded funds – also means phase three may not take the normal pattern.

It may instead be truncated, like phase one, and markets will not clear because of the volume of intervention. There has been $11 trillion of central bank purchases and fiscal support globally, plus a significant amount of capital withdrawn from low yielding bond instruments that is looking for a home.

This excess liquidity, combined with central banks' promises of years of low interest rates, may lead to 'zombie capitalism', as experienced in Japan. Companies that should default would instead be able to borrow at low rates, leading to lower default availability for a large volume of newly raised distressed funds.

Our sources confirm there are many funds in the market raising capital and, if they are successful, more than $70 billion will be waiting to be deployed into phase three distressed from next year. If stressed companies, buoyed by covenant-lite loan terms, do not default in large numbers, there may be a shortage of opportunities for these specialist distressed funds. ■