The Investment Podcast

Episode 18: The mysterious case of the missing distressed deal
11 May 2022

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Riccardo Cumerlato: On 11 March 2020, the World Health Organization declared that Covid-19 could be characterised as a pandemic.

As the world tried to make sense of the pandemic, a record number of distressed funds hit the road to raise capital in the expectation of an avalanche of investment opportunities. This expectation soon failed to meet reality. We can call it the mysterious case of the missing distressed deal.

This is *The Investment Podcast* brought to you by M&G investments. I'm your host, Riccardo Cumerlato, and joining me today to help solve this mystery are Biliana Sourlekova and Mustafa van Hien, Directors in [the] M&G restructuring and debt solution team. Hello, Biliana and Mus.

Mustafa van Hien: Hi, Ricardo.

Biliana Sourlekova: Hi, Ricardo. Thanks for having us.

Ricardo: My pleasure. Mus, let's start with you. From the beginning, how did the distressed deal go missing?

Mustafa: Sure. When we're considering the distressed debt market, it's important to distinguish between the more liquid parts of the market, like leveraged loans and high-yield bonds, and less liquid parts of the market, like private debt and what we call "special situations." Now, the liquid markets did sell off in the opening period of the first lockdowns. There was some opportunities to buy the debt of good companies at distressed levels, although most investors invested with some caution given the unprecedented nature of the pandemic and the unknowns at the time.

This was relatively short-lived, though, and liquid markets then rallied within a few months as government support programs and central bank intervention reinsured investors. Government support programs included furlough and the landlord moratoriums. Central bank intervention in the markets kept asset prices high and lender and investor support also helped to rally liquid markets through a combination of liquidity injections into businesses and forbearance on covenant defaults of issuers.

As a result, during the remainder of 2020, distressed debt opportunities in liquid markets were limited to companies that were facing challenges pre-Covid anyway, most notably physical retail. On top of that, there were industries are heavily reliant on footfall, such as travel, leisure, and hospitality. Now, the story in the less liquid and less visible part of the market, like private debt and special situations was different. Companies in this part of the market tend to be smaller and are more likely to be starved of capital when credit conditions tighten.

While leveraged loans and high-yield bonds rallied, smaller companies found it a little harder to find capital. Investors with the ability to source opportunities in private debt and special situations, and a willingness to work in a more hands-on way with smaller companies would have continued to see interesting high-return opportunities throughout 2020 and 2021.

Ricardo: Mus, what you're saying is that the distressed deal didn't go completely missing? It was there all the time, but in [a] different form and size than expected. As my kids would say: "spooky." Is it the end of this mystery then? Or do we think that the guess we originally expected, the big public distressed debt here, will make its appearance sooner or later? Biliana, do you want to take this one?

Biliana: Yes. You have to bear in mind all of the factors that kept a cap on distress that Mus discussed have a temporary nature to them. Government support programs such as furlough and landlord moratoriums have started to roll off now, and central banks have indicated intentions to pull back their activities gradually, which may reduce market liquidity, and we may see that knock on to asset prices. In some cases where lenders or shareholders provided support, the businesses or recovery plans in which that support was predicated haven't really come to fruition.

This would be the case in some companies in the travel sector, for example, which have been slower than others to recover for all of the obvious reasons. In practice, this will mean those lenders or shareholders who initially supported them will face another question as to whether or not they can support even further. For some, the answer will be no, and that will necessitate assistance from investors with capital set up for those types of situations. While the impact of lockdowns has largely subsided now, the impact of Covid is still being felt.

Rising interest rates and energy prices, and the sharp increase in the cost of living more generally will unfortunately also cause problems for businesses and households. We very sadly now also have a conflict in Europe and a highly uncertain geopolitical environment, which is already amplifying all of these issues.

The problems caused by inflation and supply chain issues were already being borne out in a variety of idiosyncratic opportunities this year, including the provision of rescue financing for a biomass plant, an events company, a European shoe manufacturer, and retailer, as well as various real estate situations. We had also seen an increase in banks selling portfolios of non-performing loans and assets that they have been forced to take onto their balance sheets.

Mustafa: Yes, I agree, Biliana. In addition to that, the developments in Russia and Ukraine have led to turbulence in debt markets, which have added to these problems, and yields have risen markedly on issuers in a range of sectors. There are some businesses who have historically counted on Russia as a key source of revenue, but who no longer will, and whose capital structures may need to adjust to reflect that. There's also evidence of yields going up on businesses without any direct links to Russia or Ukraine at all, but whose exposure to commodities or energy pricing means they're in need of assistance.

On top of all that, at the time we are speaking, the high-yield and leveraged loan markets are, by and large, still closed to all but the very strongest issuers. If that persists, companies are going to need to look for alternative sources of capital for refinancings and other needs.

Ricardo: Thanks, Mus and Biliana. Yes, sombre considerations, of course. Yes, I can see how these macro events will lead to distress – and to the closing of our missing deal case. Now, Columbo would say: "just one last question." Are there other high-yielding opportunities hiding out there and how can they be tracked down?

Mustafa: Yes. Even absent the recent bump in distress, we've been seeing plenty of opportunities to invest in growth or turnaround situations that offer healthy, risk-adjusted returns. For example, the pandemic has led to a fundamental shift in thinking around the uses of different types of real estate, and this is leading to value opportunities in various markets across Europe. In the last few months, we've witnessed this through the opportunity to acquire retail park assets and a brownfield development scheme, to name but a couple.

On top, bank de-leveraging also continues around Europe, and we have seen opportunities to participate in that through the purchase of non-performing loan portfolios, and also to step into other financing areas where bank appetite is waning, such as the provision of revolving credit facilities. We're also looking at a range of opportunities in what might be labelled "alternative asset classes" that are growing, such as music rights or agriculture.

Biliana: Yes, precisely right. The common theme here is that these are the types of businesses and assets that don't normally attract traditional capital. Then in times of uncertainty and change, such as now, new business platforms arise and the use of assets change, which creates opportunity for those with flexible capital. Then the question is, how would you access them successfully? As well as having a flexible capital mandate, you'd be looking for expert investment appraisal and structuring capabilities and then a deep network of contacts in the market able to connect you with the opportunities.

Ricardo: Thanks, Mus and Biliana. If we wanted to summarise what we discussed about this mystery, we were expecting a certain type of deal, it was the big public distress deal. The pandemic, in fact, led to more special situation distress deals that were still distress deals but a different form, and that they continue to be available today.

The last point is that macro-events and the end of government support suggests that what we were expecting at the beginning, the big public distress deal, might well be coming soon. That's all we have time for in today's episode of *The Investment Podcast*. Biliana and Mus, thanks for helping solve this mystery.

Mustafa: Pleasure.

Biliana: Thanks, Ricardo.

Ricardo: Thanks to you, our audience, for tuning in. I hope you will join us next time. Goodbye for now.

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Speaker 2: For further information, please view the notes which accompany this episode. This podcast is for investment professionals only. The value of investments will fluctuate, which will cause prices to fall as well as rise, and investors may not get back the original amount they invested. Past performance is not a guide to future performance. The information and views expressed should not be taken as a recommendation, advice, or forecast.

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