Credit Events

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Destra

What's so Special about Special Situations?

We recently sat down with special situations and distressed debt expert, Adam Phillips of the BlueBay Fixed Income Team at RBC Global Asset Management, to ask him why he thinks the current economic backdrop may be presenting a multitude of opportunities for special situations investing.

"The macro environment is providing a rich opportunity set for investors in special situations and distressed debt. And fortunately, our special situations team here at RBC has seen at least six major default cycles going back to the 1990s. This gives us a huge amount of experience and is useful to look at the current market in the context of previous cycles, including those in the 1990s in Asia, the dot.com bubble, the global financial crisis and the Covid period."

Corporates face challenges

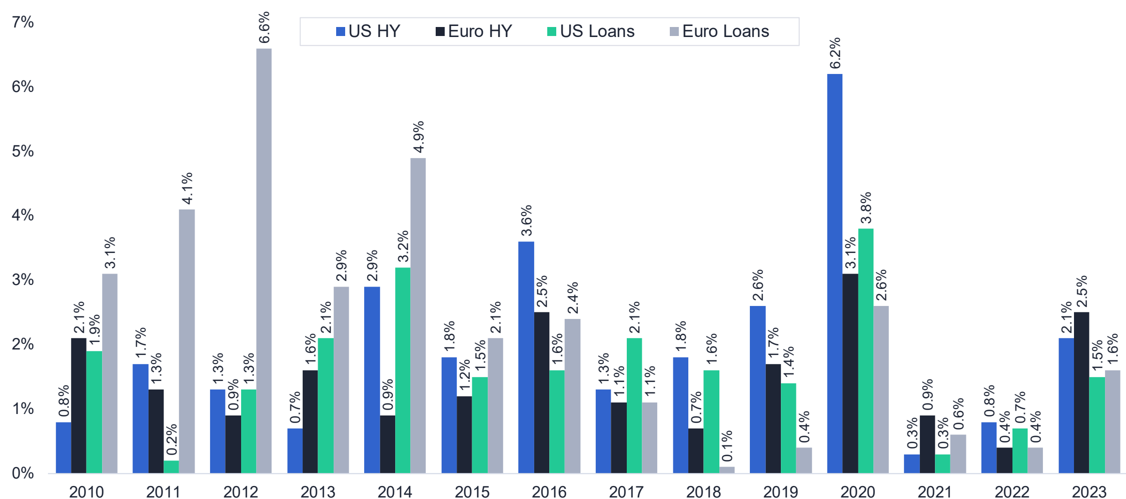
Many companies went into Covid very highly leveraged due to the availability of money at unprecedentedly low-interest rates and have subsequently had to borrow more to survive. Macro factors are also causing turmoil, including supply disruptions, surging inflation, the war in Ukraine, energy prices, and interest rates rising to rates unseen since before the global financial crisis.

Rising defaults

Looking at these highly challenging market conditions, it is unsurprising that defaults are rising, albeit from a low base. Interestingly, they are rising at a slower pace than might be expected when focusing only on these macro factors. The pace of defaults will likely increase but, for the time being, the market remains relatively tight, with spreads narrower than they have been at this point in previous cycles. This can partly be attributed to the high-yield market quality this time. Notably, there is a higher proportion of BB-rated companies than in previous cycles, indicating a higher level of creditworthiness.

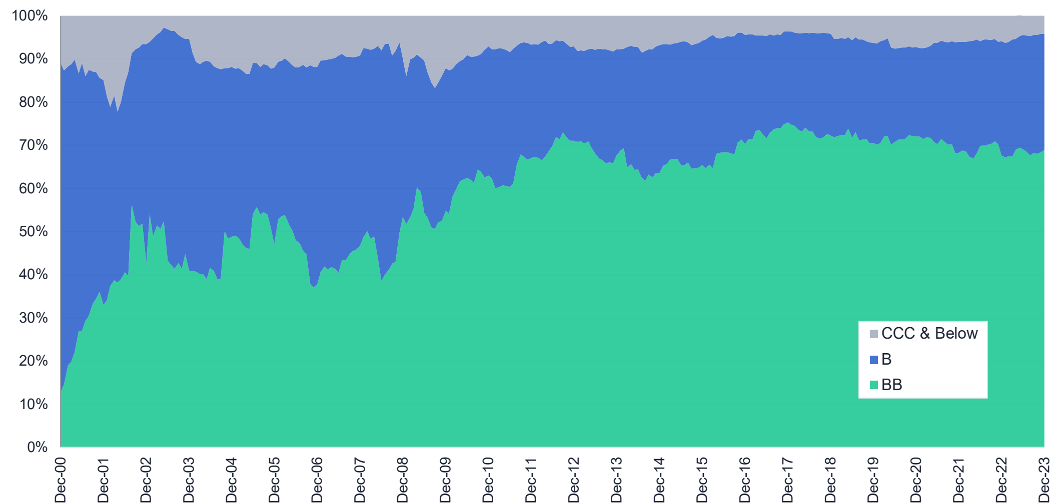
Leveraged Finance Historical Default Rates

2010-present default rates across US and European HY bonds and loans



Source: JPMorgan for US and Euro HY data. S&P LCD for US and Euro Loans data. As of 12/31/2023
For illustrative purposes only. There is no assurance that any of the trends depicted or described herein will continue.

Rating Allocation Across the European High Yield Index



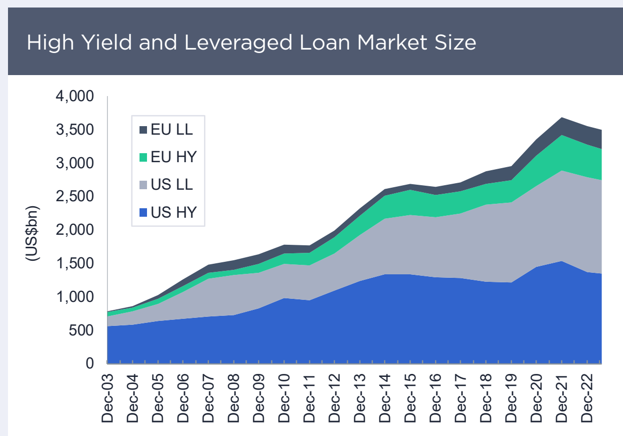
Source: RBC Global Asset Management, ICE BofA as of 12/31/2023
Note: European High Yield Index refers to the ICE BofA Euro High Yield Index

A $3.5 trillion market

That said, there is also a good proportion of CCC-rated companies, and we need to consider default rates in the context of the current size of the combined high-yield and leveraged bond market, which has increased significantly since the global financial crisis: today, the US and European high-yield and leveraged loan markets total around $3.5 trillion.

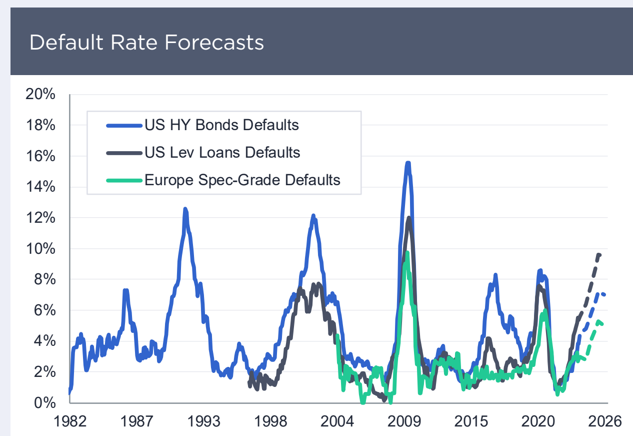
So, while we are not predicting default rates to reach the 10-12% per year that we saw towards the end of the global financial crisis, given the market's current size, we may end up with a similar volume of defaults.

High Yield and Leveraged Loan Market Size



Source: Bloomberg, as of 7/31/2023. LHS: Indices = ICE BofA European Currency High Yield Constrained Index (EUR) and Morningstar European Leveraged Loan Index. RHS: Indices = ICE BofA US High Yield Index (USD) and Morningstar LSTA US Leveraged Loan Index

Default Rate Forecasts



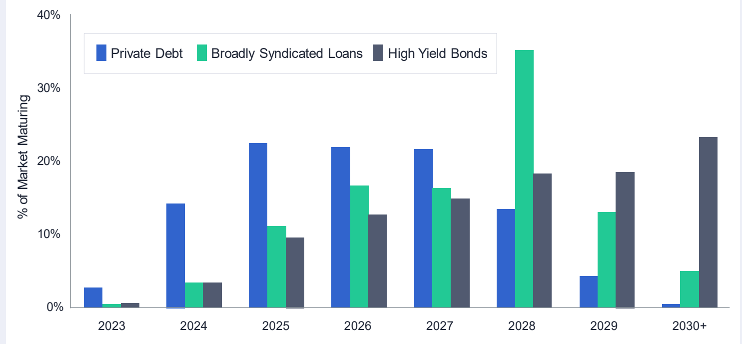
Source: Moody's Investor Services, as of 11/30/2023

Private debt now plays a much larger role

In addition to the market's increased size and number of participants, we also need to look at the potential role of private debt in the current environment. Private debt funds play a significantly larger role, and refinancing by these funds is much more prevalent than in previous cycles.

The strategies and portfolio underwriting of these funds are a further consideration and add to the complexity of the current landscape. Defaults are rising in a huge and dynamic market, with significant stresses coming down the pipeline. Our expertise, experience and agility with deals of varying sizes and across multiple sectors and geographies enable us to approach this default cycle with a clear understanding of risk and reward.

Private Debt Faces a Steeper Maturity Wall Than High Yield Bonds and Leveraged Loans



Source: BofA Global Research, ICE, DLD, Oaktree Capital as of 6/30/2023

Special situations landscape an almost "perfect storm"

While the US and European high-yield and leveraged loan markets are massive in scale, this is a highly dispersed market, with a notable proportion of CCC-rated companies across a wide range of sectors and geographies facing a perfect storm of challenges. Many are starting from a position of being highly leveraged. They are also having to manage the effects of Covid, address rising interest rates, high inflation and surging energy costs, as well as the consequences of war on the edge of Europe. These significant challenges for corporates create opportunities for special situations teams.

Mid-market opportunities, especially in Europe

The mid-market, is rich with opportunities for special situations investors. Further to general macro factors, companies of this size have the additional challenge of having limited access to credit markets compared to their larger counterparts. Mid-market companies are, therefore, more reliant on banks just at the time when banks themselves are tightening their lending criteria and becoming more risk averse. These companies are also naturally less diversified by geography and sector.

Growth in the opportunity set has been particularly evident in this mid-market sector – a space we broadly define as companies with EUR30-500 million in revenue. Mid-market companies, specifically, are less resilient to these shocks compared to their large-cap peers. We believe that Europe is the global epicenter of stress and distress and that mid-market companies in Europe are less diversified, less resilient and have less access to the capital markets. In short, we favor the European mid-market because there are more opportunities, and at the same time, we see less competition, as larger funds tend to focus on much larger capital structures.

European real estate is stressed

The European real estate market is one specific sector that represents an interesting opportunity, especially when we consider the impending maturity wall anticipated in 2024 and 2025. As a sector, it is undoubtedly stressed and, in specific incidences, distressed, leading to investment opportunities arising from reduced asset prices. Valuations are highly uncertain across a range of asset types. There is also the question of whether real estate companies can divest assets and refinance their balance sheets in this challenging environment when access to credit may be more limited.

Multiple sectors may offer opportunity

Surging energy prices have also created challenges. Any sector that uses a lot of energy will face challenges and contain potential opportunities. We see these in industries such as chemicals, paper and packaging and auto parts. However, one of the most interesting things about this cycle is the broad opportunity set.

There are opportunities in industries as varied as oil and gas, manufacturing, shipping, telecoms, cinemas, retail, and food and beverages. This is a crucial differentiator from previous cycles, which have been more sector-specific, such as telecoms and cable in 2000-2001 and the dot.com bubble.

Hedge funds too big for mid-market

As well as the sectors themselves, we also need to consider the impact of other market participants. Many hedge funds and asset managers investing in special situations and distressed debt have grown significantly over the past ten years. As they grow, their appetite for smaller deals wanes, enhancing the opportunities available in the mid-market.

Providing capital to fund solutions

Companies encounter credit stress for many reasons, such as economic cycles, sectoral stress, underperforming business lines, upcoming debt maturities, or just too much debt. But, in current market conditions, rolling over the debt is no longer straightforward, and in a rising rate environment, debt can become more challenging to service. For certain businesses no longer able to refinance their way out of difficulty, distressed investors can be the only source of capital, providing options for companies facing financial stress.

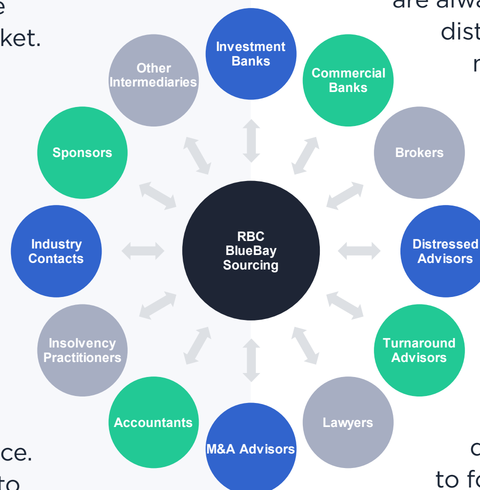
Event-driven credit

We invest in bonds and loans in developed markets, selecting single-name corporate issuers where an identified event will likely provide a clear path to exit. Our investment process is predicated on maximizing risk-adjusted returns and benefits from the skills of the wider BlueBay leveraged finance team at RBC GAM, ensuring breadth and depth of issuer coverage.

Identifying opportunities

We focus on identifying suitable opportunities using bottom-up research and fundamental credit analysis. Our specialists have both the resources and knowledge to participate in and, in many cases, lead the restructuring process, which means we can provide our expertise from start to finish to drive a restructuring. And for us, the relationships and networks we have fostered over time are crucial to sourcing differentiated investment deals. The BlueBay Fixed Income Team's broader research channels, market-leading intellectual capacity and trading capabilities further enhance our proprietary sourcing networks.

> **"We focus on identifying suitable opportunities using bottom-up research and fundamental credit analysis."** – Adam Phillips



An unusually broad opportunity set

We believe there is always something to do, there are always pockets of opportunity, and distressed situations can emerge in any market environment, whether during an economic expansion or a contraction. That said, corporates are currently facing a number of challenges, and the opportunity set is unusually broad across multiple sectors and countries. Our watchlist of potential opportunities is now five times the size it was two years ago, consisting of over 300 names across multiple sectors and countries. Managing the list with discipline and process is essential to focus analysts in the right areas. Furthermore, we believe that the timeframe for the opportunity is likely to extend over several years.

It's a dynamic market with new deal potential

Within the market, we increasingly see companies need an overhaul of strategy and operational restructuring. However, the ideal investment for a special situations or distressed debt investment team is a business with a sound underlying strategy that needs financial restructuring. These cases involve having the wrong capital structure, for example, in an otherwise good underlying business.

There are more participants, and the market is more dynamic with the addition of private debt funds refinancing leveraged companies, which was less prevalent 10 or 20 years ago. It is difficult to know what will come from the private debt market in terms of opportunity for special situations investors.

Liquidity considerations are key

Liquidity is also a key parameter in the investment decision-making process. As we've noted, the European and US high-yield and leveraged loan markets currently stand at around $3.5 trillion, and this is where a lot of the immediate opportunity lies. These investments are typically more liquid, now a key area for us.

While liquid investments are a natural priority given the market opportunities today, we are also looking at illiquid situations. These do, however, carry a requirement for higher returns. We might find returns for liquid investments for example of between 15-20% to be interesting, However, to be compensated for more illiquidity, we would be looking for an internal rate of return (IRR) of about 25-30%.

Liquidity considerations within our portfolios during this cycle are aligned with historical norms. The time horizon for our liquid portfolio is generally between three months and two years. In contrast, more illiquid investments require an extended timeframe and could take two to five years to realize.

Identifying the right deals

Mid-market companies across sectors as varied as oil and gas, manufacturing, shipping, telecoms, cinemas, retail, food and real estate are particularly exposed to these challenges and have limited access to credit and refinancing.

Within this opportunity set, we need to apply rigorous analysis to identify the right deals with the right returns. Our BlueBay special situations specialists have decades of experience across multiple default cycles of doing exactly that.

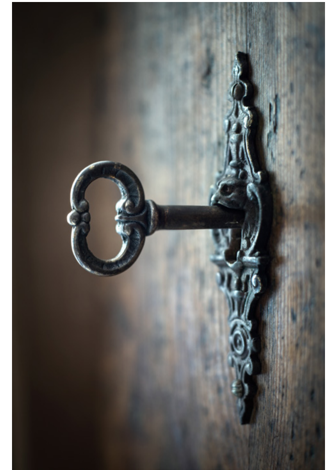
Fundamental analysis and active involvement drive returns

We focus on bonds and bank debt trading at stressed or distressed prices, where our analysis suggests there is a clear path to recovery, sometimes including a financial restructuring. We look to remain senior in the capital structure and secured. Given low entry prices and limited downside, these investments can deliver attractive asymmetric returns.

We look at more liquid and less liquid opportunities, with investment vehicles designed to take advantage of both while ensuring assets and liabilities are matched appropriately.

Experience is key

Experience is essential for special situations investing, and each of the senior members of the team have been working in the industry for over thirty years. All our portfolio managers and analysts can participate in, or lead, restructuring processes, helping to drive favorable outcomes for clients.



Looking ahead

Defaults are increasing, and we expect this trend to continue. The opportunity for special situations is wide-ranging across sectors and geographies. For investors with the flexibility to pursue a special situations credit approach, the European mid-market presents an exciting opportunity set with the potential to deliver compelling risk-adjusted returns.

We anticipate that this opportunity will be prolonged and that there is a strong case for investors to consider such a strategy. At RBC, our BlueBay special situations specialists are positioned at the forefront, ready to take these opportunities as they arise.

High levels of leverage, rising interest rates, changing consumer behaviors and the geopolitical situation have created a perfect storm for corporates generating a surge in special situations opportunities.

Adam Phillips is the BlueBay Head of Developed Market Special Situations for RBC. He is based out of London, England and brings over 30 years of special situation, stressed, distressed and event-driven investing experience to the team. Along with institutional accounts, hedge-funds and private funds at RBC BlueBay, Adam is a Co-Portfolio Manager of the BlueBay Destra International Event-Driven Credit Fund.

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