CAMRADATA

Distressed Debt Whitepaper

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To discuss your requirements
+44 (0)20 3327 5600
info@camradata.com

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Welcome to CAMRADATA's Distressed Debt Roundtable

The onset of Covid-19 had the potent side-effect of accelerating bankruptcies in areas already priced in as though they were going to fail. As the first quarter of 2021 comes to a close, with uncertainty still a key theme, it appears that the distressed debt pipeline is still in full flow.

Among the sectors most heavily hit are hydrocarbons, as industry disruption is driving the move towards cleaner forms of energy in line with the Paris agreement.

The pandemic has also impacted hospitality, transport, and retail. With signs of fragile balance sheets already showing towards the end of last year, many businesses look set to fall victim to Covid-19 this year as well. Companies that depend on frequent human interactions, for example, are most at risk of getting caught up in the coming cycle.

But this cycle could be prolonged due to high levels of liquidity, alongside ongoing fiscal stimulus packages and suppressed default rates.

As distressed debt is cyclical, funds specialising in the asset class often see strong performance following a crisis – but where do the opportunities lie as the dust still settles from the Covid fallout?

Funds need to be agile, given the current circumstances. This is where active-investing can come into its own, as portfolio managers endeavour to balance positions and quickly respond to an ever-changing macro-environment.

Looking forward, due diligence, as always, plays a key role – and ESG is crucial.

Distressed Debt Roundtable

The CAMRADATA Distressed Debt roundtable took place virtually in London on 25 February 2021.

The CAMRADATA Distressed Debt Roundtable began with some revealing insights into institutional investors' expectations for the year ahead. The mix of representatives from investment consultancies, pension plans and asset managers expected State support in the fight against Covid to continue through 2021. There was little conviction that inflation will rise in Europe, with the possible exception of the UK due to Brexit. Given these responses, would now be the right time to up allocation to Distressed Debt, before State largesse definitively begins to recede and companies have to support themselves? Or do investors need to see blood on the streets first?

Sarah Miller, manager researcher of illiquid credit strategies at consultancy, Redington said she expected better performance from vintages that were able to invest over 2020 than those that had completed their investment periods before March last year.

Tom Wilson, deputy head of credit research at consultancy, Isio, expected more defaults in the next two to three years as businesses coming out of the COVID-19 crisis facing higher levels of leverage and lower revenues struggle. But he said Isio is not seeing strong client demand for Distressed Debt from its pension fund clients because they don't typically need high-risk, high-return strategies. He did see a place for Distressed Debt in the portfolios of Isio's less risk-averse High-Net Worth clients as an opportunity to deploy capital in times of wider market distress.

> ***" Would now be the right time to up allocation to Distressed Debt, before State largesse definitively begins to recede and companies have to support themselves? "***

Shuntao Li, co-head of manager research at Barnett Waddingham, agreed with Wilson that stressed and distressed debt do not behave the same way. She said that the rapid recovery of markets in May had, however, turned clients' attention away from Distressed Debt.

Alison Trusty, manager researcher in illiquid credit at Aon, offered a different perspective. She told the CAMRADATA panel that Aon's delegated investing team had shifted in 2017 all of its illiquid credit into Distressed Debt. The team believed then that the economy was late-cycle and shifted capital away from direct lending and commercial property debt to fund the allocation.

Rohit Kapur, head of private markets at the £10bn Centrica Pension Scheme, reckoned there are plenty of opportunities for Distressed Debt funds and that he would have no problem allocating in 2021. Kapur's role, however, is not that of a traditional top-down asset allocator making relative decisions. He has capital available to invest in private markets and makes commitments based on the attractiveness of each opportunity.

The asset managers at the roundtable then explored how far success in Distressed Debt depended on timing the market. Jonathan Butler, head of European Leveraged Finance for PGIM, recalled that when the battle to contain Covid really took hold last spring, "everything was trading at over 1,000 bps. The options were infinite." He emphasised that to profit from these conditions, a trading mentality was required because the speed of recovery proved almost as swift as the fall. "If you had needed six months to organise yourself, then the opportunities were lost," Butler said. "Look at European High Yield in February 2021 and spreads are less than 500 bps. You're not going to make 15% in European High Yield from here."

Paul Triggiani, head of Distressed Credit at Invesco, distinguished market-timing in large-cap and small-cap opportunities. "Larger managers taking larger opportunities may need longer duration," he said. "It does take longer to find something in large-cap distressed."

Triggiani described the financing of smaller companies in trouble, on the other hand, as an evergreen strategy. "There is always something to do in small cap because these kinds of businesses hit bumps in the road more frequently." Potential challenges he cited include a more concentrated client base, ineffective sales processes and acquisitions with sub-optimal integrations. Then there is financing: Triggiani noted that large companies have access to public markets, which does not mean that their business is fundamentally sound, but it helps. In contrast, smaller companies have generally not been able to tap into the same markets. And even in the current wave of State support, Triggiani noted that intervention by the Federal Reserve has not served certain smaller companies. "Of a US$600bn lending facility created last April, only 1% has been drawn," he said.

> ***" The consultants were then asked what return expectations they had for Distressed Debt "***

The conditions of the Fed loans were written in a manner to effectively bar private equity sponsors. "They are treated as single owners of all their common holdings," Triggiani explained. "And when the holdings are all rolled up and employee numbers counted, these sponsors do not qualify for the facility," he said. The obvious conclusion is this facility was not designed to bail out private equity. "If that is the case under a Republican administration, then it has little chance of happening under a Democrat administration," concluded Triggiani.

The consultants were then asked what return expectations they had for Distressed Debt.

Wilson said he expected net IRR of 15% over the lifetime of a closed-end fund. For the same type of vehicle, Miller, and Li likewise suggested mid-teens for net IRR (with multiples of 2x for Miller).

Kapur had a lower figure of 10-12% IRR over the cycle. He added that Distressed Debt managers had recently been asking for fund life extensions, reflecting a less favourable exit environment.

"We are probably looking at larger companies than Invesco's focus," said Butler. "That whole universe has recovered remarkably well." He gave the example of a hotel chain with near zero revenue for times during the last 10 months that can currently borrow at sub 1% even when its doors are shut. "In a traditional recession this chain would have been highly stressed and likely to have defaulted, but governments do not want good businesses to fail," said Butler. "Advanced mature economies will do whatever they can in this healthcare crisis to support businesses because letting them fail and then restarting/

re-encouraging enterprise is too expensive."

He added that no tool exists to distinguish good from bad companies. Echoing Wilson, Kapur and Li on the delay to distress, Butler said it would only be from next year that companies "have to stand on their own two feet."

The end of distress

For Triggiani, what was interesting is that the previous five cycles for distress have all been economic, starting with autos in 2001 and ending most recently with retail. By contrast, this has been a pandemic-led cycle, which he believes is much more definable and consequently less risky: "In this cycle, business models are not broken but are stressed," said Triggiani. "Companies do not have operational issues. You can see to the end of the distress."

Miller then asked about the role of private equity sponsors, an important source of stressed and distressed private debt for many Distressed Debt strategies. She wanted to know the group's opinion on the impact of record levels of Private Equity dry powder and whether having this at their disposal would be an extra buffer, beyond State support.

Kapur said initial reaction from private equity sponsors to the pandemic had been positive. They had drawn on revolving credit facilities, sourced additional loans and taken advantage of government support schemes. But he warned that there had to be an economic imperative to draw on the dry powder. "They will be making decisions about which companies to save, depending on the viability of business but also where and when the fund is in its cycle: investing or harvesting."

Triggiani acknowledged the notion that there would be fewer opportunities in distressed in this cycle because of the availability of more dry powder from sponsors. His viewpoint was that sponsors were able to play in their own capital structure. "Private equity has always done this," he said. Done correctly, Triggiani had no bones with this approach. It makes some restructurings easier with sponsor support. His concern was a newish trend for one creditor to come ahead of another with equal status in the capital stack. This was more irksome than the well-publicised trend to lighten covenants and, in Triggiani's eyes, responsible for a lot of the aggressive litigation around Distressed Debt deals in the US.

He said it was one reason why Invesco had been focusing on deals in Europe recently more than North America. "The first thing we do is a legal review of the documentation by three different teams, including one external law firm," said Triggiani.

Butler agreed that there had been creditor-on-creditor battles in the US which are virtually non-existent in Europe. "The documentation in Europe is better," he said. "More intact."

"This brought the CAMRADATA panel onto which kinds of asset manager will fare best in the years ahead"

Where Butler had seen some poor underwriting was involving direct lending firms. "There are 70 direct lenders now in Europe; more than there are banks. With this proliferation has come fighting over those assets that the banks have already rejected." He noted one problem with closed-end funds is that they can be amended and extended unilaterally to mask trouble. "But in the end they will have to do something with distressed holdings," he concluded.

Working it out

This brought the CAMRADATA panel onto which kinds of asset manager will fare best in the years ahead. Trusty agreed with Butler's comments on direct lending. She said that lots of smaller managers which entered this field in the last five years don't have workout capabilities, which brings interesting options for Distressed Debt veterans and bold newcomers. Catchy phrases such as "special situations" are back in fashion, as are new terms such as "capital solutions". Kapur explained that the latter is an advance on traditional bridge financing, where a provider steps up when the situation is too risky for direct lending. The company needs liquidity to get through a certain period of time. The capital solutions provider will try to put themselves at the top of the capital structure and might take equity upside as well.

Butler added CLO managers to the list of groups not suited to handling Distressed Debt. CLOs hoover up much of the syndicated markets. "Their portfolios will be highly diversified, with maybe just 30 basis points in any name," he explained. "Are they going to help companies in distress? Do they have expertise? They are more likely to sell out than engage in heavy lifting."

At this point, Triggiani noted that both he and Butler were part of two of the biggest platforms in performing credit. That means there is a "firehose of sourcing opportunities" available to them, according to Triggiani. His argument was that even specialists in Distressed Debt are better placed as part of a larger business. "I see fewer than ten Distressed Debt specialists that are really growing," he said.

Triggiani then related this breadth to Invesco's evergreen approach in small caps and claimed "we can recycle the portfolio two or three times every five years."

"In Europe PGIM has direct relationships with 500 companies," said Butler. "We talk to the CFOs. We are with them in good times. If they slip up, who do they want to do business with - the same firm or a standalone distressed specialist demanding 20-25% IRR?"

PGIM's Credit Opportunities Strategy, is an evergreen, open-ended fund targeting 10% throughout the cycle and across most sectors of credit, including Emerging Markets.

'Similarly, Triggiani said his team's approach as a distressed investor in sponsor-owned companies is often viewed as that of a constructive partner, particularly given his broader credit platform's relationship in performing credit as a leading financier to private equity firms.'

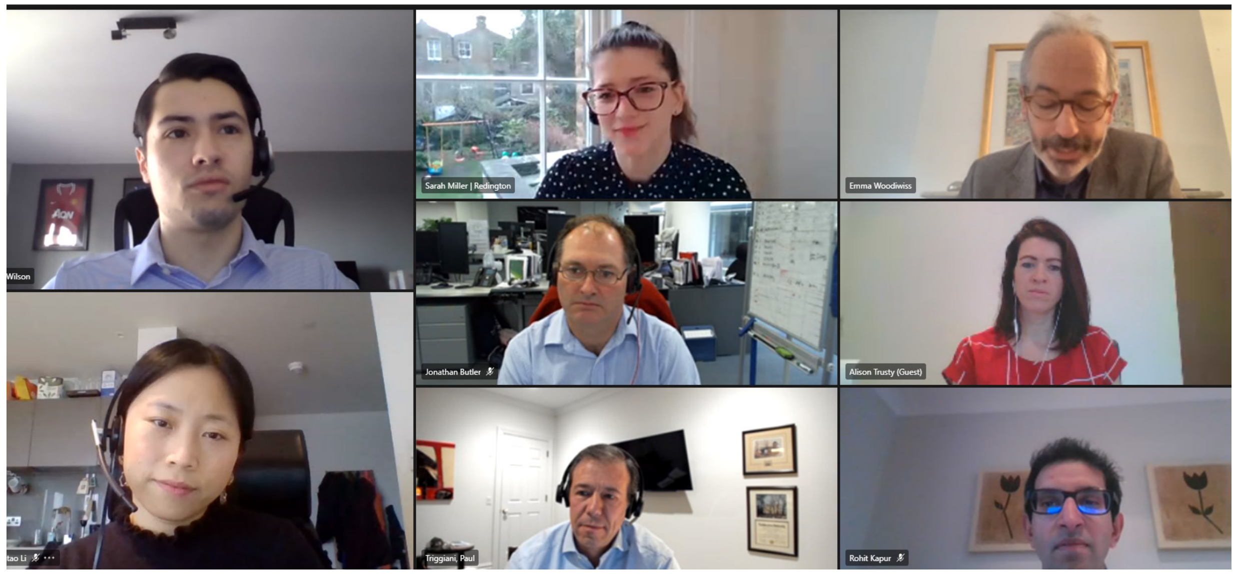
The consultants at the CAMRADATA roundtable were asked if Distressed Debt was more palatable to their clients as part of a wider credit offering.

"Take a step back," said Wilson. "For the last five to ten years Distressed Debt hasn't had the widespread default opportunities required for a standalone distressed-for-control strategy. You'd have been concentrated in retail, shipping and energy. We feel it is natural that the line between stressed and distressed has been blurred; and sensible for these managers to maximise their investible universe."

While he did not believe in imposing unnecessary restrictions on managers, Wilson nevertheless warned that the challenge remained in finding competent managers who can deploy capital successfully across the wide range of areas distressed/stressed strategies cover. Miller agreed. She said Redington was looking for managers specialised in structuring, e.g securing debt against inventory or working capital. "Managers who are still able to have control if everything goes wrong," she said.

Kapur said that the Centrica fund expected its third-party managers to pivot between stressed and distressed. "Playing in all the different markets makes it easier to hit your return target. And it takes market-timing out of the equation," he said.

"Catchy phrases such as "special situations" are back in fashion, as are new terms such as "capital solutions"



Going green

The CAMRADATA panel's final talking-point was ESG. Given the volatility in the US energy sector and its weighting in junk debt, the question was whether Distressed Debt is naturally an anti-ESG strategy. Miller said that it was now very important to model carbon intensity in client portfolios. For UK pension schemes there is a requirement to evaluate and report. "We don't time markets but when you look at recent track records, there has been poor performance where Distressed Debt managers have had large exposure to energy," she said. "Most managers are wary of that sector."

Wilson noted that, while the US has had an "anti-ESG" President for the last four years, a new administration may make US oil and gas more palatable from an ESG perspective. He said that distressed opportunities had been constrained in recent years and Distressed Debt managers have been unwilling to restrict themselves by avoiding oil and gas: "The oil price swings and that can have knock-on effects in a wider portfolio. If you want to play oil, then there are easier ways to make that bet."

He was one of several panellists who said that managers with control of a business can improve its ESG credentials. "I think compared to a lot of other managers, they can have the most influence possible over the company," said Trusty. "I have seen KPIs that include ESG indicators, gender diversity targets introduced and ESG targets put into board members' incentives. That is very different to what I see in other types of investment strategy which purport to engage."

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Regarding ESG, Kapur said that the governance is crucial. "Where Distressed Debt managers have opportunities is where governance has gone wrong; where they can take control, rectifying governance issues, aligning management with shareholders and setting a strategy, that creates value."

"We see Distressed Debt as a positive impact strategy," said Miller. "For example, labour standards can be surprisingly low in private companies – lots don't have minimum requirements or supply chain audits."

Kapur agreed that regarding ESG reporting, private markets have been behind the curve in providing the information now required by asset owners.

Regarding a hard exclusion on fossil fuel energy, Butler said the problem for Distressed Debt is that "we don't choose a sector or company moving into our space. Oil and gas gets dinged by ESG ratings but looking to the future – which is not well captured by sustainability ratings – Butler noted that gas pipelines could be used to transport green hydrogen.

For now, he described oil as a necessary evil, which fuelled not just most of the vehicles we rely on but also powered steel and cement works.

Triggiani was also bullish on selective allocations in oil and gas. "Done correctly, with management we know, we think these are some of the best opportunities around. Even if the oil price drops, we can underwrite interesting returns."

He closed the event with a comment on control: "We don't proceed where we aren't going to get board seats. That's in our thinking and investment process upfront."

Roundtable Sponsor

Paul Triggiani, Managing Director and Head of Distressed Credit

Personal Profile

Paul is focused on credit opportunities, distressed debt and special situations investments. Prior to joining the firm, Mr. Triggiani was a managing director of H.I.G. Bayside Capital, where he focused on control and non-control distressed debt and credit opportunities. Prior to Bayside, Mr. Triggiani was a managing director of Strategic Value Partners with responsibility for distressed and special situations investments in general industrials, oil and gas, building products, homebuilding, infrastructure, gaming and financials. While at Strategic Value Partners, Mr. Triggiani was co-head of US corporate investments and was a member of the investment committee, which approved distressed-for-control and private equity investments.

Prior to Strategic Value Partners, Mr. Triggiani was a partner at Heartland Industrial Partners LP, a leveraged buyout firm focused on industrial companies. He began his career at Goldman, Sachs & Co. as an investment banker in the corporate finance and real estate departments.

Invesco Ltd.

Company Profile

Invesco is one of the world's leading independent global investment firms, solely focused on investment management. With over 8,000 employees worldwide, the firm directs all of its intellectual capital, global strength and operational stability toward helping investors achieve their long-term financial objectives. By delivering the combined power of the firm's distinctive investment management capabilities, Invesco provides a wide range of investment strategies and vehicles to retail and institutional clients around the world. On the ground in 26 countries, the company is proud to manage assets of $1,349 billion on behalf of our clients (as at 31 December 2020).

Invesco offers diversified investment strategies spanning all major equity, fixed income, asset allocation and alternative asset classes. These strategies are managed across various worldwide investment centres, each of which focus on distinct asset classes, investment styles or regional expertise and adhere to clearly defined investment philosophies aligned with client expectations. Each team is able to operate independently, allowing them to follow and further their specific investment style and expertise.

Invesco Private Credit is one of the world's largest private-side senior loan managers with over $32 billion in assets under management[1]. With a preference for senior secured debt, our global investment capabilities include broadly syndicated loans, direct lending, distressed credit, and multi-asset opportunistic credit.

Roundtable Sponsor

Jonathan Butler, Head of the European Leveraged Finance Team

Personal Profile

Jonathan Butler is a Managing Director and the Head of the European Leveraged Finance Team (High Yield and Bank Loans) at PGIM Fixed Income, based in London. Mr. Butler is also the co-Head of the Global High Yield Strategy. He is a member of the board of directors of PGIM Limited, PGIM's UK-regulated business, and assists with developing and implementing the Firm's business strategy in the UK.

Prior to joining the Firm in 2005, Mr. Butler was responsible for establishing and managing NIBC's third-party CLO asset management franchise. At NIBC, he invested in senior and mezzanine loans for financial sponsor transactions (leveraged buyouts). Previously, Mr. Butler held investment positions with Chemical Bank (now JPMorgan Chase & Co.), where he originally received his credit training, and Industrial Bank of Japan (now Mizuho). Mr. Butler received a BA with honours in Financial Services from Bournemouth University, UK.

PGIM FIXED INCOME

PGIM Fixed Income

Company Profile

PGIM Fixed Income is a global asset manager offering active solutions across all fixed income markets. The company has offices in Newark, N.J., London, Amsterdam, Zurich, Munich, Singapore, Hong Kong, and Tokyo. As of December 31, 2020, the firm has $968 billion of assets under management including $415 billion in institutional assets, $197 billion in retail assets, and $356 billion in proprietary assets. Over 900 institutional asset owners have entrusted PGIM Fixed Income with their assets.

Roundtable Participants

Alison Trusty

Senior Investment Consultant

Alison Trusty is a senior investment consultant within the global investment management team, with over 12 years investment experience. At Aon Alison's research focus is on alternative credit, with expertise across both liquid and private debt markets. In addition, Alison is a member of Aon's global private credit group.

Before joining Aon, Alison spent five and half years at Hymans Robertson, a UK Consultancy, where she led the firm's research and advice on hedge fund strategies and managers. Prior to this, Alison worked as a hedge fund analyst at Olympia Capital Management, a Paris-based multi-strategy fund of hedge fund.

Alison started her career at a private wealth management firm where she was co-portfolio manager for the firm's discretionary managed AIM portfolios.

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Shuntao Li

Co-head of Manager Research Team

Shuntao is an experienced senior fund manager researcher. Her responsibilities include researching funds and managers across a spectrum of asset classes including multi-asset, equity and fixed income. She is also a member of Barnett Waddingham's Strategic Research Team that directs the firm's asset class research priorities and views.

Shuntao started her career at Barnett Waddingham in 2011 and is a CFA charterholder.

BARNETT WADDINGHAM
beyond the expected

Roundtable Participants

Rohit Kapur

Head of Private Markets

Rohit is Head of Private Markets at the Centrica Pension Scheme. He joined Centrica in 2017 from Aon Hewitt where he was a senior manager in their Fixed Income Manager Research team covering liquid and illiquid credit strategies. Prior to that, he was a Fixed Income Portfolio Manager at the BMO Financial Group. He is a qualified chartered accountant and a CFA charterholder.

Tom Wilson

Deputy Head of Credit Research

Tom is an Investment Consultant at Isio, specialising in fixed income research whose roles include conducting market research, manager searches and fund monitoring. During his career Tom has played an active role in KPMG/Isio's ongoing research on credit asset classes including secured finance, direct lending, commercial real estate debt and distressed debt. Alongside these research responsibilities Tom also advises several defined benefit pension scheme clients, consulting on their long term objectives, investment strategy, asset allocation and manager selection/implementation. Tom holds a BA (Hons) in Economics from the University of Sheffield and has passed all three levels of the CFA examinations.

Isio (formerly KPMG UK Pensions Advisory) is an independent business which was spun out of KPMG via a private equity buy out process, established as a new firm in March 2020. Isio's investment advisory practice advises clients on c.£90bn worth of assets across defined benefit and defined contribution pension schemes, as well as charities, endowments, high net worth individuals and insurers.

Sarah Miller

Vice President, Manager Research

Sarah works as a Vice President in the Manager Research Team where she has a primary focus on illiquid credit strategies. Sarah joined Redington in July 2019 having previously worked at BMO Global Asset Management and Janus Henderson. She is a CFA charterholder and holds a BSc (Hons) in Mathematics with Psychology from the University of Birmingham

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REDINGTON

Moderator

Brendan Maton

Freelance Jounalist

A highly experienced financial journalist with an expansive network of contacts in the UK and across Europe. Brendan has written about pension schemes and national welfare systems from Finland to Greece for 18 years and understands the retirement savings industry in each European country.
Brendan has interviewed EU commissioners and national ministers; central bankers; pension scheme heads; insurance chief executives; chief investment officers; actuaries; union officials; professional and lay trustees.He worked at Financial Times Business for eight years, finally as editor-in-chief of all international pensions titles. Brendan has spent the last ten years as a freelancer for a number of publications, including Financial Times, Responsible Investor, Nordic region pensions news and IPE. He is also Chief webcast host for IPE. Brendan has acted as conference chair for Financial News, the UK National Association of Pension Funds, Dutch Investment Professionals Association (VBA), Corestone, Insight Investment, Marcus Evans, Robeco Asset Management, Sustainable Asset Management (SAM), Towers Watson.

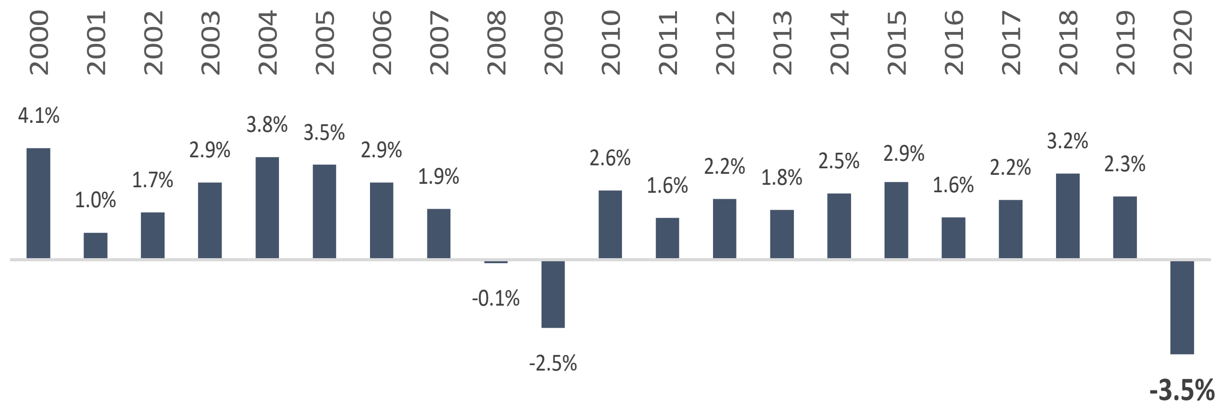
Invesco

Persistence of Small Cap Distress Post-COVID

2020 was an immensely challenging year—one that tested our understanding of how societies and markets respond to an emergent global health crisis. Through the first and second quarters, we saw a historic drop in revenues and earnings across both large and small companies. Global supply chains were heavily disrupted causing businesses to immediately evaluate cost structures and resources. Employers both large and small embarked on widespread layoffs and countries around the world saw a sharp rise in unemployment.

In the U.S., virtually all businesses were significantly impacted; most acutely were those products and services which were not conducive with social distancing behaviors. Unsurprisingly, the debt of these companies saw a steep valuation drop in the first half of 2020 as investors struggled to determine the total economic damage that would result from the pandemic.

Figure 1: US %GDP Change Over Previous Period
2020 Represented Worst U.S. GDP Growth Year in 75 Years



Beginning in June 2020, the U.S. Federal Reserve, in an effort to put a floor beneath the potential economic carnage, announced intentions to support capital markets broadly. The program inspired confidence and catalyzed a corresponding rally in U.S. credit markets as investors perceived a 'Fed put.' As yields for new issuance dropped, larger companies raised record amounts of bonds to secure cheap financing—even in the most COVID impacted sectors. News of vaccine development and distribution further sparked widespread investor optimism in public markets beyond the current pandemic and its economic devastation.
Meanwhile, smaller companies have continued to struggle with revenue and earnings significantly impacted. Unlike larger companies, smaller companies were generally unable to raise liquidity from traditional debt markets. Compounding their pain, government stimulus efforts, such as the Main Street Lending Facility in the U.S., have been difficult for many to access (< 3% usage of facility) due to strict requirements around leverage, ownership and bank risk retention requirements—as an example, virtually all sponsor-owned companies have been excluded from participation due to common ownership restrictions. Unsurprisingly, many sponsor-owned small companies struggled in 2020—we expect a continuation in 2021 with the ongoing pandemic's impact on earnings and further pressure from rating agencies. The debt of these companies exists in private, less liquid, and less efficient markets and remains available at stressed and distressed levels. We have also seen an expanding opportunity set in special situations and opportunistic investments (e.g. rescue financings, distressed asset sales, bankruptcy auctions, etc.). Given where we are in the broader economic recovery, we believe this dynamic is expected and will benefit general partners with flexible pools of capital to opportunistically and creatively structure solutions in an often overlooked segment of the market. Moreover, distressed investment managers, with the expanding support of their limited partners, are beginning to demonstrate interest in Environmental, Social and Governance ('ESG') considerations and we expect they are increasingly likely to leverage their influence in portfolio companies to foster ESG change.
The persistence of the distressed opportunity in small cap and middle market credit is in contrast with large cap where the global rally in more liquid risk assets and their ability to access traditional capital markets has led to the evaporation of opportunities outside of the most COVID impacted sectors.

Small Cap vs. Large Cap Distressed

We define the small cap/middle market distressed opportunity as that of companies with less than USD100mm of earnings before interest, taxes, depreciation and amortization (EBITDA) and/or less than USD1 billion market value of debt. The debt of these companies tends to be closely held across a smaller group of lenders and is typically issued by private companies. We believe there are three important distinctions between large cap and small cap distressed:

1. Inefficiency and Information Asymmetries:

Small cap debt is often to private companies and tends to be held amongst a small group of investors. There is not always an active market in the debt and pricing inefficiencies are common. Market intermediaries and trading desks often have little to no coverage of these companies. Most distressed managers avoid this segment as they look for greater efficiencies in deploying larger amounts of capital into transactions. Small cap investors tend to be a fragmented set of boutique managers.

Large cap debt is public or generally tends to be widely syndicated across a broad base of investors. Consequently, circumstances around the company are typically more widely known and accessible to all interested investors. This debt may be covered by several trading desks which are able to provide extensive company information, in addition to being able to readily source and transact in the debt. There are instances where large cap debt exhibits similar information inefficiencies to small cap, but these scenarios tend to be less common.

2. Evergreen Opportunities:

Small cap distressed opportunities tend to arise from idiosyncratic credit issues irrespective of the market cycle. The credit issues arise in both low and high default cycles and tend to occur for "fixable" reasons (e.g. working capital issues, customer losses, unrealized synergies, operational or manufacturing issues). This dynamic can persist in all environments. In the years leading up to the present crisis, small cap distressed managers, such as our ourselves, were able to deploy capital against attractive opportunities despite sub-2% loan market default rates. This creates a more evergreen opportunity set more suited to a permanent portfolio allocation.

Large cap distressed opportunities tend to be cyclically driven or isolated to sectors experiencing secular shock. This "feast or famine" dynamic leads to opportunity set growth in a recessionary environment with limited opportunities in a benign credit environment. In recent years, many large cap distressed managers have been criticized by limited partners for being unable to deploy capital.

3. Diversity:

Small cap distressed opportunities tend to be diversified across a wide array of sectors. This pattern has persisted through the present instance as we continue to see a diverse pipeline of fundamentally sound businesses which we believe are more resilient and lower risk.

Large cap distressed opportunities have historically required either a change in cycle or a sector shock. As a result of this relationship, opportunities in large cap distressed have been concentrated in specific sectors experiencing the most acute distress.

Conclusion

In our view, small cap distressed credit represents an attractive opportunity to pursue equity-like returns while undertaking credit-like risk. The present dynamic suggests a persistence of opportunities as smaller companies continue to struggle with revenue and earnings amidst the global pandemic. Moreover, given the potential for attractive overall returns in our less efficient, more diverse, and evergreen opportunity set, many of our institutional clients view small cap distressed credit as both a compelling opportunity in the present but also a mainstay portfolio allocation as we look forward past the pandemic.

" The present dynamic suggests a persistence of opportunities as smaller companies continue to struggle with revenue and earnings amidst the global pandemic "

Paul Triggiani
Managing Director and Head of Distressed Credit

Why Now Is A Good Time to Invest in Distressed and Stressed Credit Opportunities

We see a wide range of outcomes across sectors and geographies as we move from a market fuelled with excess liquidity to expectations for economic momentum in the back half of the year. The pivot from liquidity to leverage is a theme that will likely drive returns (and volatility) by seeding both long and short opportunities in the coming quarters and years.

Covid-19 accelerated an investment theme that was developing before the pandemic began. Interest in distressed and stressed credit opportunities has been growing since the Great Financial Crisis (GFC) as global central bank easing and negative interest rates helped to drive record levels of corporate debt issuance and structurally higher default rates. One can look no further than to the record amounts of distressed capital raised primarily in drawdown vehicles before and during the pandemic to gauge investor enthusiasm. Record issuance and lower underwriting standards have driven average default rates in U.S. leverage finance from $4.9bn per quarter between 2010-2014 to $10.2bn average per quarter in the latter half of the decade (2015-2019)[1].

Financial repression has created excesses that are manifesting themselves in a number of ways such that financial risks and distressed opportunities are likely to persist long after the immediate effects of the pandemic fade. Covid-19 pulled forward the credit cycle and created a period of substantial volatility led by cycle high default rates and record low recoveries. While the sprint to herd immunity is easing credit conditions and boosting confidence in re-opening trades, an enormous amount of debt was added over the last twelve months and must be dealt with. If the global economy does not reach the escape velocity required to de-lever said balance sheets, issuers will turn to other means to reduce debt and push out maturities. Weak covenants and poor underwriting standards are well known in the marketplace, but are not top of mind as investors focus on issuers flushed with liquidity and the arrival of spring. The reality is that issuers, industries, and spread sectors are more vulnerable than ever before to deteriorating fundamentals or eroding macro conditions.

> ***"The reality is that issuers, industries, and spread sectors are more vulnerable than ever before to deteriorating fundamentals or eroding macro conditions "***

Keys to Success

We believe that any approach to managing distressed and stressed credit requires three measures for success:

Credit Sector Specialists: analysts must not be late to the party. They must be able to track market developments to find the best opportunities, even those that are not in the public domain. Analysts must be experts in their industries and wear a private equity like hat when assessing idiosyncratic and long-term industry risks. Protecting creditor rights is paramount but the investment must also be underwritten to the underlying intrinsic value which may be shifting over time. Understanding and anticipating problems and closely monitoring businesses proactively is important to determining the art of the possible.

Patience and Flexibility: it's important to be solution-driven, and perceived by companies to be helpful, while having the balance sheet, the capital, and the creativity to craft successful outcomes. Patience is essential to help avoid costly and complex in-court restructurings, and flexibility is required to react swiftly to capture price movements and improve the certainty of positive outcomes.

Scale: having scale provides market access and intelligence to assess various technical factors such as fund flows and supply from capital markets activity. It also brings you closer to key credits and to the market more widely.

Our Approach

PGIM Fixed Income has a deeply resourced global approach designed to capitalise on firm-wide expertise in credit. We source ideas from the over 1500 credits that we currently invest in or follow. Our deep credit platform and breadth of issuer coverage offers our strategy a strong competitive sourcing advantage.

To identify stressed or special situation opportunities, we comb through all global credits we cover, seeking public debt or private bank loans currently trading with outlier yields or depressed dollar prices. Much of the excess return in our credit strategies comes from our ability to capture the opportunity in lower-quality issuers.

Issuers are reviewed with sector managers, and names where we continue to have a strong fundamental view on the credit are further scrutinised. The distressed analyst teams are drawn to credits they expect will have a near-term liquidity event over the next four to six quarters, such as a maturing bond, covenant breaches, a situation requiring junior capital or a credit operating with an overall thin liquidity cushion.

" Distressed debt funds perform well around times of economic stress "

We believe that we are a strong voice in the market given our scale and reputation. Furthermore we have robust relationships with the management teams of a significant number of companies and are often viewed as a solutions provider.

Market Recovery

While the economic recovery is gaining momentum, we expect it to be uneven with considerable dislocation and stress. Certain sectors will hurt more than others, especially discretionary consumer sectors such as leisure, travel, and retail.

Overall, looking ahead, we are constructive and positive on distressed and stressed credits. We still see attractive value across the credit curve in both performing and stressed and distressed loans. The vaccination programme, accommodative monetary and fiscal policies, and liquidity in the system will all help put people back to work. Accelerated inflation is a potential low probability risk, and it is one that we are watching closely.

According to Preqin, distressed debt strategies perform well around times of economic stress[2]. We believe that this period will be no different. But for both distressed and stressed credits, in order to access the right opportunities, investment firms will need to be strongly embedded in the market. They will need to be trusted by management teams, have strong brand credibility, and the balance sheet to really make a difference. We believe that there will be more opportunities ahead, and that we are well positioned to take advantage of them.

Ryan Kelly
Principal and lead portfolio manager for PGIM Fixed Income's Credit Opportunities strategy

[1]. *October 1, 2020 JP Morgan Default Monitor*
[2]. *Julian Falcioni, Preqin "What We Can Learn From Classic-Era Distressed Debt Returns" 14 October 2020*

Meet the Team!

Sean Thompson

Managing Director

Natasha Silva

Managing Director, Client Relations

Amy Richardson

Senior Director, Business Development

Natasha Fletcher

Senior Associate, Client Relations and Business Development

Yasmin McKeon

Associate, Marketing and Events Co-ordinator

Mithursha Kesavan

Database and Publication Support Associate

CAMRADATA

CAMRADATA
5th Floor, 11 Strand,
Charing Cross, WC2N 5HR

+44 (0)20 3327 5600
camradata.com

Join us on LinkedIn

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