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Why the Distressed Debt Opportunity Looks Different This Cycle

BARINGS INSIGHTS

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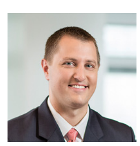

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A surge in defaults and distressed opportunities seemed likely when COVID struck—but stimulus measures and creative financing solutions have reshaped both the opportunity set and the timing.

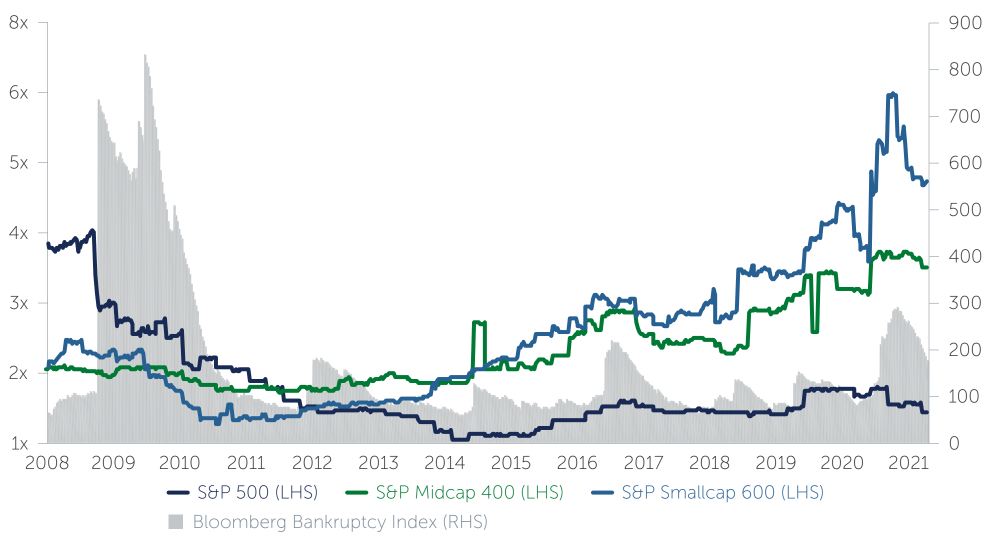
Last year brought with it one of the most acute economic disruptions in our lifetime, with virtually every business experiencing some disruption as a result of widespread lockdown conditions and ongoing restrictions on activities. Against this backdrop, it is perhaps no surprise that distressed debt has fairly quickly returned to the forefront. Given the amount of capital flowing into the asset class, some investors are now questioning whether there will be enough investible opportunities going forward. In our view, the answer is 'yes'—but understanding the evolving opportunity and casting a wide net will be key.

A Longer, Flatter Default Curve

The massive spike in defaults that some market participants were calling for after the initial onset of COVID has failed to materialize, thanks in large part to the unprecedented support from global policymakers. Whether injecting liquidity into the capital markets or allowing some companies to defer certain fixed costs from their balance sheets, these support measures have effectively given issuers more time and flexibility to work through this prolonged, low-revenue environment.

While this has been largely positive for businesses and markets in the short term, there are some potentially significant longer-term implications. For instance, much of the capital and liquidity that has gone into businesses has served the primary purpose of balancing losses or making up for the earnings that didn't materialize over the last year. As a result, many companies will emerge from this crisis with lower revenue and higher levels of debt, and will need to begin deleveraging and rebuilding their working capital as the economy begins to normalize.

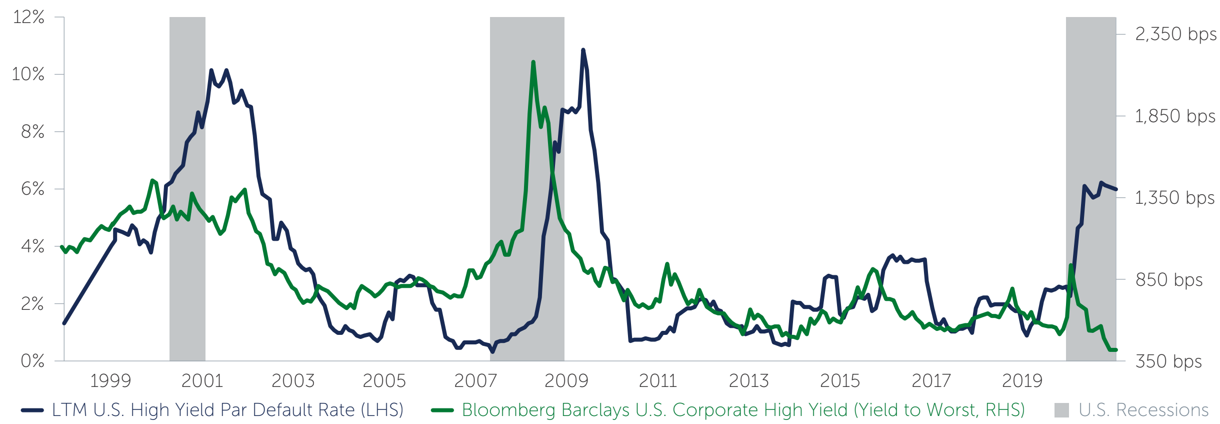
FIGURE 1: More Stress May Be Ahead (Net Debt to EBITDA vs. Bankruptcies)



SOURCE: Bloomberg. As of January 31, 2021. S&P data represents leverage levels.

To be sure, some companies look well-positioned to manage higher debt levels going forward, particularly those that had strong balance sheets coming into the crisis. But for a number of sub-investment grade issuers, the room for error has narrowed, leaving capital structures ripe for the redistribution of value as stimulus programs expire and certain triggers approach—from covenant violations, to pending maturity walls to liquidity shortfalls. This suggests that defaults will happen, but rather than coming in a widespread surge like we have seen in previous cycles, they may play out over a longer (multi-year) timeframe and in a more organized manner.

FIGURE 2: Defaults Likely to Increase Over a Longer, 2–3 Year Period



SOURCES: J.P. Morgan; Credit Suisse; Bloomberg. As of January 31, 2021.

As these expected defaults materialize, there may be opportunities for distressed debt managers to take control positions in companies, which often results in forgiving some debt in exchange for a majority equity stake. Becoming part of a company's shareholder group, in turn, can give managers the leverage to implement change and drive an outcome—whether that's through a management team change, a board change or a strategy change. In addition to potentially generating attractive returns for investors, this process can help right-set the distressed company and, ultimately, lead to significant value creation.

Market Dislocations, Rescue Financing

Despite all the attention that corporate default rates get, it's a misconception that a material default cycle is required for ample opportunities to emerge. In reality, the sub-investment grade corporate credit universe is large and diverse. Across high yield bonds, loans and private credit, for instance, there is roughly $6 trillion of debt, suggesting opportunities going forward should be plentiful, even if defaults do not rise significantly. That opportunity, of course, is amplified when taking into account non-defaulted opportunities such as discounted securities and rescue financings.

Indeed, as we look across the market today and consider the next 12-24 months, there are a several types of opportunities we expect to see outside of defaulted credits. On the one hand, we continue to look for price dislocations. While we do not necessarily expect a broad-based market dislocation such as we saw at the onset of COVID, idiosyncratic opportunities continue to emerge, often on the back of technical selling pressure that causes certain credits to trade below what fundamentals would suggest.

We also continue to see opportunities to provide rescue or gap financing to companies currently experiencing more acute liquidity issues. Early on in the crisis, large syndicated rescue deals became fairly prevalent in the

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market, particularly with companies like cruise lines and airlines that were heavily impacted by the pandemic and prolonged lockdown. Roughly a year in, that opportunity has come in quite significantly, with smaller, bilateral transactions currently looking more attractive, in our view. In these types of deals, a manager's experience and access to capital are critical. In many cases, managers with sufficient capital and incumbent positions have benefited from the ability to engage with companies early on and inject capital in a more thoughtful or deliberate way—still targeting distressed-type returns, but often through more favorable secured or super-senior positions in the capital structure. Another way of accessing these kinds of transactions and non-correlated returns is through direct origination channels with advisors, sponsors and bankers. But again, managers with long-standing origination platforms are typically best-positioned capitalize.

Casting a Wide Net

While we do expect to see opportunities going forward, there are also challenges when it comes to identifying and accessing those opportunities, as well as in executing and deploying capital efficiently. This is partly due to the trend toward 'megafunds' in recent years—as distressed managers have raised larger and larger (multi-billion dollar) funds, we have seen an overconcentration in the largest LBOs and stressed credits in the market. In addition to putting LPs at risk of having too much exposure to the same issuers, this approach can make alpha generation difficult if the same names are owned across the funds of multiple managers.

A potentially more effective way of generating alpha in this space is by looking at smaller or mid-sized transactions (<$1B), where there tends to be less competition given that capital structures are often too immaterial for 'megafunds' to commit resources and capital to efficiently. The opportunity set within this segment of the market is substantial—over 80% of issuers in the global high yield bond market have capital structures of less than $1 billion. It's a similar story with European and U.S. loans, where issuers with debt stacks totaling less than $1 billion account for 86% and 75% of the markets, respectively.

There can also be benefits to looking beyond traditional high yield bonds and loans, such as in the structured credit market or in illiquid asset classes like direct lending. In the private credit market, for instance, a combination of weaker documentation, higher leverage levels and a proliferation of new entrants in recent years may result in more middle market issuers running into stressed situations going forward. Because private credit is an opaque asset class, managers can often attempt to deal with impaired credits over a period of months or even years. Thus, while we haven't seen many distressed opportunities emerge to date, that doesn't mean they do not exist. Collateralized loan obligations (CLOs) are another consideration. While the opportunity from CLO tranche downgrades has diminished since the onset of the crisis—as rating agency actions were not as severe as feared—we could see further volatility and weakness on the back of negative economic data or macro/geopolitical factors.

U.S. vs. Europe

Relative value tends to also fluctuate between geographies, and will likely continue to do so as the U.S. and Europe provide varying levels of stimulus going forward and re-open their economies at different paces. From a geographical perspective, both regions presented opportunities in the wake of the pandemic, although that initial dislocation has come in quite a bit with the significant rebound in prices and spread tightening across most markets. More recently, the U.S. pipeline has been slightly more active, on balance, in part due to its higher exposure to energy, one of the first sectors to see an increase in defaults last year. Europe's relatively robust government support measures have also helped keep defaults low throughout the region. Nonetheless, there is stress across sectors and companies in both markets, and we expect activity to become more balanced going forward.

In order to appropriately measure true relative value between the regions in stressed and distressed credit, managers must be able to parse the risks associated with potential jurisdictional challenges. Understanding the nuances of each European insolvency process, for instance, requires different expertise and capabilities than North America, where insolvency can be complicated but is still relatively uniform.

Key Takeaway

The key to navigating the distressed debt landscape, ultimately, is having the flexibility to capitalize on opportunities as they arise and the ability to execute on the best ideas across geographies, sectors and credits. As we look down what is sure to be an uneven road to recovery, there should be no shortage of opportunities—whether stemming from defaults, market dislocations or in the form of rescue financing. But experience matters, and being able to track a credit from the time of issue until, if ever, it encounters a distressed situation, will be critical to navigating this space.

The Barings Team

Our 12-person distressed debt team sits at the intersection of three global research platforms—high yield, structured credit and private credit—giving us a window into each market and often providing an early read on opportunities that may be in the pipeline. Almost every investment we make is one we have looked at historically or are invested in currently, meaning we are often re-underwriting a credit or updating an existing analysis rather than starting from scratch. Typically, we already have a relationship with a company's management team and a model in place, as well as information into how the company has performed historically. This gives us the ability to get up to speed, and potentially deploy capital, quickly and efficiently.

BARINGS' 12-PERSON DISTRESSED DEBT TEAM SITS AT THE INTERSECTION OF THREE GLOBAL PLATFORMS

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and
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and
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As of December 31, 2020

This piece was adapted from a recent podcast. Listen to the full recording here.

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