Opportunities in dislocated credit markets

Alternative investments

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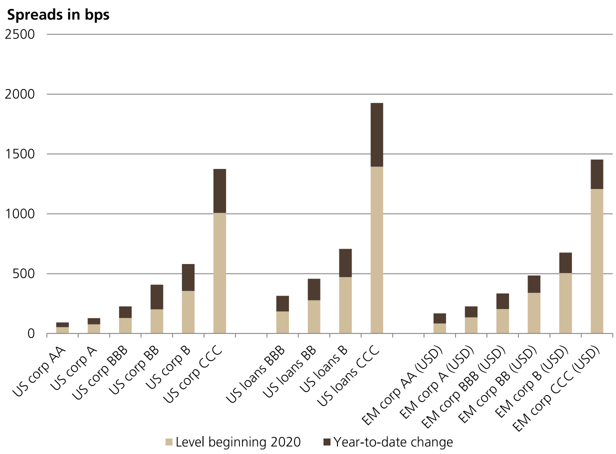
- The credit market dislocation following the COVID-19 outbreak is likely to be a generational event. We expect a long and lasting downturn across liquid and illiquid debt instruments, unfolding in three stages and with a material pickup in default rates.
- For active investment strategies in stressed and distressed assets in the private market and hedge fund universe, this presents a unique opportunity to deploy capital, help companies at a critical time, and potentially generate attractive returns.
- Investors should, however, consider the risks involved in distressed investing, including illiquidity, long lock-up periods, and volatility. Importantly, investments should be made within a well diversified portfolio of hedge fund or private market strategies.

Source: Unsplash John Colton, Getty Images

Foreword

In an instant, the COVID-19 outbreak brought the global economy to a standstill, paralyzing countries, causing revenue losses across industries, and putting many businesses at risk of closure. In reaction to the pandemic, governments globally have deployed unprecedented monetary policy and fiscal responses. While this may have reduced the amount of dislocated credits since March highs, the significant buildup in credit markets following the global financial crisis (GFC) suggests policy alone may not be enough to stem the economic damage from the pandemic. As such, we expect a large supply of stressed, distressed, and default situations across both public and private markets in the coming quarters. For distressed managers in the hedge fund and private market space, this is a unique opportunity to deploy capital, help companies in a difficult situation, and generate attractive returns.

Fig. 1: Spread widening across credit markets



Source: Bloomberg, UBS, as of June 2020

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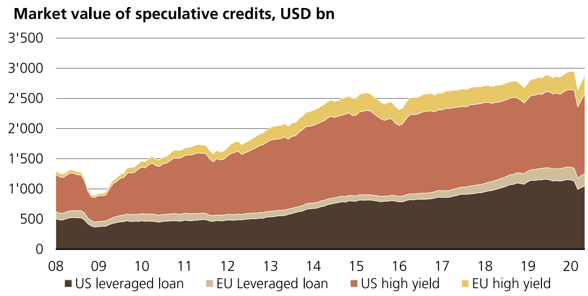
What are distressed strategies?

Distressed strategies typically invest in publicly traded debt, private debt, or equity instruments of companies at risk of or undergoing a major financial event (possibly leading to bankruptcy). These strategies aim to profit by realizing value from oversold credits, providing liquidity to stressed borrowers that are having difficulty paying off debt obligations, restructuring, normalizing firm profitability, or liquidating assets. Both hedge funds and private market funds invest across these areas and are typically categorized as "distressed debt" (which tend to focus on listed markets and/or restructuring situations) or "special situations" (which tend to focus on providing liquidity to stressed borrowers) strategies. Generally, the opportunity set for these managers is linked to the amount of dislocation in the credit market. Returns, however, are largely driven by company and deal-specific factors. In recent years, investment opportunities for these strategies were generally constrained to certain sectors and idiosyncratic situations. Following COVID-19, this has changed.

The beginning of a new cycle

Record-low interest rates and investors' intense search for yield since the global financial crisis have fueled an unprecedented buildup of listed and private debt, especially in the speculative grade segments. Over the past decade, the global high yield and leveraged loan markets doubled in size to USD 2.9tr. In the private credit space, outstanding debt grew almost five times to USD 308bn. During most of this period, default rates remained low, with leveraged loan defaults (by issuer) averaging around 2% and high yield default rates averaging around 4% since 2008.

Fig. 2: Speculative grade credit markets have doubled since 2008



Source: Bloomberg, S&P LCD, UBS, as of June 2020

Entering 2020, credit markets were strong, with the exception of idiosyncratic issues in sectors such as energy and CCC rated leveraged loan markets. The situation changed almost overnight following the outbreak of COVID-19. Credit markets experienced steep price markdowns amid forced sales, rating downgrades, rising defaults, and margin calls. Meanwhile, numerous businesses across the globe and of all sizes have been seeking a liquidity lifeline to stay afloat.

The supply of distressed credit is growing

While credit markets have partially normalized since March, as of this publication, we estimate that about half a trillion dollars across credit segments are trading at distressed levels. Specifically, in the high yield space, about USD 125bn of US and EUR 25bn of European high yield are trading at spreads above 1,000 points. In the leveraged loan market, we estimate that about USD 125bn of US and EUR 15bn of European leveraged loans (including collateralized loan obligations, or CLOs, which pool leveraged loans into tranches) are currently in distress. In the private credit space, we estimate that around 20%, or USD 120bn of outstanding loans, may require borrowers to seek alternative sources of liquidity. Meanwhile, in emerging markets, aside from corporate credit, we also see dislocations in sovereign debt where approximately USD 75bn is at distressed levels. Current market pricing implies a sizable pickup in default rates moving forward.

Opportunities in the distressed cycle

Stress in the credit market has expanded the opportunity for hedge fund and private managers to deploy capital toward dislocations, provide liquidity, and help restructure balance sheets. A typical distressed credit cycle develops in three stages, presenting distinct sets of opportunities:

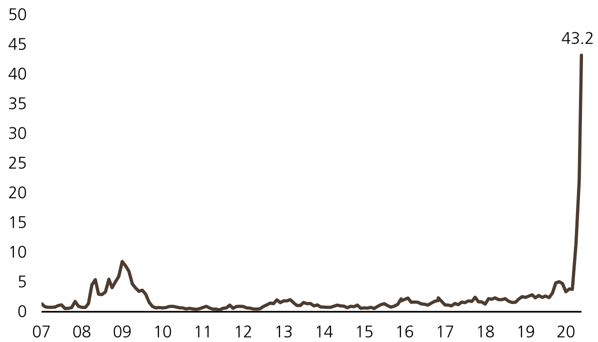
Stage 1: Post-shock liquidation in listed credit markets

Listed credit markets are typically where dislocations materialize first. This can be attributed to their more liquid nature, daily mark-to-market, as well as forced selling activity from some credit investors or asset managers (mutual funds, ETFs) that need to raise cash to cover redemptions or margin calls, or to reduce leverage. Spreads widen across the board, with companies having the weakest fundamentals deteriorating the most. This is typically a time of maximum uncertainty and may present attractive opportunities to purchase oversold credit at a discount to intrinsic values.

In the current cycle, we've seen government and central banks across the world inject liquidity, so many of the mark-to-market-driven opportunities have already normalized. This is evidenced by the strong spread tightening of investment grade and high yield since March/April. Idiosyncratic opportunities remain, however, in those areas that have not been targeted by government and central bank buying. These may include convertibles, CLOs, and other parts of the structured finance space. CLOs in particular may see a further deterioration in the short term, as rating downgrades by agencies may trigger technical selling.

Fig. 3: Record increase in the number of loan issuers downgrades

US leveraged loans: ratio of downgrades to upgrades



Source: UBS, as of June 2020

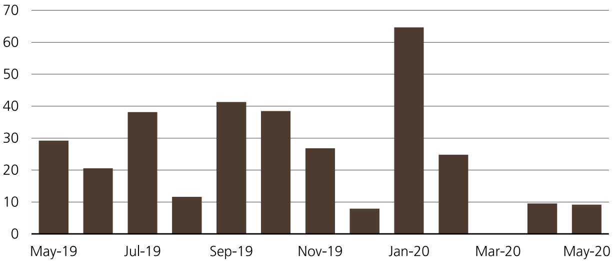
Stage 2: Providing capital to liquidity-strapped borrowers

In parallel with listed credit market dynamics, companies start to face short- to medium-term cash needs after revolving credit facilities have been drawn and reserves dry up. Upcoming debt maturities may also intensify the need to access capital. Liquidity injections or recapitalizations are required to avoid defaults. Technical selling turns into more fundamental challenges that require credit and underwriting expertise.

To address the current cycle, governments have provided emergency funding, but not all firms are eligible or can access this funding. Credit fund managers have stepped in to offer rescue lending or liquidity solutions such as opportunistic sale leasebacks (ranging from real estate or hard assets and equipment) and hard money loans to those companies that can't access capital markets or other traditional funding sources. Such solutions may be in the form of senior secured loans and/or subordinated structures such as preferred or convertible equity that provide higher return potential. Aside from issuing loans toward more defensive liquidity situations, we note that these managers can also find opportunities to fund offensive acquisitions for stronger borrowers looking to grow their market share among weaker competitors. Overall, we expect increased activity in this area in the next few months.

Fig. 4: Primary loan issuance has dried up post-COVID-19

Institutional leveraged loan volume, USD bn



Source: S&P LCD, UBS, as of June 2020

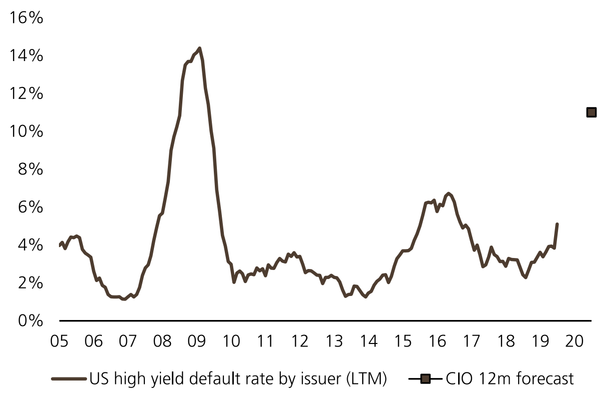
Stage 3: Restructuring and rebuilding

As the range of economic outcomes narrows with more certainty on the path to recovery, borrowers will start to focus on rebuilding their balance sheet (funding working capital needs, hiring labor) and potentially consider restructuring. Pricing will have adjusted across liquid and illiquid credit segments; defaults and bankruptcies will have picked up; and banks will have recognized their pools of nonperforming loans (NPLs). These opportunities take time to unfold, typically in the order of 12–24 months from the start of the downturn, but they last longer and also present the highest reward.

So far this year, 88 companies globally have defaulted, with 37 technical defaults (missed interest or principal payments) and 41 bankruptcy-related defaults, according to S&P. The majority of defaults are in sectors or companies that already faced challenges before COVID-19 (i.e., retail, energy). Meanwhile, many companies are still trying to use out-of-court financing solutions rather than resorting to bankruptcy law. We expect this to evolve as the damage resulting from shutting down economies materializes in large scale. As the credit cycle matures, we expect fund managers to focus more on opportunities across restructurings, liquidations, acquisition of NPL portfolios, participation in more illiquid debt to control transactions, or debtor-in-possession financing.

Fig. 5: Default rates should pick up in the next 12 months

US high yield default rate (by issuer) and UBS CIO forecast



Source: BofAML, UBS estimates, as of June 2020

Active managers are uniquely equipped to take advantage of stress in credit markets

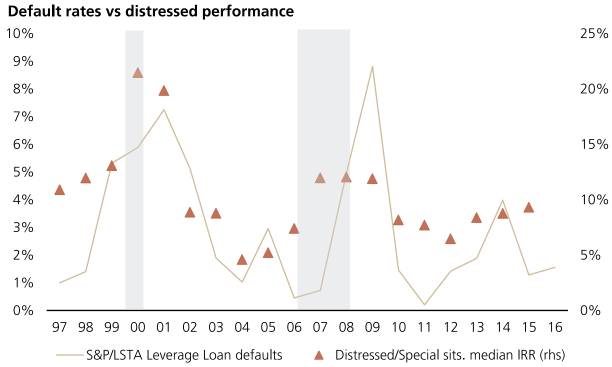
Acquiring assets or providing financing to stressed or distressed companies is a challenging endeavor. Once issuers or firms are under stress, investing in these situations requires a deep understanding of the company's fundamentals, capital structure, operating model, as well as expertise in the legal framework. We view distressed private market funds and hedge funds as best positioned to identify and source opportunities, provide compelling financing solutions, and manage potential downside risks along the way.
Managers can add value across the following:

- **Sourcing:** Managers with extensive industry relationships and partnerships can proactively source deals, avoid competitive bidding situations, and reduce friction costs by leveraging an existing borrower base
- **Pricing:** Managers with robust due diligence teams can identify mispricings in the market by thoroughly assessing credits to invest in, or better price risk when originating loans to borrowers.
- **Underwriting:** Deals are often complex and require legal and structuring expertise. Knowledge of regional bankruptcy laws can help navigate and execute on deals involving restructurings and workout situations.
- **Active management:** With the window of opportunities often short (particularly for strategies investing in listed markets), agile managers with access to capital will be at an advantage. Teams with industry expertise can influence positive outcomes by managing businesses through uncertainty and adding to operational improvements.
- **Risk management:** Proactive portfolio monitoring via active dialogue with management teams and thorough macro/company assessment can help offset risks before credit deterioration occurs. Managers can also reduce risk by structuring portfolios with appropriate position sizes across regions, industries, or sectors, as well as hedge themselves against potential negative outcomes.

Overall, managers with extensive in-house resources to evaluate deal flow across industries and situations are paramount. Given the difficulties in timing when these dislocations will occur, we favor seasoned managers that can invest across the different stages of the credit cycle while having the flexibility to shift focus from more liquid to less liquid instruments as the opportunity set evolves. In this context, drawdown structure (where the managers make capital calls as they see opportunities) typically used by hybrid hedge funds and private managers, can be useful to alleviate the challenges of market timing these events.

Fig. 6: Historically, managers have been able to monetize on credit dislocations

Default rates vs distressed performance



Source: BofAML, S&P LCD, Pitchbook, UBS, as of June 2020

Attractive post-crisis return prospects

Historically, distressed strategies have generated attractive returns. For private funds, vintages between 1997 and 2016 delivered median IRRs (internal rates of return) of around 9%, according to Pitchbook data (Fig.6). Over the same period, the HFRI Distressed/Restructuring index generated around 7.5% annualized average returns. Importantly, both strategies delivered their highest returns after major market dislocations such as 2000–2001 and the GFC. Please note that vintage year IRRs for private funds and calendar year returns for hedge funds are not directly comparable. For more information, please refer to the hedge fund and private market education pieces on distressed debt.

Risks to consider before investing

While distressed opportunities can offer very attractive return prospects following a crisis, they also present challenges that investors should consider before investing. By definition, distressed strategies incur a high level of credit risk and potential volatility given the troubled nature of underlying companies and assets. Managers may face trading restrictions (for legal or market reasons) and may not be able to sell an asset at the desired price. Restructuring is a complex process. Many events are beyond the managers' control, including unforeseen regulations, unsuccessful reorganization, or miscalculation of underlying assets. Adverse market factors could negatively impact returns for certain investments. Given the time and resources required to analyze and work through restructurings, managers may hold fairly concentrated portfolios. Reputational risk can also arise in investing with distressed debt strategies. Some managers may engage in strategies perceived to be controversial (e.g., vulture investing), which may result in legal action or attract public and media criticism. Other, more general risks may still apply, including the lack of transparency, illiquidity, high fees, and long lock-up periods. These risks cannot be fully eliminated, but can be reduced significantly through careful due diligence and strict investment and monitoring processes.

Our bottom line

We see robust opportunities to invest in dislocations occurring across credit markets. Whether it be through trading in publicly listed securities, providing capital when liquidity is in short supply, or restructuring balance sheets, each stage of the downturn can present unique opportunities. Overall, we believe distressed hedge fund and private market managers are well positioned to generate attractive returns in the post-COVID-19 world and beyond. Investors who can tolerate some illiquidity in their portfolio may find these strategies a good and alternative way to invest in the current environment.

Non-Traditional Assets

Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, "junk bonds," derivatives, distressed securities, non-U.S. securities and illiquid investments.
- Managed Futures: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- Real Estate: There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- Private Equity: There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- Foreign Exchange/Currency Risk: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer's "home" currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a U.S. investor.

Appendix

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Number 01/2020. CIO82652744