Perspectives

OCT 2020

Distressed Investing: Missed Opportunity?

As the calendar flipped to 2020, many market prognosticators agreed that one of the longest economic expansions on record would continue throughout the year. Unemployment rates were near record lows across most major economies and many were expecting a record year for corporate earnings. The signing of the Phase I U.S-China trade deal helped drive markets to all-time highs in the early part of February. Nobody saw the rapid escalation of a global pandemic that pushed the global economy into recession and global markets into a tailspin.

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During the month of March, equity markets experienced their worst performance since the Global Financial Crisis as unemployment claims spiked, oil prices plunged by more than 60%, and the yield on the 10-year U.S Treasury dropped to an all-time low. The CBOE Volatility Index ("VIX")[1] reached its highest level ever when it hit 83 in mid-March versus a long-term average of 19.[2] Credit markets experienced a sharp sell-off, making it the worst quarter since 2008 across most debt assets, including structured credit, U.S. municipal bonds, investment grade bonds, leveraged loans, and high yield bonds. Those credit instruments were led downward by the energy sector and other industries that were directly impacted by the slowdown in consumer consumption related to COVID-19.

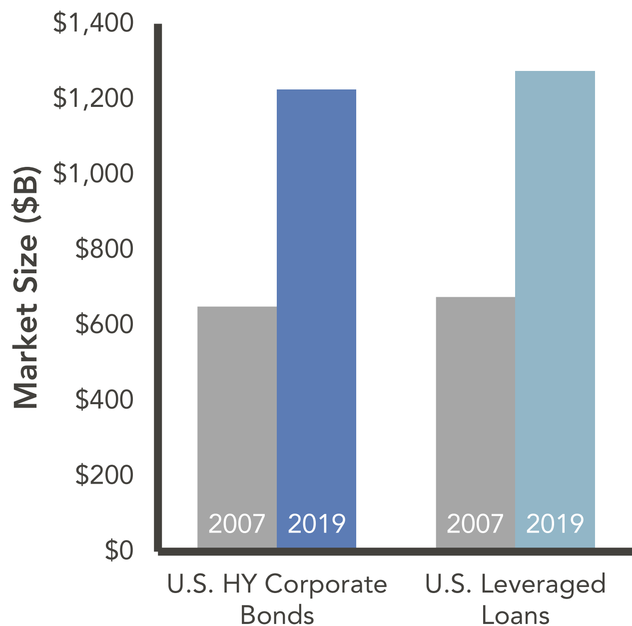
Globally, governments and central banks took swift action via monetary and fiscal policy to support markets and stunt the economic impact of a global pandemic. The Federal Reserve implemented quantitative easing, including emergency lending programs that purchased corporate credit, along with cutting the target Federal Funds rate to 0%. In addition to that, the U.S. Government passed a historic $2 trillion stimulus plan. Credit markets rallied broadly during the second quarter following actions by central banks and governments that boosted market sentiment. Investment grade and higher quality high yield bonds saw the greatest rally, as the Federal Reserve stepped in to provide substantial quantitative easing via the purchase of both index and single-issue credit. Meanwhile, lower-rated high yield and distressed credit have materially lagged, as many businesses

remain under extreme distress. When it comes to structured credit, Collateral Loan Obligations ("CLOs") AAA tranches have fully recovered from their March lows but lower quality tranches have been slower to recover given the unprecedented wave of downgrades and the lack of support from the government buying programs. Commercial Mortgage Backed Securities ("CMBS") continued to languish as delinquencies rise in retail and lodging properties. Credit markets experienced a tale of two totally different quarters, as the first quarter saw spreads widen out drastically, muted issuance, and net outflows. The second quarter saw a meaningful rally across ratings and sectors along with a strong pick-up in new debt issuance.

CREDIT OPPORTUNITIES MOVING FORWARD

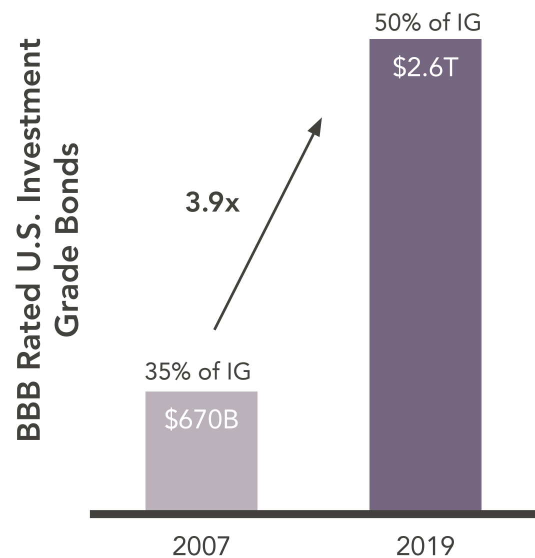
As the following charts show, the quality of the credit markets weakened considerably during the prior expansion as the search for yield by investors fueled the growth of inferior credits that the market desperately wanted. This exponential growth of leveraged credit markets has provided lower-rated companies access to leveraged lending.

Exhibit 1: Dramatic Growth in High Yield and Leveraged Loan Markets



Sources: Bloomberg Barclays, Credit Suisse

Exhibit 2: Lower-Rated IG Bond Market also Grows Significantly



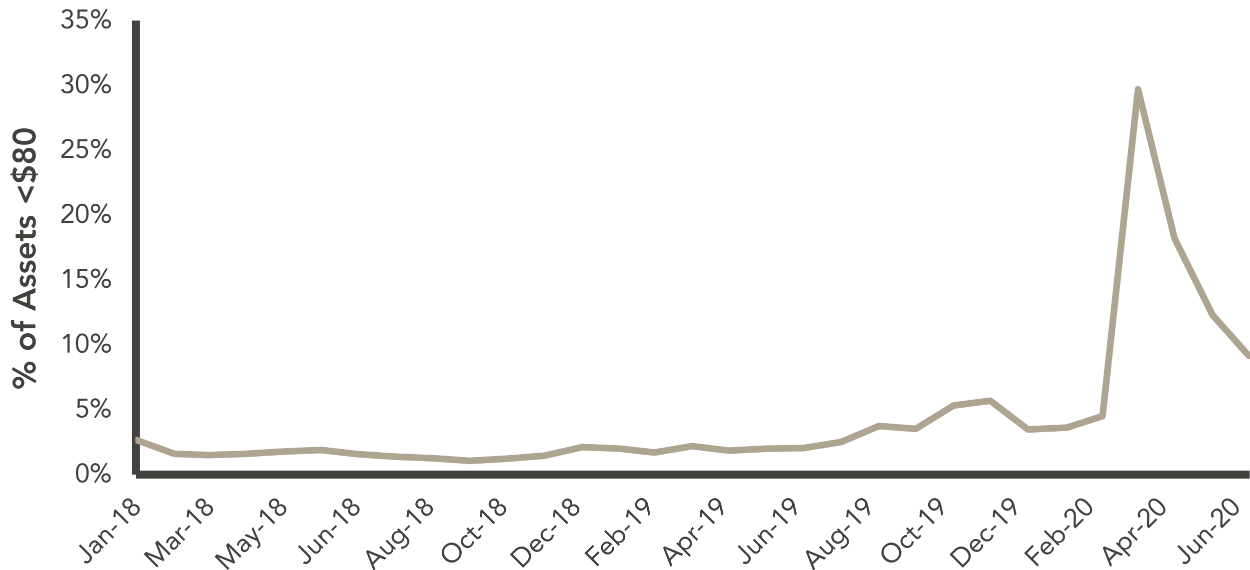
Source: Bloomberg Barclays

Over the last several years, most of the corporate distressed opportunities in the market were concentrated in secularly challenged industries. This pandemic has put immense pressure on revenues and earnings for companies across many sectors, which could create a robust opportunity set as companies confront financial issues. As COVID-19 continues to spread, the recovery in economic activity remains uncertain and uneven, with the possibility of forcing companies into rescue financing, bankruptcy, or pursuing out of court restructurings as their debt loads become unmanageable. Companies that are involved in the following sectors are the most likely to face issues over the coming years: lodging, retail, gaming, consumer products, and transportation.

Structured credit is one area of the market that saw less support from government and central bank credit facilities in March, causing its recovery to be much slower compared to investment grade and high yield credit. While higher quality CLO tranches have recovered from their March lows, lower rated tranches continue to slowly claw back, albeit it with plenty of remaining headwinds. As Exhibit 3 shows,

the percentage of CLO loans trading below $80 (a widely accepted level indicating distress) has fallen considerably after hitting 29% at the end of March.

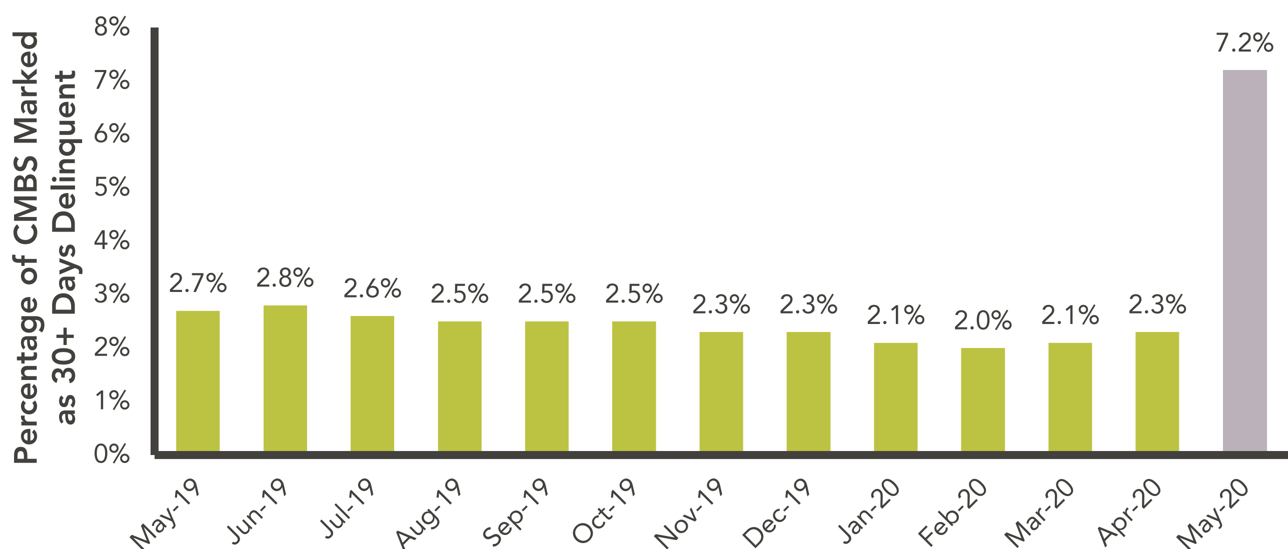
Exhibit 3: CLO Market Showing Signs of Recovery



Sources: Markit and Kanerai; based off all BSL USD CLO deals issued after 2010

Despite this recovery in leveraged loan pricing, concerns linger as many businesses remain under extreme distress which could lead to more downgrades in the future. A wave of new downgrades would force holders of these CLO tranches to sell, opening attractive entry points for investors who have the bandwidth to conduct credit research on the underlying liabilities. In the CMBS space, cracks remain as Exhibit 4 shows the level of delinquencies has increased following the March sell-off. Concerns remain for retail and lodging as this pandemic continues to drag on while many questions about the state of office space following the pandemic will play out over the next few years.

Exhibit 4: CMBS Market Faces Growing Delinquencies



Source: Trepp. Loans that are past their maturity date but still current on interest are considered current.

Exhibit 5: Retail and Lodging Show Greatest Sign of Stress

Delinquency Rate by Property Type (% 30 Days+)

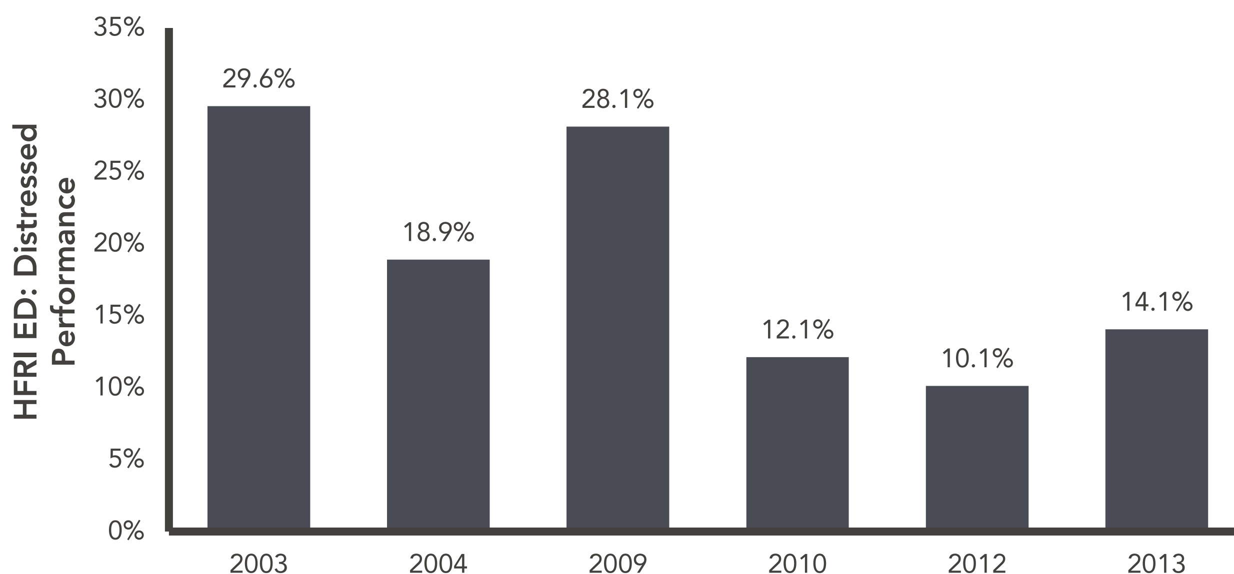
	May 2020	April 2020	March 2020	3 Month	6 Month	12 Month
Industrial	1.8	1.4	1.4	1.5	2.0	2.1
Lodging	19.1	2.7	1.5	1.6	1.5	1.4
Multifamily	3.3	1.9	1.6	1.8	2.0	2.2
Office	2.4	1.9	1.9	1.7	2.0	3.0
Retail	10.1	3.7	3.9	3.6	4.4	4.3

Source: Trepp. Loans that are past their maturity date but still current on interest are considered current.

If delinquencies continue to pick up through the remainder of the year, there will likely be opportunities for investors to purchase deeply discounted loans that will need a workout or equity infusion. Hospitality is one sector where defaults and foreclosures could lead to properties changing hands toward the end of this year, where capital infusions or outright loan purchase would be needed by investors.

Historically, distressed hedge funds have performed well after a crash and this current cycle is likely to be one of the largest in recent history. The below chart of the HFRI ED: Distressed/Restructuring Index[3] shows returns for the index following stressed credit years. It is quite possible that 2021 could lead to outperformance for distressed hedge fund managers.

Exhibit 6: Distressed Hedge Fund Performance Following Credit Market Stress



Source: Hedge Fund Research Inc.; calendar year returns for years following stressed credit environments

CONCLUSION

Marquette believes the unprecedented decline in global economic activity in response to COVID-19 and the lockdown of large parts of the global economy has created an attractive opportunity set in distressed investing. The quality of the leveraged credit markets had weakened considerably in the prior economic expansion, which is causing over-leveraged companies to make difficult decisions as they navigate a global pandemic. The uncertainty surrounding the length and economic impacts of the pandemic should give rise to trading opportunities both long and short across the credit spectrum. Through Marquette's investment and operational due diligence, we have identified a number of select distressed hedge fund managers that we believe can profit off these opportunities in the future, and we encourage investors to consider this emerging opportunity set if it dovetails with organizational risk and return goals.

NOTES

[1] Created by the Chicago Board of Options Exchange, the VIX is a real-time market index that represents expectation of 30-day forward-looking volatility.
[2] Bloomberg; long-term daily average from January 1990–June 2020
[3] Hedge Fund Research Inc.

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