MV|Credit

The Decline of the Distressed Debt Investor?

Key Highlights:

- *Distressed debt investors may be locked out of deals due to restrictive documentation post 2008 resulting in limited deal flow*
- *Experienced private debt investors are seeing greater opportunities across the capital structure to deploy into creative and supportive solutions for performing credits*
- *Distressed debt has high return volatility and requires precise timing on when to invest resulting in uneven performance among managers*
- *Return streams more closely resemble private equity with uncertain cashflows and exit dates in comparison to the regular distributions typically associated with private debt*
- *Greater risk-adjusted returns can be achieved elsewhere given the right amount of investment flexibility within the private debt landscape*
- *ESG conscious LPs may be left conflicted with distressed investors methods when extracting value from failing companies*

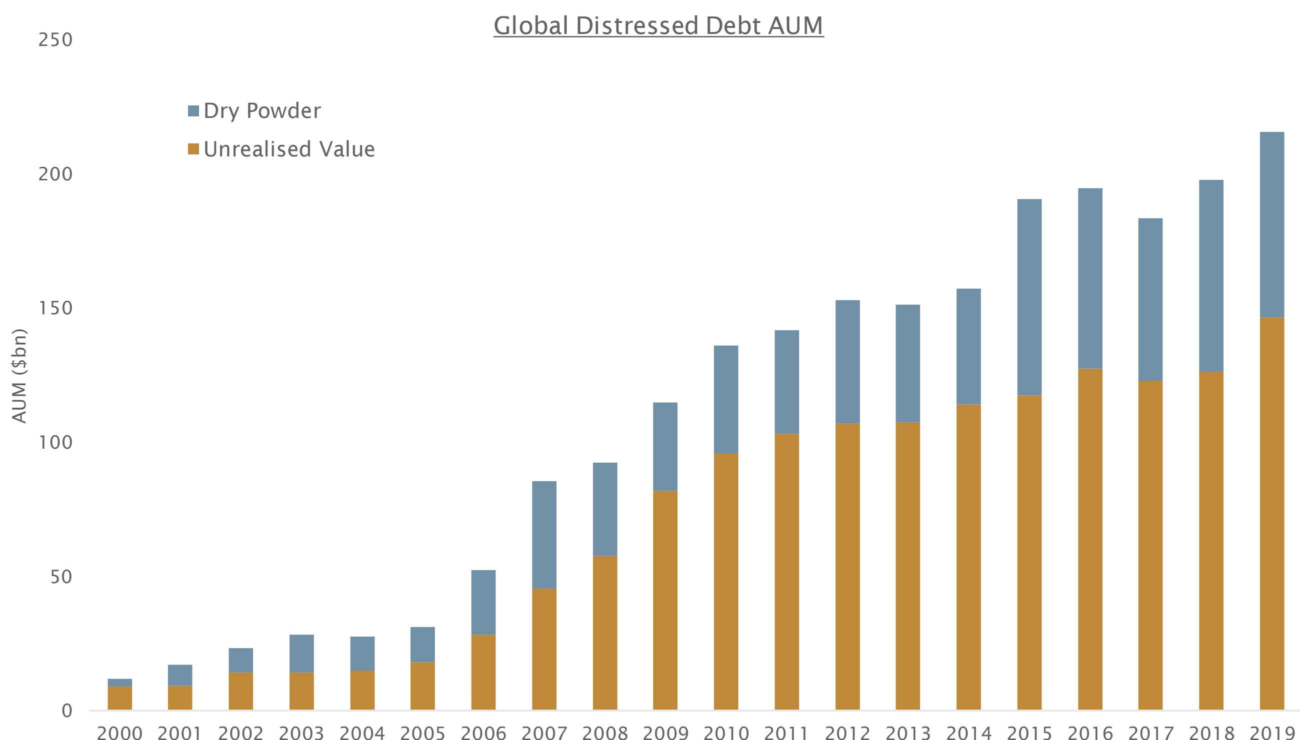
INTRODUCTION

In times of an economic slowdown where businesses are fighting to stay alive, a distressed debt investor has a potentially fertile hunting ground. Given the current environment, and as an investor in (performing) debt we are frequently being asked why not go headfirst into distressed debt in this climate? We aim to highlight here a few issues which cause us to take a pause and reflect on what sort of private debt strategy is best placed to meet an investors expectations', even during a significant downturn in the economy.

SOURCING OPPORTUNITIES: TRANSFER RESTRICTIONS

Put simply, a distressed debt investor aims to profit from buying debt at a deep discount (due to underperformance, default or even bankruptcy) from existing lenders who want out of the loan. Dry powder in distressed debt funds has been growing since 2008 and investors in the asset class have struggled to find places to deploy. As recent as last September Howard Marks, the co-founder of Oaktree Capital and renowned distressed-debt buyer was quoted as saying:

"Investing in distressed debt is a struggle today.... The economy is too good; the capital markets are too generous. It's hard for a company to get into trouble."



Source: Preqin (31/12/2000 – 30/09/2019)

Distressed debt investing relies on several factors such as a time of economic stress but also finding actionable opportunities. The ability for one lender to sell (or to "transfer"[1]) to another is essential in actioning an investment strategy based on buying other's positions. Post 2008 (and particularly in recent years), loan documentation has tightened and various restrictions[2] on transfers have been put in place:

- **Consent rights:** if no event of default (typically now restricted to a bankruptcy or missed payment event) has occurred then transfer of the loan will require prior borrower consent. A private equity sponsor can therefore block such a transfer including to a distressed investor.

- **"Blacklists":** further restrictions can follow even after an event of default if a "blacklist" is in place which specifically prohibits a list or class of lenders (typically so called "vulture" or "loan to own" funds) in all circumstances from transfer of the loan, even after an event of default.

- **"Whitelists":** the same as the above but this is a list of pre-approved lenders to whom a transfer is acceptable. These generally only include par lenders.

This leads to distressed investors facing challenges in purchasing debt on the secondary market before they have even started looking. In 2019, Reorg Debt Explained found that 66% of leveraged loans had restrictions on transfers to distressed funds[3]. Even more staggering is that 58% of loans sold in 2019 had restrictions on selling to distressed funds even after certain types of default, compared with just 14% in 2017. While this does not lock distressed investors out of the market, we believe these restrictions will restrict their addressable market scope, slow down their pace of deployment and potentially lead to slightly higher costs (e.g. legal) which could potentially impact their returns.

The above restrictions have coincided with so called "cov-lite" loan documentation which sees financial loan covenants generally removed for term loan lenders. This has the added impact of delaying the threshold before a company falls into default (typically an actual payment default has to occur) as covenant breaches will no longer be triggered. This removes a significant amount of leverage available to distressed investors as they cannot bring the owner to the table and must work collaboratively with the other stakeholders to find a solution.

SOURCING OPPORTUNITIES: BEYOND DOCUMENTATION

We have heard reports that investment banks (specifically their distressed loan trading desks) are looking at ways to hold loans "on behalf" of distressed investors. The investment bank might "front" a secondary purchase for an investor. This process involves transferring the loan to an investment bank (i.e. the bank "fronts" the purchase) and then passing certain underlying rights of the loan to the distressed debt investor. Whilst this might be technically possible in some instances, we believe there are a number of potential challenges:

- For a bank to "front" the transaction they must be the lender of record which under current regulation requires them to use their balance sheet and hold capital against the loan. The bank can charge the distressed investor to do so but the reward for doing so is potentially unattractive for the capital it consumes. To compensate a bank could charge the distressed investor higher fees but this create higher costs for the distressed debt investor themselves.

- Distressed investing remains a niche asset class in comparison to traditional private debt and private equity. A universal bank could face reputational damage with its host of existing clients should it participate in such an arrangement and disrupt relationships elsewhere (e.g. within its substantial private debt and equity franchise).

- Borrowers, upon becoming aware of the arrangement, may seek to unwind the trade or challenge its structure. Documentation frequently seeks to block the movement of economic and contractual rights as well as transfers.

SOURCING OPPORTUNITIES: FINDING A SELLER

If a solution can be found around loan documentation, then an opportunity must be identified. We believe this differs from 2008 or any other crisis we have faced:

- The current economic crisis is largely a liquidity crisis (i.e. short-term funding needs over fundamental business failures). If the owner of a business (i.e. a private equity firm) is supportive and provides capital to see the company through, then the opportunity to invest into a distressed credit is eliminated (as the asset never becomes distressed).

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[1] https://www.proskauer.com/alert/private-credit-considerations-for-debt-portfolio-acquisitions-in-times-of-uncertainty
[2] https://uk.reuters.com/article/sponsors-restrict-loan-sales-in-private-idUKL8N29E35W
[3] https://www.bloomberg.com/news/articles/2019-06-12/pe-firms-race-to-block-exit-doors-to-ward-off-vulture-funds

Performance data shown represents past performance and is no guarantee of, and not necessarily indicative of future performance. This document is intended exclusively for Professional Investors.

- In addition, we believe that sponsors are better prepared and more socially conscious that in 2008, enhanced by an increasing focus on ESG. They also benefit from more flexible lending documentation. This is not a 2008 style crisis.

- Lenders are also better prepared. For example, existing lenders provide flexibility on covenants or interest payments (e.g. capitalisation of interest to PIK)

Whilst it is undoubtable that opportunities will exist, we believe that they will be limited in scale in comparison to previous economic downturns.

SOURCING OPPORTUNITIES: ALTERNATIVE PRIVATE DEBT

Experienced private debt investors are seeing opportunities across the capital structure to deploy into creative solutions for performing credits during this period of economic uncertainty. For example:

- Support to companies with short term liquidity needs but otherwise stable credits.

- Bespoke financing to support the refinancing of strong performing credits at preferential terms given banks are stepping away from underwriting of second lien, in the context of increased volatility.

- Top up financing to support potential expansions as well as restructuring of frozen syndications which were not launched due to the COVID crisis.

- Acquiring performing credits on the secondary market that have depressed pricing due to the market and not fundamental valuations.

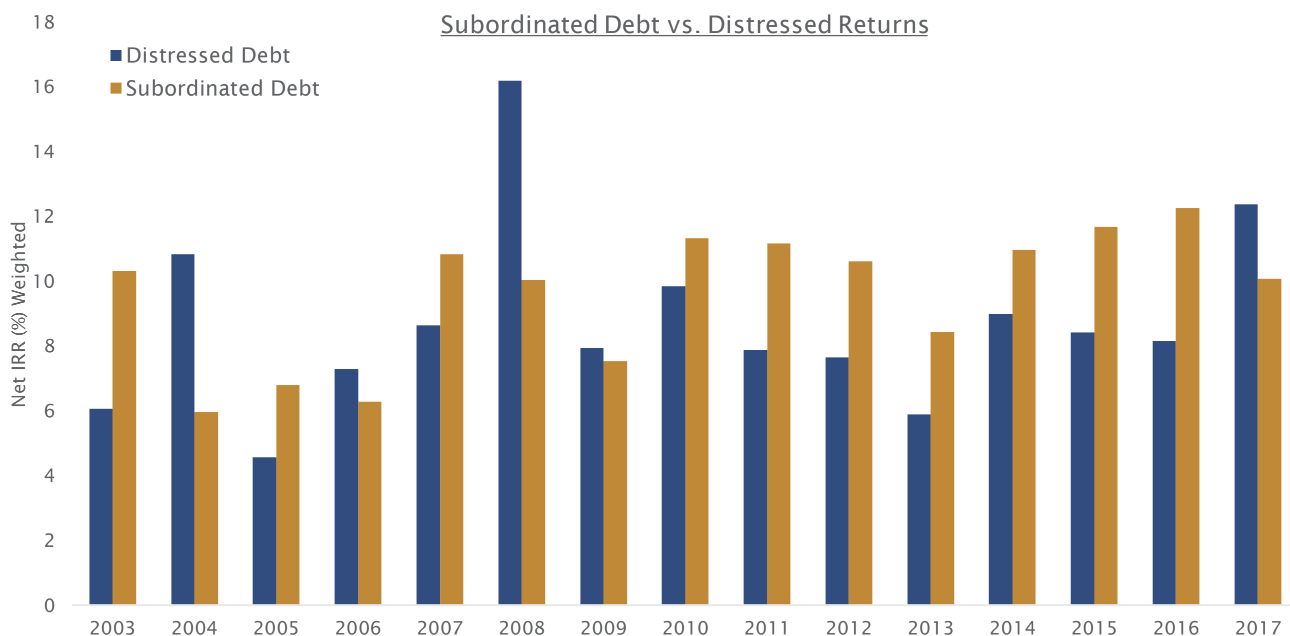
In addition to the above, we expect the following trends as private debt investors continue to deploy:

- The strongest credits will come to the market first, with cyclical assets having difficulty in sourcing financing (e.g. fashion retail, automotive etc.)

- Terms (legal, pricing etc…) will be more lender-friendly while demand grows slowly after a period of economic stress (our experience post the Great Financial Crisis (the "GFC"))

RETURN VOLATILITY AND TIMING

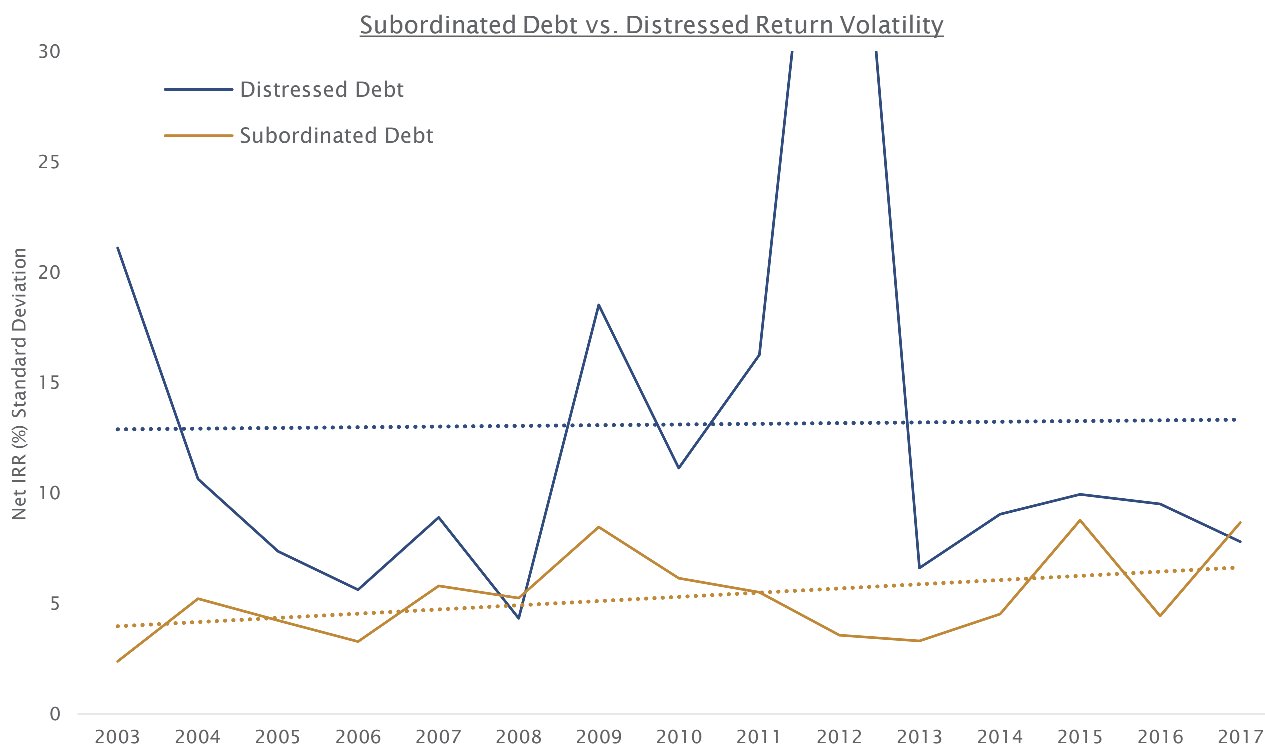
Investing into distressed debt comes with increased levels of volatility in comparison to other forms of private debt and is predicated on entering at the correct time. We have analysed historical return and volatility data for various types of private debt since 2000 (prior to 2008, the senior debt market was predominantly a banking market and senior debt funds emerged as a result of increasing banking regulation which limits the data set for this strategy).



Source: Preqin. Data period from 2000-2017. Subordinated Debt universe consists of European and North American mezzanine with vintages 2000-2017. Performance for funds with vintage year 2018-2019 not yet available. Data retrieved December 2019.

Subordinated debt funds outperform distressed debt funds 67% of the time with an average outperformance of 2.83% (from 2003 to 2017). Whilst the returns for subordinated debt funds in 2008/2009 were lower than those of distressed debt, they remain compelling given the market and comparable asset class performance. In addition, subordinated funds raised during and post crisis outperformed those raised prior to the GFC.

Whilst the absolute return is only one half of the story, we must also examine the volatility (standard deviation) around those returns.



Source: Preqin. Data period from 2000-2017. Subordinated Debt universe consists of European and North American mezzanine with vintages 2000-2017. Standard deviation for funds with vintage year 2018-2019 not yet available. Data retrieved December 2019.

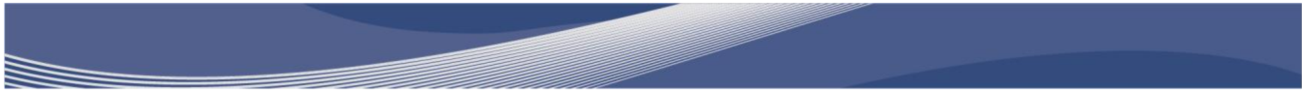
Subordinated debt fund returns have lower volatility 87% of the time and in the two cases where they do not, the difference is only 0.90% (in standard deviation) in comparison to 9% when it is less volatile than distressed debt. During 2008, distressed debt funds made outsized returns with lower volatility, but the years following and preceding, saw a spike in volatility in returns. Therefore, selecting the right year and the right strategy is paramount. Subordinated debt has offered consistent returns with low volatility throughout time and in the years of and following the GFC.

Ultimately, no crisis is the same and we do not know what will happen with the current one. Warren Buffet was recently quoted as stating that "in 2008 and 09 our economic train went off the tracks and there were some reason the roadbed was weak… but this time we just pulled the train off the tracks and put it on its siding… and I don't know of a parallel". The volatility around vintages in the distressed space highlights how uncertain returns can be in that asset class in comparison to the consistent returns afforded by subordinated debt.

ESG CONSIDERATIONS

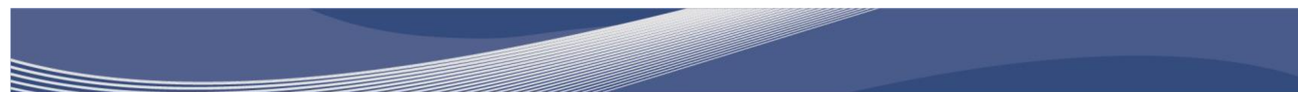
While in certain instances, a distressed purchaser could open new options to borrowers in financial difficulty, we believe that strategies focused on "loan-to-own" or "short term profits" may create conflicts for ESG conscious LPs.

- It for example creates additional pressure and instability on management team and longer term "Par" stakeholders during restructuring processes.
- LPs in such strategy would also need to be comfortable with a higher exposure to weaker borrowers that would require significant operational restructurings in order to support a return to profit.
- ESG conscious LPs may be left conflicted with distressed investors methods when extracting value from failing companies



CONCLUSION

Economic uncertainty is what distressed debt investors thrive on, but uncertainty also surrounds their return profile and investment opportunity set given the climate and restrictive documentation. Other types of private debt can offer stable and outsized returns in these uncertain times. We believe that this crisis is fundamentally different to 2008 and that ESG conscious stakeholders will continue to support their companies through this difficult period, resulting in attractive long term returns for those involved and supportive, as well as simultaneously locking out potential distressed investors.



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