EXPERT Q&A

Stressed investments that don't require restructuring can prove a rich source of performance, says Adam Phillips from RBC BlueBay Asset Management

Capitalising on special situations in the mid-market

Q Why do you believe that Europe is the epicentre of stress and distress?

Over the past decade, many European companies took advantage of easy money and ultra-low rates to lever up their balance sheets. They then had to borrow more money to survive the covid years, so exited with even more leverage. Companies were then confronted with supply dislocations, war on the edge of Europe, hyper commodity and energy inflation, and the most aggressive rate hiking cycle in a generation.

This meant that many European businesses, and indeed whole sectors, have struggled to revert to pre-covid levels of profitability. Many companies have tried to tough it out, but their balance sheets are showing clear signs of stress, and it is becoming evident that they are simply not engineered to endure a higher interest rate environment. Accordingly, more and more businesses are realising they need to restructure in order to right-size their balance sheets.

The situation has not been helped by the lack of GDP growth at a macro level. Most European countries in the post-covid era have either been in recession or are bumping along the bottom in terms of GDP growth, and this has been the case for the past three to four years. Consequently, there has been a significant increase in the supply of special situations opportunities in Europe, which is why we believe that Europe is the current epicentre of stress and distress globally.

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Q Why is there a focus on the European mid-market, in particular?

We go where the stress occurs, and the reality is that the most stressed part of the market is the mid-market. Mid-market companies are often less resilient in market downturns than larger companies, as they are typically less diversified in terms of products, services and geographical reach. They also have less access to capital markets and are more reliant on bank funding.

As banks tighten lending criteria, mid-market companies are finding it increasingly difficult to raise funding through European banks, particularly if they are over-levered or are showing other signs of stress. Many mid-market companies will need to restructure their balance sheets or find other solutions, and this will create new special situations investment opportunities.

Furthermore, the special situations market in Europe is dominated by large funds. Generally, these funds seek to deploy at least circa €100 million per investment and consequently, in our view, they are forced to focus on companies with larger capital structures. Given that there are a relatively limited number of these bigger structures in trouble at any one time, we believe there is crowding in this area.

There are probably only 10 funds in Europe focused primarily on the mid-market and, given the size of the market opportunity, we believe that competition in the European mid-market is relatively limited. This should allow our special situations team to produce higher risk-adjusted returns.

Q How large is the opportunity set, and how do you source the majority of these opportunities?

We source the majority of our investments from the European high yield and leverage loan markets (€750 billion) and the European banking system (€7 trillion), as well as finding other opportunities from private networks of intermediaries and contacts. The opportunity set is large and broad, and it is continuing to grow.

Many companies and sectors are facing stress, and the opportunity set is likely to last three to five years, as excess corporate leverage from the quantitative easing years is unwound. Our watchlist of potential opportunities is now around three times the size it was two years ago, consisting of more than 300 names across multiple sectors and countries.

Our relationships and networks are crucial to the sourcing of differentiated investment opportunities. As one of the most experienced special situations teams in Europe, with around 120 years of aggregate experience, we have deep relationships within the special situations debt and restructuring communities. We are backed by BlueBay's fixed-income institutional grade infrastructure, and the team's broader research channels, market-leading intellectual capacity and trading capabilities further enhance our proprietary sourcing networks.

Q What is the difference between the opportunity set in Europe versus the US?

The first point worth making is that many European countries are in recession or, at best, struggling with low GDP growth. Naturally, this creates opportunities for special situations investors. The US has a different issue, namely an over-heating problem, whereby the Fed is trying to control inflation through higher rates.

Secondly, the European corporate funding market is dominated by banks, which currently lend some €7 trillion to European companies. This sets Europe apart from the US, where approximately 70 percent of funding originates from the capital markets. Historically, European banks had very large workout departments and were generally reluctant to sell non-performing loans at a discount into the market. The world has changed in this regard and European banks are now not set up to deal with higher NPLs.

The banks do not have the manpower in their workout departments to deal with high volumes of NPLs – they are heavily penalised in terms of the amount of capital that they have to hold against NPLs – and they are actively encouraged to sell problem assets by the ECB to keep their balance sheets clean.

"The largest misconception is that special situations is a high-risk investment strategy"

"The most stressed part of the market is the mid-market"

In addition, as a result of post-GFC recapitalisations, European banks are well capitalised, so they are able to mark down NPLs and sell at market-clearing prices. All of this means European banks are selling NPLs earlier and in greater quantities than they have done in previous cycles.

Q In a challenging fundraising market, special situations appears to be one of the few bright spots. Are you seeing strong appetite, and how should institutional investors think about special situations in the context of alternatives?

It is probably fair to say that special situations investors have generally over-promised and under-delivered for the past 15 years, hence post-covid there was a certain amount of scepticism as to whether a distressed cycle would present itself. However, given the opportunity set that has now occurred, particularly in Europe, investors almost never challenge the assertion that there is a significant special situations investment opportunity. Many investors recognise that they can invest a proportion of their investment portfolios into special situations as a way of increasing returns across their portfolios.

Investors have a reasonably wide range of investment opportunities in the alternatives space, but probably the most common alternative is direct lending. The direct lending market in Europe has exploded over the past 10 years to an estimated size of €500 billion. Generally, we do not think investors necessarily need to make a choice between direct lending and special situations – the strategies are fundamentally different and can be complementary.

However, it is also worth saying that, given that direct lenders have effectively stepped into the shoes of banks in terms of lending to European mid-market companies, we believe there will be an inevitable fallout from the direct lending market over time, and indeed we expect to source stressed and distressed opportunities from the European direct lending market.

Q Do investors have any common misconceptions about special situations, and how do you address these?

Probably the largest misconception is that special situations is a high-risk investment strategy. We would argue that, if executed successfully, this should not be the case. The reason for this is that most of the time we are buying into company debt stacks high up the capital structure at significant price discounts to par. Most of the investments we make have security either on the underlying operations of the business or on real assets such as real estate, inventory or receivables. Hence, the vast majority of the time, investments have downside protection that underpins the investment in a downside scenario.

It is also probably fair to say that special situations investors do a different level of investment analysis to other parts of capital markets. These investors not only perform deep-dive analysis on the fundamentals of a business, but they also undertake rigorous analysis on corporate and capital structures and take legal advice on the legal position of underlying instruments, as well as understanding the process risks involved in restructuring companies in different jurisdictions. Therefore, the levels of understanding on underlying businesses, corporate structures and legal remedies are far higher than in equity markets or general corporate credit markets.

We will only invest if a particular investment displays the right characteristics in terms of risk versus reward and downside protection. This targeted investment approach can achieve an attractive risk-reward balance.

Q What are some of the keys to sourcing opportunities and getting the analysis right?

We are well placed to source differentiated investments through the proprietary networks of our team and BlueBay's wider relationships within the investment community. As a well-known name in the market, we are often a first port of call for investment ideas, and within BlueBay, a collaborative mindset means investment ideas are shared between teams.

The senior members of our team each have over three decades of experience within the special situations market, and they have built a wide network of contacts with restructuring and turnaround advisers, restructuring lawyers, insolvency practitioners, M&A advisers, investments banks, brokers and other intermediaries. These networks not only help to source potential transactions, but enable discussions with advisers, lawyers, industry experts and other contacts, which gives us an edge over less experienced and less well connected competitors.

Within the opportunity set, we apply rigorous analysis to identify the right deals with the right returns, and we have decades of experience across multiple default cycles. Our deep, fundamental research-orientated approach focuses on rigorous bottom-up selection of single-name corporate credits, while taking into account ESG factors and integrating ESG risks.

Q Are there any deal types or sectors that are especially prominent?

Part of the appeal of the special situations opportunity set is its breadth. Many mid-market companies borrowed too much money pre- and post-covid and are now suffering as a result of supply disruptions, higher costs, reduced profitability and higher interest rates. Many of these factors have affected a variety of different sectors, including real estate, cinemas, retail, chemicals, paper and packaging, manufacturing, telecoms, and food, among many others. We are seeing a mix of stressed, distressed and refinancing opportunities. So, generally, there is a very broad opportunity set and no prominent sector or deal type.

Q Is buying a business out of administration a good source of deals?

A sub-strategy of special situations is distressed private equity, where investors can buy assets of a company from an administrator in a 'business and asset sale' and leave the liabilities on the old balance sheet behind. The aim is to restart the business and create a private equity investment at very cheap multiples. Therefore, these types of deals can be very lucrative, although the potential returns are offset by somewhat higher risks and the amount of time it takes to execute and manage these types of investments.

Consequently, distressed private equity deals are likely to be a lower proportion of the book relative to stressed, distressed and rescue financing deals. ■

Adam Phillips is managing director, head of developed market special situations at BlueBay