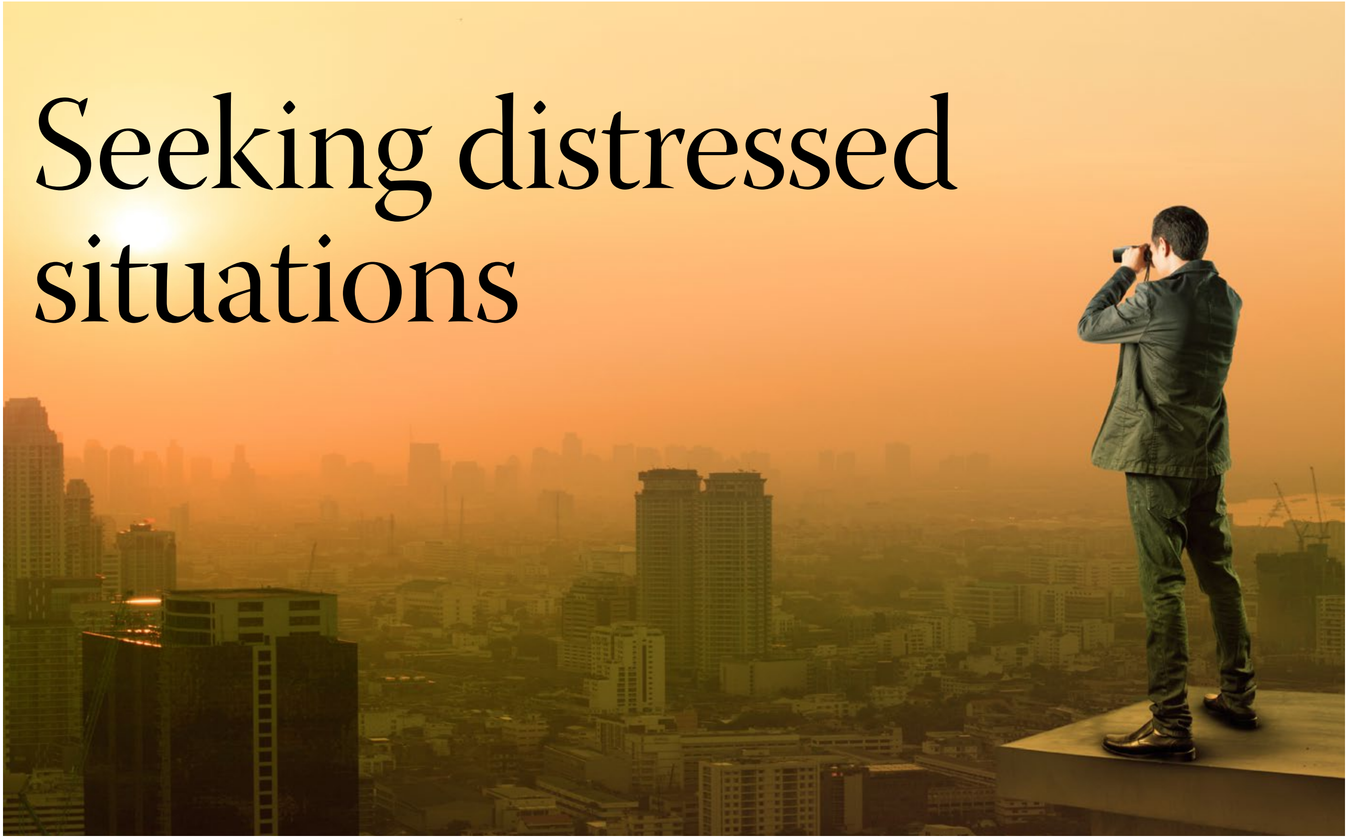
Seeking distressed situations



Alt Credit Intelligence investigates the stressed and distressed opportunities that are getting managers excited

By Sophie Segal

The distressed cycle in US corporate credit remains several quarters in the future. Given the search for yield among credit investors, some funds are putting capital to work where they spot attractive returns.

With global growth around 3% for 2015, a global recession may remain distant. However, as Chinese growth slows reducing the demand for commodities, emerging markets have started to show signs of stress.

"In countries with more commodity exposure, you'll see a continued trend of distressed corporate debt and restructurings," says Regina Borromeo an analyst at $69bn Brandywine Global, which manages about $52.8bn in fixed income.

"At the same time, there's so much corporate supply in hard currency, and the strong US dollar has been a hindrance. Many of the larger emerging market credits that are distressed are quite linked to their sovereign risk."

While some distressed opportunities have begun to emerge in US corporate credit in sectors such as energy and commodities and also in retail, but prospects in countries such as China and Brazil are also on investors' radar.

"The opportunity set has gotten larger over the last three to six months, so it's created a lot of thought generation," says one $11bn New York distressed manager, who expects to generate decent returns with existing positions in Argentina, GSEs and structured credit.

Stressed in the US

While the US economy is not in recession – interest rates are rising, the county has near full employment and GDP remains steady, albeit slow – certain industries are clearly stressed. Energy has been hard hit over the past year with some related bonds trading at extremely low levels – some as low as the teens.

Last month, it was reported that $27bn Boston-based Baupost has started to purchase distressed corporate debt both within the energy complex and non-energy commodity businesses.

"The more cyclical parts of the economy – such as energy, metals and mining and industrials – already appear to be in a profits recession. We may see that sector be a drag on GDP growth, at least over the next several quarters," says Trey Parker, a portfolio manager at $20bn Highland Capital Management.

"From an interest, liquidity, balance sheet, and maturity perspective, we don't believe there's a mass precipice of defaults on the near-term horizon," he adds.

In addition to metals and mining, Parker says the Dallas-based manager is noticing dislocation in technology, media and retail and has started to put capital to work in these sectors. He characterises most of these scenarios as stressed rather than distressed, though the returns sometimes resemble those expected of the latter.

For instance, he says that liquid stressed and distressed bonds over a three-year period yield about 20% returns in the base case. "We think there are equity-like returns in distressed debt and you don't see that everywhere. If you have the right capital, and you can withstand some volatility you can find some attractive opportunities right now."

Highland views stressed and distressed credit as an important strategic approach. He also notes that risks are higher with this type of strategy, but that the firm has seen this play out in past cycles and is prepared to take advantage of the opportunity.

The $11bn New York-based credit manager says that as the firm started considering opportunities in emerging markets, it started to identify more attractive trades in the US.

"At the same time that things started to get interesting, we saw things trading off in the US and we decided to prioritise US names and US law," says a portfolio manager from the firm, which has a mandate to invest in a range of credit strategies including special opportunities, distressed debt and structured credit.

Seeking distressed abroad

When Argentem Creek Partners completed the spinout of its $500m emerging markets credit business from Black River Asset Management in December, CEO Daniel Chapman noted that emerging market corporate credit had grown to $1.6trn, with a 20% compound annual growth rate over the last decade across more than 30 countries with different laws, regulatory environments and disclosures. "We believe that these factors, coupled with recent emerging market distress, have created abundant investment opportunities," he said.

The emerging markets fund invests in distressed debt and special situations, and is looking to raise an additional $1bn in 2016.

"Emerging markets corporate credit represents a large and inefficient asset class with fewer participants today than five or more years ago as banks have curtailed their proprietary trading desk activities and, as a result, we have observed that market liquidity has diminished materially," Chapman added.

The company said that distress driven by weak currencies, weak commodities and negative asset flows in emerging markets will lead to stressed and forced sellers, providing attractive long-term investment opportunities.

KKR also announced in January that it would seek distressed opportunities in China in anticipation of real estate defaults to rise in the region.

The $98bn credit manager said it would partner with China Orient Asset Management (COAMI) and China Orient Summit Capital (COS Capital) in search of Chinese non-performing loans (NPLs), a market which is estimated to be worth $180bn. Most of these are real estate NPLs, according to KPMG.

The need for local expertise is important, however. KKR, which operates strategies across the credit spectrum including special situations and opportunistic credit, will provide its investment expertise and Chinese network, while COAMI and COS Capital will source deals and manage investments.

Brazil heats up

The Brazilian NPL market has already started to attract large funds such as Baupost, Fortress and Elliott, according to one source *ACI* spoke with.

"Now is a pretty good entry point, given historical valuation of the real over the dollar over the last 10 years. It's at a historic low, which, if you have a seven-to-10-year investment horizon long term, it makes a lot of sense," says Brunel Advisors CEO Daniel Rummery.

After significant growth of the credit market over the past 10 years, in 2015 the economy started to slow as interest rates and inflation both rose. This, combined with the gradual introduction of Basel III regulation, has resulted in a liquidity crunch for the banks, and need to dispose of NPLs .

"We see much more investment interest from US and Europe into Brazil for this highly distressed non-liquid market rather than the public markets," says Rummery.

Rummery, who advises foreign investors in Brazil, adds that three to four years ago, when Brazil was really taking off, there were a lot more end investors such as US pension funds investing in Brazil. "These days, there are many much more family offices or large US distressed funds," he says noting that the pension funds have virtually disappeared. One concern for fund managers is currency risk. Rummery says these funds target a 20% to 30% return and hedge the currency risk at a cost of about 10% to 11%.

Many banks, including State-owned Caixa Econômica Federal and Brazil's development bank BNDES, sold NPL portfolios last year. But also the large privately owned banks have become more active too. Jive Investments, which is the largest independent investor of Brazilian corporate NPLs, manages a $752m portfolio. In July, the firm, which targets a 30% internal rate of return, closed $130m fund composed mostly of family office investors. Jive has pursued corporate NPLs since it was established in 2010, but the mandate was recently expanded to include distressed and special situations, which includes distressed real estate and claims.

"Opportunities in corporate NPLs will increase because of macro issues and banks needing to shrink their balance sheets. On the distressed side, claims that we wouldn't have had access to buy earlier in the cycle for the returns that we target are now available," says Manuela Lanageria Kayath, a partner at Jive Investments.

Real estate loans offer attractive returns for knowledgeable investors, partly because the market is in trauma. Due to the availability of debt, real estate grew from 3% GDP to 10% of GDP over the past decade, according to Ken Wainer, managing principal at VBI Real Estate, a local firm that provides debt to Brazilian real estate developers.

But with the banks pulling out as lender, debt is scarce. "Our primary theme on the credit side has been stepping in and providing funding to orphaned developers. We fill in the gap," says Wainer, who has raised about $870m in equity commitments since 2006.

VBI Real Estate targets returns with a fixed coupon in mid-20% in Brazilian reals, with profit participation. "Returns on being a lender are better than equity because of the scarcity of bank lending at the moment," he says.

> "If you have the right capital, and you can withstand some volatility, you can find some attractive opportunities right now"
> **Trey Parker, Highland Capital**

Long-time investors in Brazil agree that the overhaul of the bankruptcy process in 2005 has made investing more secure for creditors. However, several investors agree that the application of bankruptcy law in a restructuring still remains a concern.

"There are a lot of idiosyncrasies to the law and how it's interpreted by local judges," says Wainer. He emphasises the importance of having local partners in certain jurisdiction.

But when it comes to investing in distressed assets abroad, the ability to recover investments will play a big part in investors' decisions to get involved in a given market. KKR has chosen to partner up in its pursuit of Chinese NPLs, while Jive and VBI Real Estate are betting on their local expertise.

But despite the attractive opportunities abroad, some managers still prefer to stick to home soil. As the New York firm put it: "We're more comfortable with US law if we're looking at distressed debt."

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