DEALS

Chasing yield in special situations

Distressed debt opportunities are on the rise but in a dynamic market investors must be flexible and prepared, explains **Bill Brady**, a partner with law firm Paul Hastings

The global private debt industry marked a banner year in 2017. As noted by PDI, total fundraising reached a new record of $187.5 billion and several asset classes set individual fundraising records. Although Q1 2018 fundraising slowed with $37.1 billion raised – annualizing at $148.4 billion, it still represents the second-highest annualized amount on record.

One of the most interesting aspects of the record-breaking fundraising in the private debt industry in 2017 was the nature of investment. Distressed debt outpaced all other private debt raised in 2017 ($61 billion) with senior debt fundraising in second place ($60 billion). While investors are shifting part of their focus from junior debt to safer senior debt, investors are also seeking to capitalise on opportunistic distressed investments as well as performing deals in unique or "tricky" industries.

These recent gains in distressed and senior debt come on the heels of a record-breaking decade for private debt generally, as a result of many market factors, including:

- the drying up of bank credit at the outset of the Great Recession;
- the regulatory reshaping of banks' credit exposures; and
- the enduring low interest rate environment which persisted in the US until very recently -- which made finding yield a priority.

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That low-yield environment elevated the attractiveness of, and interest in, private debt transactions. In turn, that produced better yield than conventional instruments, but offered levels of low volatility and capital protection that secured them a place in sound portfolio management.

The attraction to special situation investments is clear: price. With billions in "dry powder" available to invest, it has nonetheless proved increasingly difficult to find attractively priced deals or, in the case of private equity, sensible acquisitions. But the ground rules around private debt deals are changing. Steadily increasing interest rates and the growing deregulation of bank lending will bring greater competition to secure the "best" debt deals in the market.

To capitalise on distressed investments, it is important to note that no two special situations are created equal. Distress can be caused by several factors, whether performance related, market related, or as a result of a stressed balance sheet of a performing company. As such, whether your special situation is exit mapping with respect to your existing borrower in distress, or you are seeking a new opportunistic distressed investment, it is critical to unpack all of the factors that have caused the distress so you can craft the path, or multiple paths, to maximise your likelihood of success.

In addition to understanding all of the factors causing the distress, it is equally important to provide the necessary levers to pull. For existing deals gone bad and for new distressed investments, the path to recovery will depend directly on charting a course to maximise your creditor rights in terms of structure and documentation. There are always multiple paths available, and exit mapping on the front end is critical.

In this environment, distressed asset acquisitions and debt finance need to reflect what are increasingly changeable market environments. The aging bull market and the impact of repatriation of US earnings have created what could be at least one more year's lift in asset prices. The longest-ever predicted market downturn that never happened may indeed become a reality – and for that, lenders must be securely positioned and protected. ■