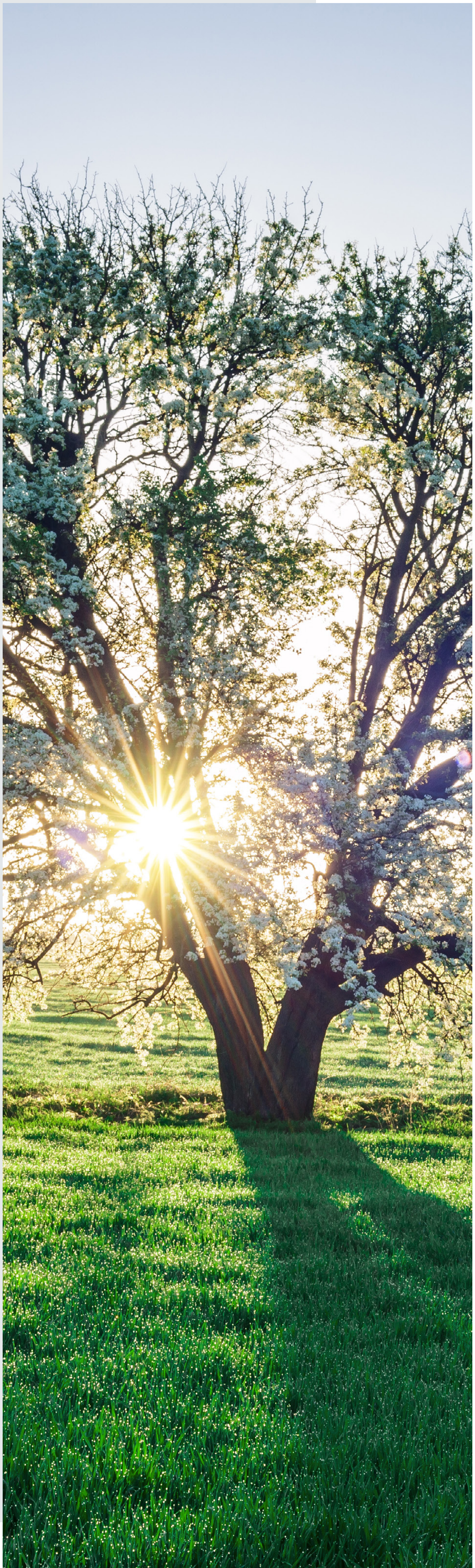
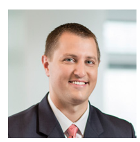


FIXED INCOME

# The Evolving Opportunity in Distressed Debt

BARINGS INSIGHTS

**Bryan High**
Co-Portfolio Manager,
Global Special Situations Strategy

**Stuart Mathieson**
Head of Global Special
Situations Investments Group



As the pandemic recedes, some companies may have a harder time managing higher debt levels than others—and as weaker issuers undergo restructurings or other stressed situations, there may be opportunities for investors to deploy more capital into distressed debt strategies.

Whether COVID-19 has been cause or catalyst for tipping the global economy into recessionary territory, the credit cycle has certainly turned. Virtually every business has felt some impact as a result of widespread lockdown conditions and ongoing restrictions on activities, from dining out to travel—with revenues across some sectors declining 75–100% early on.

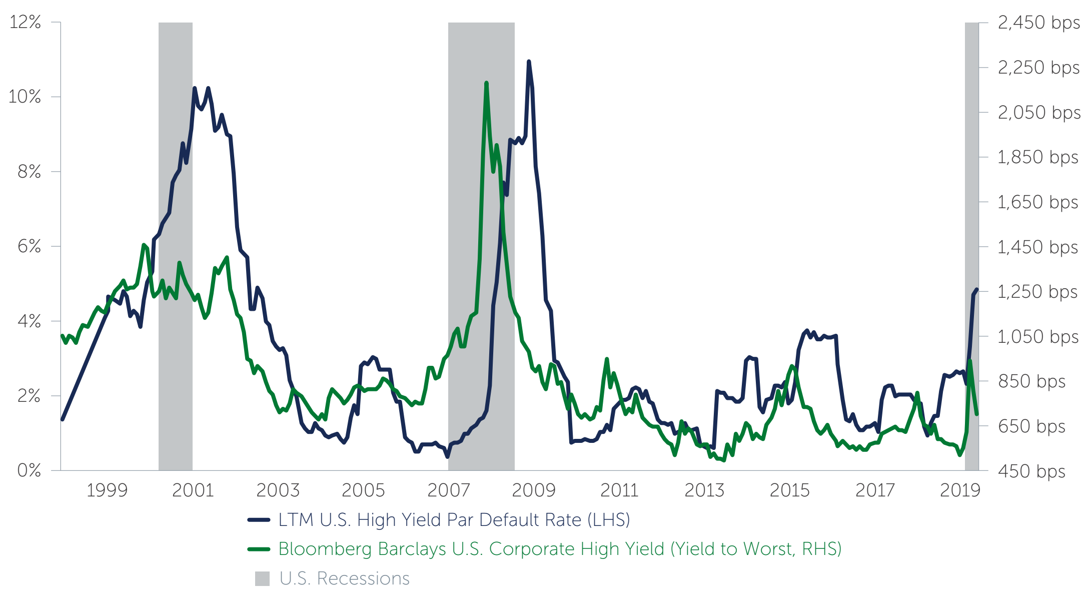
Due in large part to global policymakers' unprecedented stimulus measures, many issuers today appear to have the liquidity necessary to bridge themselves through the initial shock from the pandemic. But one question going forward is which companies will be able to manage higher debt levels, particularly if confronted with a weaker global economy once the pandemic recedes. Inevitably, some will have a harder time managing than others—and as weaker issuers undergo restructurings or other stressed situations, there may be opportunities for investors to deploy more capital into distressed debt strategies.

As we look across the markets today and consider how the landscape will evolve going forward, there are certain dynamics at play that could result in opportunities. For one, we continue to look for price dislocation in the market. The broad-based market dislocations that occurred across asset classes in March and April have subsided to a large degree, with many markets experiencing strong rallies in the second quarter. But idiosyncratic opportunities continue to emerge across a variety of impacted sectors—gaming, entertainment and certain parts of the travel sector, for instance—where certain credits still trade at heavily discounted prices, offering the potential for capital appreciation. We are also seeing opportunities to provide rescue financing to companies currently experiencing more acute liquidity issues.

## A Flatter (Default) Curve

Top of mind for many investors is the potential for widespread defaults. If we were to use history as a guide in terms of recessionary default environments, a wave of defaults and restructurings entering the market in the short term may seem likely—indeed, some sell-side forecasts were in the low to mid teens when the pandemic took hold in March. But so far, that has not been the case, and default expectations today are much less severe.

**FIGURE 1:** The Anticipated 'Wave' of Defaults Looks More Likely to be Spread Over Several Years
*(U.S. Corporate High Yield Default Rates vs. Yields)*



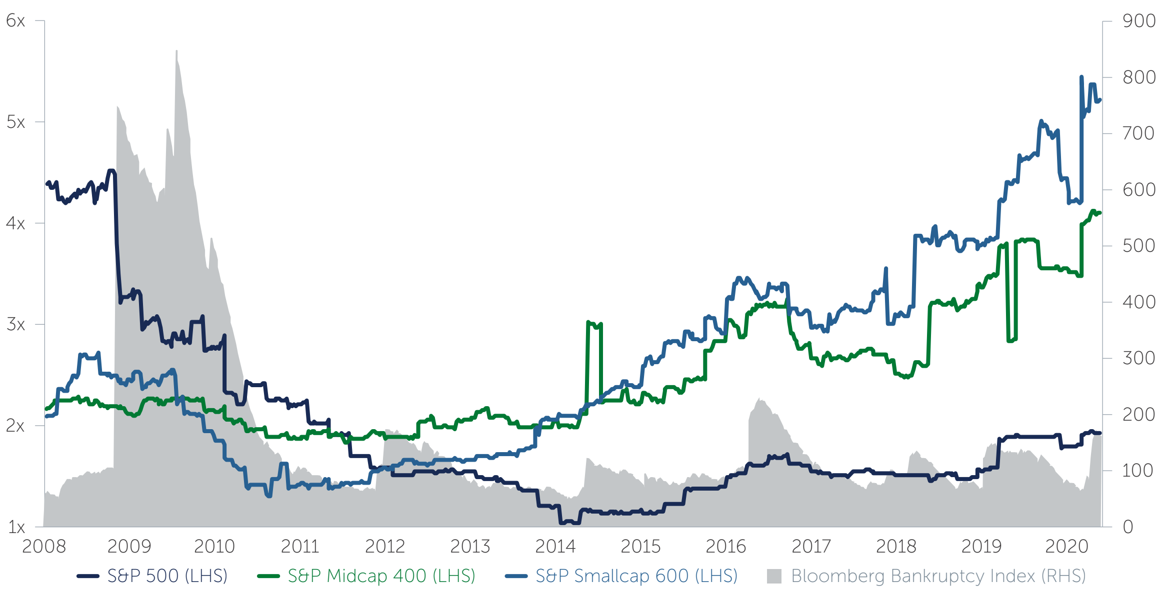

SOURCES: Credit Suisse, J.P. Morgan, Bloomberg. As of May 31, 2020.

*"Fiscal and monetary support from central banks globally has effectively flattened the default curve—with the anticipated 'wave' looking more likely to be spread out over a number of years."*

The aforementioned fiscal and monetary support from central banks globally has effectively flattened the default curve—with the anticipated 'wave' looking more likely to be spread out over a number of years. That's not to say we won't see an uptick in defaults in the near term—and in fact we already have—but those defaults will likely continue to be concentrated in two main areas. The first comprises companies that were perceived as high risk heading into the crisis. Many were already headed for default or restructuring, and the pandemic has likely accelerated the process. The second consists of companies with strong business models and market positions, but poor balance sheets—some of which were on an improving trajectory prior to the pandemic, but are in industries that have been on the frontlines of COVID.

Over the next couple of years, however, we expect some businesses that appear in good enough shape to withstand the near-term shock to emerge from the other side of this event with lower earnings and, likely, higher leverage. Against what could very well be a weaker economic backdrop, the liquidity concerns facing these companies may evolve into longer-term solvency risks. As companies encounter liquidity or covenant issues, opportunities could emerge to buy assets at discounted prices—including in areas beyond traditional high yield bonds. For active managers in particular, or those with the flexibility to deploy capital quickly and efficiently, new financing and restructuring opportunities could also present a chance to drive favorable outcomes and enhance returns.

**FIGURE 2:** Elevated Corporate Leverage Means Solvency Risks are Top of Mind
*(Net Debt to EBITDA vs. Bankruptcies)*



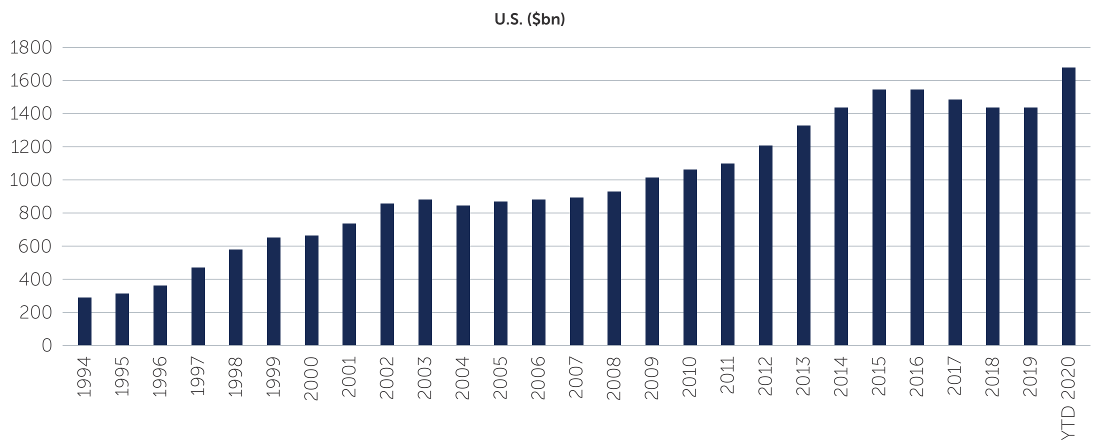

SOURCE: Bloomberg. As of June 19, 2020. *S&P data represents leverage levels.*

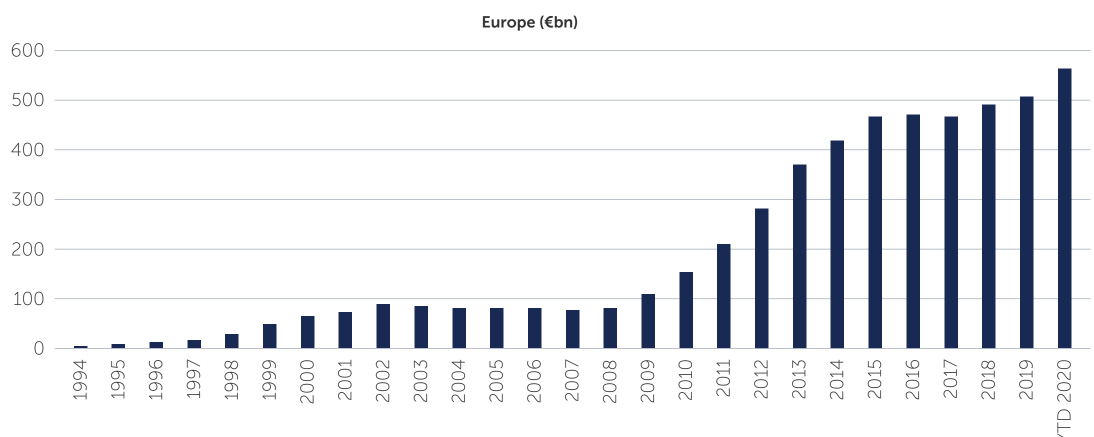
## An Evolving Opportunity Set

The high yield bond and loan markets have experienced tremendous growth over the last decade—with the total universe exceeding $3.5 trillion in size—meaning opportunities going forward should be plentiful. The European high yield bond market in particular has undergone tremendous growth since 2007, with the U.S. market also increasing notably over that period **(FIGURE 3)**.[1] The leveraged loan market, too, has expanded—in the U.S., it comprises more than 1,400 issuers, which is 20% more than were in the space in 2007. In Europe, there are over 350 loan issuers, an 11% increase since 2007.[2]

But there are also challenges, including the ability to access and identify the most attractive opportunities and execute and deploy capital efficiently. This is partly due to the trend toward 'megafunds' in recent years—not only in distressed strategies, but also in a variety of others, including private credit. In essence, managers have continued to raise larger and larger (multi-billion dollar) funds, the consequence of which has been an overconcentration in the largest, most liquid LBOs and stressed credits in the market. While on one hand this makes sense—larger funds need to deploy capital efficiently, and large, liquid names allow them to do so—it also puts LPs at risk of having too much exposure to the same issuers. In some cases, the same names are owned across the funds of multiple managers, making alpha generation more difficult.

**FIGURE 3:** The High Yield Bond Markets Have Grown Notably Since 2008



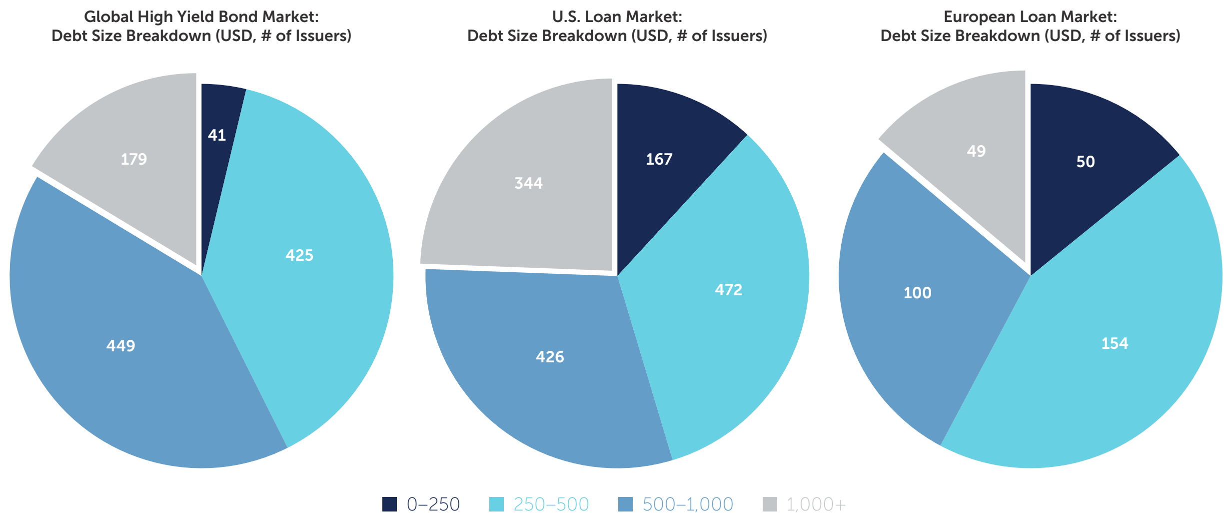

SOURCE: Credit Suisse. As of July 31, 2020.

1. Source: Credit Suisse. As of June 30, 2020.
2. Source: Credit Suisse. As of December 31, 2019.

## Looking Beyond the Largest LBOs

In our view, a more effective way of generating alpha in this space is by casting a wider net—or considering a broader set of stressed and distressed situations beyond the traditional, large, highly trafficked LBOs. This could mean looking at smaller or mid-sized transactions (<$1B), as well as those across different geographies and asset classes. The opportunity set within this segment of the market is larger than many people realize. In fact, 84% of issuers in the global high yield market have capital structures of less than $1 billion. And the percentages are similar across European and U.S. loans, where issuers with debt stacks totaling less than $1 billion account for 86% and 75% of the markets, respectively **(FIGURE 4)**.

**FIGURE 4:** Global High Yield Markets are Dominated by Capital Structures Below €/$ 1b[3]




SOURCE: Credit Suisse, ICE Bank of America Merrill Lynch. As of September 30, 2019. Non-USD assets converted back to USD using FX rates. As of December 31, 2019.

Often, smaller capital structures are too immaterial for 'megafunds' to commit resources and capital to efficiently, as they may not move the needle, so to speak. This in and of itself presents an opportunity, particularly for managers with the local teams, resources and incentives to deploy capital into deals of various size and geographical location. In addition to potentially being better positioned to capitalize on relative value opportunities, modestly sized strategies tend to be sized appropriately to access differentiated deal flow—both in the lower end of the broadly syndicated market and within the private market as well.

## Structured Credit, Direct Lending

Casting a wider net could also mean looking for opportunities beyond traditional high yield bonds and loans, such as in the structured credit market, and even in illiquid asset classes like direct lending. The private credit market, for instance, has grown substantially over the last decade—as more managers raised larger and larger funds, there was more capital chasing deals in the space. At the same time, leverage levels were increasing, in some cases beginning to resemble those for larger, broadly syndicated corporates. And covenants and structural protections were weakening, particularly in the upper part of the market, where nearly 50% of transactions in recent years were cov-lite, versus 20% in the traditional middle market.[4]

3. Source: Credit Suisse, ICE Bank of America Merrill Lynch. As of September 30, 2019. Non-USD assets converted back to USD using FX rates. As of December 31, 2019.
4. Source: Reuters. As of December 31, 2018.

The combination of weaker documentation, higher leverage levels and a proliferation of new entrants may very well result in more middle market issuers running into stressed situations in the coming months and years. Many consumer-facing companies, in particular, will have to adjust their business models in light of the disruptions from COVID, and may need to revise their cost structures.

In the middle market, where there is little to no liquidity, a manager's experience and access to capital for rescue and gap financing, as well as for restructurings, will be critical to the outcome of those investments. And in our view, when it comes to potentially taking the keys and owning the business—or seeing companies through bankruptcies and workout situations—there is somewhat of a lack of experience in the marketplace. While this is less true of larger, more established participants, it is often the case among the many smaller participants who have entered the space more recently.

Collateralized loan obligations (CLOs), too, may be a source of stressed or distressed opportunity. Going forward, any credit deterioration and increase in defaults of the underlying loan collateral could potentially lead to downgrades of the CLO tranches themselves. In the months and years ahead, this could cause some CLO managers to trim their exposure to downgraded (less liquid, smaller, CCC-rated) tranches. In the broadly syndicated loan market, some of the smaller issuers tend to be dominated by CLO holders because they tend to offer a higher spread—which works well for the interest arbitrage in the structure—and CLOs are less concerned with the lack of liquidity in smaller names, given the closed-end nature of the investment vehicle. While the potential opportunity from CLO tranche downgrades seems to have diminished somewhat more recently as rating agency actions have not been as severe as feared, we could see further volatility and weakness on the back of negative economic data or factors like the U.S. election and continued U.S./China tensions. As a result, distressed debt managers may have the opportunity to buy assets at discounted prices because of technical selling pressure.

## Key Takeaway: Experience Matters

Many questions remain around how much damage the pandemic and lockdowns have caused to the economy—and to what extent that has been counterbalanced by the massive fiscal and monetary responses from governments around the world. Compounding this, economic data has been extreme to both the upside and the downside, making it difficult to assess how quickly the economy may recover. At the company level, particularly for sub-investment grade issuers, the room for error has narrowed, leaving capital structures ripe for the redistribution of value as certain triggers approach—whether it be covenant violations, a lack of liquidity or pending maturities.

While the challenges facing businesses today—as well as the toll the coronavirus has taken around the world—should not be downplayed, in some ways, the pandemic may very well be the trigger that distressed debt investors have been waiting for. But experience in this space matters, and the ability to track a credit through its life cycle—from the time of issue until, if ever, it encounters a distressed situation—is as critical as ever.

### THE BARINGS TEAM

At Barings, our 11-person distressed debt team sits at the intersection of three global research platforms—high yield, structured credit and private credit—giving us an extensive window into the 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—in other words, 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, sometimes going back a decade or more. This gives us the ability to get up to speed—and potentially deploy capital—quickly and efficiently.

### BARINGS' 11-PERSON DISTRESSED DEBT TEAM SITS AT THE INTERSECTION OF THREE GLOBAL PLATFORMS

**GLOBAL HIGH YIELD**

$48.4B AUM

*and*

61 **INVESTMENT PROFESSIONALS**

*covering over 1,600 names across U.S. and European high yield bonds and loans*

**STRUCTURED CREDIT**

$16.6B AUM

*and*

13 **INVESTMENT PROFESSIONALS**

*with models and data covering more than 3,300 CLO transactions*

**PRIVATE CREDIT**

$14.2B AUM

*and*

71 **INVESTMENT PROFESSIONALS**

*with relationships with more than 700 middle market companies and sponsors*

*As of March 31, 2020.*

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**As of June 30, 2020*

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