BlueBay's Farley: 'We're Looking At A Multi-Year High In Default Rates'

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CHUCK JAFFE: Duncan Farley, portfolio manager for the BlueBay Destra International Event-Driven Credit Fund is here, we're talking the changing world of interest rates and credit now on The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization representing the entire closed-end fund business from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator will point you in the right direction. And today we're looking in the direction of event-driven credit with Duncan Farley, portfolio manager on the Developed Markets Special Situations team at RBC BlueBay Asset Management. Duncan is portfolio manager for the BlueBay Destra International Event-Driven Credit Fund, that's ticker symbol CEDIX, and you can learn more about the firm and the fund at DestraCapital.com. And if you want to learn more about closed-end fund investing generally, go to AICAlliance.org, that's the website for the Active Investment Company Alliance. Duncan Farley, welcome back to The NAVigator.

DUNCAN FARLEY: Thanks Chuck, it's been a little while but it's always a pleasure to be on the show.

CHUCK JAFFE: We are at a point where the interest rate environment is changing and that's changing the way people are looking at fixed income and credit, and you guys recently did a white paper that was titled, and I don't normally hang just on titles, but it was titled "Hangover After Low Interest Rate Party". Let's talk about the hangover and what might be affected now that we think that rates are actually going back in a lower direction.

DUNCAN FARLEY: Look, the white paper is I guess a summary of what we've been saying for a little while now, we may have even talked about it when I've been on previously. Look, it's easy to see that over the last, post-GFC, rates have been very low and corporates have been dining out on cheap finance, and they've got comfortable with the amount of debt, increasing amount of debts that they have on their balance sheets. Then we had Covid and the implications that had for corporate earnings and profitability, which meant that in many cases that reduced them, and in many cases as we sit here today companies still haven't grown back into the level of earnings that they had previously. But at the same time, their debt is now as high as it's ever been and the leverage has gone up, and more importantly the cost has gone up. I often say to people, I may have said it to you before, but if you do the mathematics as we say over here, if you're four times levered and you're facing the prospect of having to pay over 10% for your debt, then those maths, or the math as you would say in the US, doesn't work. Unless you're not incurring any other cash flows, you're simply not going to be able to service your debt, so you're going to need to come up with some kind of solution. So the piece that we put out summarizes that in more words with a few charts to show how this leverage has been creeping up and how this presents a problem to corporates globally, and specifically in the European market where we are most focused.

CHUCK JAFFE: But problems tend to be opportunities when you're in special situations, and that's where you are, so given the trends, what do you see happening over the next year or so?

DUNCAN FARLEY: Yes, people obviously if you're in the high-yield market you're very focused on default rates, and we're interested in default rates, a higher default rate typically means that there's more opportunities for us to look at. Our anticipation is that over the coming years, unlike post-GFC where the default rates spiked very quickly, blinked and you missed

it, there were a lot of big defaults that happened and then everything sort of settled back into a pretty easy life for a long period of time. This time around we don't think it's going to be like that, we think we're looking at a multi-year higher default rate. Frankly for us, it doesn't matter whether that's 2.5% or 5.5%. Personally I would expect it to probably be at the lower end of that range, but I do think that that is likely to be the case for say, two, maybe even three or four years. And given the size of the asset universe that that default rate is measured on, whether it be the high-yield market, the levered loan market, these markets now are multiples of what they were 10 years ago, they're multiples of what they were even five years ago. So a two or three or four percent default rate on billions of dollars, or nearly trillions of dollars of debt, plus of course in Europe we've got a $7 trillion corporate bank debt market, if you apply 2% or 3% on that it's still a large, large sum of money and a large number of opportunities. In our funds we only look for between let's say 30 and 50 investments, so we're very confident, and we're already seeing it and already have seen it for the last two or three years, that we will continue to see plenty of companies struggling. Hopefully the ones that we invest in are good companies, classic good company, bad balance sheet, some will be able to survive but many will need a radical restructuring in their balance sheet to survive.

CHUCK JAFFE: It sets up a very interesting side of things when you start talking about high yield, or as most people call it here, junk, because we haven't seen a massive wave of defaults, we've seen a few. Obviously higher interest rates suggested it, but now we're starting to be more confident that interest rates will go down here, and the more that that happens, the more you're going to have a disconnect between the standard markets and high yield. So if you're looking at that, how do you dive into the valuation gap between distressed and non-distressed portions of the market? Are we going to be in a situation where we'll be getting paid to take that extra risk more than we have been?

DUNCAN FARLEY: Yeah, I think you've got to be a little careful here, because remember special sits, although a lot of what we saw is coming from the high-yield and levered loan markets, if you're investing in this asset class you're not investing into a high-yield product, there will be some but not a huge amount of correlation. We're talking about the companies whose debt is trading anywhere between, well, five cents on the dollar and let's say 80 cents on the dollar. I'm going to call those, let's say, the have-nots, i.e. they don't have access to the capital markets to be able to refinance at sensible rates. So even if rates, as we've seen in the

UK in last half an hour, have started to come down 25 bps cut here from 5.25% to 5%, even if we were to see 100 bps or even 150 bps; if you're paying, if you're facing the prospect, and we're seeing lots of companies, not necessarily the have-nots but certainly companies that they want to access the market having to pay well above 10%, 100 bps cut isn't going to change things dramatically for them, and that's not going to change dramatically for those that need to restructure and refinance and source new money as well. So remember, in the special sits area we're focused on I suppose many of those companies that are the have-nots at this moment, that haven't got access to the markets in a traditional way. Look at Crossover as an index, it's trading sub-300, i.e. there's plenty of haves out there that do have access to the markets, the high-yield market, levered loan market has cash, is looking for product and will invest, but there's plenty that fall outside of that and that's where we're focused.

CHUCK JAFFE: There's a number of different types of deals that you do that my audience may not be entirely familiar with, things like payment-in-kind deals which are very common in private credit markets, and you also get involved in corporate restructurings. How is that kind of stuff impacted by the conditions we're seeing right now?

DUNCAN FARLEY: Yes, well, that's the increase in activity that we've been seeing for the last couple of years, and we continue to see today and expect to probably escalate in size. It's a big question, there's a lot to address there. Obviously a payment in kind, a PIK arrangement where you're essentially accruing the interest and not having to pay the cash is a solution along with an amend and extend, it's the simplest type of restructuring that you can find. So if you're the shareholder or the sponsor of a business and you can convince your bond holders or lenders that actually a PIK arrangement [inaudible 0:08:35] is the answer, maybe for a bit of fee and an uptick in coupon, albeit not cash coupon, then clearly that's the solution that you'll want to go to, it's the easiest one. But for many corporates, that is impossible, the lenders would say, "Well, you're just differing out a potential problem here. We've got the docs that suggest to us that actually if you breach, if you default, then we can potentially take the keys." I think one of the, and we haven't got the time to discuss it, one of the trends that we're seeing here is a lot of creditor on creditor violence, which sounds quite dramatic, but essentially one group of creditors outthinking and out-documenting, if that's even a word, the other creditors, and often that is because they're willing to provide the new money. I think more than any other cycle here we're seeing the power of the new money. If you're the

equity sponsor and you're willing to write a very big check to keep this thing going, you're clearly going to have a much greater chance of negotiating with your lenders. But let's say you're a private equity sponsor and it's in a fund that's late of life and there is no scope to put in new money, then you're not going to be the provider. And we're seeing big funds and middle sized funds and funds like ourselves that are willing to write new money checks to put in stronger, more collateralized instruments in a structure, but also importantly to take the equity, take the keys to the company as well and sort of play for the long-term upside as well as the short-term returns that you're getting from the new instruments that you're writing. So pretty complicated stuff and pretty resource intense, but if you get it right then it can be very lucrative because you're targeting return at 25-30% in an investment such as that.

CHUCK JAFFE: Last question in limited time, you're already seeing rate cuts on your side of the pond, rate cuts are very much now expected here starting as soon as September. So if and when we see them, what does that do for current holdings, what does that do for prospects of the fund and returns? How much better or worse is it for you in a lower rate environment?

DUNCAN FARLEY: Yeah, so as I've just said, in terms of the have-nots it's probably not going to make too much difference to most, if not the majority of the companies that we could potentially be invested in over time. In terms of our existing portfolio, I guess it depends why we're cutting rates. If we're cutting rates because the economy is slowing, labor unemployment rising, i.e. for the wrong reasons, then clearly we've got to be careful that the companies that we're invested in are not too impacted by that, so you have to be careful what you wish for a little bit. In a perfect world, obviously rates would come down nice in a smooth pattern and the economy would not go into any kind of recession, that's what all the economists and all the central bankers I assume would like to happen. The reality is that tends not to be the case. As we look here today, certainly some of the macro data coming out of Europe is not as strong as it was three or six months ago, so there is a little bit of concern there. The chances are maybe rate do come down a bit quicker, but that could create more opportunities for us because obviously a weak macro environment means earnings are under pressure, cash flow is under pressure, and corporates are under pressure.

CHUCK JAFFE: Duncan, really appreciate the updates and everything you see going on. Obviously we're at the start of what might be a rate-cutting cycle, we'll talk to you again down the line as we see how it plays out. Thanks for joining me.

DUNCAN FARLEY: Thanks, Chuck.

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