For Investment Professionals only

M&G INSTITUTIONAL

M&G INVESTMENTS

Investment insight

European distressed debt investing in a late-cycle environment

May 2019

- Corrections can occur at any point of the credit cycle to expose weak borrowers and offer distressed debt investment opportunities
- Managers can also use their skills to unlock value in private special situation financings, without solely relying on a market downturn
- Investors that allocate capital to distressed debt through cycles may be best positioned to capitalise on opportunities when they arise

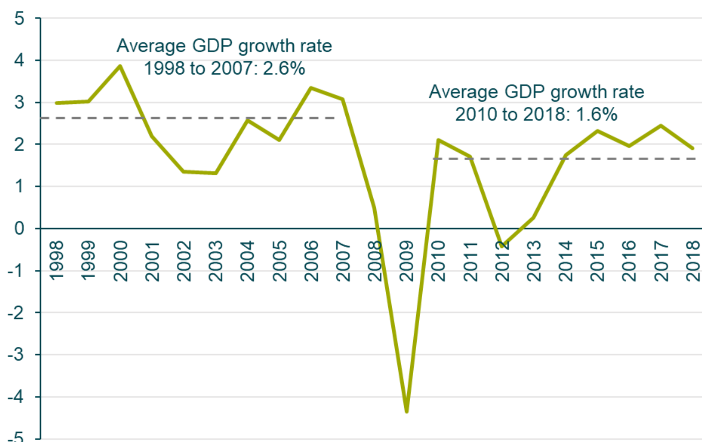
Paul Taylor
Head of Restructuring — Investment

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Wherever past performance is shown, please note that this is not a guide to future performance.

How 'late' are we in the current cycle?

Investors have tended to focus on strong economic fundamentals and healthy corporate earnings rather than worrying about the adverse impact of rising interest rates and higher inflation on asset prices. More recently though, lofty valuations, bumper M&A activity and unwinding of easy monetary policy have helped to fuel classic late-cycle fears. Despite there being, on balance, no imminent threat of recession, analysts and market commentators alike are turning more cautious on the outlook for corporate profitability and global growth. Investors are finally realising that the significant earnings growth – which underpinned the unprecedent amounts of debt raised by many issuers – is unlikely to materialise before a refinancing becomes due.

EU 28 annual GDP growth (%), 1998 to 2018



Source: Eurostat, data updated 21 March 2019

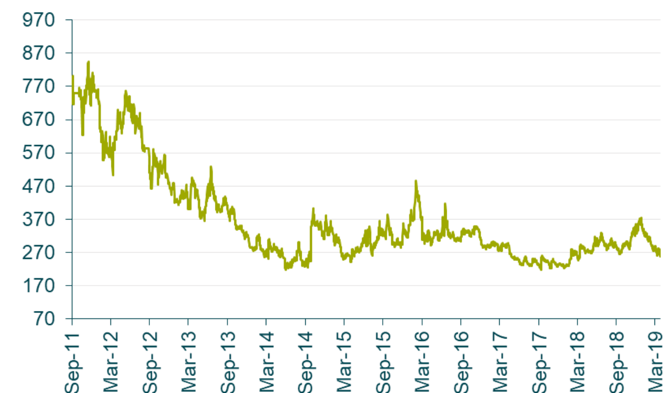
In reality, 'late' cycle phases can last quite some time, fuelled by years of liquidity build-up, making it difficult for investors to accurately gauge how much further the current credit cycle has to run. And trying to time market cycles or turning points may mean missing out on investment opportunities.

Looking at today's credit markets, what can investors infer about the outlook for corporate defaults?

Global corporate bond issuance has held up relatively well – although 2018 data shows total debt raising by investment grade and high-yield issuers down by a quarter from the year before[1]. Demand from investors for both bonds and loans remains high – notwithstanding more recent periods of market volatility and macro uncertainty – while credit conditions remain benign and default levels low, particularly in Europe. Additionally, European private debt markets continue to expand, with higher fundraising levels outstripping the available investment opportunities. This has pushed dry powder to record levels, providing an additional source of financial support to companies.

Secondary markets have, so far, supported this benign view of the cycle, with credit prices trading within their normal ranges.

Crossover credit default swaps (CDS), basis points

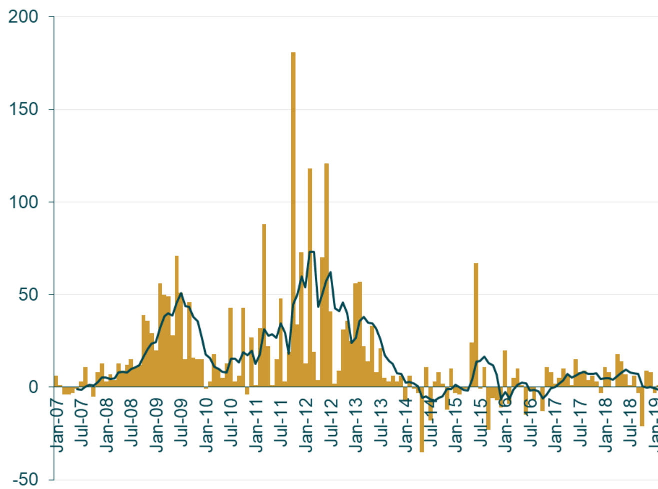


Source: Bloomberg, as at 1 April 2019

Rating agencies have also remained positive. Average high yield bond and loan defaults remain close to historical lows and corporate borrowers appear to be shoring up their balance sheets by improving free cashflow, extending their debt maturities, and paying down existing debt or making pledges to delever. On account of this, more companies are seeing upgrades to their public credit ratings than downgrades.

[1] Thomson Reuters, 'Corporate bond issuance shrinks to a 7-year low as selloff deepens', 21 December 2018

Net rating upgrades: Western Europe companies



Source: Moody's, as at 1 April 2019. Net upgrades represents the total number of upgrades *minus* the total number of downgrades. Data includes financial and non-financial, investment grade and high yield Western European corporations

The many potential triggers of distressed opportunities

It is worth remembering that a reversal of the credit cycle is but one of the many situations and circumstances that could generate distressed credit opportunities – whether issuer-specific, driven by market-wide concerns or a combination of both. The probability (and pace, for that matter) of a company moving from encountering difficulties in the short term to facing financial distress and a subsequent loss of control, can be influenced by any of the following factors:

Too much leverage amid tightening credit conditions

Weaker or lower-rated credits that have been artificially propped up by cheap and abundant capital could be vulnerable to a less-accommodative refinancing environment. For instance, it could be costlier for a corporate borrower to refinance existing loans or roll-over its bonds due to higher interest rates or the market may simply not be there anymore if it has taken on too much debt, as indicated by a rising net debt-to-EBITDA (earnings before interest, taxes, depreciation and amortisation) ratio. Fewer lenders may be willing to lend to highly-indebted companies that have taken advantage of historically-low interest rates, making it more difficult for these companies to refinance in the private bank loan and public high yield markets.

Declining profitability and higher idiosyncratic risk

While many companies are struggling to deliver on their underwriting business plans and failing to grow into overstretched capital structures, some sectors are susceptible to even small changes that can test the resilience of the balance sheet, such as tougher trading conditions and revenue pressure, a rising cost base and loss of confidence from trade creditors. This happened in the high yield market during 2018, where the debt securities of a number of issuers quickly, and unexpectedly, dropped to near-distressed levels having failed to achieve the elevated expectations of company performance. While this issue affected a broad spectrum of companies, the market paid particular attention to disappointing earnings reports from issuers operating in sectors such as retail, construction, shipping and offshore oil and gas, which have been subject to extreme cyclicality in the recent past and have higher historical default rates compared to other sectors.

The changing nature of market liquidity

Liquidity itself is not constant over time, as the experience of the 2008 global financial crisis has shown. Financial markets can behave differently in times of stress than under 'normal' conditions; volatility can spike, relationships between assets can change, while liquidity can rapidly dry up even in efficient and highly-liquid markets. Events may conspire to cause a material increase in corporate defaults and bankruptcies through contagion – we may already know the catalyst(s) to trigger the next default cycle or it could be an unknown unknown.

In summary, corrections and disruptions can occur at any point of the credit cycle to expose weak borrowers and offer distressed debt investment opportunities, so it is important to be prepared and consider allocations to distressed debt through cycles.

This time will be different

The ongoing dilution of investor documentary protection, due to borrower-friendly surplus market liquidity, has led to a near 80% conversion from maintenance to incurrence covenants in the global leveraged loan market – essentially taking the form of a high yield bond covenant. This has not been without periods of successful pushback and other, non-financial covenant protections, governing disposals, dividends, change of ownership, largely persist. Together with greater instances of financial metric 'manipulation', some are fearing that the proliferation of covenant-light (cov-lite) structures in the market could cost lenders and expose underlying investors to losses – through lower recoveries – when the credit cycle eventually turns.

Covenants do not offer one-size-fits-all protection against capital loss. There are factors, like the quality of the business and the priority ranking of the debt in the capital structure, that are arguably more important than covenants in determining the ultimate value of the business and thus the ability to protect capital in the event of a default. However, covenants can influence the timing of when a lender can act by providing triggers linked to early warning signals of deterioration in creditworthiness, thus helping protect value and cash in a struggling business.

A lack of triggers is therefore likely to impact the timing of restructurings once the current cycle ends, as companies are more likely to run out of cash before approaching lenders for help. At that stage, a borrower will be under enormous time pressure to refinance its debt and raise additional liquidity to prevent a short-term cash squeeze from becoming a full-blown liquidity crisis.

This creates an opportunity for an agile and well-founded distressed debt investor, who has kept some 'dry-powder' on the side to take advantage of these unexpected and fast-moving opportunities. By providing a cash injection upfront to meet upcoming debt obligations and removing the short-term pressure, the investor has the opportunity to bring a business with a 'reason to exist' back to financial health and benefit from the upside in the investment.

How to approach distressed investing:

- Fundraise cautiously to minimise unnecessary pressure to hastily deploy capital
- Be nimble and stay (very) patient
- Start doing your homework before the opportunity materialises
- Have quick access to capital
- Be adept at navigating different jurisdictions
- Have a Plan B for the investment, always

Investing in distressed opportunities, now and when the cycle ends

An ability to act quickly and decisively is often crucial in distressed investing. Opportunities to invest in stressed and distressed credits could come thick and fast, and may be highly competed, so distressed investors with flexible investment mandates may find themselves at an advantage when the cycle turns. This also relies on having access to capital to quickly put to work when opportunities arise.

Patience and discipline are also vital. Investors with the capability to actively manage investments through a restructuring in a disciplined and risk-averse manner are likely to be able to unlock exceptional value. Late in the cycle, we think it is especially important to stick to your investment strategy and not to be distracted by the 'fashionable' deals that offer rare opportunities to quickly deploy capital and may tempt other distressed investors. There may be too much credit and execution risk in these deals, for example where the true value of the underlying company cannot be reliably assessed, and an investor is ultimately relying on an increase in market prices to exit the investment and achieve the expected returns.

By the same token, finding successful investments often requires a deep understanding of the specific sector to perform a close analysis of the business and establish whether it has a reason to exist or is merely a 'value trap'. In situations where time is of the essence – as it is often the case in distressed situations – having in-house specialist sector or industry know-how and a robust network of well-established relationships can help investors quickly distinguish between the opportunities likely to benefit from the restructuring process from those that will not.

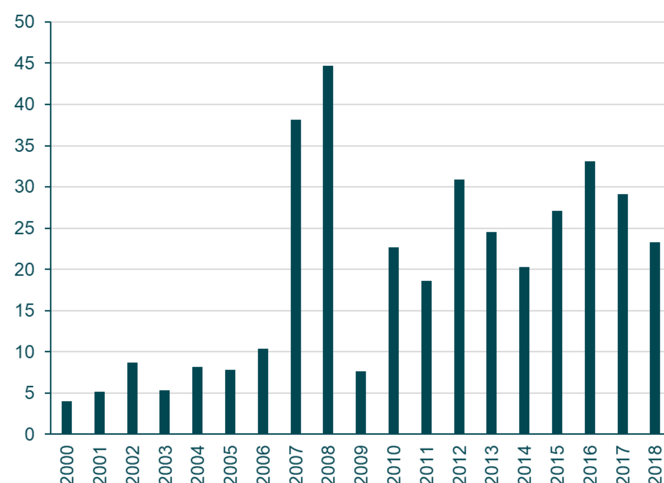
By closely monitoring the companies we believe may become distressed down the line, with the help of M&G industry analysts, we can front-load the work needed to understand and analyse the credit before a restructuring becomes apparent. This way we can position ourselves for the best opportunities.

Last but not least, we believe in fundraising cautiously, avoiding the temptation of a 'mega-fund'. The European distressed debt market tends to offer only a limited number of big-ticket investment opportunities – which are the bread-and-butter of large funds – so raising smaller funds can provide a manager with the flexibility to pick and choose the best deals, both large and small, to deploy capital. If the market is particularly buoyant, it is always possible to raise for the next fund earlier than planned.

Waiting for the cycle to turn: Why special situation investments can be a complementary strategy

Specialist funds have spent a few years raising money in anticipation that the next economic downturn will create new investment opportunities. According to financial data provider Preqin, distressed debt fundraising amounted to $23 billion last year, albeit moderating from the bumper $29 billion raised in 2017.

Distressed debt aggregate capital raised by year (in US$ billion), 2000-2018



Source: Preqin, 2019

European distressed debt offered a limited number of highly-competed – and rather opaque – public investment opportunities during 2018, with long-term bottom-up distressed investors focusing instead on privately-sourced special situation opportunities.

Rather than simply waiting until the cycle turns for new opportunities, distressed debt managers may find that special situation financings sourced through a proprietary network of local advisors, can offer similar returns to distressed opportunities and better downside protection. We invest in hard assets, for example. These investments tend to be relatively small tickets that require a lot of work and effort, together with local partners, to generate value; this dramatically reduces the competition and consequently offers a better negotiating position.

Special situation investment in Spain

The following investment example of seafront development land in Spain illustrates how a distressed investor can unlock value in a special or 'complex' situation with a compelling risk-reward profile.

Complex but solvable situation: A local contact, with whom we had worked previously, presented us with an opportunity to buy and develop a plot of land in the sought-after Costa Blanca region of Spain at a deep discount to market. This was a complex situation due to a convoluted owner base with a number of insolvencies, multiple cross seizures and significant liabilities. The land was divided into various sub-plots suitable for residential development, and was one of the few undeveloped but fully-permitted sectors left on this part of Spanish coast popular with holiday makers.

Restructuring experience at work: As a number of the existing land loans owed by the current owners were held by Sareb, Spain's so-called 'bad bank', we entered into bespoke negotiations with both Sareb and each of the owners, some of whom were undergoing bankruptcy proceedings. This process allowed us to purchase the whole sector directly rather than buying each of the underlying loans and subsequently enforcing on them.

Multiple options to unlock value: Dependent on the nature and timing of our exit from this investment, we target a mid-to-high-teen IRR (internal rate of return). The current development strategy, which will be project managed by a local real estate partner we have appointed, is to build and sell apartments and townhouses targeting second residence national and international buyers. A portion of the sector will also be sold to other developers in order to de-risk the project.

To sum up, we are cognisant that some of the more unwelcome 'late cycle' features of credit markets continue to be cause for concern, but fears about the next downturn appear largely contained for now and markets are generally not pricing in the next recession. While it may be a just a matter of time before it happens, investors looking to time the turning point of the current cycle may find themselves missing out on opportunities. Investors that instead allocate capital to distressed debt through cycles may be best positioned to capitalise on opportunities as and when they arise.

Distressed debt managers looking to quickly deploy capital at this stage of the cycle may find themselves considering highly competed investment opportunities that lack the transparency to fully evaluate the creditworthiness of the business and / or that come with high execution risk. As an alternative, managers should consider using their skills and expertise to unlock value in privately-sourced special situation financings that offer comparable risk-adjusted returns to distressed opportunities and better protect the downside.

Contact

Andrew Swan
+44 (0)20 3977 2166
andrew.swan@mandg.co.uk

Henry Barstow
+44 (0)20 3977 3776
henry.barstow@mandg.co.uk

John Atkin
+44 (0)20 3977 3718
john.atkin@mandg.co.uk

Sunita Dey
+44 (0)20 3977 2428
sunita.dey@mandg.co.uk

www.mandg.co.uk/institutions
institutional.clients@mandg.co.uk

For Investment Professionals only.
This paper reflects M&G's present opinions reflecting current market conditions. They are subject to change without notice and involve a number of assumptions which may not prove valid. Past performance is not a guide to future performance. The distribution of this paper does not constitute an offer or solicitation. It has been written for informational and educational purposes only and should not be considered as investment advice or as a recommendation of any security, strategy or investment product. Reference in this document to individual companies is included solely for the purpose of illustration and should not be construed as a recommendation to buy or sell the same. Information given in this document has been obtained from, or based upon, sources believed by us to be reliable and accurate although M&G does not accept liability for the accuracy of the contents.

The services and products provided by M&G Investment Management Limited are available only to investors who come within the category of the Professional Client as defined in the Financial Conduct Authority's Handbook.

M&G Investments is a business name of M&G Investment Management Limited and is used by other companies within the Prudential Group. M&G Investment Management Limited is registered in England and Wales under number 936683 with its registered office at 10 Fenchurch Avenue, London, EC3M 5AG. M&G Investment Management Limited is authorised and regulated by the Financial Conduct Authority. **APR 2019 / IM-2398_UK**