Bi-Weekly Update

May 15, 2020

Invesco Fixed Income

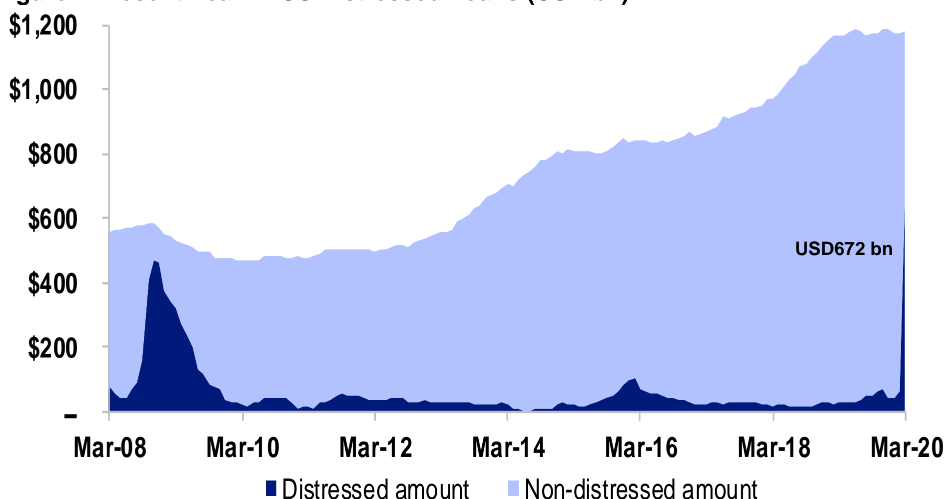
Increasing Opportunity in Distressed Credit

Beginning in late February, financial markets began to price in the escalating health and economic costs of a global pandemic. The introduction of increasingly restrictive social distancing measures across the world aimed at containing the spread of Covid-19 put a sudden stop to vast swaths of social and commercial activity. Simultaneously, Saudi Arabia and Russia initiated an oil price war which was followed by an historic collapse in oil prices, as markets calibrated to sudden demand reduction. The economic damage resulting from this unprecedented situation is likely to be significant, both in depth and duration.

Ultimately, we are optimistic about the ability of the US economy to recover following a mitigation of the current health crisis, given the extent of fiscal stimulus, aggressive monetary policy and the fundamental signs of health in the US economy prior to the outbreak. However, the exact timing of that recovery is uncertain, given the potential for the virus to endure seasonally and the unknown consumer behavioral adjustments that will likely result. Moreover, from a risk perspective, we believe this requires underwriting a non-linear recovery with expected resurgences and sporadic quarantines.

In Europe, where near-recessionary conditions existed pre-virus, the situation is far more dire. Germany, the UK, and Italy were all in, or near, recessionary environments for much of 2019. We believe global supply chain disruptions, reduced demand across major industrial sectors, and what is likely to be an almost non-existent tourism season, will combine to produce a more lasting correction across the European Union. The region lacks the ability to enact large scale and coordinated fiscal stimulus across the continent and, unlike the US, the European Central Bank has limited monetary firepower, given that rates are already at, or below, zero.

Figure 1: Recent Peak in US Distressed Loans (USD bn)



Source: S&P LCD, March 2008 to March 2020.

As a result of Covid-19 and related events, we are seeing a clear unfolding of opportunity across the global credit markets. In March, the volume of distressed loans reached a high, eclipsing levels reached during the global financial crisis, with more than 50% of outstanding loans priced at distressed levels (Figure 1). Since then, large cap liquid credit (BB loans, etc.) has rebounded substantially, while the more infrequently traded, more inefficiently priced small cap/middle market loan universe has yet to recover. We do not believe the full extent of the pandemic has been priced into the credit markets, particularly in small cap/middle market credit, where we expect weak earnings in the second and third quarters to cause further fundamental pricing pressure. Additionally, we expect earnings misses to trigger ratings downgrades, which can create technical selling pressure for many of the structured vehicles that own the majority of the loan market. Put simply, we believe we have only seen the “tip of the iceberg” with respect to distressed opportunities.

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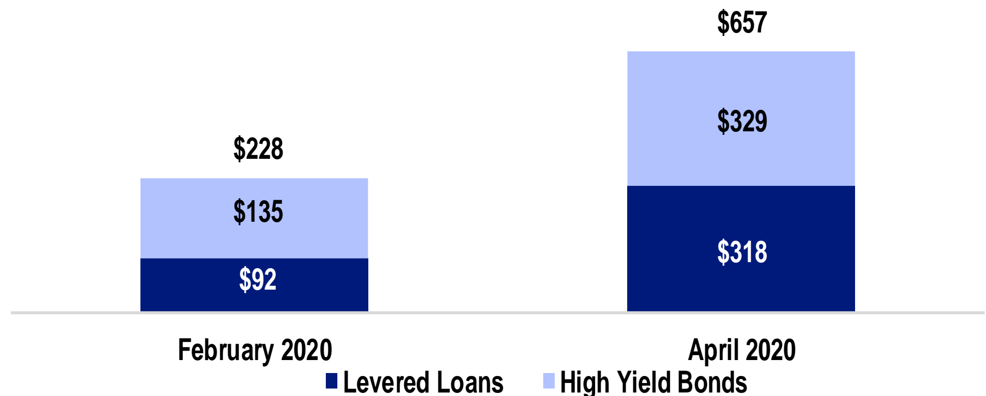
Small Cap/Middle Market Distressed Opportunity
We typically define the small cap/middle market opportunity set as issuers with USD30-USD75 million of earnings before interest, taxes, depreciation and amortization (EBITDA) and less than USD1 billion market value of debt. This segment of the market tends to exhibit three important differentiators relative to large cap distressed credit: (1) the space tends to be much less efficient as the debt is "private side", held by relatively few lenders and information is scarce as the credits are not covered by trading desks, etc. (2) the investment opportunity tends to be "evergreen" as these companies continually face idiosyncratic credit issues irrespective of the market cycle for routine reasons (e.g. working capital issues, customer losses, integration inefficiencies, operational or manufacturing issues) and (3) the opportunities tend to be diversified across sectors. By contrast, large cap distressed credit tends to be more efficiently priced and the opportunity set is cyclically driven, with investments typically concentrated in specific sectors experiencing the most acute distress. In recent years, large cap distressed credit opportunities have been heavily focused on energy and retail. In today's environment, large cap distressed credit opportunities are predominantly focused on the first-derivate Covid-19 impacted names related to travel, entertainment, leisure, etc.

In our experience, past "cycles" increased the opportunity set of small cap/middle market distressed credit by 30-40%.[1] Covid-19 presents a unique outlier scenario in which a global economic near-shutdown has multiplied the pipeline almost three times (Figure 2). Many of these opportunities are good companies, with sustainable, long-term business models and fundamentally sound prospects; however, we have seen their loans trade off by 20-plus points since February.[2] These are companies we would not have expected to be available at distressed prices.

Figure 2: Expanded US Small Cap/Middle Market Opportunities (USD bn)
Face Value of Distressed Credit* in Small Cap/Middle Market**



Source: JPMorgan April 24, 2020. Notes: *Defined as debt with an all-in yield greater than 10%. **Small cap/middle market defined as companies with less than USD1 billion (market value) tranches of debt.

The opportunity set in distressed credit has been widely recognized and vintages of distressed credit appear well-poised to deliver compelling total returns; however, we think there is an equally interesting story regarding the potential to take advantage of these opportunities with reduced risk relative to previous cycles if executed correctly. Distressed transactions typically involve two distinct restructuring activities to create value. The first is restructuring operational challenges within target companies, such as resolving a manufacturing issue. The second is the execution risk of financial restructuring. Most often, distressed investing requires both of these levers to achieve target total returns. However, in the current opportunity set of small cap/middle market distressed companies, we are observing that very little, if any, operational restructuring may be required. These are not "broken" businesses that need significant operational changes or management transitions. They are companies dealing with demand, liquidity, and supply chain issues that can be resolved in sectors where we have confidence in their post-Covid-19 business models. We believe the reduced need for operational restructuring will improve the risk profile of these investments relative to large cap distressed investments.

While small cap/middle market distressed credit represents an attractive opportunity, we believe the effort is best pursued by credit platforms with sourcing, diligence and execution advantages paired with a dedicated team with experience in the segment. This segment has

traditionally been challenging for larger strategies looking to deploy large amounts of capital in single transactions while smaller stand-alone competitors lack the broad market connectivity and coverage. The current environment is the most significant distressed pipeline our team has seen in its decades of distressed investing. We believe this opportunity will persist over the coming quarters and years and believe patience and discipline will be the best approach in capital deployment.

[1] Source: Invesco estimate, data as of May 15, 2020.
[2] Source: Invesco, data from Feb. 15, 2020 to May 15, 2020.

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