Private Debt Investor

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EXTRA
Why senior debt is the investor favourite

Gauging distress

Companies feel the pressure of global events

New York
130 West 42nd Street
Suite 450
New York
NY 10036
T: +1 212 633 1919

London
100 Wood Street
London
EC2V 7AN
T: +44 20 7566 5444

Hong Kong
19F On Hing Building
1 On Hing Terrace Central
Hong Kong
T: +852 2153 3240

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Editor's letter

Why large-scale distress may be back in fashion

Andy Thomson
andy.t@peimedia.com

With the world in a state of flux, it seemed an appropriate time to revisit the distressed market and see whether there is a sense that today's dramatic events – ranging from inflation and rate rises to war on the European stage – might produce a new wave of activity. Hence, our cover story on the topic, starting on p. 12.

Having raised large amounts of capital in 2017 and struggled to identify dealflow, it had seemed that investor sentiment had turned somewhat against the large distressed funds. Under pressure to deploy, some have been accused of making concentrated bets in just one or two sectors, which then failed to perform according to expectations. Special situations and capital solutions funds, with smaller and arguably more flexible mandates, have been more in favour.

> **"Could we in fact be looking at an 'old-fashioned' wave of distress after all?"**

However, backing for the smaller funds has been partly based on the assumption that distress would be more at the single company, operational level rather than being structural as companies sought help to refinance and apply some fixes to balance sheet difficulties resulting from the pandemic. But that assumption is being challenged by the new energy crisis making inflation a bigger problem than it was originally perceived to be. Could we in fact be looking at an "old-fashioned" wave of distress after all?

Also in this issue, we examine AustralianSuper's ambitious expansion plans for private debt (p. 8) and have a series of features exploring prospects for senior debt (starting on p. 20). We also bring you our *Mid-Market Lending* report, which explores all the key dynamics in areas such as deals, fundraising, regulation and reporting for the asset class's medium-sized players.

Andy Thomson

Cover story

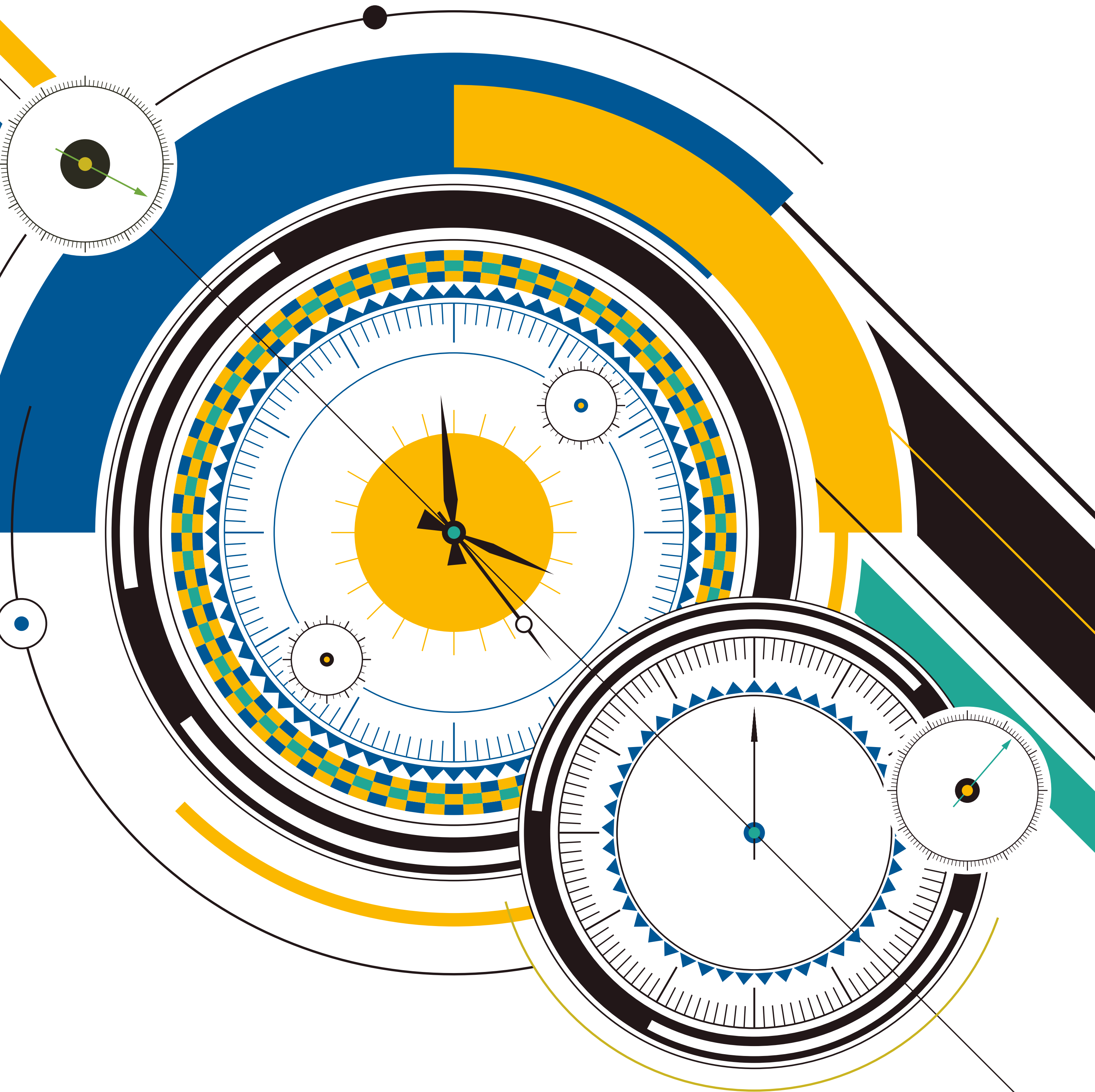
Distressed investors poised as the pressure builds

With investors tending to favour special situations and capital solutions funds, the large-scale distressed opportunity has fallen out of fashion. But in a world shaken to its foundations by conflict, in addition to an array of troubling economic indicators, has the real world usurped the best-laid plans? Andy Thomson investigates

The covid pandemic, inflation that now looks more long term than transitory, the promise of hikes in base interest rates, supply-chain pressures, the conflict in Ukraine. The list may go on, though one can only hope it stops there – at least for long enough to take a breath and take stock. But regardless of what the future brings, surely there is already enough volatility to create a serious amount of dealflow for distressed investors?

Abhik Das, managing director and head of private debt at Munich-based fund of funds manager Golding Capital Partners, has a sceptical view of large, distressed funds based on the 2013-14 vintage. These were often multi-billion dollars in size, but struggled to deploy capital. Under pressure to invest, some took concentrated bets in the energy sector, which didn't tend to have favourable outcomes.

"The investment professionals at the largest distressed debt fund managers are undoubtedly very smart," says Das,



> *"In the leveraged loan market, there are a number of issuers that raised money on heavily adjusted and hence inflated EBITDAs, with unsustainably high leverage levels as a result"*
>
> **ABHIK DAS**
> **Golding Capital Partners**

"but we remain wary when it comes to the multi-billion-dollar pools of capital that some of these firms have raised. What typically follows is the necessity to invest into larger, more liquid capital structures – an often very limited opportunity set depending on the market cycle. At the same time, investors naturally worry about deployment, which creates an unfortunate conundrum for very large distressed funds when those opportunities do not arise."

Bev Durston, founder of Australia-based alternative assets consultancy Edgehaven, says: "The problem with the 'jumbo size' fundraisings is the size of deals which they are restricted to. If the minimum deal size is between $300 million and $500 million, then you really want to be the only firm which is looking at the deal. So, whilst you may see 30 opportunities of this size you may also miss out on 500 or more which are all smaller but won't move the needle for your fund size.

"Many consultants rightly point out that the larger fund raises justify their capital raising because they have amazingly diverse industry and workout experience, and this is generally true. But the fact that fundraisings have become so large is at least partly a function of sovereign wealth funds coming into the market with very large tickets to commit, causing a concentration in large fund sizes."

Nonetheless, even accounting for these concerns, does the pressure to invest mean that the era of large-scale distress is once again upon us? Das concedes that it may be. "I think things could change. In the leveraged loan market, there are a number of issuers that raised money on heavily adjusted and hence inflated EBITDAs, with unsustainably high leverage levels as a result. Will they be able to refinance that debt in a year or two if there's a prolonged period of volatility? Even before higher rates came into play, there was always a question around whether the

refinancing environment might change. Now, with the geopolitical uncertainty, inflation and ensuing rate hikes, you have a perfect storm."

Rationale for big funds

Trevor Castledine, a senior director at London-headquartered consultancy bfinance, also thinks the larger distressed funds have discovered a rationale in current market conditions. "The big funds are not dead and buried," he says. "There will be additional distress in public and private markets. Companies will be hit by rising energy prices, which could lead to some substantial bankruptcies and restructurings. If you can provide $1 billion in debtor-in-possession financing, for example, you're one of only a handful of firms that can do that and you can charge a lot for it."

Not everyone is convinced, however, that – even in the face of the pressures that are universally acknowledged – the distressed opportunity is guaranteed over the long term and that LPs should therefore be revising their strategic priorities. Selecting the right kind of opportunity is critical.

"To succeed in higher-yielding private credit opportunities, including distressed, you need to be able to allocate to a single name in distress as it occurs for idiosyncratic reasons, allocate to wider corporate credit dislocation if it occurs, and then allocate to primaries when the market is open and you have good opportunities," says Andrew Davies, partner and co-head of private credit at London-based fund manager CVC Credit.

It's the sense that LPs may be boxing themselves into a corner with a restrictive mandate that has encouraged many to support smaller funds which specialise in complexity rather than outright distress, with labels such as special situations, opportunistic credit and capital solutions. Fund managers named in dispatches include the likes of CarVal Investors, Cheyne Capital and Signal Capital Partners. Fund sizes are typically around the €1 billion to €2 billion range and they often invest on a pan-regional basis. Crucially, says one market source, "it doesn't particularly matter to them what the market does, they find the opportunities anyway".

Arguably typical of this new generation of asset managers with flexible approaches is London-based Sona Asset Management, which was formed in 2016 and launched its second capital solutions fund with a $500 million target in December last year. The firm was launched with a background in liquid credit but branched out into private credit in 2020 and is now active across the entire credit spectrum.

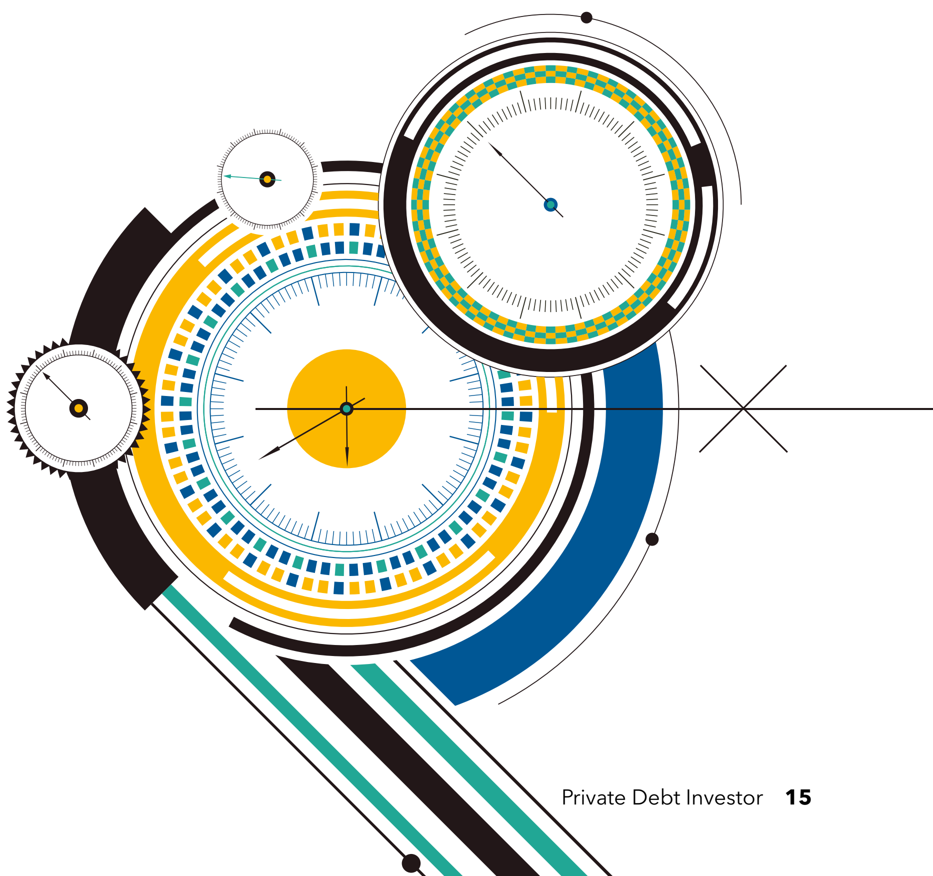
"Covid was the catalyst," says John Aylward, Sona's chief investment officer. "The credit markets had a huge initial shock and while things are now closer to normality, there will be more interesting opportunities than there were pre-covid. It was a structural challenge, and we see ourselves as part of the structural solution. The key is to put capital into interesting situations.

"There are a lot of providers but we feel we have a niche. We are not trying to be generic mid-market. We have a very large market footprint already on the liquid credit side where we trade approximately $1 billion in credit a week. We have access to information flow and opportunities that others don't see."

"You don't just want a focus on hospitality, retail and travel in your portfolio," says Durston of the maturing distressed opportunity. "Even the multi-billion funds are not limited themselves to the obvious areas anymore. Everyone is pivoting to certain things. The opportunity sets can be small and concentrated as you might get just a few months of forced selling in a certain industry."

Don't limit yourself

One industry that may see this dynamic is energy, given the extreme disruption



it is experiencing. This is somewhat ironic given the earlier point about the concentrated energy bets made in previous years that fell short of investor expectations. But while performance is certainly a key issue, perhaps an even bigger one will be navigating the moral maze that may accompany such investments given the geopolitical backdrop.

"Asset management firms may end up struggling with what's morally right versus what the monetary opportunity set offers them," says Durston. "What about if a deal involves the Asian subsidiary of a Russian energy group – where do you draw the line? There may be a distressed opportunity there but there's also an ethical issue to resolve with clients. We believe that this will throw up some thorny dilemmas and investors may need to think about drawing up more formal policies. Unfortunately, this may become a long-term situation and so it is best to understand what clients want."

Durston says that, even before the Ukraine conflict erupted, LPs were considering it more feasible that a distressed opportunity could arise over the coming few years and "if you don't have a distressed allocation, now is the time to start assessing GPs for the future". This was based on the general macroeconomic environment and the withdrawal of government support that was offered during the pandemic. The gush

> *"What about if a deal involves the Asian subsidiary of a Russian energy group – where do you draw the line?"*
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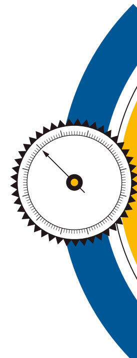
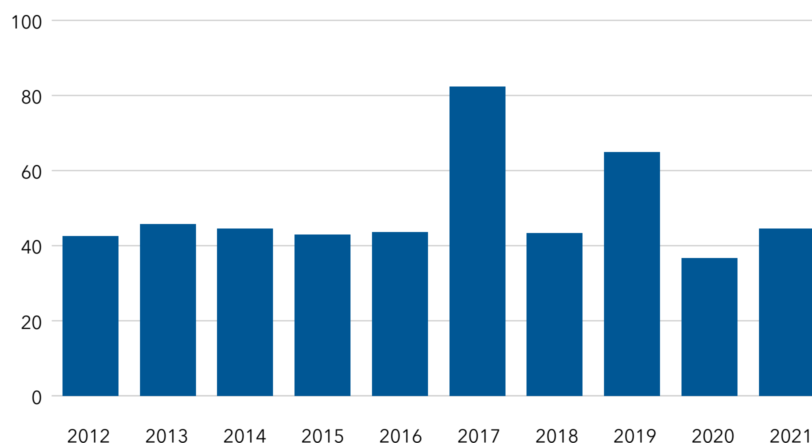
> **BEV DURSTON**
> **Edgehaven**



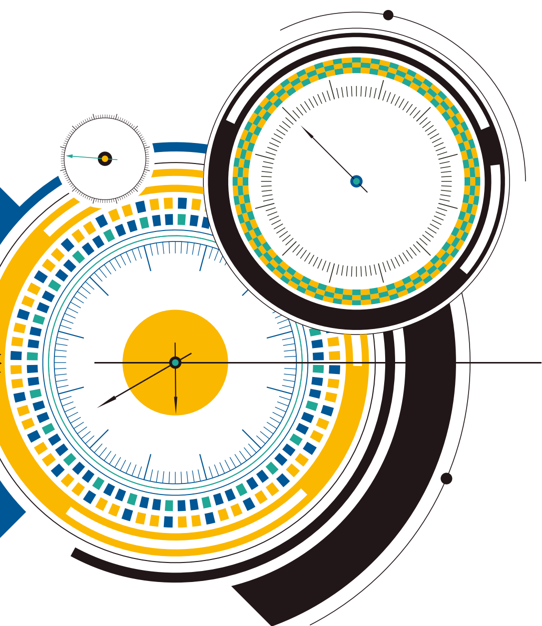
Distressed private debt fundraising ($bn)



Top five distressed private debt fund closes, 2017-21

Fund	Head office	Manager	Target size ($bn)	Current size ($bn)	Year close	Region	Sector
Apollo Investment Fund IX	US	Apollo Global Management	23.5	24.7	2017	Multi-regional	Corporate
Oaktree Opportunities Fund XI	US	Oaktree Capital Management	15.0	16.0	2021	Multi-regional	Corporate
Oaktree Opportunities Fund Xb	US	Oaktree Capital Management	7.0	8.9	2017	Multi-regional	Corporate
Lone Star Fund XI	US	Lone Star Funds	6.0	8.2	2019	Multi-regional	Diversified
GSO Capital Solutions Fund III	US	Blackstone	6.5	7.1	2018	Multi-regional	Corporate

Source: PDI



of liquidity, in other words, is slowing to a trickle.

There is little doubt that the stresses companies are facing create a compelling opportunity for fund managers to step in with financial and operational assistance. This is something which many investors increasingly recognise. "With special situations funds you're less likely to suffer the inconsistent drawdowns that have plagued distressed funds," says Castledine. "What's good about such funds is the current cash pay. You don't give up current cash return, which is what you may have to do with distressed funds where it can be more based on capital gain than coupon."

But while investors may be fully sold on the notion of an allocation to more complex investments, actually making an allocation can be challenging for some – especially since the roots of many private debt LPs are in the conservative world of fixed income. "Fixed income investors are on a journey," says Castledine. "These are unrated investments which are perceived as

Why it's 2020 all over again

Volatile market conditions may usher in another period of fundraising for dislocation funds.

It wasn't meant to be this way. With the worst effects of the covid pandemic beginning to recede, this was supposed to be the period of economic recovery where companies that had demonstrated their resilience through that most challenging period could look forward to riding a growth wave. The dislocation funds that cropped up in early 2020 as covid chaos reached its peak would be fast becoming a distant memory – a one-off phenomenon, something of a flash in the pan.

And now they're coming back. At least that's what London-based fund manager AlbaCore Capital Group appears to hint at. In a reflection on current credit market conditions, the firm's founder and chief investment officer, David Allen, said: "Periods of adjustment in markets broaden opportunities, and the current environment is no different. We assumed a more attractive entry point would return – dislocations occur more often than one might assume – and here we are."

Here we are, in a world where we're reminded that crises can follow on from one another with alarming rapidity. Of course, it's a difficult thing to say out loud but the truth of the matter is that crises that may cause untold misery to human populations can also, as a by-product, catalyse the kind of volatility in financial markets that can be highly profitable. KKR showed just how profitable when revealing that its dislocation fund returned 52 percent in 2020. Anecdotal reports suggest other such funds also shot the lights out.

If a new generation of these vehicles is heading to market, they would do so with every expectation of raising capital successfully. Nonetheless, the decision to invest is not an easy one for LPs. As we highlighted when the 2020 vintage was raised, these funds demand capital be committed very quickly. The reasoning is solid enough, given that that the opportunity set may be fleeting. But many investors simply can't get approval from investment committees with sufficient speed.

Another issue is transparency. One market source remarked to us that dislocation funds tend to "take your money and do what they like with it". "Flexible mandate" is the official description, but however you describe it, it's not especially see-through. Some say these funds act more like hedge funds than private debt funds. Returns may be a strong point – transparency isn't.

Connected to the point about flexible investing is a related one about possible strategic drift. Dislocation has a tendency to straddle public and private markets and demands a strategic approach that can operate successfully in both arenas. Some organisations are able to readily demonstrate the expertise to do this, but for investors there will always be discomfort around the notion of GPs straying from their core specialisations.

A new opportunity may be springing up, but some old challenges still remain.

more risky and which involve giving up liquidity. Moreover, they have to make the case to committees and boards, which can be a hard journey. Certain decisions may not be bad from an investment perspective, but they could be from a career perspective."

> *"Certain decisions may not be bad from an investment perspective, but they could be from a career perspective"*
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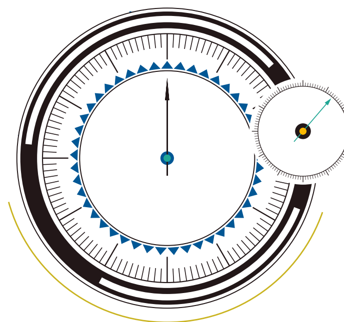
> **TREVOR CASTLEDINE**
> **bfinance**



Shifting out of liquid market

Das acknowledges similar issues: "A lot of clients see private debt as fixed income replacement and are primarily interested in direct lending. When we seek to mix in junior and opportunistic credit, we are often met with a certain degree of resistance. Some of these strategies are just harder to understand for less sophisticated investors. However, larger or more experienced LPs, who are prepared to consider a wider range of approaches, also look at more differentiated private debt strategies as a hedge."

For those able to move into this space, the stresses in the system are likely to prevail for some time to come, Das predicts. "Coming into this year, many experts were saying that it could be 12 months or longer to get back to the way things were before the pandemic. With geopolitical uncertainty on top of that and soaring prices of everything from energy to various (natural) input materials, many companies are operating in unprecedented territory. Not to mention the personnel shortage in addition, where firms are finding it harder to attract skilled workers to replace key people that have left. Wage inflation is a real structural problem in many industries."

There is also inflation to consider. "The effects of inflation depend upon the individual company," says Castledine. "If you're in an energy-intensive sector such as manufacturing, transport or logistics, do you have the pricing power to pass costs on? Some companies will be caught out and we'll discover what's really counter-cyclical and what's not."

Castledine also hints that there should be no room for complacency about the resilience of private debt-backed companies through the pandemic. It's harder to see the stress without the mark-to-market that you have with public companies, and there has been no trigger event to make stress evident at this point. There might still be hidden cracks, however.

"The length of a loan is typically only five years, and 2017 and 2018 were big years for fundraising," he says. "Those that raised funds then have now deployed a lot of that capital and good debt refinances quickly. What's left is debt issued by less strong performers. There is a lot of refinancing to happen over the next three to four years and that must lead to some opportunity. Some businesses have been placed under significant pressure by covid, they've been put under stress and government support is being removed. They're good companies but they may not look as healthy to a lender as they otherwise might."

Castledine believes that, when it comes to refinancing, some companies will have to take financing based on a higher EBITDA multiple and possibly featuring the likes of payment-in-kind notes and equity kickers. "Special situations funds will look at these," he says. "The companies have not defaulted but they'll have to pay up a bit more to get the leverage they want."

The prospect of a refinancing wave will offer encouragement to a distressed market that has struggled with dealflow over the past couple of years. As the pressure builds, so too do hopes of more fruitful times ahead for investors. ■