Zombie capitalism will distort the distressed debt cycle

by **Bev Durston** 23rd November 2020

Much has been written about the opportunity to buy dislocated and distressed credit brought about by the global Covid-19 pandemic. Indeed, many managers have been busy fundraising this year offering their clients new private debt funds specialising in the sector.

Whether this makes sense in today's environment is quite another matter – not least with two vaccines prepared for final release, others a few steps behind, and billions of doses pre-ordered across the globe.

Edgehaven is concerned about the limited number of opportunities for bankruptcies available to large scale, specialist distressed debt funds which may lead to a poor vintage outcome.

The average return on the Barclays US Corporate high yield index plummeted to an all-time low of 4.56% recently, below the previous record set in June 2014. Governments and central banks are all set to provide continual support to interest rate and credit markets.

Record issuance of corporate debt has been available to both investment grade and high yields markets at ever-lower rates. Despite the on-going pandemic, equity markets are setting daily new highs in US and Asian markets.

We agree that many sectors of the market – such as hospitality, transport and energy – are experiencing a stressful environment. Companies are suffering significant revenue losses over an extended period as they endure rising debt levels.

But with a possible upswing in growth, as vaccines are delivered, all they need do is continue trading for a few more months and limp through to survive on the other side.

Edgehaven believes that "zombie capitalism" will mean the cycle for distressed debt may be different this time around.

Zombie capitalism exists when companies which would otherwise go bankrupt are able to stay afloat by borrowing at near-zero rates. This means that inadequate management and governance structures are not punished by market forces and that markets do not clear at a lower price, preventing innovative new businesses springing up with a lower cost base.

This happened in Japan in the 1990s, known as the "lost decade" when years of low interest rates and central bank injections of cash meant that poorly managed companies could survive for far too long and corporates were not restructured.

Distressed debt funds require either bankruptcy or a catalyst – such as a debt which cannot be refinanced – to capitalise on such opportunities.

Without this, there may be scant opportunities for the $70-plus billion of specialist funds raised to be put to work in large scale, complex restructurings.

Take the airline sector for example. National flag carriers – or those companies allied closely to governments – have been strongly supported throughout this crisis despite closing operations and reporting billions of dollars of losses.

The average subsidy to these airlines provided by various state support packages has been estimated at over 30% of the previous year's revenue. This support has kept them alive. Since these are the best quality airlines, the firms will likely not be allowed to go into bankruptcy even though they currently have many thousands of jets lying idle (except perhaps in the US).

There will probably be restructuring for smaller and regional airlines which have not received as much support and are likely to provide interesting pickings. But we expect the chances of distressed debt funds doing significant workouts for large fleets of aircraft will be minimal.

It would surely be better if debt could be written off and some savvy investors were able to buy the planes at a substantial discount, re-structure the contracts and liabilities so that the firms could hit the ground running with new management and an innovative strategy.

Despite early pain, this would be far better for future productivity, for travellers not buying tickets to cover historical losses and for a competitive recovery.

Sadly, zombie capitalism does not work like that. And, as business returns to normal, there is a distinct risk that some of the larger distressed debt funds will be left competing among themselves for a small number of bankruptcies.

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