Distressed Credit

Snapshot

Distressed Credit market update: March 2020

Economic impact of recent events

Over the last several weeks, we have seen increased volatility in the equity and credit markets as investors prepare for significant, material impacts to the global economy from both the now widely spreading COVID-19 as well as the recent price war between OPEC, led by the Saudis, and Russia. We believe the economic impact of the virus spreading is real and will certainly slow global GDP with most analysts and experts expecting a potential contraction in the second quarter. At this point, a mid-year recession appears likely with some pointing to greater than 50% odds of this occurring. Given most experts believe the virus will abate after spiking globally in the coming months, we could see a quick rebound to GDP at the end of 2020 or in 2021. However, with respect to the US, we believe the short to medium term pain will be significant. Supply chains globally have been disrupted, which will impact all businesses and all parts of the economy. In the US, economic activity is far more weighted to the consumer and as a consequence actions such as social distancing, less movement of people, and more time spent at home will all result in a reduction of spending far beyond the expected declines in pure travel and entertainment-related businesses. The impact of the market sell off, which has only begun to give back last year's gains, is pricing some of this slow down into future expectations, but the overall significance is likely to be much greater on a host of derivative industries far beyond airlines, cruises, and hotel and leisure segments. There is good news for the US – the economy should snap back as the virus plateaus over time – the Federal Reserve was quick to act and will continue to take proactive actions to cushion the economic blow, and the government will likely do what it can to implement fiscal stimulus primarily through tax cuts and other incentives. In Europe, where recessionary conditions existed pre-virus, the situation is far more dire. Germany, the UK, and Italy were all already near or in recessionary environments, particularly within the manufacturing sector – and what has happened in Asia with supply chain disruptions, reduced demand across major industrial sectors, and what is likely to be an almost non-existent tourism season – will all combine to produce a more lasting correction. The European Central Bank has limited monetary firepower to stop or mitigate the economic fallout as rates are already below zero and additional, quantitative actions will need to be investigated. Furthermore, Brexit will likely serve to exacerbate the adverse economic impact in the short run.

Oil Markets: In early March, the Saudis decided to both increase production and decrease the selling price of their oil largely in reaction to Russia's refusal to comply with an OPEC desired cut in production – directly punishing Russia with much lower prices today – but also to some extent to diminish US shale production. Over the last 12 months, oil prices have dropped roughly 50% to approximately $30 per barrel making much of the US shale uneconomic and certainly challenging new development in the Gulf of Mexico. Nevertheless, there are a few low-cost producers with better assets and better management teams who have navigated this price environment before. Low oil prices will be painful in the near term for many companies in the sector, and we should expect a material uptick in defaults as a result; however, in a post-coronavirus world, low oil will prove helpful and necessary, and likely help drive a quicker recovery in demand in the exact sectors that will need it most – tourism, travel, transportation, leisure and entertainment, as well as all ancillary services businesses.

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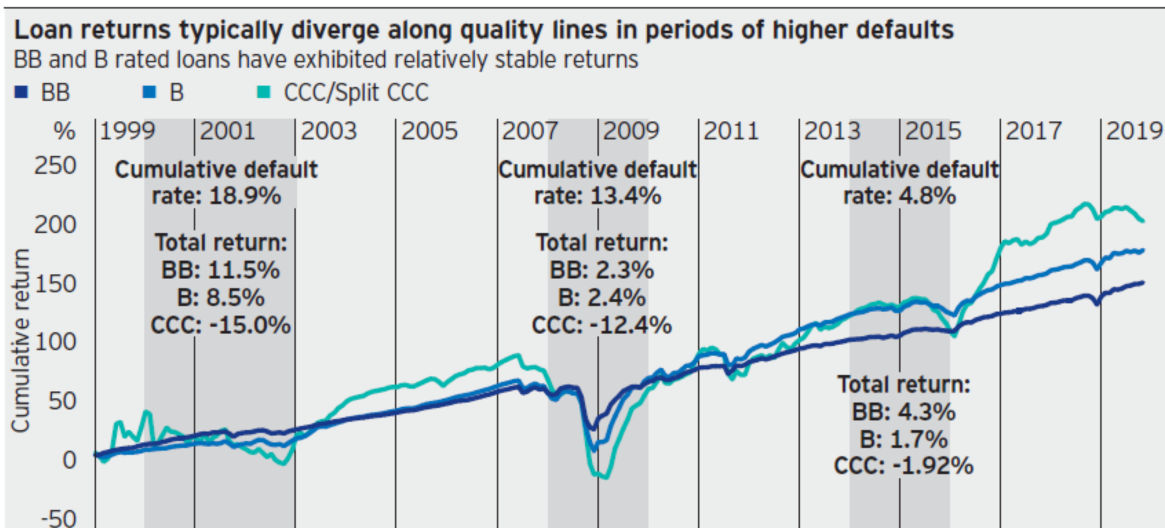
Broadly Syndicated Loan market impact

As global fears of COVID-19 continue to spread, volatility in the broadly syndicated loan market began to pick up in the last week of February, albeit the overall weakness in the loan market looked relatively minor compared to that of high yield bonds and equities. In the first week of March, continued volatility in global equity markets drove liquid loan prices lower overall throughout the week. During this period there were intermittent periods of relative strength in the secondary market, often mirroring the movement in domestic equity markets. Demand continued to be consistent from CLOs, while supply was a bit mixed from retail funds and high yield funds with bank loan exposure. While fears of the outbreak of the COVID-19 continued, the bank loan market also reacted to the decrease in interest rates, with Libor falling 0.60% during the first week of March. (Source: Bloomberg LP, 3/10/19) This rapid drop in rates caused additional anxiety and will directly impact flows out of retail funds.

From a company standpoint, we expect lower rates to have a positive impact on the fundamentals of borrowers as leverage levels should remain manageable, and the interest coverage ratios should improve for high quality issuers. Overall, we expect liquid loans will continue to exhibit relatively low volatility compared to other risk assets given their senior secured status, and relatively strong coupon – even in the face of a rate cut. Even as late cycle pressures and other idiosyncratic and sector specific risks have risen, high quality loans are poised to continue delivering strong coupon income and relatively muted price volatility. This optimism reflects our view that high quality assets are likely to continue outperforming as they historically have done late in a cycle when issuer distress and defaults are rising.



Sources: S&P LCD default rate as of Nov. 30, 2019, historical average of US market covers the periods Jan. 31, 2000 – Nov. 30, 2019. Default Rates based on principal amount. Credit Suisse Leveraged Loan Index as of Jan. 31, 1999 – Nov. 30, 2019. Past performance is not a guide to future returns. An investment cannot be made in an index.

Small Cap / Middle Market Distressed Credit market impact

As expected, a number of small capitalization and middle market loan issuers have come under pressure. Many of them are good companies, with sustainable, long-term business models, and fundamentally sound prospects – however, we are seeing their loans trade off 20+ points. Many smaller companies have limited access to the capital markets, and therefore are much more likely to become distressed due to short-term liquidity issues related to all of the issues discussed above. We are already seeing this opportunity and believe it will accelerate into the second quarter, which we believe will create the best opportunity for broad sector distressed that we have seen in over a decade. Our market is much larger today than in 2008 – two to three times bigger – with fewer broker / dealers acting as intermediaries. There is more volatility and more rapid price corrections as a result. The increase, specifically over the last two years, in single B leverage loan issuance in our target market has been unprecedented – more low quality issuance than we have ever seen – and we are seeing many of these companies on the precipice of downgrade to CCC due to the stress experienced during the last several weeks. As the number of defaults and downgrades increase, many of the structured vehicles that hold these loans will become forced sellers to natural buyers like ourselves. In an already illiquid part of the market, price volatility will continue to increase, and we will have a significant uptick in our pipeline of high-quality distressed opportunities – the traditional "good company, bad balance sheet" investments we all like to make. While these technical

factors are interesting from a sourcing perspective, the fundamental macroeconomic picture will drive the breadth and depth of this opportunity set. To that end, some of the effects of the virus and the recent oil price moves will be felt immediately – but most will play out over the next several quarters. In the short to medium term, the likely contraction in the US and European economies will disproportionately affect smaller companies for all the reasons we have discussed – as the slowdown in economic fundamentals impact revenue, earnings and cash flow, liquidity will tighten and leverage will increase. So for us we will continue to focus on selecting the best businesses in this environmental where the key value drivers are sustainable and protected over the long term with a prudent and measured pace of deployment.

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