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Unleashing the distressed ‘war chest’

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Today’s strong, low-defaultUS market still bears distressed fruit, experts at Pension Bridge conferencesaid.

As waves of capital flow into distressed debt and special situations funds in the later stage of the credit cycle, US-based fund managers should not wait for a recession to deploy this “war chest” of capital, financiers were told at the Pension Bridge Private Equity Exclusive conference in Chicago on Tuesday.

As default rates have stayed low and corporate earnings remained high over the past seven years, several funds are idle, waiting for the distressed cycle to come, panelists told a packed conference room in the Trump International Tower.

There are 88 distressed debt or special situations funds in the market globally, seeking almost $94 billion, according to *PDI* data. Nine funds closed on just under $11 billion in the first half of this year.

Meanwhile, private firm default rates – one common indicator of rumblings for a distressed cycle – have declined steadily during the past five years. As of May, the rolling one-year default rate stood at 1.5 percent, according to Moody’s Analytics, which is down 73 percent from its September 2009 peak of 5.3 percent.

But the panelists pointed out that they don’t need an economic downturn in order to invest distressed or special situations capital. Sectors of note included energy, manufacturing, and retail, the last of which is undergoing a dramatic dislocation due to Amazon stealing market share that once belonged to brick-and-mortar retailers.

“It doesn’t take recession to do what we do,” Ethan Vogelhut, executive director at investment firm Adveq Management. He pointed to plenty of opportunities for distressed-for-control or corporate carve-out deals. As part of those deals, managers can make returns after taking control of troubled companies and addressing the company’s problems.

Alan Kosan, senior vice president and head of investment manager research at Segal Marco Advisors, added that an investor today can still get a 15 percent net internal rate of return on distressed debt investments, despite the strong economic macroeconomic fundamentals.

The key to investing in distressed in a strong market today, he said, is to first invest in a company that finds itself with a good market position but that has bad management and is in a poor financial position. To do so, investors can then buy the debt or direct equity of that company and add the value the company is missing. This strategy can garner fund managers mid-teen net returns today, Kosan said.

Because firms can't tell when a large market disruption is going to happen, they need to be investing at some level in the distressed or special situations asset class during both economic booms and busts, he added.

"There's some signals in the market of softening, i.e. multiples are up, large outstanding debt levels, and a surge in the issuance of covenant-light deals that masks some default activity happening," Kosan said. "There's always companies doing dumb things," he said.

Like the investment managers, institutional investors also agree that special situations and distressed debt will be attractive credit investments, conference attendees heard.

According to a Coller Capital survey of 110 institutional investors around the globe – which the firm presented at the conference on Monday – at least 79 percent of the LPs believe that special situations investing will provide attractive credit investments in the next two years, Also, 75 percent of LPs think the same about distressed debt opportunities.

The strong preference for those two strategies surpass the percentage of LPs that see positive opportunities in direct lending (58 percent), mezzanine debt (37 percent), unitranche (27 percent), syndicated loans (23 percent) and CLOs (14 percent), the survey results showed.