Private Debt Investor

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NEWS & ANALYSIS

State of the market: A turn for the better, but struggles persist

An improving economic backdrop in Europe may not offer much hope for firms that now face the prospect of further interest rate rises

As 2023 began, fears of a major global recession began to subside and, with them, the expectation of a major wave of distressed selloffs appears to have also dissipated. However, market conditions remain challenging for many companies, and fund managers that invest in special situations are reporting strong pipelines of future deals.

"We've seen surprising resilience in earnings and so we're expecting a less dramatic move into the distressed cycle than the market thought there would be back in the autumn," says Tristram Leach, partner and co-head of European corporate credit at Apollo. "While we see a shift in the macro outlook away from a hard recession, the price of that will be sticky inflation and sticky interest rates, and that's very challenging for the most levered, CCC-rated part of the market."

Last year, the threat of a major recession led many to expect interest rates were about to peak before central banks would be forced to cut rates in an effort to reinvigorate their economies despite the threat of inflation. However, if the economic outlook appears better, they may continue to raise interest rates this year. Markets have adjusted their pricing accordingly.

"If you were fully levered in 2020 and you're trying to refinance in 2025 with base rates up, these kind of rates we expect will kill cashflows on any businesses. Unless you're growing very fast then you cannot carry six turns of leverage," says Leach.

Despite an overall improving position, there remain particular areas where there is still risk. Europe in particular is expected to continue to struggle as it remains heavily impacted by the energy crisis and the war in Ukraine.

The economic environment is looking better now than what was feared six months ago. However, Europe remains fragile. Germany and the UK, the largest economies in Europe, are experiencing slower growth, the ECB remains hawkish and is continuing to raise rates to counter inflation, energy prices remain high and raw material and labour costs are at record highs. "Companies are facing a fundamentally different operating environment than a year ago," says Victor Khosla, founder and chief investment officer of distressed and special situations investor SVP Global.

While it is tough for European businesses, for investors that are targeting dislocation and looking for opportunities to restructure company balance sheets, Europe could also offer more substantial dealflow than the US.

"European banks are holding almost $400 billion in NPLs (compared to around $90 billion in US banks) that they will need to work through, and we are anticipating a wave of restructurings due to the build-up of high-yield debt that is set to mature across the continent," Khosla adds.

While last year, distressed and special situations investors were expecting a wave of potential deals to come through due to worsening economic conditions, the latest

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data now points to a delayed reaction that is likely to hit when existing loans arranged during the covid-19 crisis begin to mature around 2025.

As a result, many players in the market today are being more selective about the deals to pursue and staying away from the public markets.

One of these is Barings. Stuart Mathieson, managing director and co-portfolio manager at Barings Capital Solutions, says: "We're being cautious in the current environment as prices are still quite high. We're engaged in stressed financing on either a bilateral basis or in small club deals. There's too much risk in the secondary market right now that prices could fall further."

Industrials in favour

Barings is veering away from companies exposed to energy prices.

Barings' Stuart Mathieson says his team is currently deploying more capital in the US than in Europe as there is added uncertainty in Europe today based on economic expectations and its exposure to the energy crisis.

"We try to avoid building portfolios around one specific driver, but right now we do tend to have a lot of industrials because they can often better manage their cashflow on their order books. We tend to avoid companies that are exposed to energy prices right now and also those where cost of labour could be important as these are areas of high inflation," he explains. "Of course, we also steer clear of those that are highly leveraged or where operational leverage is problematic."

Restaurants and retail businesses have also been mentioned as areas to steer clear of given they are highly exposed to consumer discretionary spending, which is being significantly scaled back as households face significant inflation on essential goods and services.

Opportunities building

The current situation requires investors to be more targeted and have a strong origination network to be able to pick out the best deals.

"What we are seeing now as this cycle grinds on are both event-driven and restructuring side opportunities as companies face ratings downgrades and also a need to refinance in a different interest rate environment," says Khosla. "In fact, we are already seeing opportunities where such restructurings can lead us to have full control of businesses, and the number of such situations should build over the course of the cycle."

Mathieson concurs that, while Barings does not expect a major wave of refinancing activity for the next 18 months, there are still a number of opportunities around for firms that are suffering stress due to current market conditions.

"There will be fundamentally good businesses that struggle, and when we make an investment decision it really comes down to the quality of the business and how well we understand what it does. We need to assess why it is struggling and what the fix is, and with some businesses it may not be clear what is going wrong and so we will steer clear of those," he says.

Investing in stressed and distressed situations requires a lot of flexibility, but there are still some types of companies and sectors that are typically being avoided at present, and some geographies are less attractive than others too.

"There are certain regions and industries we do stay away from," says Khosla, "such as emerging markets and countries where the bankruptcy laws are not clear or outcomes are unpredictable. We also tend to stay away from industries that are in secular decline or high growth/high multiple industries, where it's hard to find real value even buying debt at discounted prices."

Events of the last six months have demonstrated how the landscape for special situations and stressed lending can change rapidly in the face of evolving market conditions. Firms expect opportunities to arise in the medium term, but will need to be flexible and creative to ensure they are able to originate a solid flow of deals through this period of market turbulence and rapid changes in monetary policy. ■

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