

## Distressed debt & special situations

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**A global strategy** *PDI* data show that distressed debt remains a predominant and widespread theme for the asset class following its 2017 peak

# Insight

## Five perspectives **The industry shares its thoughts on the leading trends in distressed debt and special situations**



**I**n recent years, investors have become increasingly concerned that many traditional growth assets, like developed market equities, are hovering near all-time highs. At the beginning of May, the S&P 500 hit 2,945, double the level of January 2013, while the MSCI World Index, was near its all-time record set in January 2018. Meanwhile, low yields from income assets are frustrating investors who require a certain level of returns to meet their liabilities.

### **1 More money is arriving**

These two trends have already directed investors to look at alternative assets, but the prospect of an economic downturn has stimulated interest in distressed debt and special situations opportunities.

"In this environment, where yields are generally low and many asset classes seem at, or near fully-valued levels, we find there is strong appetite for distressed debt globally, including in the UK and Europe," says Brad Bauer, partner and deputy chief investment officer at Vårde Partners.

Bauer explains that there has been a build-up of corporate leverage in Europe

and investors have been increasingly mindful of headlines suggesting geopolitical headwinds and the prospect of additional economic distress.

### **2 Fund managers are under scrutiny**

However, with lots of new money arriving into the sector, experts are warning investors to scrutinise the skillset of their chosen fund manager. JPMorgan advises investors to look for "continuity" and "experience" along with "strong sourcing networks" to find top notch opportunities.

Prior to the global financial crisis in 2007, real estate managers faced a similar problem. The arrival of large sums of cash in quick succession forced some managers to deploy cash too quickly in assets they didn't fully scrutinise. When the crash happened, some saw their funds wiped out.

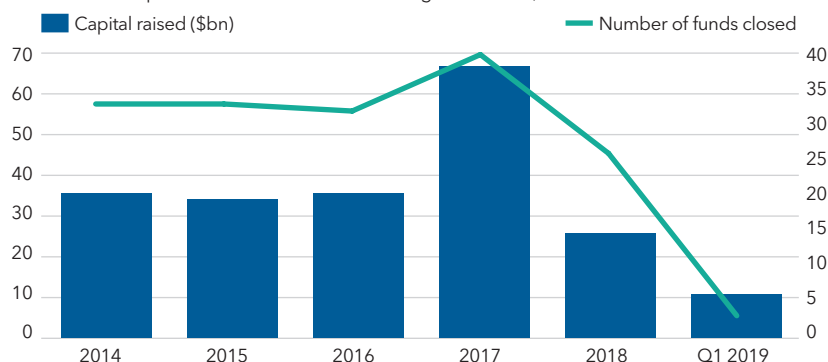
### **3 New launches are everywhere**

One of the upsides of greater investor interest in distressed debt is that there are an ever-increasing number of funds to choose from.

Since the start of 2019, there have been new launches or fundraisings from a host of major players including Cerberus, Contrarian Capital, Ninepoint and Safe Harbor Equity.

"There is a huge amount of dry powder chasing deals," explains David Ampaw, a partner at DLA Piper. "There is huge demand for distressed debt across Europe. The proof of this is evidenced in the multibillions raised by a number of

The most recent peak in distressed debt fundraising was in 2017, with \$66bn raised across 40 funds



Source: PDI

regular distressed debt investors as well as by newer entrants.”

#### 4 Investors expect geography to determine returns

Despite the keen interest in distressed debt and special situations more broadly, fund firms are warning that the opportunity set may be riper in some geographies than others.

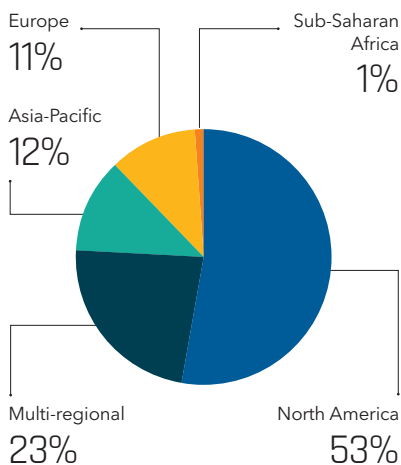
Duncan Farley, a portfolio manager with BlueBay Asset Management, says: “Within oil and gas, there is always a good constant source of opportunities, including US shale. We are also seeing a growing emergence of problems in Germany, in the industrials space, and issues relating to how a fall in Chinese demand is hurting the automotive market.”

Vårde Partners’ Brad Bauer said he is focused particularly on markets where there are “systemic problems that drive motivated sellers” or where there are gaps in capital availability.

#### 5 New opportunities will come from downturn

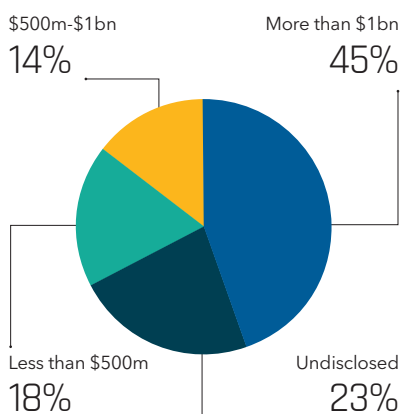
Market participants believe that any global downturn will result in a shake-out of opportunities in the distressed market. As a result, fund firms have been bolstering in-house expertise in anticipation that market experience will be useful. In its 2019 distressed debt outlook, JPMorgan concluded that the risk of a global recession “in the next few years” underscores the need for investors to seek out a fund manager with multiple private credit strategies that include both special situations and distressed debt. ■

More than half of funds in market with a distressed debt and special situations strategy are focused on North America



Source: PDI

Around 45% of all funds in market are looking to raise more than \$1bn



Source: PDI

## S O U N D • B I T E

“This situation cannot continue, especially at a time of weakening economic growth”

Christoph Rieche, CEO of lending platform Iwoca, commenting on UK finance data that showed the number of approved business overdrafts in the country to have declined by nearly 30% since 2011

“Smaller enterprises, the backbone of the economy, are suffering under the weight of high costs, skills shortages and weak productivity”

Tej Parikh, senior economist at the Institute of Directors, on a business leaders’ survey it conducted that showed UK business confidence plunging to new lows

“The prospect of a severe downturn has strengthened the case for more explicit safeguards on investment portfolios”

Toby Goodworth of bfinance on a report showing investors gravitating to ‘explicit’ downside protection strategies

## Year in review The biggest distressed debt stories reported by *PDI* over the past 12 months

### Värde Partners to tap into Indian distressed debt market

Minneapolis-headquartered private credit manager Värde Partners formed a strategic partnership with Mumbai-headquartered Aditya Birla Capital. The parties will evaluate distressed and special situation investing across various sectors in India. Värde Partners had been raising capital for its first Asian credit fund, which eventually closed in November 2018. "We see India as a core market for Värde and a critical part of our long-term strategy in Asia," said Ilfryn Carstairs, a Singapore-based co-CIO of Värde Partners.



### Louisiana pension commits to third GoldenTree distressed fund

The Louisiana State Employees' Retirement System committed \$75 million to GoldenTree Asset Management's latest distressed debt vehicle. The Baton Rouge-based pension plan's allocation to GoldenTree Distressed Fund III was LASERS' first commitment to the credit manager. LASERS has additionally made distressed debt investments with Siguler Guff and Marathon Asset Management. New York-based GoldenTree closed the fund on \$1.7 billion in April 2019.

JUN 18

JUL

AUG

SEP

OCT

NOV

### New Mexico SIC eyes direct lending and distressed debt in FY 2019

The New Mexico State Investment Council was reported to be looking for additional opportunities in direct lending and distressed debt in 2019. Direct lending and distressed debt comprise two of the four sub-categories in the sovereign wealth fund's non-core fixed income bucket, which houses alternative credit investments. The pair of strategies has a 20-40 percent allocation range. SIC's direct lending portfolio was under its target at 14.7 percent, while distressed debt was at the lower end of the goal range at 21.7 percent as of 31 March, according to sources familiar with the situation.

### Oaktree posts strong distressed, US private debt gains for 2018

Oaktree Capital Management posted gross returns of 10 percent for distressed debt and 12 percent for US private debt for 2018. The LA-based firm deployed \$4 billion from its closed-end funds in the fourth quarter, which includes the distressed, senior debt and mezzanine debt funds. "Market psychology proved to be incredibly volatile [in the fourth quarter]," Oaktree co-chairman Howard Marks said, making a rare earnings call appearance. The market plunge was "driven by no new real concerns", he added, noting that slower global economic growth, rising interest rates and trade tensions have been in the picture for some time.





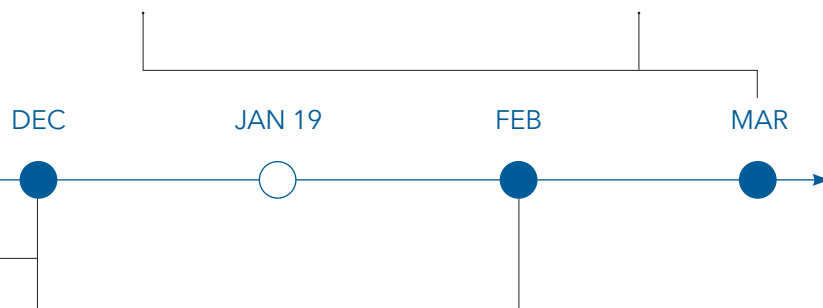


### GSO builds out its distressed debt team with two key hires

GSO Capital Partners hired two distressed debt professionals as the firm looked to increase its focus in that area. The New York-based credit manager brought on Robert Carroll as a managing director and head of distressed trading, the firm said. GSO also hired Adam Maitin as a vice-president on the trading desk. Carroll will oversee the distressed debt trading activities across all of GSO's distressed vehicles.

### Contrarian targets \$400m for latest distressed RE fund

Contrarian Capital Management re-entered the market with its fourth real estate distressed fund. The Greenwich, Connecticut-based firm is targeting \$400 million for its Contrarian Distressed Real Estate Debt Fund IV, according to a source. The fund held a first close on more than \$132 million and will follow a similar strategy to its predecessors and invest in US-based distressed commercial real estate.



### CDPQ backs Edelweiss' second distressed debt fund

Edelweiss Alternative Asset Advisors held a final close on the second of its distressed fund series, EISAF II, on \$1.3 billion in capital commitments with Quebec City-headquartered Canadian pension fund, Caisse de dépôt et placement du Québec, acting as anchor investor. EISAF II is targeting an internal rate of return between 16 and 18 percent, net of fees. The vehicle has a four-year investment period within a nine-year fund life. Edelweiss Financial Services' executive director and co-founder Venkat Ramaswamy told *PDI* that the fund will invest in stressed assets, targeting turnarounds in the corporate and real estate markets.

### Contra Costa County earmarks \$200m for distressed debt, buyouts

Contra Costa County Employees' Retirement Association revealed that it could commit \$200 million to its private equity programme – an allocation that includes investments in distressed debt and special situations vehicles. According to meeting documents, the northern California pension fund heard plans for commitments of \$25 million-\$50 million to two to four funds. The focus would include North American distressed debt funds and US buyout funds, including vehicles focused on small-cap and mid-market transactions, as well as those concentrating on large-cap deals.

# 22%

New Mexico SIC distressed debt allocation in 2018

# \$75m

LASERS commitment to GoldenTree Asset Management's third distressed debt fund

# \$200m

Amount earmarked for distressed debt by Contra Costa County Employees' Retirement Association

# 10%

Gross return posted by Oaktree Capital Management distressed debt strategy in 2018

# \$4bn

Deployed by Oaktree from closed-end funds in Q4 2018

# \$400m

Reported target for Contrarian Distressed Real Estate Debt Fund IV

## Editor's letter

# The importance of selectivity in uncertain times



**Andrew Woodman**

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When Brookfield Asset Management bought a 62 percent stake in Oaktree Capital Management this year, not only did it bolster its private debt offering as a combined asset manager, but it also revealed a growing appetite for distressed debt and special situations.

Howard Marks, Oaktree's co-chairman, told *PDI* that the sale is as significant now as it would have been a year ago, or a year from now. But it is hard to ignore the fact that the timing is fortuitous. Bruce Flatt, CEO of Brookfield Asset Management, told *PDI* that while Oaktree can thrive in any environment, it can excel at a time when "stress in credit is robust".

2018 was a good year for Oaktree's distressed debt and special situations strategy. The strategy posted gross returns of 10 percent, compared with 12 percent for US private debt, beating other alternative asset managers in similar categories. Limited partners demonstrated their appetite for distressed debt and special situations in 2017, when funds with a distressed debt focus raised a total \$66.6 billion. While this was already a strong year for private debt fundraising, funds with a distressed debt focus accounted for around one-third of the capital raised.

Much of this investment has been made in an anticipation of a downturn yet to materialise. With growing pressure on managers to put the dry powder to work, there is a danger that scrutiny will suffer. That is where the emphasis on quality comes in.

Managers need to be able to show discipline when choosing where to invest. In the long term, investors will favour those with consistency, expertise in their chosen sector or geography and the ability to prove a strong track record. A downturn is sure to unveil a groundswell of opportunities, and early investors will be rewarded, but until that happens, those focused on distressed debt and special situations must be able to show it can also be an all-weather strategy.

Andrew Woodman



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# E X P E R T Q & A

*David Forbes-Nixon, co-founder, chairman and chief executive at Alcentra, and Eric Larsson, co-portfolio manager of the special situations team, discuss energy, retail and other opportunities amid economic strain*



## Where to ramp up in a slowdown

### **Q** Are macro conditions a tailwind for the European distressed market?

**David Forbes-Nixon:** We are in the very late stages of the longest credit bull market in history, and whilst we do not forecast a recession, there is clearly a slowdown taking place. Christine Lagarde of the International Monetary Fund said recently that two years ago about 75 percent of the world's economies were growing, but now about 70 percent are slowing. Europe is seeing an economic downturn due to geopolitical risks and other factors with some countries suffering a great deal, such as Italy, where there is a large number of non-performing loans on bank balance sheets.

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Furthermore, the leveraged loan market is priced to perfection. Leveraged loan multiples reached 5.4x last year, compared with a peak of 5.2x before the Global Financial Crisis.

**Eric Larsson:** Because everything is priced to perfection, one does not need to see a big miss in performance relative to a borrower's target, before it can become stressed.

### **Q** So, opportunities are increasing?

**DFN:** The market is very fragile. We

witnessed this late last year, when there was enormous volatility on very little news. Taking 2018 as a whole, 135 European high-yield bonds traded down 10 points or more, but only five traded up 10 points or more, partly because of the announcement of the end of quantitative easing and the lack of dealer capital to support their deals. Compare this to 2017, when only 13 traded down and 63 traded up to a similar degree. Also, the European Central Bank currently holds about 10 percent of all European triple-B corporate bonds: this could create an enormous potential opportunity for investing in fallen angels – bonds that have fallen from investment-grade to high-yield ratings, perhaps in part because they are

no longer supported by the ECB buying and also due to performance and market issues.

Another way of measuring the increasing opportunity is to look at the overall amount of stressed and distressed syndicated loans and high-yield bonds outstanding in Europe – securities trading below 80 cents in the euro or at a yield to maturity above 12 percent. We measure this every quarter. The total for the fourth quarter of last year was up 31 percent, or €23 billion, from the previous quarter, to €70 billion.

### Q Which sectors have particularly interested you recently?

EL: Our biggest single industry exposure at the moment in our special situations business is in energy. We have been active in both exploration & production and services. We do not profess to have better knowledge than anybody else about what will happen to oil prices, so our first aim is to try to take this out of the equation. Then it comes down to valuations. We strive for entry points sufficiently low so that, on the basis of probability-adjusted outcomes, we are comfortable that we can at the very least sell the debt at the price at which we bought it. On the services side, we look for companies that will benefit from ongoing demand, even allowing for the fact that E&P activity will go up and down over time.

*“The European Central Bank currently holds about 10 percent of all European triple-B corporate bonds: this could create an enormous potential opportunity for investing in fallen angels”*

DAVID FORBES-NIXON  
ALCENTRA

### Q How about retail?

DFN: We are not making primary loans to retailers in our direct lending or syndicated business, and we are pretty cautious about retailers in our distressed business too. However, there are certain companies that can be interesting, if you buy into the debt at an extremely low multiple and in some cases then convert that debt to equity. You have to cherry pick the best companies and may need to replace management teams and implement operational and financial restructuring measures.

### Q What countries do you like?

EL: Generally, we focus on northern and western Europe, because the jurisdictions are more favourable to creditors. We do not exclude southern Europe, but the fact that they have less creditor-friendly restructuring and insolvency regimes is surprisingly often not taken into account in the pricing: a deal in the UK with certain leverage may be priced in a similar fashion to a deal with the same leverage in Italy, despite the fact that the process in the UK may take two months, but in Italy it may take two years.

It can be difficult to perform restructurings in France, but they do get done, and they get done in favour of senior creditors, though you have to be well-connected in that market to get the results you want. To explain, a handful of law firms and court-appointed people are involved in these interactions, and they do things in their way. If you know them, and have dealt with them in the past, as we have, you know how they work, which way they will push the cases and so forth, and you can anticipate and adjust your strategy accordingly.

DFN: We like to have local people who know the jurisdiction, and know the people to deal with when we are investing in a credit in a particular European country. We have the advantage that we can tap into the expertise of the 30 European analysts who work for the broader Alcentra group in Europe in addition to our dedicated special situations team of 10 professionals, plus our three lawyers, who are all experts in bankruptcy law and leveraged finance documentation. Alcentra has 17 years' experience of doing this, and I personally have been involved in the European leveraged finance market since 1987 and the distressed debt market since its inception in 1992.

### Q So, the legal side of distressed investing is very important?

DFN: We spend as much time analysing the

*“Our biggest single industry exposure at the moment in our special situations business is in energy. We have been active in both exploration & production and services”*

ERIC LARSSON  
ALCENTRA

legal and documentation risk as we do on the credit and cashflow of a company. The UK is probably the best bankruptcy jurisdiction in Europe from a senior secured lender perspective and is similar to the US in terms of higher recovery rates. In the UK, if you are the senior secured lender, and you have fixed and floating charges on the assets and cashflows, you will not find yourself challenged successfully by other creditors in a UK bankruptcy court trying to subordinate your claim. As well as the UK, Germany, the Netherlands and Scandinavia are also quite creditor-friendly jurisdictions.

### Q Most recently, where have opportunities been increasing?

EL: We were interested to see, when compiling our Q4 2018 numbers for stressed and distressed debt, that German companies accounted for 11 percent of the total – the highest total for Germany in three years.

I think that reflects troubles in the German economy, including the existence of numerous sectors that export a great deal to China and other Asian countries, whose economies have been slowing down.

When it comes to sectors, we think there may be cyclical opportunities in the future in autos and industrials. It is illuminating that in the sell-off of debt in the last quarter of last year and first quarter of this year, a couple of auto companies entered our distressed universe – I do not think that is a coincidence, and I think some sectors will come back in a way that we have not seen for a long time. ■



# Mapping out a new perspective in Europe



When Schefenacker – the world’s biggest maker of car mirrors – ran into trouble in 2007, it became clear that the German manufacturer would need outside restructuring expertise and that it would have to look to the UK. Its City of London-based lawyers, Allen & Overy, moved the corporate headquarters to Hampshire by incorporating a new English company and transferring its assets and liabilities. Through this device, the business effected a rescue under the more flexible English legal procedures. According to Jenny Marshall, a partner in Allen & Overy’s London restructuring team, this set the ball rolling.

“The Germans said, ‘That’s not right – we’re losing business to England. We’re going to make it easier to do restructurings in Germany,’” says Marshall, who notes the same sentiment is now gradually spreading across the rest of Europe. “Reforms are springing up like mushrooms across the whole of Europe.”

*European Union member states are gradually harmonising insolvency and restructuring regimes. David Turner charts the changing regulatory landscape*

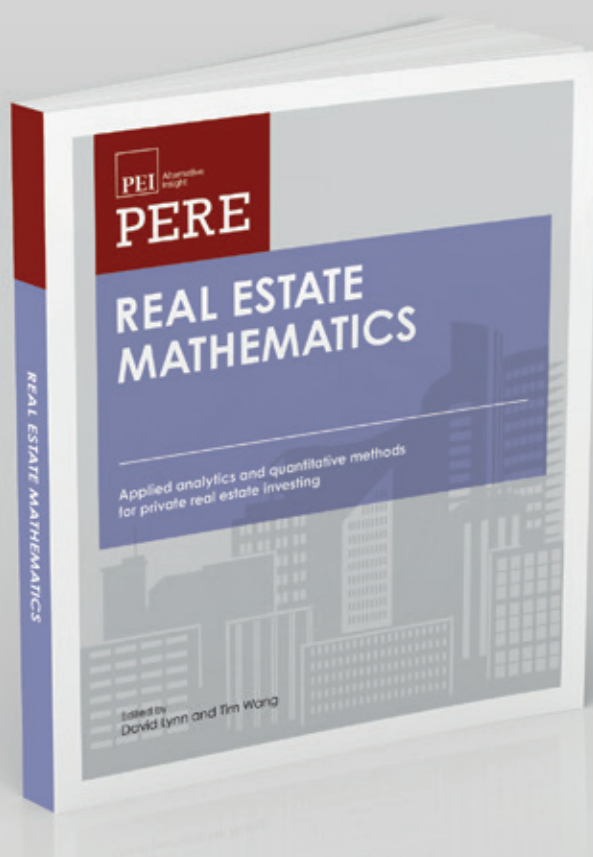


Looking at the pan-European trend, Jo Windsor, partner and insolvency specialist at London-based law firm Linklaters, notes a trend towards greater convergence, with “the intention over time to flatten distinctions in the hierarchy from more to less creditor-friendly regimes”. This process is creating minimum acceptable standards across the EU, say debt fund managers.

“Regulations governing restructuring are definitely progressing in Europe as a whole,” says Nicolas Nedelec, a Paris-based managing director at Idinvest Partners. “It’s no longer the case in international deals that a small local creditor could leverage a position to get preferential treatment – we are in a more balanced environment.”

Distinctions will be flattened further by the EU Preventive Restructuring Framework Directive, agreed by member states in December 2018. This compels every nation to create rules that enable early restructuring, be-

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fore a company falls into insolvency. “The directive is an important step in creating greater legal certainty,” says Muge Adalet McGowan, senior economist at the Organisation for Economic Co-operation and Development, in Paris, who notes that present procedures can be complex, convoluted and lengthy in some countries.

Analysts retain a healthy dose of scepticism about the pace of change, however. “Even if you have the best insolvency regime on paper, if you don’t have an efficient judicial system, it will not yield the results you want,” says Adalet McGowan. Observers often lament the law’s delay in Italy, for example, where insolvency cases can take years.

“This will be very much a gradual process, particularly as member states are being offered a wide range of options when it comes to exactly how they will implement this directive,” adds Windsor of Linklaters.

Moreover, the directive will not suit all creditors. Member states must provide for an optional moratorium before the creditors seize control of the company, to be granted by a court or other arm of the state for a maximum of four months. This is similar in some ways to the Chapter 11 provision in the US, which is designed to allow companies to work out a plan to save the business before creditors start selling off assets. However, there is enthusiasm for reform, and several member states are already agreeing changes ahead of the directive. Here we look at a few examples.

## How Europe’s insolvency and restructuring regimes are evolving

### UK

#### **UK insolvency lawyers are doing battle with the government over plans to allow a moratorium for borrowers, initially for 28 days.**

As the chair of the City of London Law Society Insolvency Law Sub-Committee, Jenny Marshall of Allen & Overy has led resistance to plans for a “monitor” to oversee the moratorium.

“Under the current proposals, the monitor has all the responsibility but none of the power: they have no teeth,” says Marshall. If they are worried about an abuse of the moratorium by the borrower, such as the transfer of assets to an offshore jurisdiction where they cannot be touched, “the only thing the monitor can do is to bring the whole house of cards down, by stopping the moratorium. They can’t say during the moratorium: ‘You have to do X, Y, and Z.’”

The sub-committee has suggested instead adapting the existing procedures so that the responsibility for overseeing the moratorium could be given to an administrator, who under current insolvency law has clearer duties and powers.

Marshall says that if this idea is accepted, the UK will remain, along with Ireland, Europe’s most creditor-friendly regime. But under the present proposal for a monitor, “the UK would fall somewhere down the order. I doubt we will ever be as debtor-friendly as France, but we might end up more on a par with Germany.”

### France

#### **Changes since 2005 have made it progressively easier for borrowers and creditors to facilitate restructurings before the business slides into liquidation.**

Fabrice Damien, head of origination at Hayfin Capital Management in Paris, and the person responsible for investment opportunities in France, notes that in recent years the law has increased the rights of creditors in court-supervised restructuring processes, and facilitated the execution of these processes. This includes the ability for creditors holding two-thirds of the debt to override the objections of dissenters to any restructuring plan.

Damien says that restructurings can at times take place within a few months, but acknowledges that on average they tend to take slightly longer in France than in the UK. He adds: “The process may be a bit more protracted, a little different and maybe a bit more French, but at the end of the day, the end result tends to be the same. For instance, if there is a significant liquidity issue, either the sponsor commits additional capital or they cede control to the lender or a new third party that wants to put money in.”

He also notes there is “the very well-trodden path of consensual restructuring, through out-of-court procedures under the aegis of a *mandataire ad hoc*”. The latter plays the roles of facilitator and umpire, and usually of administrator, should the business end up in insolvency. Damien points to the large number of precedents overseen by a relatively small number of these experienced professionals, which creates predictability for creditors.



## Netherlands

**Outside formal insolvency proceedings, a restructuring is currently only possible on a consensual basis with the support of all parties.**

This means that every minor hold-out creditor, as well as equity holders, can frustrate the process. However, under the current proposals, a restructuring plan could be created to prevent the debtor going insolvent, or to facilitate a controlled liquidation and distribution of the debtor's assets. These plans could include deferring or partially releasing payment obligations, amending the terms of debt instruments, or

offering debt-for-equity swaps. The debtor could also amend the terms of onerous contracts, such as leases.

Once approved and confirmed by the relevant percentage of creditors and the court, the restructuring plan will be binding on all creditors and shareholders. Subject to certain safeguards, creditors and shareholders who have voted against it can be bound by a "cross-class cramdown" – the process by which creditors across all classes of debt, and other parties, are compelled to accept a restructuring plan devised by a majority of creditors.

"The options to successfully restructure financially distressed, but viable, businesses in the Netherlands are about to widen substantially," concludes Sigrid Jansen, partner at Allen & Overy in Amsterdam.

## Germany

**"On the European continent, Germany is the most creditor-friendly jurisdiction," says Frank Grell, chair of the German restructuring and special situations practice at law firm Latham & Watkins' Hamburg office.**

"We still have some small changes to do, but in general we have a process that works," says Grell. He acknowledges that the Netherlands will move ahead of Germany once its proposals are in force. However, he believes Germany will then catch up with its neighbour when it adjusts in response to the EU directive.

In some respects, Germany is even more creditor-friendly than the UK, asserts Grell. For example, creditors with only 51 percent of the debt can cram down dissenting creditors, and dissenting classes can be bound by the restructuring plan as long as the majority of creditor classes approve it. In the UK the current threshold is much higher at 75 percent, and this threshold must also be met by all classes.

There are, however, still issues that might irritate a lender used to UK restructurings. For example, creditors extending a fresh loan that delays an insolvency filing by breathing new life into the business can be held liable for any damage to new creditors and suppliers caused by that delay. For this reason, creditors unfailingly hire a third-party expert such as an auditor to protect them from liability by providing a long "restructuring report" to furnish evidence that the restructuring plan is viable.

## Italy

**Italy is introducing an updated insolvency regime to improve efficiency and encourage the rescue of distressed companies.**

Ongoing reforms aim to make liquidation the last resort. These include improving the judicial procedure that allows restructuring solutions with widespread creditor approval to be imposed on dissenting creditors.

"How efficient and effective these reforms will be, and how quickly they produce results, will depend on both the individuals

implementing them, and the courts overseeing the procedure," says Jo Windsor of Linklaters.

"A cynic might wonder how much things will really change in practice, but it is important to bear in mind the context of these reforms," he continues.

"They are intended to address identified concerns which impact the Italian economy and, importantly, they must be seen in the context of a wider initiative, of which the recently published EU Insolvency Directive forms a part, to make insolvency regimes across the EU more effective."

Windsor thinks this will put Italy under pressure "to try and raise the standard if, for any reason, the new regime in Italy is perceived as falling short of other jurisdictions".

# E X P E R T Q & A

*Stuart Mathieson, head of Barings' Global Special Situations Investments Group in London, and Bryan High, co-portfolio manager for the Global Special Situations strategy in the US, discuss the outlook for distressed debt investing*



## Where the dry powder goes next

**Q** Recently, we've seen leverage levels for high-yield corporate issuers creeping up on both sides of the Atlantic. Does this create opportunities for you?

**Stuart Mathieson:** The large inflows of capital into high-yield markets have certainly allowed companies and private equity sponsors to structure more aggressive transactions – which means there's more single-B and triple-C debt available, in general. Although defaults have so far remained low, at some point they will inevitably increase. That said, we do not need a higher default rate to deploy capital efficiently. For our special situations strategy, we can typically deploy about 80 percent of our investors' capital within two years, even among a benign default environment – which we attribute to our integrated model, the breadth of assets we cover,

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and our ability to size funds appropriately for the opportunity set.

**Bryan High:** Additionally, in the US, sponsors are paying high multiples for assets because there's so much capital to put to work and it's a very competitive market. To then achieve good returns, private equity sponsors are pushing the envelope on leverage – which doesn't provide much leeway if their plans fall through, but creates an opportunity for managers with the expertise to navigate stressed and distressed credits.

**Q** How common is it for you to become heavily involved in a deal, from an operational perspective?

**BH:** While we are certainly not looking to take over and operate all of the companies in our special situations portfolios, we do have the ability to get more involved when the need arises. We find that it's helpful to have a seat at the table when companies go through challenging situations, so we can help drive outcomes that are most beneficial for our investors. In certain cases, we are able to help restructure a company to provide a stronger balance sheet, a new board, and a fresh management team, for example.

**Q** What returns do you target?

**SM:** In our special situations strategy, we target a net internal rate of return (IRR) in the mid-teens. To achieve that, we're flexible and look to seek out the best relative value opportunities across our target markets and strategies. If we can achieve a 15 percent IRR

*“In the US, sponsors are paying high multiples for assets because there’s so much capital to put to work and it’s a very competitive market”*

**BRYAN HIGH**  
Barings

on a discounted debt instrument, we’re happy with that. We’re equally happy if we can target a 2x money multiple by investing in a good business with a bad balance sheet, and unlock value by providing capital to invest or taking control through a debt-to-equity conversion.

**Q Geographically, where are you finding good relative value at the moment?**

**SM:** Our platform benefits from being fully integrated into Barings’ wider credit business, which gives us access to proprietary research on a wide range of credits, many of which are not widely covered – and provides a great view into our target markets. Over the last several years, we’ve been weighted toward opportunities in Europe. But, looking forward, we see a growing opportunity set in the US. In addition to currently offering more attractive prices, the US loan and bond markets are around five times the size of the European markets. For this reason, even if default rates remain low, we expect that we will be able to source a sufficient number of attractive investment opportunities, given the breadth of assets that we cover.

**Q On the flipside, are there any countries where you’re more reluctant to do business? And what role does jurisdiction play?**

**SM:** While we seek opportunities across the US and developed Europe, we do approach certain countries with caution. Italy is a good example. There have been relatively few broadly syndicated deals, as it’s more of

an SME market, comprising family-owned enterprises. The founder of a business, or members of the founding family, can be less predictable than a private equity sponsor. Additionally, there have been fewer cases involving restructuring processes, which means outcomes are less well understood. For these reasons, we have not yet completed a deal in Italy.

It’s important to understand the rules of the game for restructurings and insolvencies in different countries, because we need to underwrite for the downside in every deal. The UK has a very well-understood and well-defined insolvency regime, and enforcement is straightforward, so most managers are comfortable with that.

Aside from the UK, within Europe we commonly invest in France, Germany and Spain, and adapt our approach accordingly. For example, France can be a difficult place to do business because it’s almost impossible to enforce on a share pledge, so the company and its shareholders have a strong position in any negotiation. Consequently, the amount we’re prepared to pay for an opportunity there is much lower than in the UK. However, we are comfortable with the process in France because we know it well, having done a number of deals there.

**Q Looking across sectors, retail is experiencing a lot of stress at the moment. What is your take?**

**SM:** The high street isn’t going away altogether. However, we don’t currently have any retail exposure in the portfolio. We’re very cautious about the direction of that industry – primarily due to its rising costs, which have become a problem for almost all retailers. Even successful companies are having to manage their legacy cost base in bricks and mortar down, at a time when

bricks-and-mortar sales are declining globally due to the increasing penetration of online retail. Simultaneously, these companies are having to incur new costs to service their online platforms. The economics of delivering something to a customer and then dealing with returns can be challenging. It’s also incredibly tough on margins when you’re trying to offer the lowest-cost product due to competition.

**Q Energy is another stressed sector. Are you seeing any opportunities there?**

**BH:** There are several discounted investment opportunities in energy. However, we look to invest across a broad portfolio of idiosyncratic ideas. As such, to maintain diversification, we cap energy exposure for the strategy at 20 percent. We don’t want the price of a commodity, like crude oil or natural gas, to drive the ultimate performance of the portfolio. Within the energy sector, we avoid having too much concentration in any one area, and therefore spread exposure across sub-sectors like offshore exploration and production, land drilling, service companies and US onshore shale.

**Q What else can you add to your overall outlook for the market?**

**BH:** In the months and years ahead, we expect to continue to see a broad opportunity set of stressed and distressed credits that represent compelling value. It’s critical to be able to cast a wide net across the US and Europe, and to be flexible enough to invest in a deeply discounted credit or take a control position in a restructuring process. While we will see another credit cycle in the coming years, we think the opportunity is so broad at this point that it’s not a requirement to put capital to work. ■





# Is there a strong case for litigation funding?

*As investors assess lesser-known assets to meet their investment needs, litigation funders are witnessing a surge of interest. But how appealing are the returns, given the risks in this developing market? Joe McGrath reports*

Institutional investors have been increasingly looking for asset classes uncorrelated with equities or bonds in recent years as they seek strong, diversified returns that will meet their liabilities or cashflow requirements.

This search has led some alternative asset classes to become crowded, with large groups of investors seeking non-traditional options in the ongoing low yield environment, and where mainstream asset classes are now widely considered “fully valued”.

With appetite for new investment opportunities unsated, investors have become intrigued by the potential that exists from backing legal challenges, through litigation funders, say those familiar with the market.

“There seems to be a lot of appetite out there for these investments,” says Tim Wainwright, a partner at Eight Advisory. “There is more capital coming into the market and people are chasing opportunities. Investors are willing to take a bit more risk because it is part of the valuation equation for them.”

David Ampaw, a partner at law firm DLA Piper, adds that the market for more mainstream distressed debt has become “hot” and this, in turn, has made litigation funding a tantalising option.

“The returns on funding for quality providers have proven very strong, generally, to date,” he says. “Performance of litigation funding is largely divorced from the equity and debt capital markets, and there is often a quicker route to return.”

“In terms of some of the special situations funds we work with, a multi-strategy

approach also facilitates portfolio diversification as a risk mitigation tool.”

## Growth story

With investors seduced by the promise of another diversifier for their portfolio and litigation funders promising strong double-digit returns, it is easy to see why the market is attracting attention.

Burford Capital floated on the stock market back in 2009 and has since established itself as a recognised player by

institutional investors globally. At the end of 2018, the company announced that a major sovereign wealth fund had signed a deal to back its future investments. The deal sees the unnamed fund stumping up \$667 million, which Burford will match with a further \$333 million of its own.

The growth of this market was also illustrated by funders Manolete Partners and Litigation Capital Management when they listed on the UK’s Alternative Investment Market in December.

A survey of 495 international lawyers published by Burford, in October last year, found that 77 percent of lawyers now consider litigation finance important to their business models. And, of those yet to use a litigation funder, 70 percent said they expected to do so in the next two years.

With lawyers sending a clear signal that they value this market, there is plenty of optimism. An increase in the number of market entrants in recent years can partly be attributed to the success of businesses such as Burford and Harbour Litigation Funding, which have shown the return potential to investors.

“Insolvency litigation and investor/state arbitration, in particular, are proving fertile ground for funders, albeit that they often require a longer-term commitment than many non-specialist funds are able to commit to,” explains Jason Yardley, a partner at international law firm Jenner and Block.

Yardley explains that, previously, legislators had treated external funders with suspicion.

It was thought that they might harm the

*“Performance of litigation funding is largely divorced from the equity and debt capital markets, and there is often a quicker route to return”*

DAVID AMPAW  
DLA Piper

way that disputes were resolved by inflating claims or manipulating evidence. But, more recently, rules in many global jurisdictions, including the UK, have been relaxed, thus paving the way for litigation funders.

“All this has been made possible by a gradual relaxation around the world of rules prohibiting champerty and maintenance, or the funding of a dispute by a third party,” Yardley explains.

### Careful consideration

However, like any market witnessing substantial interest, there are consequences. Concerns have emerged that the market may soon suffer some growing pains from the deluge of new entrants.

In December, while Manolete Partners and Litigation Capital Management were enjoying successful initial public offerings, rival Calunius Capital announced that it would cease investing in any new cases in the immediate future.

In an announcement, Calunius said it had committed all of the investors’ capital from the Calunius Fund 3 and confirmed that the partners were not seeking to raise another fund at the current time. Jenner and Block partner Yardley says that the move indicated that a shake-out of the market will “almost certainly” follow.

“There are too many players entering an already-crowded funding market and not enough cases suitable for funding,” he says. “Given the often-competing needs and requirements of litigants and funders, many cases are simply not suitable for funding.

“Secondly, while the relaxation of rules prohibiting champerty and maintenance has allowed litigation funding to become a mainstream investment activity, courts are continuing to scrutinise closely the involvement of funders and the allocation of risk between parties.”

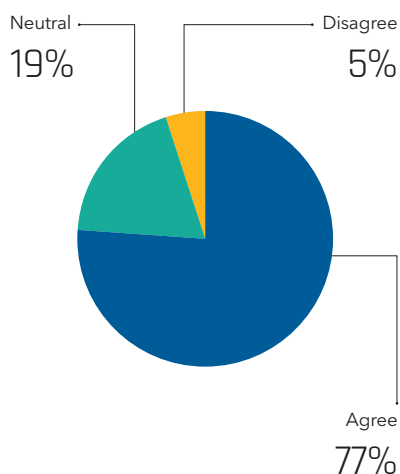
This second observation is topical. In April 2019, a high court ruling in the case of *Davey v Money* showed that a litigation funder can be found liable for additional costs in instances where it fails to win the case.

“As the very recent judgment shows, if they allow or encourage proceedings to be fought in an unreasonable manner, they will increase the risk of finding themselves liable for adverse costs in the event of an

*“For the funder, [corporate portfolio funding] is more beneficial [than single-case funding] as the risk is spread across multiple cases and it provides increased visibility on potential returns”*

**NICK ROWLES-DAVIES**  
Litigation Capital

A survey of 495 international lawyers found that most agree that litigation finance is important to their business



Source: Burford Capital

unsuccessful outcome,” Yardley explains.

The considerations for investors do not end there. A final consideration is to think about the amount of information available at the time of funding, market experts say.

“The high returns reflect the inherent risk and unpredictability of outcome in litigation,” explains Daniel Spendlove, a partner at Signature Litigation.

“Investment decisions are typically made very early in the life cycle of a case, when, in most cases, the full evidential picture is unavailable. Funders price this risk into the returns sought.”

### New approaches

For investors, the benefits of a more competitive market, however, are that litigation funders are starting to think about innovations to protect and improve the chances of returns.

Litigation Capital Management, for example, has recently moved to a corporate portfolio funding model, where the funder finances several or all the cases outstanding on a company’s book, instead of just one.

Nick Rowles-Davies, executive vice-chairman at LCM, says this decision is a departure from the majority of his competitors, which “remain fully committed to single-case funding.”

He explains: “For the funder, this type of financing is more beneficial as the risk is spread across multiple cases and it provides increased visibility on potential returns. This is less of a distressed investment and closer to a form of direct lending where the funding is secured against a company’s legal assets.”

Rowles-Davies believes that this is a largely untapped market with substantial growth potential and says that LCM is one of a small group of funders, internationally, that have already managed to successfully complete such a transaction.

“Investors should recognise that the traditional single-case funding model, where claims are financed on an individual basis, typically in distressed situations, doesn’t necessarily represent the future of the industry.

“While there will always be opportunities to generate returns through single-case funding, the growing number of funders makes this an increasingly competitive environment to operate in when you’re only willing to finance the strongest claims.” ■

# E X P E R T Q & A

*Kartesia Capital founder Jaime Prieto  
explains where the future opportunities lie for distressed debt  
and special situations in Europe*



## Why 'distress' does not always equal 'risk'

**Q** Distressed debt and special situations include a variety of deal types. How do you define these?

Our fund is set up to cover the whole economic cycle. We tend to look at distressed and special situations as a way of offering solutions to good businesses where the seller is distressed or stressed, or where there are “tired” creditors. There are points in the cycle where you see solid companies that are facing difficulties because of economic or industry issues and where their existing lenders may also be facing difficulties or they simply need liquidity. That might include non-core loan sales by banks or CLOs. We’re not an aggressive loan-to-own investor. Rather, we see ourselves as offering assistance to companies to get them through the credit cycle into better times – that’s about 50 percent of what we do.

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**Q** What do you mean by “tired” creditors?

These are classic special situations. Here, you’d have a business that isn’t performing to its original business plan perhaps because the industry is going through a tough point in the cycle. The business may have required covenant resets from lenders and had to renegotiate with sponsors, but they are not basket cases. Often, these companies can sit on lenders’ balance sheets for years not really going anywhere, even though they have solid potential for growth. That’s often because the business has been subject to increasing constraints through the request for waivers, etc. We can offer these companies and their

lenders a way out through new debt structures.

**Q** Where are you seeing most opportunity in these spaces?

When we started out, we saw these across the board. In 2009 to 2012, there was a lot of opportunity buying from lenders that needed to exit certain geographies. From 2013 to 2017, most of the deals we saw were in France and Spain and, to a lesser extent, Germany.

However, over the past year, we’ve seen a lot of opportunity emerge in the UK and it’s now a clear focus for us. We’ve seen a change in the cycle following the extended recovery from the financial crisis. UK businesses have been subject to increases in tax, rates and salaries, many have been hit by the weakening of sterling and many companies have

high leverage. Brexit has exacerbated and amplified many of these factors, with some sectors affected more than others. You now have a base of lenders with a big exposure to the UK and are looking to reduce that as they realise the market is going through an inflexion point. We're looking to provide them with liquidity and offer support to the businesses concerned.

**Q If you're looking for solid businesses, does that mean there are parts of the economy that you actively avoid?**

There are certain sectors of the UK economy that have suffered more than most – retail and dining chains are among these. They attracted high amounts of capital over the past decade or so, which means they became highly competitive and so haven't been able to weather the increased rates, higher staff costs and effects of Brexit well.

This has been compounded by – in retail in particular – the impact of technology. It's uncertain how the shift to online shopping will play out. They also have high fixed cost structures and so tend to perform poorly in challenging consumer conditions. They present binary risk and that's not something we are looking to get into.

**Q How do you view and mitigate risk in distressed and special situations?**

We don't see these deals as inherently riskier. We see them as an opportunity to improve returns without increasing risk. After all, these tend to be deals completed away from highly competitive segments of the market – areas I'd argue are pretty risky. We have ability to complete primary and secondary deals across European markets so that we can construct deals with low risk but high upside potential.

**Q Are these opportunities always sponsored, or is there scope for non-sponsored deals too?**

We can do both and it really depends on the market structure as to which type of deal is predominant. In the UK, for example, there is an abundance of sponsored special situations because the market has seen a lot of private equity activity. In France, it's about 50-50 sponsored to non-sponsored, while in Spain, deals are mainly sponsorless – here, the economic downturn was so severe that corporate loans were still emerging as a good opportunity for us even seven years

*“LPs may not want to deploy capital for some time and then when they decide to resume commitments, perhaps into distressed strategies, it may be too late”*

JAIME PRIETO  
Kartesia Capital

after the crisis. The sponsorless market is less competitive because it tends to be far more complex than sponsored special situations. Sponsored deals tend to carry a far lower degree of complexity, they are more transparent and easier to execute. There are advantages and disadvantages to both.

**Q How can these deals be originated?**

It takes a lot of legwork, particularly at the outset. So, you have to get to know the secondary trading desks at banks, cold-call sponsors and CLO managers. That's what we did in the early days to get the word out that we were looking to offer them liquidity. So, you have to address the lending market, but you also have to get to know the intermediaries because, even if you approach a lender directly, they'll often run a process using advisers to ensure they are getting the best price. Companies themselves also use the intermediaries for financial advice. Small independent advisors tend to be a good source of dealflow for us.

**Q Distressed and special situations are largely seen as a cyclical strategy. To what extent are you expecting an uptick in this type of dealflow in the short to medium term?**

The availability of these opportunities is inherently cyclical, although that doesn't mean

there aren't deals to be done in less challenging times. There are always businesses that underperform because of industry shifts or as a result of specific conditions within the business and there are always lenders looking for liquidity.

Currently, we're seeing a more challenging outlook across Europe. There are certain headwinds as economic growth has slowed and you have developments such as the rise of populism. Until recently, there were tailwinds in Europe stemming from the catch-up following the financial crisis, but these have now diminished in major economies, including Germany. We're getting to a stage where we'll see more distressed and special situations – probably over the next three years. I don't think the downturn will be as deep as that of 2008 to 2011, but we will still feel it.

The UK's economy may be uniquely affected by Brexit, but it is an early indicator of more challenging times in continental Europe. Germany is seeing slower growth and France continues to offer opportunities – the overall economy has only grown at around 1 percent for some time.

**Q Do you think we'll see more distressed credit funds raised in that case?**

We may do, but the issue for LPs is that they can't really time the markets if they wait for evidence in the change of the cycle. There has been a lot of capital directed at pure direct lending strategies because the M&A markets have been very attractive. Yet when the cycle changes, there may well be an element of shock – LPs may not want to deploy capital for some time and then when they decide to resume commitments, perhaps into distressed strategies, it may be too late. Funds raised may not be invested until a year or more after close, by which time, many of the attractive opportunities will have been snapped up.

That's why our strategy is designed to take advantage of highs and lows in the credit cycle. It's also why we have the direct lending and restructuring people in the same teams. Clearly, you need restructuring and structuring expertise across the different European jurisdictions, but you also need teams that understand how to restructure – you need to ensure your people are trained throughout the cycle – so that you are ready and well equipped when these opportunities emerge. ■



# Four trends in Asian distressed debt

*Deteriorating covenant quality will put some off investing in Asia, but there are attractive opportunities in the region for those who understand the risks. [Aaron Woolner](#) reports*

In a 7 May speech about debt in the post-financial crisis global economy, Sir Jon Cunliffe, deputy governor for financial stability at the Bank of England, noted that emerging nations now account for a quarter of total global debt where they had once accounted for just an eighth. The single biggest contributor to this change, he said, was China.

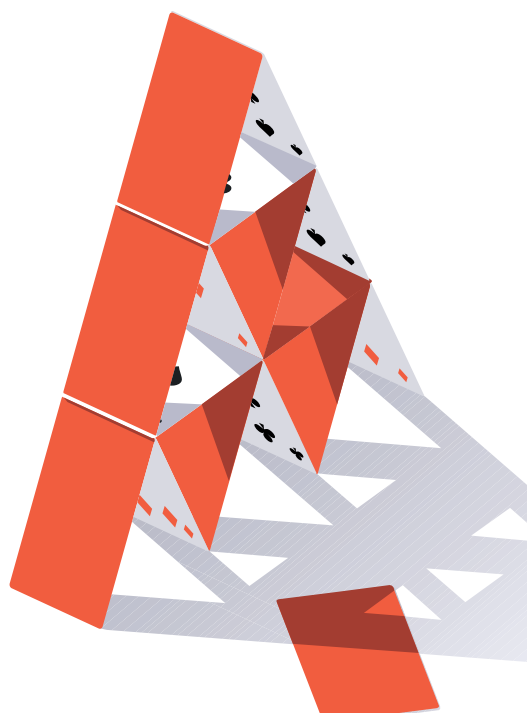
As the China-US trade war heats up further – and with Keith Wade, chief economist

with UK asset manager Schroders, predicting China's export-focused economy will suffer the most as covenant quality deteriorates across Asia – you could be forgiven for thinking that Asian distressed debt and special opportunities were a dangerous bet.

But that is not what Robert Petty of Clearwater Capital says. Instead, the firm's Hong Kong-based chief investment officer is bullish on opportunities not just in the Middle Kingdom, but across the broader region.

“In Asia the distressed debt opportunities are predominantly in China and India, but for very different reasons and types of investment,” he says. “Both countries have compelling valuations and interesting market opportunities.”

We weigh up some of the pitfalls and potential upsides from deploying an Asian distressed debt strategy, particularly in the region's two largest economies: China and India.



## Weakening covenants

**According to research published by Moody's in May, covenant quality in Asia is worsening this year and Chinese borrowers in the property sector are leading the charge.**

These borrowers have refinanced their debt and thereby achieved greater flexibility in terms of making restricted payments and risky investments. Credit facility carve-outs are also becoming more prevalent in the covenants of Chinese property bonds. Moody's found that 40 percent of these bonds, in the 12 months to the end of March, included carve-outs.

Property developers, such as China Aoyuan Group, also gained some flexibility to make investments beyond the parameters to which they had previously been restricted. These parameters are typically included in covenants in China property bonds or loans. This means that if the issuers want to make investments in other companies with the borrowed money, they need to do so in a permitted business, such as core property development.

The situation is not likely to improve. A separate report, published by Moody's chief credit officer Annalisa DiChiara, noted that, as of the end of March, Asian high-yield corporates had \$196 billion in debt that was due to mature through 2021. She added that \$246 billion of corporate debt was set to mature across the region by 2023.

## Regulatory focus on bank NPLs

**When the Reserve Bank of India issued its controversial circular on stressed assets on 12 February last year, requiring lenders to declare loans as non-performing assets on the first day of default, it shook the banking sector.**

All but two Indian banks posted losses for 2018 as a result of having to make provisions for NPLs, leaving the sector open to private capital investment.

In China, the central bank recently cut the amount of cash that banks must hold as reserves for the fifth time in a year, giving lenders additional leeway to offer cash to small and medium-size enterprises. Even so, Clearwater's Petty says mainstream lenders are at a massive capital disadvantage when compared with asset management companies. The result is that the predominant source of capital in the NPL sector will be private, whether domestic or international.

"The players in the Chinese NPL market are the AMC's, and then private capital sources like us, either from onshore or offshore," says Petty. "The capital weighting for NPLs on a bank balance sheet is prohibitive and, conversely, Chinese regulators have given a lower risk rating to the AMC's for holding non-performing assets."

## Legal uncertainty in India

**In a speech to domestic banking executives in June last year, the RBI's deputy governor, NS Vishwanathan, said the 12 February circular had been intended to bring clarity to the issue of non-performing assets in India, which remains an opaque market for investors.**

Vishwanathan cited the establishment of the 2016 Insolvency and Bankruptcy Code as the basis for the change in policy designed to speed up the collection of debts. He said the reforms had solved one of the main problems faced by private debt investors in the Indian market.

"The code is both process-oriented and time-oriented," he said. "It is process-oriented, in that it lays down, in detail, the various steps that need to be followed once a borrower is admitted for insolvency. And it is time-oriented because it specifies strict timelines for insolvency resolution, failing which the borrower would have to be taken into liquidation."

However, in practice, the RBI's circular has provided anything but



clarity, and a recent ruling against it by the Supreme Court has further muddled the waters. The lack of precedent-setting legal cases has meant that the introduction of the bankruptcy code has, in many ways, made the market less accessible to international investors. One fund administrator active in the region told *PDI* that although many of its clients were looking at opportunities in India there remained uncertainty over several aspects of the code, and particularly around how long the process will take.

"There is hesitancy from third parties and outside managers, simply because the laws on tax, and the underlying debt are not as fair or as clear as other jurisdictions," said the fund administrator. "Investors are more comfortable with India, but what drives activity in the sub-continent is the economic fundamentals, and growth is not as fast as has been expected."

## The potential for high returns in China

**China's big banks may be out of the market for NPLs, but an April report from Moody's noted the increased cost of capital faced by the country's big six banks this year, despite their underlying ratings remaining stable and positive.**

The explanation for this is the secular increase in the cost of capital across China's credit markets over 2018 as authorities looked to rein in the country's shadow banking system.

It is this repricing of credit in the Chinese economy that is the most important factor in its attractiveness to private-debt players, says Petty. Choosing the underlying asset is critical, with real estate in first- or second-tier cities mostly offering returns in the mid-teens.

"With the rate rise that took place in the second half of last year for onshore Chinese assets, and in the credit markets generally, combined with the fact that the domestic institutions are full of NPLs, we are seeing some interesting selective transactions," Petty says. "Some of these are twice as attractive as they were around nine months ago and are therefore in high double-digit returns."



# E X P E R T Q & A

*Johnson Har, head of Hong Kong at Alter Domus, Kevin Williams, head of operations for Asia-Pacific, and Jayesh Peswani, relationship manager for Asia-Pacific, offer their perspective on Asian special situations and how investors can access opportunities onshore and in the broader region*



## Patience and persistence in Asia-Pacific

### **Q** How much distressed debt and special situations activity are you seeing beyond Europe and US?

**Johnson Har:** In Hong Kong we are seeing more direct special situations investment activity. Historically this has been conducted by locally based fund managers focusing on that specific strategy, but we are now witnessing a change in the type of market participants.

Investors are diverting from fixed income hedge funds and instead going into the direct debt area, for example. Additionally, we are aware of a lot more LPs in general becoming interested in the Asia-Pacific region and are looking for managers in this area. There are a lot of discussions going on among people

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looking to launch a fund in the next six to 12 months.

**Kevin Williams:** As far as distressed debt goes we are not seeing a very high amount of transactions taking place, but mainland China is getting a lot of coverage over the non-performing loan issue, which is obviously something that foreign investors have a history in. The problem is that the deals being done are conducted in an opaque market and it's difficult to get a handle on the total amount of volumes being transacted.

That said, the main issue at the moment is one of supply, and while local and foreign players are setting up platforms to purchase NPLs, they probably wish they could deploy more, but need to be a bit patient to actually put that capital to use.

### **Q** What is driving investors' interest in Asian distressed debt and special situations?

**Jayesh Peswani:** News stories, such as the recent ramp up in the trade war between US and China, suggest that some companies will soon start to feel the pinch. When that happens, you will start to see more deals taking place. This means that those investors who have already raised capital are either actively

investing, or instead circling around some of these companies, waiting for activity to pick up. It's one of those markets where it is really hard to figure out what exactly is happening because the whole strategy of distressed debt managers is to quietly approach potential targets and do the deal before other people find out.

**Q What kind of opportunities are your clients looking at in markets like Asia?**

**JH:** With the debt market in Asia-Pacific having more depth and breadth, investors are getting more comfortable and it's no longer seen as a niche product. And it's not just first-time debt funds, but also other firms that have raised these types of funds before or are looking to expand their other fixed income strategies into that area. Real estate is certainly one of them, whether it's NPLs or special situations. Chinese real-estate developers need more flexible sources of capital, be it domestic or international in origin.

Outside of China we are definitely seeing credit opportunities with real estate as well. Whether it's a mezzanine player just getting more money than they could from the banks, or unusual situations with collateral, there is often a real estate borrower involved.

**Q What are the major challenges when operating in that region when it comes to understanding local markets and the distressed debt opportunities available?**

**KW:** Players in this sector need to become more efficient with their platforms and understand how they are going to coordinate their people on the ground, all the way up to getting a consolidated view across a portfolio they have purchased. While the market is maturing in China, investors do need to be more organised and efficient.

Often the fund managers have front-office capability, and they know what they are doing in underwriting credit, but they don't have the type of operational platform a bank would. The software available to manage this is often not tailored to alternative investment managers.

**Q From a fund services perspective, what are the specific needs of a client operating in Asia?**

**KW:** While it not something that we cover, sourcing deals is probably the main constraint when we talk to our clients. A lot of

*“With the distressed debt market in China having more depth and breadth, investors are getting more comfortable and it's no longer seen as a niche product”*

**JOHNSON HAR**  
Alter Domus

*“Often the fund managers have front-office capability, and they know what they are doing in underwriting credit, but they don't have the type of operational platform a bank would”*

**KEVIN WILLIAMS**  
Alter Domus

them could raise more capital, but it's a case of deploying it in Asia. LPs want exposure to these markets but it is more of a matter of how many deal opportunities there are out there. Once firms do find an opportunity they want to take, it's rare that there is a fully operational platform for the fund to handle all the aspects of the investment properly in-house.

Another issue is that the opportunity may be unique and that involves a lot of paperwork. Then it is a question of co-ordinating the workflow across a team. It's tough to do that in Excel, and difficult to manage these portfolios from a distance. In many cases, when firms buy those portfolios in different geographies, they must be local to capitalise and convert those NPLs into cash.

**Q How significant is the greater diversity of Asian markets relative to their European and US peers when it comes to investing in either distressed debt or special opportunities?**

**KW:** If a client originates or purchases a loan, they often don't have a platform in place. That comes from the market not being very large historically, and this certainly creates some operational headaches. Firms often don't know what opportunities are going to arise, and when they do, they could look very different from what they expected initially. It's sometimes a bit of a scramble operationally to kind of catch up with the investment and make sure they are monitoring it and reporting on it properly.

**Q Do you see the Asian market expanding, and to what extent?**

**JP:** If the Chinese market is successful, that will raise interest across the region. Take India, for example. It has become attractive now, and that is partly down to them cleaning up the rules on collecting NPLs. All of this has slowly made people a bit more comfortable with India, but what drives activity in that market is how the economy is performing there at a fundamental level. At a high level it is making progress and it is growing, so there are opportunities there as well.

If you take a look at South-East Asia there is a lot of nuance with each of the markets, so it's very difficult to say what level of opportunity there is. You have activity going through Hong Kong and Singapore, and a lot of it is directed at these markets. Nevertheless, I would say that South-East Asia is still lagging a little bit behind. ■



# Will debt dry up for UK retail?

*Property values are falling, forcing lenders to question their exposure to the sector. Alicia Villegas reports*

In June 2016, the UK's home secretary Theresa May visited the Nicholson's Shopping Centre in her constituency of Maidenhead, a town 25 miles west of London. The mall had been bought the previous March by private equity-backed property firm Vixcroft and private credit manager Cheyne Capital with the promise of a revamp. The soon-to-be prime minister was checking in on the upgrade.

"We want to see more shops and businesses attracted to the town centre so that it can become a vibrant hub for the community," May said on her visit. The opposite happened. As the UK's bricks-and-mortar retail crisis hit, several tenants vacated Nicholson's.

Last October, it became the first major example of a UK shopping centre to be placed into receivership during the current cycle – a consequence of its failure to meet its debt obligations. The scheme was bought for £37 million (\$47.6 million; €42.5 million) in 2015, backed by a £26 million loan from Hermes Investment Management, according to reports.

Morgan Garfield, managing director of Ellandi, a property company that specialises in managing shopping centres across the UK and which took on management responsibilities for Nicholson's in 2017, speaks about the impact of online shopping on the wider retail real estate market.

"Retail is challenging in the UK at the moment," says Garfield. "Across Europe, there is growing online penetration that will reshape the retail landscape. In the UK, Brexit is an additional complexity. The effective devaluation of sterling since the referendum has increased retailer costs and eroded profit margins whilst uncertainty has

undermined the confidence of occupiers and investors."

Consumer confidence continued to decline in the fourth quarter of 2018, according to data from Deloitte Consumer Tracker, as uncertainty surrounding Brexit reached new highs. Retail footfall registered a year-on-year decline of 2.1 percent in 2018, according to retail analysis firm Springboard.

The fate of Nicholson's – which has since been acquired by Tikehau Capital and Areli Real Estate – highlights the tough decisions facing real estate lenders as the high street and shopping centre retail crisis intensifies. As capital values plummet, debt providers are forced to consider the health of their loans to retail properties – as well as their long-term exposure to the sector.

## Falls in value

The challenge for lenders is ascertaining how much the collateral to their retail loans is worth. Data provider MSCI recorded a 5.7 percent decline in capital growth across the UK retail sector during 2018. CBRE's monthly index, meanwhile, showed an average drop of 10.5 percent for shopping centres over the same period. Fund manager Fidelity International's prediction is a drop of 20-40 percent for prime retail, with secondary stock expected to fall in value by as much as 70 percent.

There is a debate as to whether valuers are reacting quickly enough to the reality," says Nick Knight, executive director and valuation specialist at CBRE. "I can understand how people looking at average values in published indices might say it feels worse out there than the numbers show. But I'm disappointed by suggestions that it is valuers'



conflicts of interest that is keeping values high. You only need to look back to the global financial crisis, when values were written down by 40 percent, to see this is not a community that is afraid of taking values down."

The lack of transactions in the sector means valuers have limited comparable data to draw on. Savills data show 2018 was the worst year for UK shopping centre investment volumes since 1997, with total turnover of £1.3 billion across 34 deals, down 60 percent on the long-term average.

"Valuing retail now involves balancing sentiment and evidence," says Savills' head of valuation, Ian Malden. "Investors are placing less emphasis on yield; it is more



# 2.1%

**UK retail footfall year-on-year decline in 2018**

Source: Springboard

# 5.7%

**Decline in capital growth across the UK retail sector during 2018**

Source: MSCI

# 22,100

**Expected retail closures in the UK in 2019**

Source: Centre for Retail Research

# £1.3bn

**UK shopping centre investment volumes in 2018**

Source: Savills

about the true cashflow and geared returns. Falling rental values and questions over the sustainable income going forward are very relevant. Valuers also need to increasingly consider the value in a repurposing scenario, which adds a new dynamic to the valuation matrix.”

Knight expects more pain: “There is further to go. History tells us that when you reach an inflection point in the market, there can be a time lag.”

Lenders must also decide whether to take enforcement action if loan-to-value covenants are tripped in their facilities. Anecdotal evidence suggests lenders are desperate to avoid situations of default.

The financial crisis of 2008 remains fresh in lenders’ minds and many are understood to be reluctant to take measures that would mean admitting property lending has, again, resulted in failures.

“Some lenders have put pressure on borrowers to cure LTV breaches,” comments one UK debt advisory specialist, “but lenders are nervous of defaults, because they remember the pain they went through in the crisis.”

### Income eroded

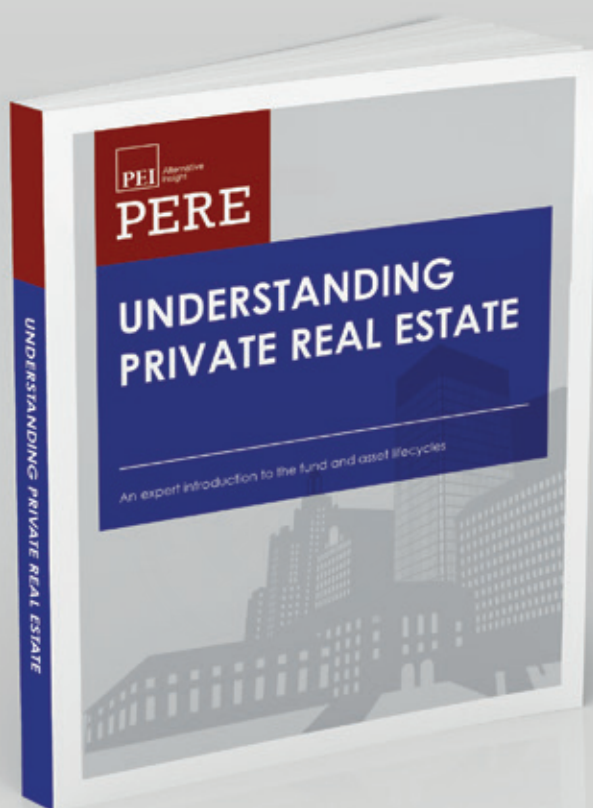
The slew of high-profile retailer administrations in the last six months has created a real danger to retail income. Retail property experts also point to the damaging impact

of retailers using company voluntary arrangements – deals allowing them to reduce rents as part of a survival plan – which many consider an abused tool in recent months. The traditional upward-only rent review, it seems, is not sacrosanct.

“Tenant failures and falling rents will erode net operating income,” says Garfield. “If, in turn, this has an impact on the ability to service debt, lenders will have to act.”

Sector analysts do not expect pressure on retailers to let up. The Centre for Retail Research expects 22,100 retail closures this year, up from 18,443 during 2018. Andrew MacDonald, head of real estate finance at asset manager Schroders, is one of those who see

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the threat to income as the most immediate concern for lenders.

"In the financial crisis, it was more a capital value-led issue. Lots of loans breached LTV covenants because of yields rising, but income was still robust in lots of those loans. The issue this time for retail is on the income side of the equation. Loans breaching their income coverage ratio covenants is more of an issue than LTV breaches."

Some, including Trevor Homes, head of senior lending at debt fund manager DRC Capital, are convinced income will hold up across many UK shopping centres, despite the crisis. "Income is holding up at a lot of shopping centres, so although there have been a few administrations, we are not seeing ultra-low occupancy at shopping centres. The serviceability of debt is usually sustainable. The lending was generally done on sensible terms in the first place."

### Liquidity

While lenders are not, at this stage, pulling the plug on their existing borrowers en masse, sourcing new finance in the retail sector is understood to be difficult. Banks are negative on the asset class in general, despite protestations from some in the industry that parts of the sector, including leases to the major supermarket chains, remain robust.

The long-term liquidity of retail property debt is in the balance, and may cause problems for those sponsors in need of refinancing come the maturity of their current loans. Many of these fall due at the end of this decade, with Savills identifying 2020 as the market's refinancing spike. Given many assets across the UK are owned by private equity funds that have deadlines to return capital to investors, debt for refinancing is a necessity.

Lenders have also taken a more conservative approach to underwriting during this cycle. Leverage levels typically fall below 60 percent, compared with the 85 percent-plus seen before the crisis.

Debt advisory specialist James Wright, head of the real estate finance business at Link Asset Services, recalls the challenges of sourcing debt for clients in recent situations. "Banks are pulling back from retail," he says, "and there is a definite focus on the best examples of retail, which means outlet centres and retail warehouses are an easier sell than high street units or shopping centres."

"It comes down to the covenant strength,

*"Many private equity investors, ranging from real estate private equity funds to hedge funds, are eyeing the retail sector, some of whom are looking at the debt as a way in"*

**CHRISTOPHER DANIEL**  
Quadrant Estates

lease lengths, the quality of the real estate, but also increasingly the alternative use value."

Although banks do not tend to signal cooling appetite for a sector, there is an acknowledgement from many that retail is problematic. Where banks retrench, alternative lenders tend to in-fill and sources say the market is playing into the hands of those debt funds with higher risk/return profiles.

### Filling in the gap

Some alternative lenders see the fall in retail values as an overcorrection and will lend, if vacant possession value is higher than the loan volume. Others argue alternative sources of capital will not be the cure-all for those in need of retail finance, with some in-

stitutional investors, which back many alternative lenders, sharing banks' qualms about the retail sector.

Some argue the vultures are already circling distressed situations. "Many private equity investors, ranging from real estate private equity funds to hedge funds, are eyeing the retail sector, some of whom are looking at the debt as a way in," says Christopher Daniel, founding partner at Quadrant Estates, which owns retail property across the UK.

However, many believe the work-out of the UK's distressed retail will require investment and long-term thinking, rather than short-term profit.

Buyers are likely to tackle problem retail in joint ventures in order to bring a combination of capital and expertise to the table, says DRC's Homes: "It might include local authorities who have the incentive to make these schemes work. When product came out of NAMA [Ireland's National Asset Management Agency], buyers knew they could do a quick turnaround. Those easy wins are not there at shopping centres – if they were, the existing sponsor would be doing it."

There is evidence of institutional investors taking the opportunity to buy into the sector. For example, LaSalle Investment Management is reported to be close to buying The Galleries mall in Bristol from Infrared Capital Partners.

"We will definitely take advantage of current pricing, to be very selective on stock," says Mahdi Mokrane, LaSalle's head of research and strategy, speaking generally about the possibility of buying assets in a changing retail landscape. "Key considerations for us are location and asset flexibility – dominant urban shopping centres are typically more attractive to us – and capital expenditure, as retail assets need more capex to convert spaces to increase footfall or for alternative uses."

The full extent of the UK's retail crisis is not yet apparent. What is clear, however, is that lenders are reacting. At this stage, the receivership at Maidenhead's Nicholsons is not the norm, but as loans come due at struggling shopping assets, more lenders are likely to pull the plug. Further forward, lenders will assess their appetite for the sector; retail, many point out, is not dead, but the wrong kind of retail – the dated stock which does not fit with the times – will not be worth lenders taking the risk. ■



## A global strategy *PDI* data show distressed debt remains a predominant and widespread theme for the asset class following its 2017 peak

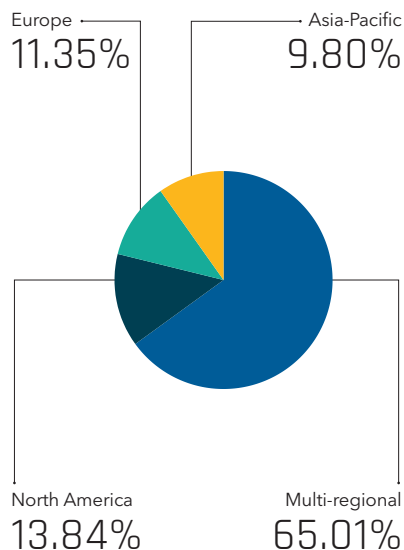


Expert analysis by **Andrew Woodman**

**D**istressed debt has long been one of three focus areas for private debt managers, alongside senior debt and subordinated/mezzanine debt. It enjoyed a surge in 2017 – a bumper year for private debt as a whole – when, for the first time since 2012, it pulled ahead of all the other strategies in terms of capital raised.

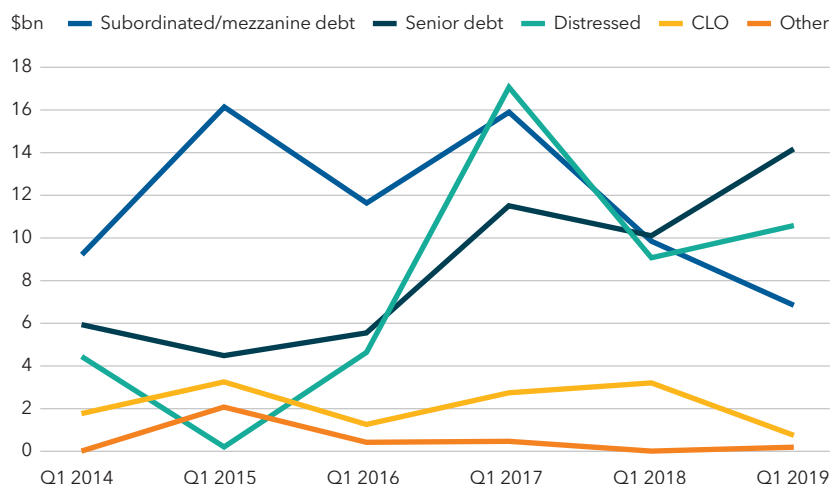
Much of this capital was raised in anticipation of the credit cycle coming to an end, but most of it has yet to be deployed. This partly explains why distressed fundraising, though still strong, has been relatively muted over the past year. Another notable trend is that among the largest funds, much of the capital is multi-regional in focus, or least evenly distributed across the globe. ■

Nearly two-thirds of distressed debt raised in 2018 and Q1 of 2019 was multi-regional



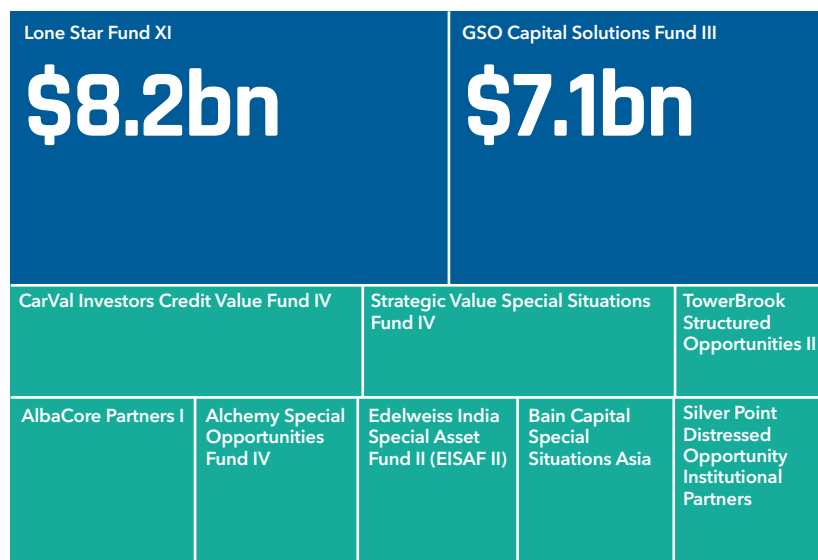
Source: PDI

Q1 of 2019 was the second strongest quarter for distressed debt fundraising over the past five years



Source: PDI

Lone Star and Blackstone's GSO Capital account for around half the capital raised among the top 10 distressed debt funds



Source: PDI

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