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Distressed Credit Can Shine, But Beware Risks

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Investors hungering for outsized returns in a time of pandemic-induced economic uncertainty are taking a close look at distressed credit opportunities - but the attendant risks are considerable, experts warn.

A large supply of public and private companies in distressed and default situations should emerge over the next year or so, according to a recent UBS report on credit market dislocation following the COVID-19 pandemic.

This represents “a unique opportunity” for fund managers specializing in distressed markets “to deploy capital, help companies in a difficult situation and generate attractive returns,” the UBS report, *Opportunities in dislocated credit markets*, said.

Managers are busy raising funds anticipating the coming wave of companies which will need capital as they face bankruptcy or need to pay off debt obligations or restructure, says Eric Bennett, chief investment officer for Tolleson Wealth Management, a prominent Dallas-based firm for ultra-high net worth clients.

“There’s a lot of smart money being raised for this,” Bennet said.

Indeed, UBS estimates that about half a trillion US dollars in credit markets are currently trading at distressed levels, with supplies growing. In the private credit space alone, UBS estimates that around 20 per cent, or $120 billion of outstanding loans, “may require borrowers to seek alternative sources of liquidity.”

As of early June, some 88 companies around the world have already defaulted, according to Standard & Poor. Nearly half fell into bankruptcy and the rest missed interest or principal payments.

Distressed hedge fund and private market managers who trade in publicly listed securities, provide capital when liquidity is in short supply or help companies restructure balance sheets can provide “a good and alternative way to invest in the current environment,” the UBS report said.

Caveats for clients

So what should wealth managers be telling clients?

For starters, an investment in funds specializing in distressed credit opportunities should be limited to high net worth or ultra-high net worth clients who have a high risk tolerance and can afford to have capital locked up for many years.

“The capital invested is illiquid and it could take longer than anticipated to realize a return on that capital,” Bennett said. “Investors and their advisors must understand the strategy of the fund and what time horizons they are anticipating. And they should keep in mind that if a fund says three years they probably mean five years and if they say seven years, it probably means ten.”

Companies with distressed credit also “tend to have lower credit quality,” noted Jay Lee, a private markets strategist for UBS in the Americas and one of the authors of the report. Consequently, distressed strategies “incur a high level of credit risk and potential volatility given the troubled nature of underlying companies and assets.”

Funds that lend to troubled companies in need of refinancing “may not be able to find another lender” for the next round of financing, said Jon Barlow, CEO of Finitive, an online fintech platform specializing in private credit transactions. As a result, the fund may be forced to repossess the assets of the company and have difficulty selling them off at a price that will reward investors.

What’s more, there’s no guarantee that distressed companies which are forced to restructure will complete that process without major problems. Consequently, investors who have tied up their money for a long period of time may receive only mediocre returns.

The economy itself is also a risk factor, said UBS’s Lee. While an economy that rebounds stronger and quicker than generally expected may be good news for most people, “opportunities in distressed credit might not materialize,” Lee noted.

Attractive upside potential
For those investors willing to incur risk, however, the rewards could be sizable.

Successful distressed funds can generate returns of approximately 17 per cent to 20 per cent net of fees, according to Bennett. “It’s a very attractive return profile,” he said.

Middle-market Canadian companies with distress issues that no longer qualify for bank loans from the country’s four largest lenders offer “a very compelling” alternative investment opportunity, according to Barlow.

The lack of lenders competing to make loans to those companies has resulted in higher yields, about 250 to 300 basis points above market rates, Barlow said. “They’re turning to non-bank lending and the spread is widening.”

Distressed cycle opportunities
Investors will have three sets of opportunities during the distressed credit cycle, according to the UBS report.

The first stage of “post-shock liquidation” in listed credit markets, where funds can buy oversold credit at a discount following the COVID-induced economic decline, has largely passed because government and central banks quickly shored up the system with liquidity.

But UBS says “idiosyncratic opportunities remain” in areas not targeted by government spending, including convertibles, collateralized loan obligations and other structured finance vehicles.

The next few months will see increased activity in the second stage of the cycle, providing liquidity to stressed businesses, Lee said.

Fund managers may provide capital to companies in the form of “opportunistic sale leasebacks” or through hard money loans in the form of senior secured loans and/or preferred or convertible equity that offer “higher return potential.”

As the economy recovers in the third stage of the cycle, companies will start to borrow to fund working capital and labor needs and will also consider restructuring. Investment opportunities typically take 12 to 24 months from the start of the downturn to present themselves but “last longer and also present the highest reward,” according to UBS.

Congressional question mark
One of the big question marks hanging over the distressed credit mark is what the US Congress will do in July when it is expected to pass another relief package to aid the recovering economy.

“I think it will have a big impact,” Barlow said. “Depending on the extent of the legislation, the number of defaults could be suppressed quite meaningfully by more loans to businesses and benefits for unemployment. Additional stimulus could suppress the negative impact of a declining economy and further mitigate defaults, reducing the amount of inventory of distressed loans available to investors."

No matter what happens, wealth managers need to make sure that their clients choose distress fund managers carefully.

"Investors need to look for fund managers who are experienced and not just trying to take advantage of the pandemic," Bennett said. "Distressed funds are totally different than other forms of investments." Patience is also critical, he added.

Distressed funds require investors to be ready for a "capital call" when the money is needed - but that could take several years. The pandemic and the damage to the global economy have added "another layer of uncertainty" to the distressed credit market, Bennett explained.

Which fund managers should investors look for?

Distressed private market funds and hedge funds are "best positioned" to identify and source opportunities, provide financing solutions and manage potential downside risks, according to UBS.

"Investors should look for seasoned managers that can invest across the different stages of the credit cycle and are well-versed in different strategies," Lee said. " need a deep understanding of a distressed company's fundamentals, capital structure and operating model as well as expertise in the legal framework."