Alcentra Opportunities in Stressed and Distressed Debt Q&A

Recent market volatility has placed renewed focus on stressed and distressed debt. Here, Eric Larsson, portfolio manager for Alcentra's special situation strategy considers market potential and the impact of recent events

How would you define stressed/distressed debt, how wide is the investment universe in this sector and what does a typical distressed debt investment portfolio contain?

Larsson: We define stressed/distressed debt as loans or bonds that yield in excess of 12%, or trade at a price below 80c of face value. We last measured the size of the European stressed/distressed market in January this year to c. €70 billion including quoted loans and bonds, but excluding privately or bilaterally issued loans (due to the lack of secondary market pricing information). We have not updated our measurement since the COVID-19 sell-off, but we estimate that the market is currently comfortably in excess of €100 billion.

The shape of a distressed portfolio depends on what the manager wants to achieve. Are they focused on trading stressed credits that may have experienced a temporary decline in performance or are they looking to take ownership of the company through a restructuring process? Alcentra Special Situations has capabilities and the fund structures to support both types of investments. In our main locked-up vehicle, we aim for 30-50% in stressed credit and 30-50% in distressed credit. This leaves c. 20% for special situations, where we include rescue-financing opportunities, liquidations, litigation funding, etc.

What specific advantages can exposure to stressed/distressed debt offer investors?

Larsson: The stressed/distressed debt investor takes advantage of the fact that many lenders do not have the expertise or the type of capital required to manage such investments and therefore become forced sellers. This creates an opportunity for the investor to buy debt instruments with a high degree of downside protection in the form of secured collateral and legal/procedural advantages, at very low entry prices. As a result, a portfolio of senior secured stressed/distressed loans or bonds can offer equity-like returns combined with a high running cash yield and limited risk to the downside.

Why do you feel now is a good time to invest in stressed/distressed debt?

Larsson: As we enter the deepest recession in living memory, corporate balance sheets are starting to come under pressure. Q1 2020 saw a 25% Y/Y fall in earnings for European companies, and the second quarter is expected to bring an even sharper collapse in profitability. Against this backdrop, a significant proportion of European corporates will have to seek relief from creditors, restructuring solutions or emergency capital. Such conditions provide a rare opportunity to acquire stressed and distressed debt in the secondary market or provide primary rescue capital at yields not seen for years.

Which geographic regions do you feel offer the strongest potential in this area?

Larsson: We believe Europe offers a particularly interesting opportunity given its patchwork of local jurisdictions without a common restructuring framework and its largely private markets with limited information dissemination, compared to the more mature and transparent US credit markets. In our view, this creates an opportunity for those investors who have good access to information and are experienced in dealing with legal processes across the continent.

How do you identify opportunities in stressed/distressed debt and how does your stock selection process work?

Larsson: We are fortunate to be part of one of the largest sub-investment grade lenders in Europe. That gives us access to a library of information covering the majority of high yield and loan issuers over the past 18 years. Our dedicated special situations team works closely with other analysts across the firm to identify new opportunities and perform due diligence on a wide variety of potential investments. Key in the analysis is to establish downside protection in the form of specific assets or a steady cash flow stream. We also dedicate considerable time to the legal and process aspects of the investment. Finally, we invest with the end in mind, i.e. establishing upfront how we expect value to be generated and how we will be able to exit the investment.

Since the recent sell-off, our predominant focus has been on stressed opportunities with an ability to garner very attractive risk adjusted returns. Looking beyond the immediate market reaction, our attention will increasingly pivot towards distressed opportunities and special situations, where we see the potential to be a highly sought after provider of liquidity to businesses which are in need of an immediate cash infusion and balance sheet recapitalisation.

What is your strategy based on and how does it achieve its targets?

Larsson: Our strategy deploys a fundamental value approach which aims to find assets that are mispriced as a result of financial stress. In addition to tools deployed in order to correctly understand fundamental value such as business strength, financial performance, valuation etc., the strategy relies on a strong knowledge and experience of how legal processes affect corporates and their stakeholders as they go through, or risk going through, restructuring processes. Our ability to correctly assess and mitigate those types of risks is core to achieving investment success.

What business sectors have been most impacted by the Covid-19 coronavirus crisis and what sectors do you believe offer particular opportunities?

Larsson: Initially the sell-off following the spread of Covid-19 was broad based, across a wide variety of sectors. However, defensive sectors such as utilities, healthcare, grocery retail and telecoms recovered relatively quickly, leaving behind sectors directly impacted by the pandemic such as oil and gas, leisure/gaming, non-grocery retail and consumer durables. We look across sectors when assessing opportunities and have been able to construct a well-diversified portfolio of mainly stressed investments. Thus far, we have remained cautious on heavily affected sectors which come with uncertainties that are difficult to quantify e.g. the likelihood of regulatory changes or support or direct commodity price risk.

How do you manage risk/ how risk averse is your strategy?

Larsson: Our strategy is focused on downside protection through strong asset coverage, solid cash flows and other fundamental factors. We also primarily invest in first ranking senior secured debt in jurisdictions with strong creditor rights i.e. mainly in Western and Northern Europe. We monitor our assets closely with risk assessments on a weekly, monthly and quarterly basis. Given that our portfolios cover a relatively limited amount of positions (c. 25-30 investments), we are able to track each individual investment very closely, including frequent interaction with management and the board.

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