

HIGH YIELD

Distressed Debt: Despite Challenges, Opportunities Persist

BARINGS INSIGHTS

Recent market and economic volatility may be the trigger that distressed debt investors have been waiting for, but capitalizing on opportunities will require a different playbook than those of past cycles.

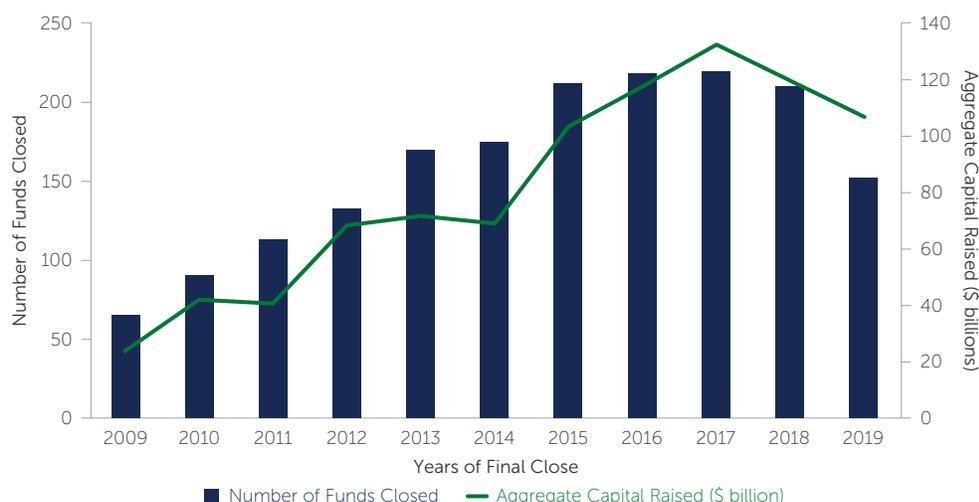
For investors trying to time their entry into distressed debt strategies, the last several years have proven tricky. Despite the elongated credit cycle and concerns about loosening terms in credit issuer documentation, defaults have remained low by historical standards across the high yield and leveraged loan markets. Some of this is surely a result of historically low interest rates, which have, in many cases, enabled otherwise troubled issuers to ride out the cycle without running into liquidity problems. And while the emergence of the coronavirus as a formidable threat to global growth prospects likely means that interest rates will not move higher in the foreseeable future, it may also prove to be the trigger that drives weaker issuers into stressed or distressed situations.

Where Stress in the System is Likely to Appear First

Most immediately, issuers with supply chain reliance on China look most exposed, although this is likely to propagate into other regions in the weeks and months ahead. The knock-on effects from supply chain challenges and increased working capital requirements will inevitably impact a wide array of corporate debt issuers. For those companies that were already teetering on the edge—or geared to perfection—liquidity issues could quickly follow. Beyond that, a general slowdown in economic growth has the potential to impact issuers across almost every industry, particularly if sustained for more than one or two quarters.

Additionally, the substantial growth of the private credit market over the last decade will naturally result in more middle market issuers running into stressed situations this cycle. Weaker documentation, higher leverage levels and a proliferation of new entrants are likely to be key factors contributing to the growing distressed opportunity in this space.

FIGURE 1: Global Private Debt Fundraising Nearly Quadrupled in Last Decade



SOURCE: Preqin. As of December 31, 2019.

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Similarly, the collateralized loan obligation (CLO) market looks set to be a source of stressed or distressed opportunities in the months and years ahead as CLO managers trim their exposure to downgraded (CCC-rated) loans in order to meet required ratings tests. And while the latter is more of a technical problem than a fundamental one, the impact is the same: distressed debt managers have the opportunity to buy assets at discounted prices because of technical selling pressure.

The Challenges Investors Face: Capital Deployment and Alpha Generation

Capitalizing on the growing opportunity set will not be easy. There are a number of challenges, including the ability to identify the most attractive opportunities, and execute and deploy capital efficiently. In recent years, many managers have struggled to put capital to work in the agreed-upon timeframe. This is partly due to the still-low corporate default environment referenced above, and partly due to the trend toward ‘megafunds.’ Not only in distressed strategies, but also in variety of others including private credit, managers have continued to raise larger and larger (multi-billion dollar) funds. While this shows a healthy demand among limited partners to invest in these strategies, the unintended consequence has been a convergence around—and arguably an overconcentration in—the largest, most liquid LBOs and stressed credits in the market.

This makes sense to a degree because larger funds need to deploy capital efficiently, and large, liquid names enable them to do so. But it also potentially puts LPs at risk of having too much exposure to the same names—many times owned across the funds of different managers. Of course, it also makes alpha generation difficult, if the result is that one LP’s distressed exposure looks very similar to others.

The Next Cycle Will Require Casting a Wider Net

The solution may well be to look beyond the largest LBOs and stressed credits in the market, to consider a broader set of stressed and distressed situations. This means that managers must be poised to capitalize on the potential stress in the private credit or structured credit markets mentioned above. Having teams that already cover these assets should help. It also means looking for opportunities across the global high yield markets—including transactions of all sizes and across multiple geographies.

Fortunately, the growth of the high yield bond and loan markets over the last decade means that opportunities should be plentiful—with the total universe now north of \$3.5 trillion in size. To illustrate this, the U.S. leveraged loan space now consists of over 1,400 issuers, which is 20% more names than in 2007; similarly, there are over 350 issuers of European loans (+11%) since 2007.¹

However, one question remains unanswered: Will these opportunities be large enough for the ‘megafunds’ to commit resources to them? If such a deal size won’t move the needle for a ‘megafund,’ then the answer may well be no, especially considering that more than half of the issuers in the U.S. and European loan space have debt stacks totaling under \$500 million.² This may be an opportunity onto itself. For managers with the local teams, resources and incentives to deploy capital into deals of varied size and geographical location, the competition is likely to be less fierce and the ability to capitalize on relative value opportunities may be far greater.

In summary, the long-term impacts of the coronavirus and related economic slowdown are impossible to quantify at this stage, but this unforeseen event may just be the trigger that investors have awaited for deploying more capital into distressed debt strategies. Opportunities are likely to be plentiful in the next cycle, but casting a wide net that covers a variety of deal types, sizes, asset classes and geographies is likely to be critical for investors aiming to generate alpha in this space.

This article is adapted from a recent episode of Barings’ Streaming Income podcast. The full conversation can be found [here*](#).

1. Source: Credit Suisse. As of December 31, 2019.

2. Sources: Credit Suisse, ICE Bank of America Merrill Lynch. As at September 30, 2019.

*Full podcast URL: <https://www.barings.com/viewpoints/distressed-debt-capturing-late-cycle-value>.

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