ALCENTRA

The great de-coupling

Europe may not be in recession, but there's a huge opportunity in distressed credit right now, says Alcentra chairman & CEO **David Forbes-Nixon**. Here's why

Left to right: Laurence Raven, Sam O'Connor, David Forbes-Nixon, Paul Hatfield, David Wallace, Amos Ouattra, Eric Larsson

Founded in 2002, Alcentra is one of Europe's longest-established private debt managers, with a focus on sub-investment grade credit. Since its early days, it has grown to become a global firm with offices in New York, Boston and Dusseldorf and representatives in Singapore and Hong Kong, although its headquarters remain in London. The firm now has 127 professionals globally, of which 65 are investment professionals, and of these, 40 are based in Europe.

Of its approximately $28 billion of assets under management, 58 percent is dedicated to senior loans and 11 percent to high yield, but the fastest growing area for the firm is credit alternatives, says the firm's chairman, CEO and co-founder, David Forbes-Nixon.

Currently accounting for 31 percent of the firm's AUM, credit alternatives includes structured credit, direct lending, multi-strategy and special situations. It's this last part of the credit alternatives space that Forbes-Nixon is particularly excited about in today's market.

It's easy to see why: "Our global special situations strategy achieved net performance of 23.4 percent in 2015," he explains. "That was one the one of the top performing distressed credit strategies globally, against a backdrop of an average performance of distressed credit in the HFRI Event Driven Distressed/Restructuring Index of -7 percent in 2015."

Forbes-Nixon says I view this strategy "as one of the biggest opportunities of my career" because of a unique set of circumstances globally, which is leading to investor demand for alternatives, and with the European market offering particularly promising investment possibilities. We spoke to him to find out more.

Q Let's start with the picture for investors. Why do you think we are in a unique situation currently?

Forbes-Nixon: "There are a number of factors converging that make today's macro picture unique and therefore challenging for CIOs of institutional investors. First, we have low to negative interest rates on a global scale. This has been brought about by unprecedented government intervention as central banks have embarked on a course of quantitative easing. And, while we've seen moves in the US to shift interest rates upwards, this is likely to happen slowly and in Europe, interest rates will remain very low for some time yet – after all, in some countries, such as Belgium and Denmark, we're even seeing negative rate mortgages.

"At the same time, we have a modest return outlook for the major asset classes, with increased correlation and volatility.

This is a reflection of the inter-connectedness of global markets apparent today as the world feels the effect of longer-term issues, such as a slowdown in Chinese growth and increasing geopolitical risk, plus, in the shorter-term, the prospect of Brexit and a US election in November.

"If we look at the traditional 50:50 bond:equity split apparent in many institutional portfolios historically, the returns seen over the last 30 years are very unlikely to be replicated over the next 20 years. A recent McKinsey Global Institute report, "Why investors may need to lower their sights" bears this out. It found that total returns in the US and Western Europe between 1985 and 2014 were significantly higher than the long-term averages for bonds and equities. These were driven by a sharp decline in interest rates from the 1970s peaks, a rise in productivity and strong global growth, driven in part by the rapid growth of China.

"The Institute concludes that this era is over and that equity returns will be 1.5 percent to 4 percent lower in the coming 20 years and those from bonds 3 percent to 5 percent lower. Leading academic, Elroy Dimson, has also forecast lower returns from the traditional 50:50 split. His view is that real returns will be as low as 2 percent per annum."

Q So what does this mean for CIOs?

"It means that traditional asset allocation models just won't deliver the returns that meet investor needs. It's why we are seeing some of the most sophisticated investors in the world making some of the most radical asset allocation changes in history. They are shifting their assets from fixed income and equities into private equity, private debt and other alternatives and, at the other end of the spectrum, they are seeking out liquid assets and cash to give them optionality in their portfolios.

"If we are looking at a future where traditional asset classes return an average of 2 - 4 percent, I really believe that private

David Forbes-Nixon

debt is part of the solution – it can offer both attractive risk-adjusted returns and absolute returns.

"The other point is that it can achieve those returns with low correlation to many other asset classes and low volatility – US Treasury bonds, for example, show annual returns of 5.7 percent over 10 years, with 7.3 percent volatility; the HFRI Event Driven Distressed/ Restructuring Index has an annualised return of 10.5 percent with a 6.5 percent volatility from January 1990 through March 2016. This provides investors with a rare opportunity for diversification in an increasingly correlated universe of investments."

Q Why do you think Europe is particularly promising for special situations?

"I think it's one of the best opportunities today for a number of reasons. Historically, the best distressed situations have tended to emerge during recessionary periods. Yet in Europe, that link has been de-coupled. Europe is currently growing at a mildly positive rate and its recovery is around three to five years behind the US, but there are multiple sources of opportunity to invest in debt at distressed prices and returns.

"We've only had quantitative easing for around 18 months and I would expect that to run for another two to three years. These low interest rates, plus the low oil prices and weak currency mean that there are the right technical factors in place to support economic growth.

"Yet we're also seeing the start of a long – and hefty – deleveraging process among European banks. While banks in the US deleveraged pretty quickly in the aftermath of the financial crisis through asset sales, European banks are only just starting to get to grips with this. Over the last few years, many bank CEOs have been replaced with a mandate to reduce costs by lowering headcount, selling off non-core assets and reducing lending.

"This is a big job for European banks – their balance sheets doubled in the 10 years running up to the crisis and, when the economy in Europe failed to recover quickly, non-performing loans became an increasing share of their lending books. In Europe, you now have between 8 percent and 10 percent of loans that are non-performing. Compare that with the US, where the figure is closer to 2 percent and you can see the opportunity.

"PwC analysis in the report "Capitalizing on the Acceleration in Bank Restructuring, 2016" suggests there are still €2 trillion of non-core assets in European banks, around half of which are non-performing. A combination of QE and the regulatory pressure applied by Basel III will lead European banks to recapitalise and sell non-performing loans over the coming years."

Q Bank deleveraging aside, what other distressed opportunities are you seeing in Europe?

"There is also a big opportunity to come out of lower-rated debt. The last few years have seen a huge growth in CCC-rated bonds – issuance in 2013 exceeded all previous records in Europe – as investors have been forced by low interest rates and European Central Bank bond purchasing to seek yield through higher-risk strategies. At the same time, leverage ratios and purchase price multiples are up to, or even beyond, pre-crisis levels.

"We are clearly in the later stages of the credit cycle – we've already seen huge volatility following last summer's fall in the

Chinese stock market, which spread to other public markets in the following weeks and has continued through to this year. Many bellwether issuers are now trading well below par. Abengoa, for example, was a large and frequent issuer and last June, was trading above par; by the end of 2015, it found it couldn't access the market and is now trading at around just 4 cents.

"In addition, European borrowers are facing a huge maturity wall. There is €345 billion worth of European leveraged loans and high-yield bonds up for refinancing between now and 2022. Yes, we saw and talked about this post-crisis, but the situation in today's market is very different.

"Up until recently, the market has been open to 'amend and extend' and so the can was kicked down the road by a few years. However, the volatility we've seen over the last nine months means that won't happen this time. Rising rates over the next five years will increase default rates as we believe some companies will fail to grow into their capital structures or be unable to refinance."

Q You're also looking at CLOs, aren't you? Tell us how you view these as an investment opportunity?

"Yes, legacy CLOs are another big story for us in Europe. Over the last 12 to 18 months, we have started to see a wave of pre-crisis CLOs (or CLOs 1.0) call or liquidate – in 2015, there were 30 and so far this year there have been eight. That compares with just six in the whole of 2014 and five in 2013.

There remains just under €30 billion of outstanding CLO 1.0 to amortise between now and 2020. We're interested in these because it's generally the weaker credits left in these CLOs towards the end of their lives. Many of the traditional buyers of CLOs, such as BDCs and hedge funds, are now out of the market, so the competition is limited.

"Knowledge and understanding of these CLOs are also limited compared with those in the US, given that they are often privately rated in Europe and the number of obligors is usually much lower per CLO than in the US. This means that pricing of these CLOs is highly inefficient. There is therefore a big opportunity for a player such as Alcentra to drill into the portfolio and figure out which are the best opportunities. We have a deep bench of analysts who are industry focused and product neutral to draw from."

Q What is your sweet spot for these deals?

"We are targeting special situations in Northern and Western Europe, with a particular focus on the UK, Ireland, Germany and the Netherlands, plus parts of Scandinavia. We don't do real assets or large portfolios of non-performing loans – we focus on specific opportunities in stressed and distressed corporate loans and bonds.

"We particularly like senior debt in companies that have been through a restructuring, where the junior debt and equity have been wiped out so as the senior debt holders we own the company, can focus on capital preservation and work to turn the business around. Following this strategy, since 2008 we have generated returns of 17.8 percent gross IRR and 2x gross multiple (14.8 percent and 1.5x net of fees)] – that's highly attractive in a low interest rate environment."

Q What do you think the challenges are in targeting this part of the market?

"I think one of the main challenges for many in European special situations is getting access to deals and being able to get them at the right price. Many of our competitors don't have a long history in Europe – of the 12 largest players in sub-investment grade credit, we are the only ones with London headquarters. We have boots on the ground – we have 90 people based in Europe, made up of 12 nationalities – and we are the most experienced European team. In addition, in many mid-market deals there are white lists, so that means some investors (such as US and, or mono-line distressed managers) are automatically shut out of deals.

"The other key point about Europe, especially when compared with the US, is that there are many different jurisdictions. Some of them are more creditor-friendly than others, which is why we focus on Northern and Western Europe, where bankruptcy and insolvency codes are less challenging for distressed debt investors than in Southern Europe. We have three dedicated lawyers at Alcentra, including a bankruptcy lawyer, and that means we can navigate the jurisdictions with confidence. Indeed, we spend as much time on the legal analysis as we do on the credit and cash flow analysis.

"Those without locked-up capital will also find it a challenge to target these special situations. This is an important factor when you consider our key targets, which are less liquid situations – we need three to five years to turn these businesses around and create value."

Q Why do you think Alcentra is well placed to take advantage of the opportunity?

"'Well, we have a 15-year track record and our professionals have been through previous cycles – that counts for a lot. However, I think our proprietary sourcing and information in Europe give us a big edge. We estimate that our firm has committed capital to around one in three leveraged loans and high yield bonds in Europe over that 15-year period, which means we have a huge amount of information on those deals in-house that we can share between teams and this is information that our potential competitors just don't have.

"Plus, of course, we can draw on the breadth and depth of our team and experience, particularly in Europe – we have eight dedicated team members working on our special situations strategy."

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