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Implementation Insight

Dislocation and Distress:
Navigating New Opportunities

May 2020

Contents

bfinance is an award-winning specialist consultant that provides investment implementation advice to pension funds and other institutional investors around the globe. Founded in 1999, the London-headquartered firm has conducted engagements for more than 370 clients in 38 countries and now has eight offices in seven countries. Services include manager search and selection, fee analysis, performance monitoring, risk analytics and other portfolio solutions. With customised processes tailored to each individual client, the firm seeks to empower investors with the resources and information to take key decisions. The team is drawn from portfolio management, research, consultancy and academia, combining deep sector-specific expertise with global perspective.

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Why read on?

No serious investor will have managed to avoid recent sales calls and marketing emails promoting ‘Distressed’ or ‘Opportunistic’ funds.

Those on the fundraising trail proclaim that economic fallout from the current public health emergency will provide the investment opportunity of a lifetime. Some of the most credible managers are in the market now, raising dry powder to deploy as opportunities arise.

The repercussions of the current public health emergency will be varied, long-lasting and likely to come in waves. Yet generating outsized returns from economic disruption is far from straightforward. The range of managers and strategies that seek to exploit the alleged opportunities is, in a word, bewildering. How can investors differentiate between, categorise and choose from the different approaches available?

In April-May 2020, bfinance has examined **more than 130** launched or soon-to-be-launched strategies. Based on fresh research, the team has developed an updated **classification approach** for the available offerings – seven sub-strategies in total – designed to help investors navigate the universe at this time. This brief paper walks through these seven, outlines the opportunities that each seeks to exploit and explores the key challenges that they could face.

If investors have capacity available to make commitments to these opportunistic strategies, there is a strong case for doing so. First, however, it is crucial to understand the role that they will play, assess the soundness of the assumptions underpinning them and ask some important questions:

- How long do we believe the path to economic recovery will be and how many ‘mini-cycles’ of distress will there be on the way?
- How quickly do we have to move, to avoid missing out on the opportunity?
- Even if we believe the market disruption will not be short-lived, should we nonetheless be concerned about the best managers’ capacity being filled very rapidly?
- How much capital is chasing each opportunity set, and should we be paying more attention to some of the less widely marketed strategies?
- Do managers genuinely have the requisite sourcing capability and the technical expertise to exploit the sub-strategy being pursued?
- Are the fee arrangements appropriate?
- How will these strategies sit with our ESG standards?

While coronavirus-related market dislocations and distress seem likely to present over a reasonably long period of time, we believe that it is important to act now and set a strategy to invest coherently into this opportunity set.

FIGURE 1: OPPORTUNISTIC FUND SUB-STRATEGIES

	Target net IRR		
Strategy	**Min**	**Max**	**Median**
Dislocated entry into Private Credit	9.5%	20.0%	14.0%
Dislocated entry into Real Assets	9.0%	18.5%	13.5%
Dislocated entry into Public Markets	8.0%	20.0%	15.0%
Evergreen Opportunistic Strategies	8.0%	25.0%	15.0%
Financing Solutions	7.5%	17.5%	13.0%
Fund Financing and Secondaries	8.0%	22.5%	15.0%
Multi-Strategy	9.0%	22.5%	15.0%

Source: bfinance, 130+ strategies assessed in April-May 2020

Implementation considerations

Before reviewing the seven sub-strategies, it is worth stepping back to consider a handful of practical questions.

Investors may seek to combine different sub-strategies in a way that diversifies risk and complements their portfolio, or may – depending on capacity considerations – prefer to seek a single solution.

The degree of illiquidity required, pricing and return expectations and the competitive landscape in which managers are operating may all be relevant factors in determining which of these seven sub-strategies (and which managers within those strategies) are more or less well-fitted for a particular investor.

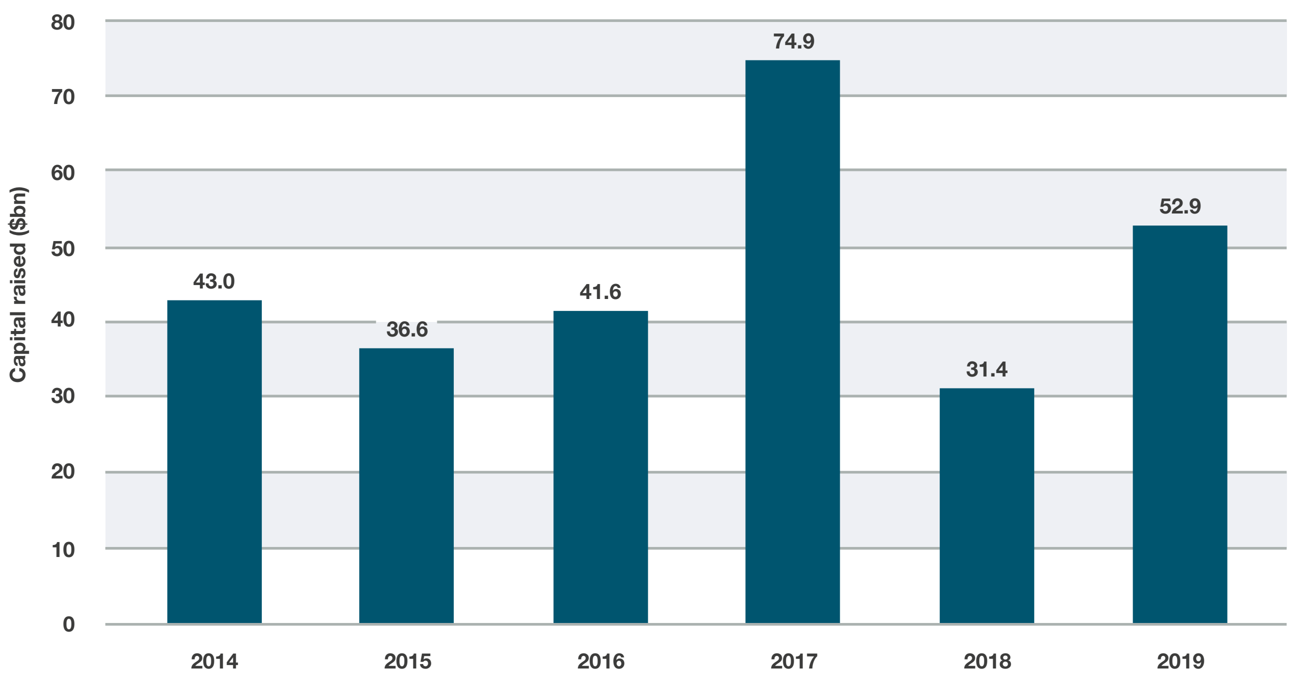
Competitive landscape

The last three years have seen considerable fundraising for distressed credit strategies, with investors seeking to express “late-cycle” convictions. Capital raising hit record levels in 2017, although a proportion of these assets have still not been deployed as distress failed to materialise, while 2019 saw some substantial funds raised as well. The 2020 figures may well be higher still; we are already seeing managers shorten their fundraising windows and bring expected closing dates forwards.

The research which forms the basis for this piece is primarily focussed on ‘new’ funds which are seeking a first close in the coming months, although a handful of funds which had a first close in 2019 are still open for final closes. Investors should consider that new funds will face a lot of competition from existing vehicles: there remains plenty of dry powder at hand, even before the new funds that are being raised in 2020. When we additionally consider the turn-around Private Equity managers, who have the capacity to shift enormous firepower towards distressed debt in order to gain control of issuing entities, it becomes clear that there could be a bidding war for the ‘best’ opportunities.

Higher competition translates into reduced returns for prospective investors, as well as trade-offs between deployment speed and risk/reward dynamics. Some sub-strategies provide better risk-reward dynamics than others, due to their degree of exposure to this competition.

FIGURE 2: DISTRESSED DEBT FUNDRAISING, 2014-19



Source: Private Debt Investor

Implementation considerations continued

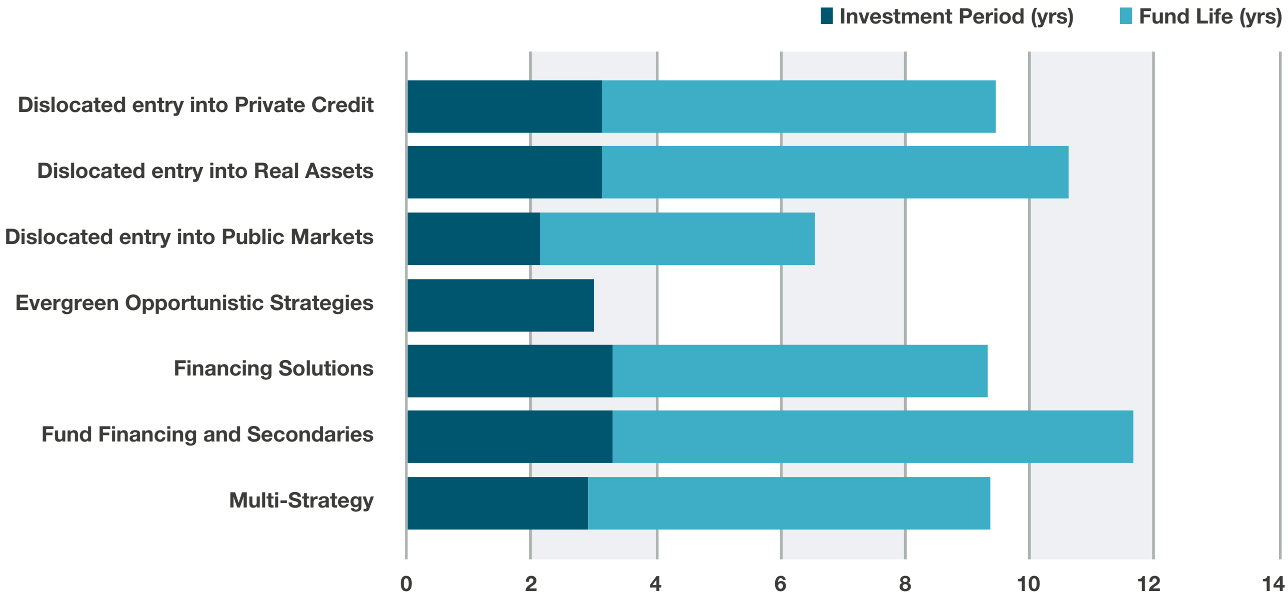
Fund structures

As confirmed by our research, nearly all of the funds seeking to exploit distressed opportunities are structured as closed end LP/GP structures with a traditional investment and recycling period, followed by a fund life leading to a 'final' maturity – although nearly any fund can be extended if realisations are taking more time.

These periods vary according to the underlying strategy, with some targeting a relatively short life of no more than five years whilst others may leave investor capital tied up for ten years or longer.

The exceptions to this rule are Evergreen Opportunistic strategy funds, where exposure can be achieved quickly and, while most funds will impose a period of lock-in after initial investment, money can be withdrawn thereafter (although substantial notice is often required).

FIGURE 3: AVERAGE INVESTMENT LOCK-IN PERIODS



Source: bfinance, 130+ strategies assessed in April-May 2020

Track records

It is not possible to extract a meaningful track record for many teams, as there has been no comparable situation in terms of scale since 2008-9. Even if a team does claim a track record from that time, its representativeness will be limited by the fundamental differences in the nature and dynamics of the current crisis compared with the GFC.

Qualitative assessment of investment teams – their depth and stability, the relevance of (and ability to evidence) their skillsets, the alignment of interest with investors – will be extremely important.

Implementation considerations continued

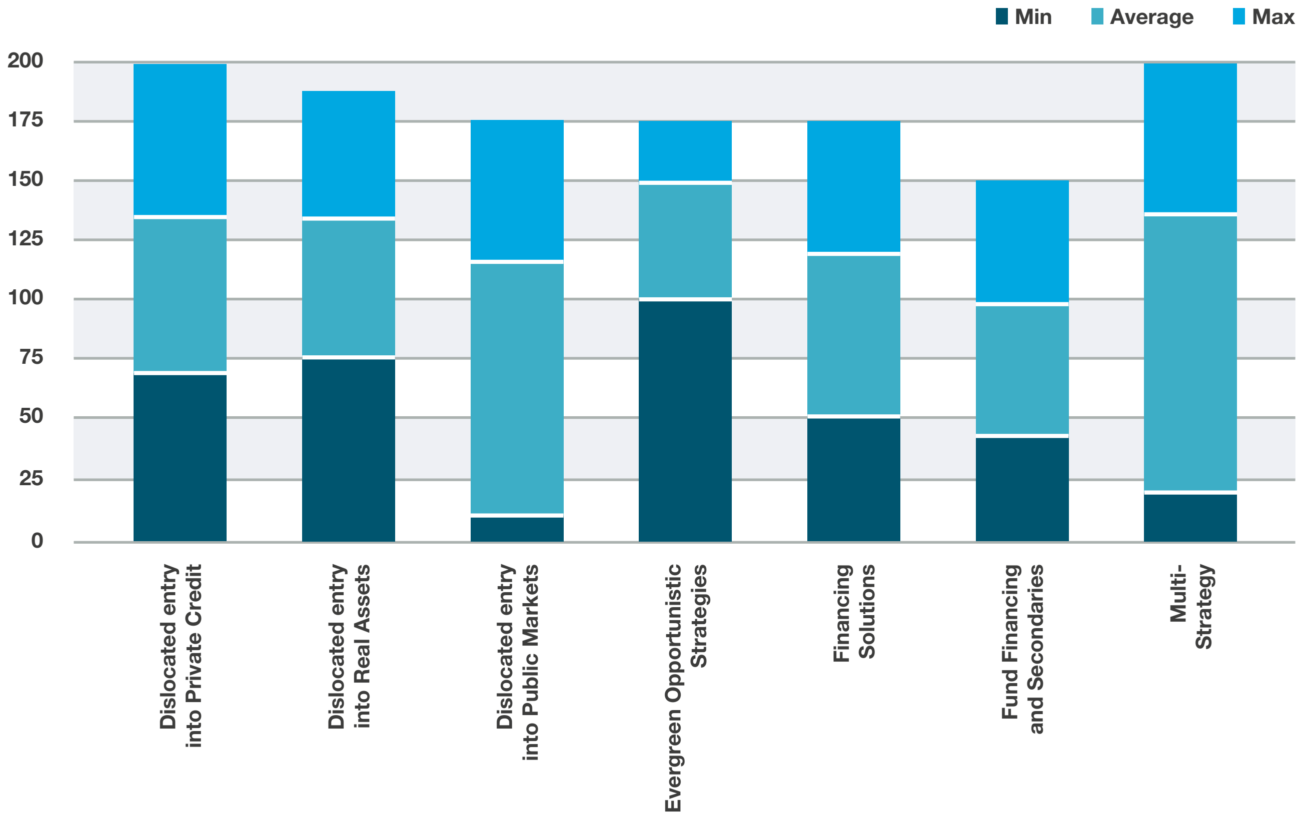
Cost of access

Average base fees are reasonably comparable across the seven different sub-strategies discussed in this paper, as are typical hurdle rates and incentive fees. There is, however, a huge amount of variation in individual fee levels and structures proposed by managers.

When it comes to costs, the devil really is in the detail. There are wide differences between the minimum and maximum base fees in each strategy and the way that managers propose to calculate their profit shares. These nuances are crucial to understand. They not only affect a manager's overall fee income (and an investor's net returns), but the sensitivity of that income to the manager's performance.

"Expected overall return net of fees" should be at the front of investors' minds; investors should also be thinking about what will happen in terms of costs and net returns in the event that gross investment performance deviates from the target (in either direction) – and who bears the most pain should that happen.

FIGURE 4: BASE FEES OF OPPORTUNISTIC STRATEGIES (BPS PER ANNUM)



Source: bfinance, 130+ strategies assessed in April-May 2020

1: Dislocated entry into Private Credit

What's the premise?

These sub-strategies focus on gaining entry into private credit investments at low prices, relying on either passive recovery or, more likely, restructuring initiatives to generate value.

They primarily target **distressed borrowers,** although some will also look to find **stressed investors** who are under pressure to sell. Positions are acquired in the **secondary markets**; existing owners typically need to offload these positions as they are no longer a natural holder – for example because they do not have the requisite workout capability to deal with a misbehaving investment, or because having a non-performing asset in their fund potentially interferes with covenants in leverage facilities, forcing wholesale disposal of assets. Other opportunities may arise from unsuccessful syndications or from **failed CLO** warehouse portfolios.

'Money good' positions may be acquired at a discount (to par, but also to intrinsic value), in which case the strategy would be to collect a coupon while waiting to crystallise a '**pull-to-par**' capital gain upon a refinancing or repayment at maturity. Where the mandate is more focussed on distressed companies, often the strategy is to seek to establish a controlling or 'fulcrum' position in the capital stack, then to achieve capital gains generated through the successful **restructuring and repositioning** of the company.

There are niche strategies focusing on specific geographies and/or industries where specialist knowledge is needed – such as Asia Pacific or Energy – as well as broader offerings.

An illustrative example:

Fund name:
Strategic Opportunities Fund

Return target:
14-16% p.a.

In brief:
The fund seeks to generate asymmetric risk / return by investing via secondary transactions in distressed corporate credit opportunities in the global private credit markets. It will focus on acquiring mid-market corporate credit at a discount to intrinsic value, aiming to capitalise on "superior restructuring capability" to unlock that value. Strategy is building controlling stakes in single name corporate credit with a view to leading bankruptcy processes.

What to watch out for

Expect significant competition for underlying positions, impacting the pace of deployment and available returns: this may be the largest area of focus for distressed credit funds, with enormous amounts of dry powder raised over the last couple of years; large Private Equity players with a 'turnaround' strategy will also compete to gain entry into companies through the acquisition of distressed debt.

Managers need to have differentiated capability in sourcing investments and the discipline to walk away when entry prices are bid up.

There are very specific skills involved in restructuring strategies; a lot of patience is needed.

Returns may be more private equity-like in profile, with little in the way of cashflow and an uncertain exit date.

There are potential ESG concerns; some restructuring houses have gained a reputation for brutal cost cutting, and many distressed assets originate in industries which are not generally considered environmentally sound.

2: Dislocated entry into Real Assets

What's the premise?

These strategies focus on acquiring 'Real Assets' (or the debt secured by these assets) at a discount to 'true' value.

Whether the stress is at the asset level or arises because of problems in the financing structure for that asset, positions will be acquired in the **secondary market** from sellers who no longer have the appetite to hold. One popular strategy is the acquisition of **senior debt**, followed by a bankruptcy proceeding to take possession of the underlying assets, anticipating that equity and mezzanine positions will be wiped out.

Managers are targeting traditional real estate and infrastructure as well as niche market segments such as **development land, aviation** and **shipping**. In all cases, specialist asset management skills and restructuring capability are both required to extract full value, and there may be a degree of **asset repositioning** which requires additional expenditure before a capital gain is generated. As an alternative, some strategies seek to **aggregate** assets acquired at a discount to create a portfolio which is more readily **refinanced**. At the higher-octane end of the spectrum there are opportunities to step into **stalled construction projects**. Those merely seeking more attractive returns than have historically been available from 'safer' infrastructure might see the opportunity to acquire either real assets (potentially with a focus on renewable energy) at a lower valuation or infrastructure debt at a more attractive yield.

Some investors are likely to have a preference for strategies underpinned by real assets, due to the perceived downside protection characteristics.

An illustrative example:

Fund name:
Real Asset Opportunities Fund

Return target:
16-18% p.a.

In brief:
The fund will concentrate on distressed opportunities (including bank divestments, fund liquidations, restructuring or recapitalisation and active management) of real-estate-backed non-performing loans (NPL) with a view to establishing control of assets. Once assets have been acquired at an "attractive basis," the manager seeks to "enhance value" through capital expenditures, refurbishment, repositioning, tenant and portfolio diversification, et cetera.

What to watch out for

There are obvious ESG issues associated with taking possession of properties through bankruptcy proceedings. Reputational risk can come into play, particularly if these properties happen to be residential.

Selected managers need to have an unusual combination of skills which will include knowledge of niche asset classes and markets; their true capability may not be easy to assess.

Profits are unlikely to arise quickly and there may be higher cost leakage, particularly with real estate transactions.

3: Dislocated entry into Public Markets

What's the premise?

These strategies target the purchase of normally liquid credit instruments at a significant discount, equating to a higher expected yield.

Managers may focus on a single sector or a combination across **Investment Grade** credit, **High Yield** bonds, broadly syndicated **bank loans** and **CLO** tranches and/or other securitised positions. Several even consider equity markets to be fair game.

The underlying premise is that systematic disruptions and exacerbated market volatility have provided - and will continue to provide - opportunities to invest at a significant discount to fair value. Investors seek income and capital gains: the aim is to exit at a later date, either through maturity at par or by trading back into the market.

Some strategies focus on taking advantage of **central bank support measures** (e.g. TALF), either accessing deeply discounted securities which can then be used to raise very **cheap financing** or simply harvesting enhanced risk/reward as a result of implicit **sovereign guarantees** or **government support**. Others will pursue opportunities which are more structural such as '**Fallen Angel**' strategies (taking advantage of forced selling dynamics) or by focussing on **securitised markets** where there are regulatory and other constraints for investors, and where complexity limits the supply of capital in uncertain times.

An illustrative example:

Fund name:
Distressed Opportunities Fund

Return target:
12-14% p.a.

In brief:
The fund seeks to exploit dislocation of high-quality assets across credit markets. Investments will be made throughout the capital structure in "high quality securities," initially focused on "dislocated sectors" including senior secured bank loans, investment grade bonds, senior tranches of RMBS, CMBS, ABS and CLOs. Fed-backed Repo financing may be used to create leverage in the fund to enhance return.

What to watch out for

Managers should have strong capability in sourcing and underwriting positions beyond just 'trading the numbers'; liquid paper may be trading at a discount because there is a genuine problem in terms of issuer fundamentals rather than market dislocation – distinguishing between the two is vital.

Theoretical liquidity of the underlying positions doesn't guarantee actual liquidity. The realisation of gains may require considerably more patience than a conventional public market investment.

4: Evergreen Opportunistic Strategies

What's the premise?

These are **open-ended** funds pursuing a broad opportunity set across multiple markets and investment styles, with the number of line items often running into the hundreds.

They focus on stressed and distressed investing, restructurings, rescue lending and non-performing loans. As well as long-only positions, these strategies will make use of **short exposures** – as 'alpha shorts', as hedges, or to implement relative value or arbitrage type trades. Managers often use the full capital structure as well as the full gambit of derivative instruments to express trade ideas.

One would classify these strategies alongside more pro-cyclical or event-driven special situations strategies, value investing, and structured credit opportunities. They are intended to be '**all-weather**' strategies, capable of generating returns throughout all phases of the market cycle.

Portfolios are typically global (developed markets) in geographic focus, with a bias towards North America. Capital allocation is dynamic and expected to be opportunistic enough to capitalise on near-term dislocations or other catalysts. Portfolios benefit from active risk management, with trades constructed in a downside-aware manner, often intentionally targeting return asymmetry or high risk-adjusted returns over outright performance. Unlike drawdown vehicles, Evergreen Opportunistic strategies are semi-liquid, offering investors redemptions spanning quarterly, semi-annual and annual frequencies..

An illustrative example:

Fund name:
Opportunistic Credit Master Fund

Return target:
10 – 15% p.a.

In brief:
Opportunistic fund investing in liquid instruments such as ABS, High Yield Bonds, preferred equities, contingent convertibles (CoCos) and subordinated debt. Active trading is both a source of alpha generation and a risk management tool. The strategy employs an actively managed short book including "alpha shorts" in overvalued securities to supplement long positions in undervalued or overlooked positions expected to recover in price.

What to watch out for

These funds are typically well-established with long track records (often the 'flagship' strategy for a manager), making it potentially easier to analyse expected risk return profiles and understand portfolio characteristics or style biases.

Their 'always on' nature means opportunity sets are often broader in scope and more diversified than others shown here, which may dampen expectation of outsized returns at this point in the cycle.

It is important to have a detailed understanding of the opportunity set and associated liquidity profile; core positions might benefit from being expressed in a longer-lock format.

Managers need to be able to demonstrate competency across a broad range of disciplines across the credit and event investment spectrum, as opposed to specialising in one; this requires large, globally present, investment teams working together with a 'one-team, one-book' mentality. The ability to maintain and develop specialisms within these teams, as well as move portfolio risk around the team as opportunities present themselves, separates the best managers from their peers.

5: Financing Solutions

What's the premise?

Rather than focussing on companies that present a high risk of going into bankruptcy or restructuring, these strategies aim to facilitate the survival of struggling-yet-viable companies (at a cost!) by providing bespoke financing solutions.

This typically involves **highly structured and complex** financing solutions targeting middle-market companies which cannot access financing from their ordinary sources or from traditional capital markets. Some companies face challenges from having been aggressively leveraged by private equity owners; others will face short-term cash flow issues arising from temporarily reduced sales revenue, creating a need for emergency liquidity.

The underlying businesses in these strategies typically have an **expectation of survival** through the crisis – such as a clear 'reason to exist' or being positioned in a defensive sector.

Buzz-words for these strategies are **flexibility** and **complexity**. The financing structures that are typically proposed focus on **downside protection** but will often also participate in the **equity upside** via warrants. Some solutions are **asset-backed**, secured on unsold inventory or receivables.

An illustrative example:

Fund name:
Special Lending and Recovery Fund

Return target:
"high teens p.a."

In brief:
The Fund will focus on fundamentally driven investments into "commercially viable issuers that are structurally impaired and require rescue financing to avoid bankruptcy." "Specialist legal and accounting skills" within the investment team enable "high underwriting and structuring standards" and "industry experts directly support those companies as they are managed through their recovery back to full potential."

Others will be structured as **super-senior liquidity facilities**, ranking ahead of lenders in the existing capital structure. These are typically expected to involve shorter term financing solutions.

What to watch out for

Managers in this space will be lending into already-troubled situations. Differentiated sourcing, underwriting and structuring of deals will be of paramount importance.

Some positions will require workout, while the best positions may (ironically) repay earlier than investors would ideally like, which can potentially leave a long tail of distressed assets.

These strategies are less likely to raise ESG concerns at the outset – after all, these strategies seek to prevent the worst-case scenarios in terms of job losses and social impact. There will, however, be potential challenges if positions do end up in bankruptcy.

6: Fund Financing and Secondaries

What's the premise?

Available throughout the cycle, these strategies are being positioned as highly relevant to current conditions. Their premise is simple: buy stakes in funds (or portfolios of investments from funds) and hold these to realisation at maturity to generate gains.

A significant minority of illiquid asset investors, traditionally in Private Equity but increasingly in Private Debt as well, have regularly sought to re-balance their portfolios or extract liquidity through **secondary sales** of their LP stakes. In the current environment there is anticipation that an increasing number of investors will be seeking this route, either for rebalancing purposes or as a result of genuine distress or liquidity needs.

There may also be demand for GPs to provide liquidity to their investors, or to support portfolio companies which may have short term liquidity needs. This leads to another opportunity in this category: **lending to funds**, secured on the underlying portfolio companies or, in some cases, secured on investors' LP stakes. A final variation on this theme is the provision of **temporary or bridging liquidity** to CLO warehouses or PE funds which may suffer from a delayed access to funding from their traditional sources (due to dislocated capital markets or to delays in GPs meeting capital calls).

An illustrative example:

Fund name:
Secondary Opportunities 2020

Return target:
10-15% p.a.

In brief:
This strategy is focused on purchasing secondary LP interests in mature high-quality senior, subordinated debt, special situations, equity and selected other private market strategies. Core opportunities include interests in private equity fund of funds and secondary funds, direct interests in private equity funds (typically small or mid-cap funds) and complex or opportunistic secondary transactions, including the financing of portfolios.

What to watch out for

Valuation of secondary interests is more of an art than a science. Due to the very private, even secretive, nature of the majority of transactions, there is little publicly available information against which to benchmark.

Selected managers need to have wide sourcing relationships, deep experience in their relevant sector, and established expertise in portfolio valuation, portfolio construction and operational due diligence.

Predictions on likely investment returns, and indeed the timing of the return of capital, will always be subject to a fairly high level of uncertainty.

7: Multi-strategy

What's the premise?

These strategies target some **combination of the investment opportunities identified above**, providing a single point of entry into a more diversified portfolio which will seek to take advantage of distress and/or dislocation.

As such they may be a valuable option for investors who may have a smaller commitment available but nonetheless want to preserve **diversification of style**. Some larger investors might see a benefit in avoiding proliferation of managers by pursuing a multi-strategy mandate.

These mandates are typically defined very flexibly and are at least in theory capable of adapting to different opportunities as the economic situation evolves. Most will have a relatively long drawdown period, allowing them to capitalise on different phases of market dislocation. Underlying investment types might include stressed high yield bonds, restructuring of corporate debt, distressed real assets or debt secured thereon, ABS or CLO tranches.

An illustrative example:

Fund name:
Global Opportunities

Return target:
13% p.a.

In brief:
Opportunistic global corporate credit strategy, investing across public and private markets. May include privately negotiated transactions to companies unable to access traditional markets, price-stressed situations (where pull-to-par profit is expected), solvency-stressed situations (where workout or restructuring is expected) and idiosyncratic opportunities (such as CLO restructuring and selected aviation or shipping finance transactions).

What to watch out for

Be cautious about managers who may typically run more liquid vehicles but may be seeking to bolster their AUM (and revenue) by making a large fundraise into a stable lock-in fund.

There is likely to be uneven performance between different sub-strategies within the fund and overall performance may be hard to compare 'fairly' between funds.

Key takeaways

A large number of asset managers are currently fundraising for strategies that focus on dislocation, including some of the most credible players in the sector. Yet there is a dizzying array of different managers and strategies available, and already-strong competition for deals. Big names with too much to deploy may not be the best bet.

Beware strategies that seem 'too good to be true.' Extracting value from a distressed situation is not easy – it's not just a case of 'buy low, sell high'. Managers need a specific combination of skills to generate positive outcomes; expect losses as well as profits.

The diversity of the universe lends itself well to building a portfolio of complementary strategies. Investors with the appropriate scale can consider this; those that don't, or who wish to avoid manager proliferation, can achieve diversification through a multi-strategy fund.

Very different fee structures are being quoted, even within the same sub-strategy. Investors should be careful about paying over the odds for access, focus on net returns and ensure that the fee schedule delivers alignment of interest.

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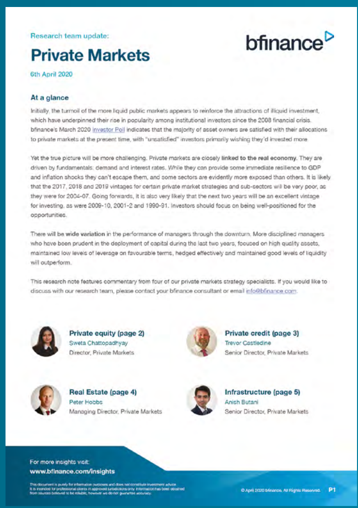

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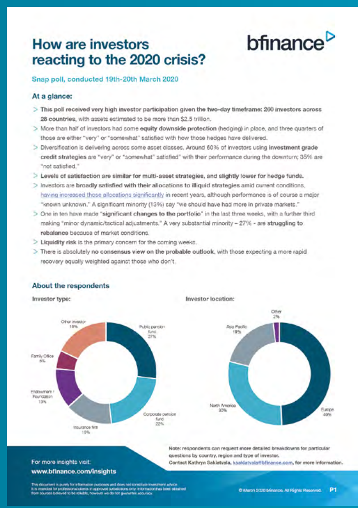

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