AICA NAVigator Interview-Duncan Farley, PM, DM Special Situations Team @ BlueBay Asset Mgmt on Event-Driven Credit Explained

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Duncan Farley, sat down with Jane King on October 16th for a NAVigator Interview and explained the Event-Driven Credit.

Duncan Farley

The podcast can be found on AICA's website by clicking here:

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Jane King: I'm Jane King at the NASDAQ MarketSite and I'm joined by Duncan Farley, portfolio manager for RBC BlueBay Asset Management, which is a sub-advisor for the BlueBay Destra International Event-Driven Credit Fund. Now the fund just crossed its five-year anniversary in May and has been the top performing continuously offered closed-end interval fund over that time returning over 12% annualized since its inception. It's ticker symbol CEDIX, and you can learn about it at DestraCapital.com. So with me, Duncan, great to have you here. New term for me, event-driven credit, so explain what that is.

Duncan Farley: Yeah, look, I think simply put it's buying stressed and distressed debt, so that could be loans or bonds at hopefully suitably discounted prices where the risk of the underlying investment is already priced in.

Jane King: Okay, are these corporate, government, both?

Duncan Farley: This is corporate.

Jane King: Okay.

Duncan Farley: Corporate bonds and loans.

Jane King: Got it, okay. So why does it make sense to have some of this in a interval fund structure?

Duncan Farley: Okay, so the interval fund structure, which I'm based in London and if I said interval funds to any of my colleagues or people I know, they'd glaze over, this isn't a structure that really exists in Europe yet.

Jane King: Okay.

Duncan Farley: But actually when you break it down, it's a very neat way to match investors' liquidity requirements with the underlying profile of the investments, the liquidity profile of the investments that we're investing in. So for instance, some of the things that we invest in, the more distressed, might have a longer term time horizon to play out, they might be less liquid to trade. So the neatness of the interval fund means that the structure of that, where you can take out 5% each quarter on the fund, means that we can invest over a longer period of time without having to hold everything that is liquid, so it's just a really good way to invest within the asset class.

Jane King: Do you see more or less opportunities in event-driven credit right now?

Duncan Farley: Yeah, the team today is busier than it's ever been.

Jane King: Okay. What do you think is the cause of that?

Duncan Farley: I think it's the cost of funding.

Jane King: Interest rates.

Duncan Farley: It's the higher rate environment that we're operating in.

Jane King: Okay.

Duncan Farley: There was a great study out, or a good study I should say, in the summer by Moody's, who analyzed the US high-yield issuance, B3 high-yield issuance, I think there are over just about 300 of them. It quantified that by December of this year, over 60% of those will have an interest rate coverage ratio of less than one. In other words, they're not generating enough cash to be able to service their debt. So in simple terms, if you are more than four times levered and you're facing a cost of financing of over 10%, then unfortunately the maths don't work. You're going to have to do something about that.

So our time is spent looking at multiple different companies and structures, working out which ones are the winners here, which ones will survive, which ones can come up with a solution. And maybe for those that can't come up with a solution, maybe we're the solution, because if it goes through a process, we could actually be involved in that process. So yeah, I think the difference today versus perhaps previous cycles, where maybe there's been a bit more of a sector focus, this is across the board.

Sure, there will be sectors that perhaps suffer more pain than others. I mean, real estate is perhaps one of those, in Europe certainly, that we're seeing, but this is broad brush. If you're a CFO today and you know your debt is coming up for maturity in the next 12 months to three years, you've got an issue that you've got to deal with.

Jane King: Yeah, you've got to figure something out.

Duncan Farley: Correct.

Jane King: So you mentioned sectors, are there some real estate that you think is in worse shape than others?

Duncan Farley: Well, it's not so much that they're necessarily in worse shape, it's just that there is a lot more issuance that has happened over the last five years. We're a European-focused fund, we can invest anywhere but our bread and butter is in Europe. There's been a lot of debt issued by real estate companies in Europe, more than there would have been in the previous five, 10 years in previous cycles. And yeah, we've obviously all read the headlines about offices and the pressure.

Jane King: You mean like the empty office?

Duncan Farley: Yeah, empty offices, and so who's going to refinance this stuff? Now our job is to work out who are going to be the winners, who will be the losers? Because there are good office blocks, there are good properties with good tenants that will be there for a long time. Our job is to sort of work through that and to work out which are the better assets to own and the right price of which to own them at.

Jane King: Now so commercial real estate, there's some evidence consumers are under some kind of financial stress as well, still talking about a recession. How do you manage this bearishness and the volatility in the markets?

Duncan Farley: Yeah, look, our job is to work out the worst case scenario, shall we say. When we sit down in our investment committees, we start with the conversation, "Okay, if this was to go wrong, what would be the outcome?" And then the important thing is to, when you work that out, because obviously that's not a straightforward analysis, then to price your entry point as close to that as you possibly can.

Now sometimes that can be very easy. You can have a business which owns a bunch of assets, you can go out and get those assets valued on a downside scenario, a blue sky evaluation. And then you can price, remember we're buying the debt that is often secured on a lot of these assets, close to those assets, so the value of those assets is vitally important.

So sometimes it's pretty easy, relatively easy to do that, but on other occasions a case of let's try and value this business, what's the worst level of profitability that it could have? What's the lowest level of multiple it can have? And if we price our entry point as close to that, then most of the time, we won't get it right every time, but if you do get it right, we target 15%+ returns, the winners will look after themselves. The important thing is when you do get it wrong, that you don't lose too much money.

Jane King: Got it.

Duncan Farley: Sometimes you have to wait. You've got to be very patient, you've got to wait for the price to come to you, and that's where you need an experienced manager to do that.

Jane King: That patience is tough sometimes when you're in the market.

Duncan Farley: Yes.

Jane King: So are these public or private opportunities?

Duncan Farley: Both. Both, to be honest. I think we talk more in terms of liquid and illiquid, and sometimes there are many private things that are very liquid, so it's not always the case of private is different to public. But we are most of the time looking at public bonds or levered loans, which is quite a public market as well.

Jane King: And explain a little bit, BlueBay, your background and the special situations team. Talk a bit about all of that.

Duncan Farley: Sadly I've been doing this for so long, it would take too long to go through that. So BlueBay, which is owned by Royal Bank of Canada, it has been now for over 10 years, we sit within the developed market special sits team in Europe, we're a team of six professionals. Sadly we have over 140 years of experience between us, but to be honest, today that's probably more important than any other point in time.

I think the cycle that we're seeing at this moment is much more akin to the cycles that we saw before the Financial Crisis, and so therefore having a team of people that were there and did that, going back into the nineties, I think drawing on that experience and see how things can play out. That's not to say that people have started afterwards aren't very good at what they do, but it definitely helps us to be able to know how things can play out. I can remember when rates were in double digits back in the early nineties, so we know.

Jane King: We're at 30-year highs for some of these interest rates, so the fact that you lived that.

Duncan Farley: Personally lived it, yes.

Jane King: Okay, and the special situations team, what's that all about?

Duncan Farley: Well, that's the six professionals I talked about.

Jane King: Okay, so you're the ones that analyze all of this.

Duncan Farley: Yes, so we have a broad-based experience. Myself, 30 years of looking at credit, debt, from the early days of the European high-yield market which started in the late nineties in Europe. Two of my colleagues worked for a very large hedge fund in the early 2000s where they were trading a lot of distressed debt. So yeah, we think we've got a good team of special sits, situations, as we call it. As I mentioned earlier, naming what we do is actually probably one of the hardest things; event-driven, special sits, credit opportunities, but this is debt trading and this is trading debt that, as I say, is trading at a big discount.

Jane King: Distressed debt. So Duncan, thank you so much. Very interesting to hear about this aspect of the financial industry.

Duncan Farley: Thanks very much.
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