EXPERT Q&A

Stuart Mathieson, head of Barings' Global Special Situations Investments Group in London, and Bryan High, co-portfolio manager for the Global Special Situations strategy in the US, discuss the outlook for distressed debt investing

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Q Recently, we've seen leverage levels for high-yield corporate issuers creeping up on both sides of the Atlantic. Does this create opportunities for you?

Stuart Mathieson: The large inflows of capital into high-yield markets have certainly allowed companies and private equity sponsors to structure more aggressive transactions – which means there's more single-B and triple-C debt available, in general. Although defaults have so far remained low, at some point they will inevitably increase. That said, we do not need a higher default rate to deploy capital efficiently. For our special situations strategy, we can typically deploy about 80 percent of our investors' capital within two years, even among a benign default environment – which we attribute to our integrated model, the breadth of assets we cover, and our ability to size funds appropriately for the opportunity set.

Bryan High: Additionally, in the US, sponsors are paying high multiples for assets because there's so much capital to put to work and it's a very competitive market. To then achieve good returns, private equity sponsors are pushing the envelope on leverage – which doesn't provide much leeway if their plans fall through, but creates an opportunity for managers with the expertise to navigate stressed and distressed credits.

Q How common is it for you to become heavily involved in a deal, from an operational perspective?

BH: While we are certainly not looking to take over and operate all of the companies in our special situations portfolios, we do have the ability to get more involved when the need arises. We find that it's helpful to have a seat at the table when companies go through challenging situations, so we can help drive outcomes that are most beneficial for our investors. In certain cases, we are able to help restructure a company to provide a stronger balance sheet, a new board, and a fresh management team, for example.

Q What returns do you target?

SM: In our special situations strategy, we target a net internal rate of return (IRR) in the mid-teens. To achieve that, we're flexible and look to seek out the best relative value opportunities across our target markets and strategies. If we can achieve a 15 percent IRR

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on a discounted debt instrument, we're happy with that. We're equally happy if we can target a 2x money multiple by investing in a good business with a bad balance sheet, and unlock value by providing capital to invest or taking control through a debt-to-equity conversion.

Q Geographically, where are you finding good relative value at the moment?

SM: Our platform benefits from being fully integrated into Barings' wider credit business, which gives us access to proprietary research on a wide range of credits, many of which are not widely covered – and provides a great view into our target markets. Over the last several years, we've been weighted toward opportunities in Europe. But, looking forward, we see a growing opportunity set in the US. In addition to currently offering more attractive prices, the US loan and bond markets are around five times the size of the European markets. For this reason, even if default rates remain low, we expect that we will be able to source a sufficient number of attractive investment opportunities, given the breadth of assets that we cover.

Q On the flipside, are there any countries where you're more reluctant to do business? And what role does jurisdiction play?

SM: While we seek opportunities across the US and developed Europe, we do approach certain countries with caution. Italy is a good example. There have been relatively few broadly syndicated deals, as it's more of an SME market, comprising family-owned enterprises. The founder of a business, or members of the founding family, can be less predictable than a private equity sponsor. Additionally, there have been fewer cases involving restructuring processes, which means outcomes are less well understood. For these reasons, we have not yet completed a deal in Italy.

It's important to understand the rules of the game for restructurings and insolvencies in different countries, because we need to underwrite for the downside in every deal. The UK has a very well-understood and well-defined insolvency regime, and enforcement is straightforward, so most managers are comfortable with that.

Aside from the UK, within Europe we commonly invest in France, Germany and Spain, and adapt our approach accordingly. For example, France can be a difficult place to do business because it's almost impossible to enforce on a share pledge, so the company and its shareholders have a strong position in any negotiation. Consequently, the amount we're prepared to pay for an opportunity there is much lower than in the UK. However, we are comfortable with the process in France because we know it well, having done a number of deals there.

Q Looking across sectors, retail is experiencing a lot of stress at the moment. What is your take?

SM: The high street isn't going away altogether. However, we don't currently have any retail exposure in the portfolio. We're very cautious about the direction of that industry – primarily due to its rising costs, which have become a problem for almost all retailers. Even successful companies are having to manage their legacy cost base in bricks and mortar down, at a time when bricks-and-mortar sales are declining globally due to the increasing penetration of online retail. Simultaneously, these companies are having to incur new costs to service their online platforms. The economics of delivering something to a customer and then dealing with returns can be challenging. It's also incredibly tough on margins when you're trying to offer the lowest-cost product due to competition.

Q Energy is another stressed sector. Are you seeing any opportunities there?

BH: There are several discounted investment opportunities in energy. However, we look to invest across a broad portfolio of idiosyncratic ideas. As such, to maintain diversification, we cap energy exposure for the strategy at 20 percent. We don't want the price of a commodity, like crude oil or natural gas, to drive the ultimate performance of the portfolio. Within the energy sector, we avoid having too much concentration in any one area, and therefore spread exposure across sub-sectors like offshore exploration and production, land drilling, service companies and US onshore shale.

Q What else can you add to your overall outlook for the market?

BH: In the months and years ahead, we expect to continue to see a broad opportunity set of stressed and distressed credits that represent compelling value. It's critical to be able to cast a wide net across the US and Europe, and to be flexible enough to invest in a deeply discounted credit or take a control position in a restructuring process. While we will see another credit cycle in the coming years, we think the opportunity is so broad at this point that it's not a requirement to put capital to work. ■