Dispatch from the Research Desk

Opportunity Amidst Turmoil

The Opportunity Framework

Despite massive monetary and fiscal stimulus, we believe that challenging times remain ahead as the fundamental economic paradigm has shifted. The world is in the early stages of a recession, with sell-side Global GDP estimates revised into negative territory (-0.3% to -1.2%). The eventual recovery will likely come with structurally slower growth, higher unemployment, lower consumer confidence and greater market intervention (broken traditional pricing mechanisms). We think the effects of COVID-19 will be with us for well over a year and likely more than two years. Our assumptions are not for a V-shaped economic recovery, but rather a U-shaped recovery that continues into 2021. In the face of real headwinds and a sober assessment of the downside risks to the current economic environment, we are still finding opportunities that we believe are compelling.

We are evaluating manager opportunities along three inter-related dimensions: Time, Dislocation Source and Asset/Business Quality. Our current emphasis is on short-term opportunities in assets that became dislocated for technical rather than fundamental reasons and where the asset quality/seniority in a long-term depression scenario is unassailable. As this crisis continues to unfold and greater visibility on corporate and economic conditions becomes available, there will be opportunities with high IRRs and greater MOIC potential in more subordinate securities and/or lower quality issuers – but we don't believe the time is now.

Credit Market Review & Policy Response - At the risk of rehashing common knowledge, we believe the magnitude and speed of credit market deterioration in March is unprecedented and warrants quick summarization. Whereas the 2008 selloff largely played out in the summer and fall of 2008 before peaking in December, credits which reached 2008-like levels last week were trading near all-time tight levels as little as four weeks ago.

- Investment Grade: Widened 300 bps in 60 days, $36 billion of bond fund outflows during the week of March 16th (5x the prior weekly record), over $100 billion of debt at distressed levels (yields over 1,000 bps).
- Leveraged Loans: Worse mark-to-market month than October 2008, average dollar prices in the high-70s, over $700 billion trading below 80 cents on the dollar.
- High Yield: Five of the worst spread widening days in history, market traded at 1,000 bps over and 11% YTW, over $400 billion trading at over 1,000 bps.

While the peak near-term market strain was eased the week of March 23rd through monetary and fiscal stimulus measures, the market remains concerned about BBB (investment grade) credit downgrades ($600 billion on Outlook Watch Negative) and forced sales from CLOs as defaults and downgrades accelerate in a recessionary economy. With COVID-19 causing a coordinated contraction across the entire economy, IG downgrades are likely to enter the High Yield (HY) market around the same time, weighing down the universe and lower quality issuers. As fundamental weakness expands, CLOs are likely to be forced sellers as Overcollateralization and Interest Coverage ratios deteriorate. As a result of these concerns, many Bid Wanted In Competition (BWIC) assets have failed to trade to date and banks have continued to limit the availability of financing. Despite this week's rally, the market continues to price in a mid-teens default rate.

The Fed has stepped in with massive monetary stimulus, including cutting rates to zero, unlimited QE in Treasury and MBS markets, a $100 billion Commercial Paper Funding Facility, a $100 billion Money Market Mutual Fund Liquidity Facility, a $300 billion Corporate Credit Facility and Term Asset-Backed Loan Facility, and a Main Street (direct SBA lending) program. Most of these programs were announced between the 14th and 23rd as the Fed stepped into markets that were becoming increasingly dysfunctional. On the fiscal side, lawmakers appear ready for bipartisan approval of a $2.2 trillion stimulus bill, including $290 billion of direct payments to families, $260 billion of unemployment insurance expansion and $900 billion to small and large businesses (loans and grants).

Snapback Opportunity

Before delving into a few actionable examples, we wanted to provide context for dislocations and snapbacks that have occurred in the last few weeks. In addition to the high-level weakness noted above, the week of March 16th saw extreme forced selling and technical dislocations, primarily driven by outflows from daily liquidity vehicles where managers sold their highest quality holdings in order to meet redemptions, and then a subsequent wave of selling as margin desks and repo dealers demanded more collateral to shore up balance sheets. However, once the market stresses subside, assets without impairment risk should quickly snapback to their prior levels. The Agency MBS market exists as a clear example of this dynamic, with 2008-like spreads reached and reversed within ten days.

Over the last few weeks, there have been record weekly outflows from IG and HY loan and bond funds and municipal bond funds concurrent with record new issuance of almost $100 billion this week as IG companies replace commercial paper funding and seek to shore up liquidity. One aspect of legacy IG bonds is that they were priced at such tight spreads to Treasuries and at such long durations (as corporate treasurers locked in cheap long-term financing), that the general spread widening environment had to cause significant price declines to normalize yields to maturity. For instance, a number of managers last week noted bonds in blue chip companies such as McDonalds, FedEx, Microsoft, Starbucks, etc. that were trading at 70-80 cents on the dollar. While almost an absurd exercise, it is worth noting that any creditor would be happy to own these blue chip companies at the creation multiples implied by prevailing valuations. While the opportunity in the highest quality blue chip companies is a fleeting one taken advantage of by existing capital in the markets,

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particularly as the Fed stepped in to support IG markets, we believe the next tiers of issuers will provide comparable opportunities.

To illustrate with just one example that we believe is indicative of the opportunity set, a credit manager recently highlighted the IG bonds of a financial services company. The bonds were issued with an 8% coupon and 2031 maturity date and in February had traded to a spread of 200 over Treasuries, or 140 cents on the dollar. In the past week, the manager acquired the bonds in the low-90s. If the bond were to recover to a spread 100 bps wider than where it traded pre-sell-off, then the manager is positioned to make 40-50% over the next year while being paid 8% to wait. From a downside perspective, the company would need losses of 3x what it experienced during the global financial crisis before impairment on the bonds. While these bonds rallied substantially the week of the 23rd, we view the price action as evidence that capital needs to be prepared to step into these dislocations as they occur.

Manager Overview

One manager identified (and also discussed below) is focused on middle market credit and fortuitously is in market with a drawdown vehicle with an April 1st first close (and subsequent closes on May 1st and June 1st). This manager has been enacting comparable trades within its existing open-ended vehicle and we have been impressed by the emphasis on businesses that are less impacted by COVID-19-related closures (telecom, healthcare services, consumer non-discretionary) or have the asset coverage to withstand extreme market stress for the next several years.

A related trade that we believe has extreme downside protection with the potential for a quick snapback is that of high rated CLO debt (A-AAA tranches). To take just the AAA tranche, these are the senior financing in CLOs, which are 10x levered pools of bank loans. At issue they were priced from LIBOR +100-150 bps and are often sold to large institutions with low costs of capital that hold them with leverage on their balance sheets. Consistent with the above themes, it appears that the levered holder base is causing the dislocation, not any rational change in impairment expectations. As a result, AAA tranches that generally traded at par fell to 85-90 cents on the dollar. While the equity and mezzanine debt of these securities is likely in trouble, the senior tranches have subordination that can withstand significant losses to the point that scenarios where AAAs become impaired stretch the imagination. For example, one manager indicated that it would take 60% defaults in year 1, 50% defaults in year 2 and 5% defaults in perpetuity for a AAA CLO bond that they were evaluating to take losses from market levels. By contrast to these draconian scenarios, the CLOs were issued with default rates at issuance of 2% per year and a default rate that peaked at 12% in 2008. Buying AAA CLOs at 85-94 cents on the dollar has the opportunity to generate double-digit plus IRRs as the market returns to normalcy, which we believe could happen in a matter of weeks/months, rather than years (some recovery has already occurred within the last few trading days). Should the pull-to-par take substantially longer, it would hint at impairment amongst subordinate portions of CLOs. Over the medium term, we believe there will be attractive opportunities within senior structured credit across sectors, as the buyer base of levered holders (especially those in daily liquidity structures) has been impaired and the pooled and often amortizing nature of assets allows for performance even in extremely weak economic conditions.

Manager Overview

We are in active dialogue with a $1 billion+ CLO manager with an existing fund business that is targeting an early April launch for a small tactical fund to take advantage of the AAA opportunity. The manager has secured bank financing for the strategy, which would allow for levered returns north of 30%+ and extremely compelling IRRs. The manager has long been one of our favorites within the CLO sector and we believe they are well set-up from a longer term perspective to dig through the carnage that has befallen mezzanine and equity tranches, which seem likely to take losses, but for now they are focused on the AAA trade which represents one of the best risk/rewards in credit markets from our vantage point.

Corporate Distressed Opportunity

The last several years have seen minimal distressed opportunities and substantial crowding amongst large managers into just a few situations (Puerto Rico COFINA/GO, PG&E, Argentina, etc.). The nirvana for distressed managers is “good companies with bad balance sheets” and most companies that were distressed in the recent past were bad companies, often in secularly declining industries. With the economy effectively shut down at this time, even high-quality companies are unprepared to have zero or near-zero revenue for months (or potentially longer). It is almost a certainty that there will be widespread defaults resulting from this period. Without being so bold as to predict how long-lasting the effects of COVID-19 will be, whether 6 months or 2+ years, eventually the economy will return to some degree of normalcy (without necessitating a V-shaped recovery). With that assumption, acquiring the debt of companies at 2-5x depressed EBITDA provides attractive current yield, upside to par and downside protection in a restructuring/equitization scenario.

As noted above, our preference for distressed managers is those that are focusing their near-term investing activities on structurally sound credits that are dislocated for technical reasons, where fundamental downside is unlikely and a return to even weak but functioning markets could represent significant near-term upside potential. The secondary opportunity will be to invest in stressed/distressed issuers with somewhat greater fundamental earnings volatility, but where asset coverage and earnings visibility imply eventual par even in a scenario of continued economic deterioration. The third opportunity will be to lower-quality issuers or subordinated issues of higher-quality issuers when there is greater clarity on economic conditions and the earnings viability of companies. For the record, we do not believe the third opportunity is an attractive one today, as currently stressed/distressed issuers are likely to be more fundamentally challenged going forward and technically challenged as the supply of truly stressed/distressed paper increases.

Our preference in this environment is to underwrite managers that have the ability to allocate to middle market opportunities. As we have communicated to our clients in the past, it is our belief that the opportunities here will be most plentiful due to the significant extension of credit to middle market private equity firms over the past few years in the form of highly levered capital structures. In addition, there has been a massive winnowing of the universe of managers with the ability to underwrite at this size (generally sub-$1 billion debt capital structures), as distressed managers have either grown to gargantuan size (and thus forced into the largest capital structures) or largely gone away. The current environment is going to create an avalanche of potential distressed opportunities with only a handful of managers with the size and focus to take full advantage of them. Our conversations with managers have emphasized those taking a conservative approach, where the targets are companies that should be insulated from the extended effects of an economic shutdown but are still trading at deep discounts.

We prefer managers that have dry powder to allocate (usually in the form of a drawdown fund), rather than saddled with existing portfolios, and are often finding managers that have already raised capital but have not deployed a single dollar - allowing them to be the most opportunistic. Our target managers are those that are planning to allocate to a number of the short-duration snapback trades we mentioned above but have the ability to recycle and allocate to the longer-term distressed opportunity that is only now beginning to emerge. We have a high degree of confidence that the distressed opportunity set will be robust over the next 2-3 years with implied defaults comparable to 2008.

Manager Overview

We have deep relationships with two mid-sized ($1.5-2.5 billion) managers that have extensive experience in middle market credit selection. Both managers are sized to matter in restructuring processes but are nimble enough to take advantage of where we believe the best opportunities will be. One manager is more conservative, and well aligned with the snapback theme with plans to rotate down the capital structure and quality spectrums as the cycle unfolds and economic realities become more certain. The other manager has a slightly more aggressive profile and is more likely to own fulcrum securities at deeper discounts to intrinsic value earlier in this credit cycle. We broadly believe return expectations are for IRRs and MOICs in excess of 20% and 2.0x, respectively.

Opportunistic Credit Opportunity

The other area that seems attractive is broad opportunistic credit platforms that have the ability to be solutions providers for complex financings that require speed of closing and significant check sizes to execute bespoke transactions. Managers that we like in this space are less EBITDA-focused corporate lenders, but rather underwriters of pools backed by hard assets or contractual cash flows, often in amortizing structures. They are also often at a size where they are able to speak for the entire check to counterparties whose needs fall outside of traditional financings channels, making them a lender/acquiror of last resort. Antithetical to our distressed manager preferences, we believe scale benefits this strategy. These managers will take advantage of non-corporate distressed across specialty finance, ABS, real estate, legal assets, and portfolio sales of these assets, as we anticipate a significant volume of sales from poorly capitalized financial services firms that must shed assets. The theme of excessive leverage is not just limited to the corporate credit sphere as a number of more niche credit assets are sitting in the hands of managers that are not equipped to deal with distress and have mismatched liquidity structures. Similar to our view on manager size in this strategy, we also prefer managers with broad mandates that have wide-ranging sourcing capabilities and look across the credit landscape to allocate where they see the best risk-reward.

Manager Overview

We are excited about a manager in this space with over $100 billion in firm assets that held a first close earlier in the year on a vehicle targeting $2 billion. They have yet to deploy capital and are in a prime position of having the resources and dry powder at an opportune moment in time. They have written up return expectations from 11-13% to 13-18% and tightened underwriting to pricing that can withstand 2-3x 2008 loss levels, a scenario they believe to be highly unlikely but representative of the level of downside protection they will insist upon as defaults increase and liquidity becomes tight.

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