

EUROPEAN SPECIAL SITUATIONS OUTLOOK

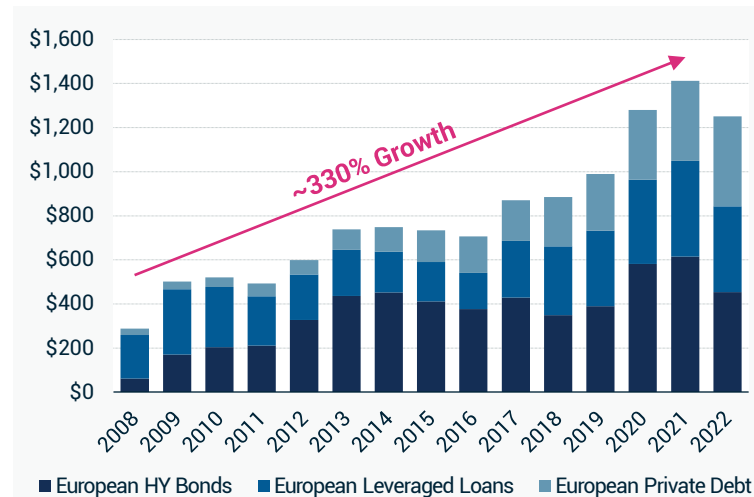
With the cost of debt rising and a maturity wall looming, opportunity is knocking

Introduction

Eric Larsson and **Laurence Raven**, portfolio managers and co-heads of special situations for Alcentra, offer their answers and thoughts on the European special situations market.

From the Great Financial Crisis (GFC) until 2022, a decade-plus of extraordinarily dovish monetary policy and ultra-low interest rates fuelled an explosion of leveraged finance, with European sub-investment grade market quadrupling in size, to US \$1.2 trillion.

European Corporate Credit Market¹



In 2022, central banks slammed the policy brakes to cool off scorching inflation, raising interest rates at an unprecedented pace. As economic growth slowed and borrowing costs surged, banks pulled back, either unable or unwilling to lend, and the new financing market essentially shut down. In Europe, high-yield and leveraged loan issuance fell 78% and 56% year-over-year, respectively. Valuations came under pressure and financial performance began declining, dramatically in some sectors. Credit spreads widened, and default rates, a lagging indicator of economic activity, started to rise. In July, Fitch Ratings forecast that European default rates will rise significantly in 2023 and 2024, with a massive maturity wall of nearly €300 billion looming in 2024-2026². With leverage levels at their highest point since the GFC, refinancing will be more challenging for many and likely impossible for some.

That's the bad news. But there's good news, too: the opportunity set in European special situations credit is gearing up to be as fertile and attractive as it has been since the GFC, in our view. In this new, higher-rates-for-longer reality, we believe the opportunity to provide liquidity, work with companies to recapitalise their balance sheets at attractive valuations and take advantage of temporary dislocations in the secondary market will likely surge. Meanwhile, loan documentation and economic remuneration will likely become more favourable for opportunistic credit investors, providing what we see as a very strong balance of risk and reward potential, complemented by strong running yields and the upside typical of equity markets.

Setting the Foundation

How does the opportunity set today differ from past credit cycles?

The sheer size and diversity, combined with the valuation at which you can access it, makes it the most attractive it's been since the GFC (the first few months of COVID-19 excepted). The opportunity set is broadly diversified across a wide range of geographies and sectors, including some historically considered defensive such as telecoms and food producers, which is highly unusual. During the expansion phase, ultra-low interest rates have encouraged borrowers to take on additional debt, while documentation has grown significantly looser. Now, the cost of financing has essentially doubled in the last year or so. With banks pulling back and a wall of debt maturities on the horizon, we believe companies will react differently as they face their troubles. In the absence of maintenance covenants forcing borrowers to engage with their creditors earlier, many will wait until the latest moment to engage, often from weaker financial positions, which we believe will lead to elevated levels of distress and transaction opportunities for capital providers at lower valuations. As a result, we believe those with capital available to invest in such opportunities will be presented with favourable technicals over the next few years.

Views expressed as of November 2023

¹ Source: Private Debt: Preqin, European Data retrieved as of December 2022. Private Debt includes Direct Lending (Senior, Unitranche, Blended/Opportunistic, Junior/Subordinated, Mezzanine) and Private Debt Fund of Funds. Leveraged Loans: Market Value of Credit Suisse Western European Loan Index, High Yield Bonds: Market Value of CE BofA Euro High Yield Bond Index.

² JPM European Leveraged Finance Capital Markets Update September 2023.

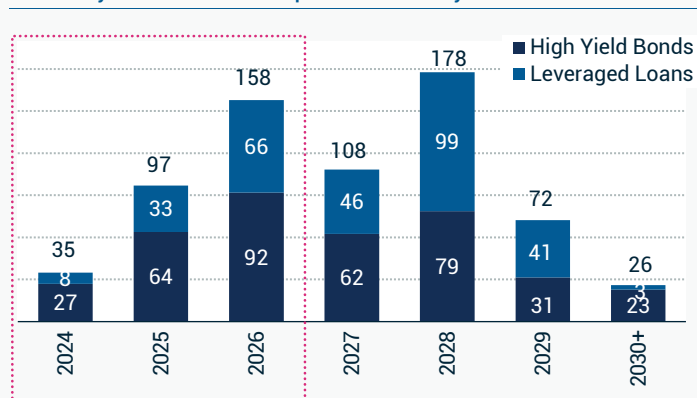
How big is the opportunity set?

In the actively traded secondary market for leveraged loans and high yield bonds, the opportunity for stressed and distressed credit in Europe stands at approximately €120 billion, twice as big as the pre-COVID average. This data excludes the private credit market, where we expect similar dynamics to unfold over time. We believe the size of the opportunity set will continue to grow as companies report weaker performance and approach scheduled maturities. We expect to see economic fallout from the dramatic increase in global interest rates, regardless of whether economies fall into recession, and that will lead to an increase in the supply of opportunities in our market. In a way, it is already here: we can construct a diversified portfolio of c. 30 senior secured loans and high-yield bonds, with an all-in return of around 20% and a running yield of 8-9%. We have not seen that type of opportunity set in the last 10-plus years.

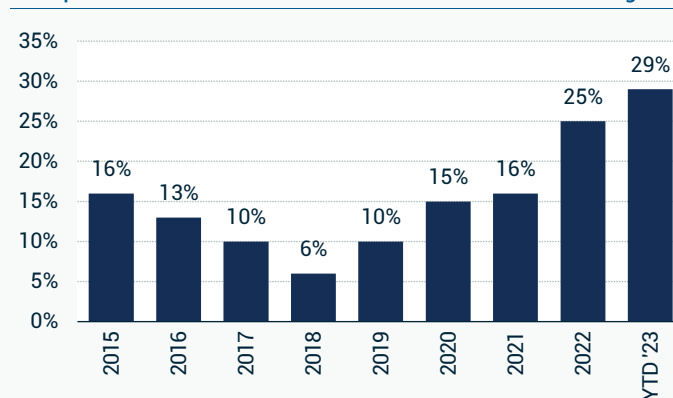
How long do you believe this window will last?

The maturity wall is a multi-year issue, and we are in the early stages of tackling it. Companies have issued record amounts of debt, and there are going to be a lot of people looking to refinance under challenging conditions. We believe the macroeconomic drivers of the opportunity – the higher interest rates, the volatility, the myriad impacts of deglobalization – will likely be with us for at least the next 3-5 years.

Maturity Profile of European Currency Bonds & Loans³



European HY And LL 3-Year Maturities at 8 Year High⁴



Why is the asset class so attractive right now?

“Good company, bad balance sheet” is an oft-used phrase in our business. Today, we believe it is spot on. In today’s environment, companies are usually stressed because they have borrowed too much, not because of management underperformance or structural changes in an industry. The businesses themselves, in most cases, are in pretty good shape. We can work with a company to fix its balance sheet – that’s what we do. An investor can buy senior secured debt in companies with a claim on the company’s assets at a loan-to-value of roughly 40% to 45%. You either get repaid at par, if the borrower successfully deleverages or refinances the debt, or you use your claim to recapitalize the balance sheet. We regard current valuation levels as very opportunistic. In our view, you won’t find many other asset classes where you can be senior secured, create companies at a 60% discount to what people thought it was worth just two or three years ago, and yet still have a targeted internal rate of return (IRR) at equity-like levels of 15% to 25%.

What is the difference between the opportunity set between the US and Europe?

The war in Ukraine, given its impact on the cost of energy and other raw materials, and the nature of fiscal support in Europe are the key differences. There’s a lot of uncertainty around Ukraine and energy prices, and it’s very difficult to project an endgame for either issue. Europe’s inflationary problems are much more cost-driven than in the U.S., where it’s been more driven by consumption. As a result, the European Central Bank’s efforts to tame inflation may come at the expense of suppressing further what are already depressed levels of demand. We’ve already seen several major European economies, including Italy and Germany, move into recessionary territory, and many others are teetering on the edge. Still, we believe the opportunity set and return potential in special situations would likely expand in the event of a prolonged, deeper recession.

Beyond this, we believe, that especially for local investors, Europe is a more attractive market than the US for several reasons. First, given the private and relationship-driven nature of the European market, it’s harder for most investors to find and access many of the most attractive opportunities. This contrasts with the US, which tends to operate more as a level playing field, with investors benefiting from a more uniform access to information. As a result, information symmetry drives more efficient pricing, whereas in Europe it is commonplace for some investors in the same deal to be “more in the know” than others. Then you need to overlay the fact that Europe runs across multiple jurisdictions, with multiple languages and distinct business cultures. Relationships and networks are key. Also, the transferability of loans is commonly restricted by ‘white lists’ of approved purchasers, which seek to exclude those investors deemed too aggressive to be allowed to enter transactions, curtailing competition for assets right at the time when motivated sellers want to exit [See “Competition for Assets and White lists: A Primer” for more details]. We believe that as long you are working with an asset manager that has access and visibility in the market, there are more opportunities to create alpha in Europe than in the U.S.

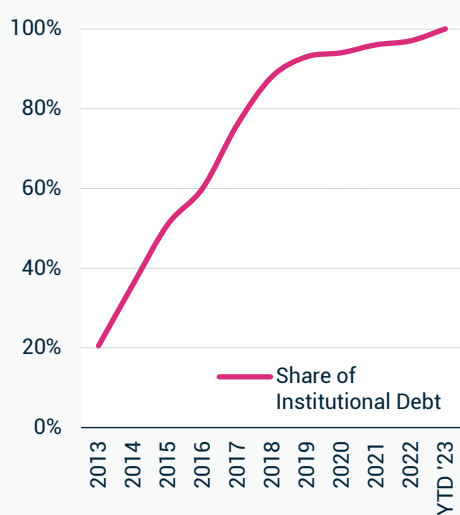
³ JPM European Leveraged Finance Capital Markets Update September 2023.

⁴ DB Default Study, Jun 2023.

Why is special situations more attractive than private debt?

First off, it doesn't need to be one or the other. There's plenty of room in a diversified portfolio for both. However, what we find attractive about special situations is that it allows you to access senior secured debt at very low implied LTVs, in companies with a recent observable track record (thus giving you the chance to make the call on whether their underperformance is likely to continue), while generating equity-like returns through high running yield and upside convexity. There is also often an active secondary market which allows capital to be recycled or scaled according to risk appetite. On a risk-adjusted basis, we believe that over the next two to three years, the market will provide ample opportunities to earn that higher level of return without taking on too much incremental risk.

Cov-Lite Share of Total New Issue Leveraged Loans⁵



Can you explain how the relaxation of documentation has impacted the market?

In the past, credit documentation set restrictions on debt and profitability or cash-flow levels which required borrowers to enter negotiations with lenders when such restrictions were breached. If debt levels got too high relative to profitability, or cash generation was weak, the borrower was forced to meet with creditors and figure out a path forward, well before the situation became an emergency. The low interest rate environment resulted in the removal of many of these documentary protections and therefore reduced lenders' ability to act early and force a reaction from companies and sponsors. It has also created potential loopholes for aggressively minded sponsors and companies to raise additional debt financing, sometimes ranking ahead of existing claims, or to sweep assets away entirely and weaken the security package of existing lenders. We believe that as a result, recapitalization processes will likely kick off at a later stage, often when an emergency is befalling all stakeholders. This will have a greater impact on secondary pricing as incumbent lenders seek to exit at the same time, with the uninformed unable to take advantage of such opportunities. The spectre of lower recovery rates for lenders invested in situations for which they are ill-equipped to navigate will also reduce transaction pricing, with this dynamic complicated further by the existence of 'white lists' reducing the potential universe of buyers.

Digging Deeper

What industries or geographies are you focused on?

Again, we've not seen such sector diversity in the opportunity set since 2008-2009. It's a luxury, even before the storm has really come to shore. It means we can maintain the same return targets that we've always had but build more diverse portfolios than before and be even more selective in our credit evaluation process. There are a lot of opportunities in defensive sectors at attractive entry points, ones we might not have had a few years ago. For example, we are spending a lot of time on healthcare, telecommunications and food producers alongside more cyclical sectors such as chemicals, industrials and autos. In the past, the opportunity set was often linked to certain sectors going through some structural change, which made it challenging to pick winners and losers from a defined group. Now, the universe is much broader, because the issue of taking on too much leverage runs across all sectors – even defensive ones. There is a lot of choice, and there's no need to settle or limit ourselves. If we cannot clearly identify what's going to happen with a particular issuer or a recapitalization process, we can choose to step away without being punished.

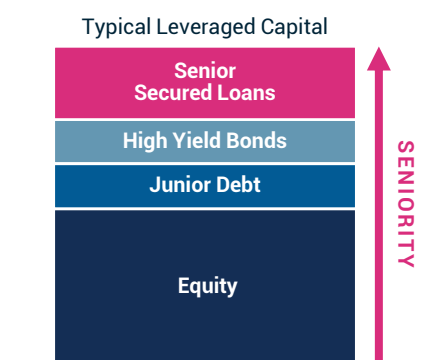
Significant Diversity of Opportunities Across Sectors & Geography⁶



⁵ LCD's Quarterly European Leveraged Lending Review 2Q23.

⁶ Alcentra, as of 31 August 2023, percentages based on market value of above specified criteria. For illustrative purposes only. The universe is representative of the types of investments Alcentra will seek for its stressed and distressed strategies and is subject to change at any time. The universe is defined as capital structures with high yield bonds or loans in excess of €100 million nominal value, trading at or above a 12% yield to maturity.

For many years we have focused on northern and western Europe, where we have reliable, creditor-friendly bankruptcy codes and tried and tested legal regimes. These are established, predictable jurisdictions, where you can be reasonably assured that if you find an opportunity at an attractive valuation, you are going to be able to get your hands on the assets when you need to. We do a lot of our business in the United Kingdom, Germany, the Netherlands, France, Luxembourg and Scandinavia. That's not to say that under no circumstances will we ever invest in southern or eastern Europe; but all other things being equal, we believe the better relative value is to be found in the north and west of the continent.



Where in the capital stack are you focused?

We primarily focus on opportunities in senior secured debt. That means we are among the first in line for repayment, and that we have security over the assets of the company. This is important as it helps protect our downside in the event of issuer underperformance, but also allows us to drive recapitalization processes forward effectively because we are usually invested in the “fulcrum” security. Of course, each case is different, but it is very important in the diligence process to make sure there are no holes in the documentation to allow the issuer to dilute your security interest in the assets which form your collateral. It also goes without saying that security is only worth something if you are able to enforce over it, which takes us back to the point made earlier about legal regimes and bankruptcy codes.

Can you speak to the relative value of stressed and distressed situations in today's environment?

To us, stressed opportunities are where we buy at a discount to par on the back of market weakness or a misplaced negative perception about an issuer, with the expectation that performance will improve and the capital structure will stay intact. They offer the potential of mark-to-market gains and running yield, while preserving a senior secured risk profile. Distressed credit, in our minds, pertains to cases where we believe there is a need for a recapitalization of the company's balance sheet, converting debt into equity, and where we may also initiate changes in management team and strategy. Our exit over a comparatively longer time horizon is achieved by selling the recovered business on to a new owner. As a result, distressed situations may allow for an equity-like return through a debt claim.

At the moment, the majority of our investment pipeline is concentrated in stressed opportunities, because we're finding attractive entry points in sustainable capital structures at lower implied LTV ratios against a backdrop of macro uncertainty and market dislocation. We expect, over time, that the universe will gradually pivot towards distressed opportunities as we move through this cycle. We do believe that you must be capable to do both types of investments in order to be successful in this asset class, not least because a detailed knowledge of how company is capitalised and how any restructuring processes could play out is a critical part of the initial diligence process. Indeed, some of the most lucrative opportunities in the space are to be found in those cases where investors able to navigate a restructuring process and own the company on the back end.

WHITE LIST SIDEBAR

Competition for Assets and White Lists: A Primer

One of the key differences between European and U.S. leveraged loan markets is the prevalence, in Europe, of white lists, which restrict the transfer of leveraged loans in the secondary market, to a select group of buyers. The goal is to prevent lenders who are perceived to be borrower-unfriendly, to enter syndicates, this reducing the likelihood of lenders seeking to take over companies. While white lists have been a feature of European loan documentation for some time, they've become more prevalent, broader and more restrictive in recent years, especially just before COVID, as a decade or so of benign credit conditions and ultra-low interest rates appeased the concerns of many lenders.

Today, as lending restrictions tighten, asset prices fall and the credit environment grows more volatile, we believe the existence of white lists are limiting market liquidity at exactly the wrong time, preventing incumbent lenders from exiting readily, and reducing the number of parties able to buy into deals. The effect is to artificially depress transaction prices and to prolong restructuring processes by adding complexity and, in many cases, making loans more illiquid. For those investors that appear on such white lists, like Alcentra, the effect is to reduce competition for assets in the secondary market, and to lower the entry point into the deal.

The Alcentra Difference

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

At Alcentra, we have ancillary businesses that lend money to hundreds of companies across Europe, many taking on this kind of debt for the first time. We have teams of analysts who monitor those investments, so when any issuer gets into trouble and the prices of their debt drop in the secondary market, we either know the company already or we can get up the curve faster than many of our peers. We believe that's a huge competitive advantage, because when you're trying to find opportunities in the market, it's both about the quality of underwriting, as well as the speed at which it is done. The window of opportunity is often measured in days. Those investors without such information access inevitably find it more difficult, and more time-consuming, to complete their initial research, by which time the opportunity is already gone. Access to management teams, private equity sponsors, and knowing who else holds the debt are not things that are open to everybody. We've been in this market, dealing with these companies, for 20-plus years. We can do the work, and we can move very quickly. That is a hugely important differentiator.

How important is local knowledge/connections/etc., in sourcing and beyond? Why such a key in Europe?

A lot of our competitors are North America-headquartered. They might have people in London, but they may or may not have people who can effectively cover multiple jurisdictions. We are locals. We've got people who are from these various countries, who speak the languages, who have their own relationship networks, who understand how different legal regimes work. We are able to negotiate and interact with the key people, to understand the management teams, their strategies, and everything else you need to know about a potential investment. It sounds simplistic, but it really matters.

When it comes to restructurings and asset management post-close, we believe it's vitally important to be active and drive value, especially given the jurisdictional complexity in Europe. Different countries require different approaches and solutions. Having local people in place can help expedite restructuring negotiations, corporate governance and management appointments, companies' strategic initiatives, and the execution of exit strategies. But having a detailed plan of action for a company post the completion of the balance sheet recapitalisation, as well as means of execution, is as important as the initial credit underwriting process itself.

How can selective sourcing drive better returns?

We saw a market shift in early 2023, just after the regional banking crisis in the U.S., with companies coming to us, seeking liquidity, either to refinance pending debt maturities or to support them as they navigate the challenging economic environment. For example, maybe it's a company looking to sell a subsidiary to de-lever the capital structure, and they need a bridge facility because they don't want to sell it right now. There is a lot of activity right now across the whole spectrum, and we believe it's only going to pick up. We are seeing a lot of activity bubbling beneath the surface in terms of primary origination. We believe this is an indication of what's really happening underneath the surface of the economy as credit terms tighten, with it driving companies to seek alternative sources of capital.

Looking Ahead

Do you have a prediction on interest rates?

There are some clever rate-plotters out there, but they're often wrong and we don't claim to be any better. Inflation has stayed high for longer than most people expected and, as a result, rates are going to have to remain elevated until inflation is properly under control. That being said, the origin of Europe's inflationary problems are different to those experienced in the US, and it is looking increasingly likely that the similar policy response adopted by the ECB will slow down the European economy faster than will be the case in the US. That will likely lead to an increase in the size of our opportunity set. Whether that in turn precipitates at least a partial reversal of such recent rate hikes remains to be seen. What does seem certain is that we will be living in a more uncertain (and volatile) world.

European Central Bank Benchmark Rate⁷



Do you have an expectation for default rates in the next 12-24 months?

Historically, we have not found default rates to be a particularly reliable or timely indicator of corporate distress and certainly not a good predictor given that it is very much a lagging indicator. The definition of default is subject to interpretation and the numbers can be stretched in any direction to fit the required needs. Maybe the official stats will indicate default rates rising to between 3% and 5% in the years ahead, but the number of near-defaults will likely be much, much higher, in our view. We've seen several situations during 2023 where companies are looking for solutions to upcoming maturities and enter negotiations with creditors. Those may not end up as defaults, under the technical definition, but all the same, represent interesting investment opportunities for us.

Conclusion

With higher interest rates causing stress to borrowers, inflation pressuring margins, and with maturities pending for hundreds of billions of euros' worth of debt issuance, we believe the opportunity set in European special situations investing is very attractive and will remain so for several years. Some companies are going to need liquidity as they navigate this challenging environment, while others are going to need debt rescheduling or recapitalisation in order to manage inflated leverage levels. We believe, as a result of the confluence of these factors, will result in a massive and disparate set of opportunities for savvy, well-positioned investors to combine strong running yields with the potential for equity-like returns over times, all with a risk/reward balance that's arguably better than it has been for a very long time.

⁷ European Central Bank Deposit Facility Rate as of 30 September 2023.

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