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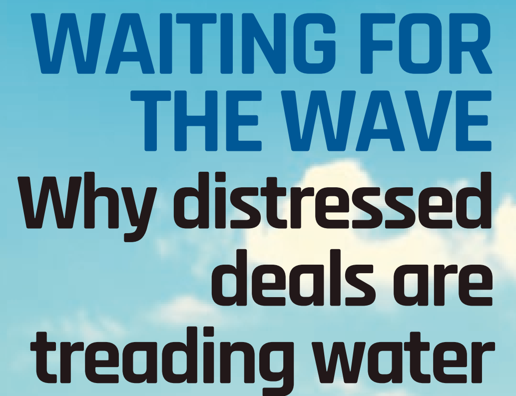
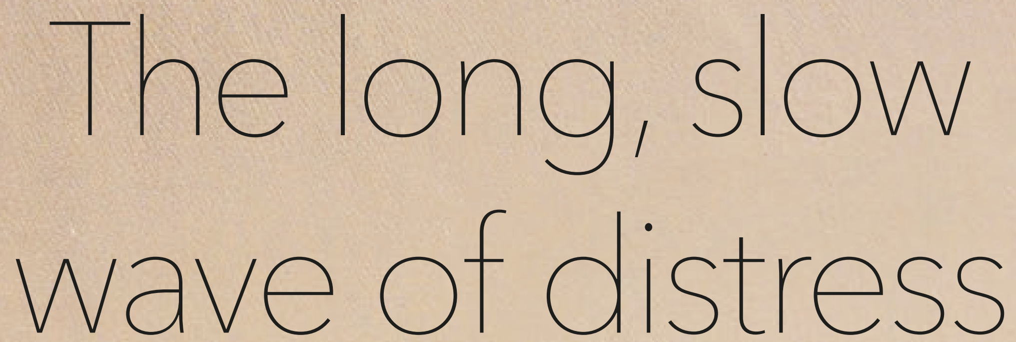




The long, slow wave of distress

Low interest rates and policy interventions may translate into a slower but longer distressed cycle than has been seen in past crises. David Turner examines the implications for fund managers and investors

Cover story

Amid the confusion caused by the pandemic, one thing is certain: the arrival of super-easy monetary policy has made the search for yield even more desperate.

A few days after the US Federal Reserve cut interest rates in early March, the 10-year Treasury yield sank to a record low of 0.318 percent. By July, the five-year yield had sunk to a new trough of 0.214 percent. Any idea of an eventual rise in Fed rates was pushed even further into the distance the following month, when the US central bank announced a move to an average inflation target, which will allow it to shrug off temporary rises in the rate above its 2 percent benchmark. As for Europe, in May the UK government sold a bond with a negative yield for the first time in history.

Surveying this background, Nick Brooks, head of economic and investment research at fund manager Intermediate Capital Group in London, concludes: "The hunt for yield is going to be very intense – more intense even than after the 2008-09 crisis – as there are pension funds and insurance companies that need yields to meet their longer-term obligations." Given this, "assets that can provide this yield will be in demand" – including private credit.

Against this background, people see opportunities in distressed. However, these opportunities will be stretched out over a longer period than during the spectacular but rather brief trough in private debt prices that followed the collapse of Lehman Brothers in 2008. Most also see promise in senior secured mid-market debt – in many cases at better pricing than before the pandemic.

To the rescue

The very first opportunity for distressed debt in this downturn has come and gone already. In the early spring, huge swaths of the US and European markets were treated by investors as, if not actually distressed, at the very least stressed.

However, businesses then recovered quickly because of multifaceted rescue packages on both sides of the Atlantic. These varied by country, but different schemes included loans to businesses, funding wages, quantitative easing by buying bonds and securitised loans, and cuts in interest rates. Some measures helped borrowers in the private debt markets by directly supporting their businesses; others aided them by reviving the economy and reducing risk

aversion among investors. Robin Doumar, London-based founder and managing partner of Park Square Capital, a mid-market direct lender in Europe and the US, notes: "In March, we saw very deep dislocation in high-quality regular senior debt, trading at around 80 cents in the euro. This had us and other people excited about the dislocation/distressed opportunity, so we deployed quite a bit of capital."

By now, however, "the easy opportunity is gone, and what remains is an extremely difficult opportunity around trying to determine just how bad some of the situations are. The policy response has made the distressed opportunity far less attractive".

Doumar warns: "A lot of global investors are focused on the distressed opportunity, but to me that's a fool's errand."

Despite this recovery, some private credit experts still see attractions in stressed and distressed debt. Bev Durston, founder and managing director of Edgehaven, an alternative asset investment advisory firm based in Sydney and London, says the market is simply at a different stage from where it was at during the spring.

What she describes as "phase two" involves "a variety of forms of rescue capital for stretched companies. Unlevered returns are generally between 15 percent and 25 percent. This involves rescue lending to companies that are unable to borrow or refinance existing debt, lending to covid-sensitive sectors such as transport, leisure and hospitality, and buying performing loan portfolios off lenders who need to raise capital". Based on history, Durston thinks this phase is likely to last between four months and a year.

'We're going to be in energy, hotels and airlines'

Limited partners are wary of looking foolish by committing to sectors battered by the coronavirus

Investors may be convinced of the intellectual case for changing their private credit allocations in reaction to the pandemic and to the policy response to the ensuing crisis. However, when it comes to making the shift from thinking about doing something to actually doing it, the turmoil of recent months has presented obstacles both old and new.

This is partly because of the usual risk aversion that occurs during downturns, but there is also a special coronavirus twist. Christoph Gort of Siglo Capital Advisors sees distressed opportunities in sectors hit by the pandemic. However, "very few of our clients want to allocate money to skilled distressed managers, if managers say upfront, 'We're going to be in energy, hotels and airlines.' Most of our clients fear that if something goes wrong, it's a big career risk. They say, 'If my investment fails, people will say, how could I have allocated money to troubled sectors when the coronavirus was not really over?'"

This wariness about seizing the opportunities provided by hard-hit sectors helps explain why distressed fundraising was muted in the first half of 2020. At $10.8 billion globally, according to *PDI* data, it was barely more than a quarter of the corresponding number for H1 2019. If fundraising stays at this level in H2, 2020 will be the worst year for distressed fundraising since 2009. Its share of total private credit fundraising, at only 17 percent, was also far below normal in H1.

Given this background, Peter Martenson of Eaton Partners thinks the protracted nature of the current distressed opportunity could in fact be just what limited partners need, if they are initially wary of distressed. This time round, "both GPs and LPs have the opportunity to get pre-positioned with thoughtful capital to help distressed companies. Because the distressed cycle is extended, limited partners can see things playing out and gradually allocate a bit to distressed – and, later on, a bit more".

Such credits are, of course, not to the taste of every investor. Any mention of transport, leisure and hospitality, three of the sectors hit hardest by the coronavirus, leaves many of them automatically ruling themselves out. This is part of a pronounced bifurcation.

"The market has become much more binary in terms of which companies are able to raise capital and which are not," says Floris Hovingh, head of alternative capital solutions at financial services firm Deloitte in London. "People are very concerned about the effect of the recession, so they shy away from companies that rely on discretionary spending, and sectors that will be impacted in the long term by the coronavirus."

Hovingh puts in the latter category hotels and leisure, aviation, physical retail and events companies. "The question is, are these companies ever going to return to where they were before – and if they do, how long will it take? If you're not going back to your pre-covid EBITDA, and are already overleveraged, it will be tough for any shareholder or lender to put more money into your business."

He adds that, by the same token, prospective buyers of secondary debt will be wary and require a significant discount to par.

However, Christoph Gort, head of credit and private debt at investment adviser Siglo Capital Advisors in Zurich, sees European possibilities in sectors hit particularly hard by the coronavirus. "Very few people want to do such deals," he says. "There's a bifurcation in the market, with a crowding-out in some sectors but not enough capital in others."

For such sectors distressed by covid-19, "if you are a skilled restructurer with turnaround experience you can find great deals today, against limited competition".

Watch out for the zombies

Although some investors are seeing some distressed openings, Durston says returns would normally be greater in what she regards as phase three of the distressed debt timeline. However, she adds that there will be much less certainty during the current credit downturn than there has been during most of its predecessors.

The third phase, which she believes is likely to start from the middle of next year, will involve restructurings, bankruptcies and other non-performing loan opportunities. "These are the more complex and longer-timeline deals, requiring patience, significant legal expertise and locked-up capital," she says.

Deals during this phase will typically be more lucrative, "with 20 percent to 30 percent-plus returns possible".

Nevertheless, Durston has greater doubts about phase three this time around because of the potential growth of "zombie capitalism" – a term coined to describe the situation in Japan after the 1990 crash. Under this scenario, companies that would in normal circumstances default and become potential targets for distressed funds, might instead be kept alive because they are able to pay low rates of interest on their debts.

"The hunt for yield is going to be very intense – more intense even than after the 2008-09 crisis"

NICK BROOKS
Intermediate Capital Group

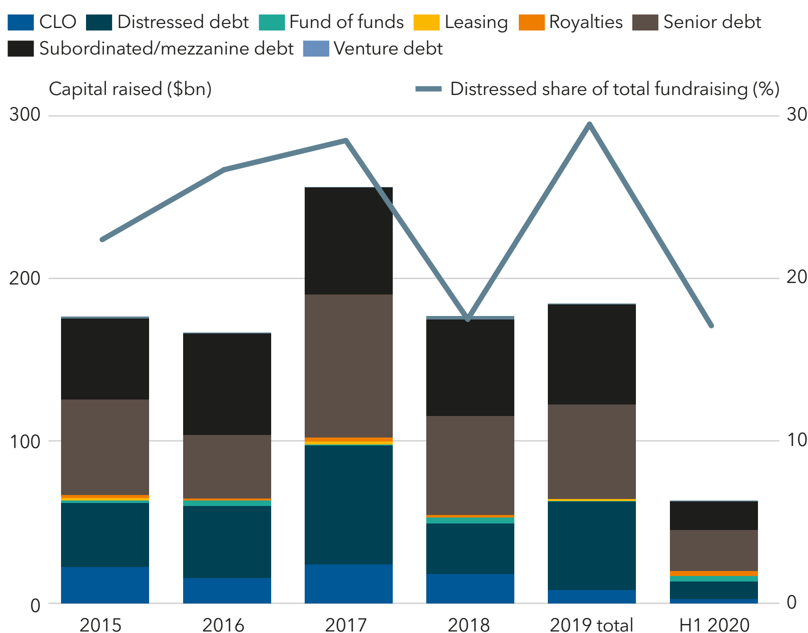
"Companies that can borrow are already protecting their balance sheets by borrowing for long periods at very low rates wherever they can, and hoping to have enough capital to make it through till revenues are flowing again," says Durston. "If this continues, specialist distressed funds – especially those with large amounts of capital to deploy – will compete with each other over relatively few deals."

This would make the returns for these vintage distressed vehicles very different from those seen during previous cycles, "which is why we are cautious about investing in the larger specialist distressed funds".

The availability of low interest rates may reduce the chances for stressed and distressed investors. However, it might also simply change the timing of opportunities. "The central bank easing has alleviated some of the pain in the medium term," says Peter Martenson, partner at placement agency Eaton Partners in San Diego, California. "However, we think it has extended the distressed cycle, rather than destroying distressed opportunities."

Distressed is not, in any case, the only game in town, even during this recessionary period. The huge intervention by policymakers may have complicated life for distressed investors, but it has also stabilised the much larger market in non-distressed debt by

Distressed debt fundraising as a percentage of total fundraising



Source: Private Debt Investor

pushing up prices. "I think private debt is a very significant beneficiary of the incredibly strong policy response from central banks and governments around the world," says Doumar.

Policymakers have steadied the market – but not totally, and this presents chances for direct lenders and secondary buyers. Doumar thinks that even "high-quality credits" in the mid-market are trading at a slight discount to par – in the high 90s – on both sides of the Atlantic. He attributes this to the lower supply of capital from the banks, which are trying to reduce the amount of debt on their balance sheets, and the riskiness of that debt, by holding fewer highly leveraged assets.

Ted Koenig, Chicago-based chief executive of fund manager Monroe Capital, estimates that yields in his firm's core domain, senior secured lending to the US mid-market, are up by 50-150 basis points depending on the deal, compared with before the pandemic. He credits that to the decision by many risk-averse institutions to sit out this market in the first half of 2020. These investors are only now gradually returning. This dearth of capital has also, he says, created possibilities in niche markets, such as real estate, litigation and intellectual property financing.

> *"A lot of global investors are focused on the distressed opportunity, but to me that's a fool's errand"*
>
> **ROBIN DOUMAR**
> **Park Square Capital**

Monroe Capital also invests in distressed if there are attractive deals. However, Koenig says the support of US policymakers means "there are not as many opportunities in distressed – normally, in a financial crisis, we see a lot of them".

Spreads worsening

Some observers on the other side of the Atlantic have another view of the return trend in direct lending. "Spreads in sectors affected less by the pandemic are very similar to before the crisis, but occasionally even worse," says Gort of Siglo, who puts forward a different opinion on Europe from that of Park Square's Doumar. "And the documentation is still very borrower-friendly."

As investors respond to the various challenges and opportunities presented by the downturn and the massive policy response, they face a problem peculiar to this crisis. Martenson notes that if limited partners are considering taking advantage of these opportunities, they may need to allocate to new fund managers; but they still like to meet prospective new managers in person.

"LPs normally make a decision about a relationship – 'I like them or I don't like them' – within the first 15 seconds of meeting," says Martenson, who believes they find it harder to do this on Zoom. Private capital is different from other investments in this respect, because the money is tied up for a longer period.

"LPs are struggling to resolve this problem," he concludes. As well as a great many video calls with prospective managers to make up for the lack of face-to-face meetings, "they do a lot more reference calls to people who know the managers better than they do". ■