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Why large-scale distress may be back in fashion

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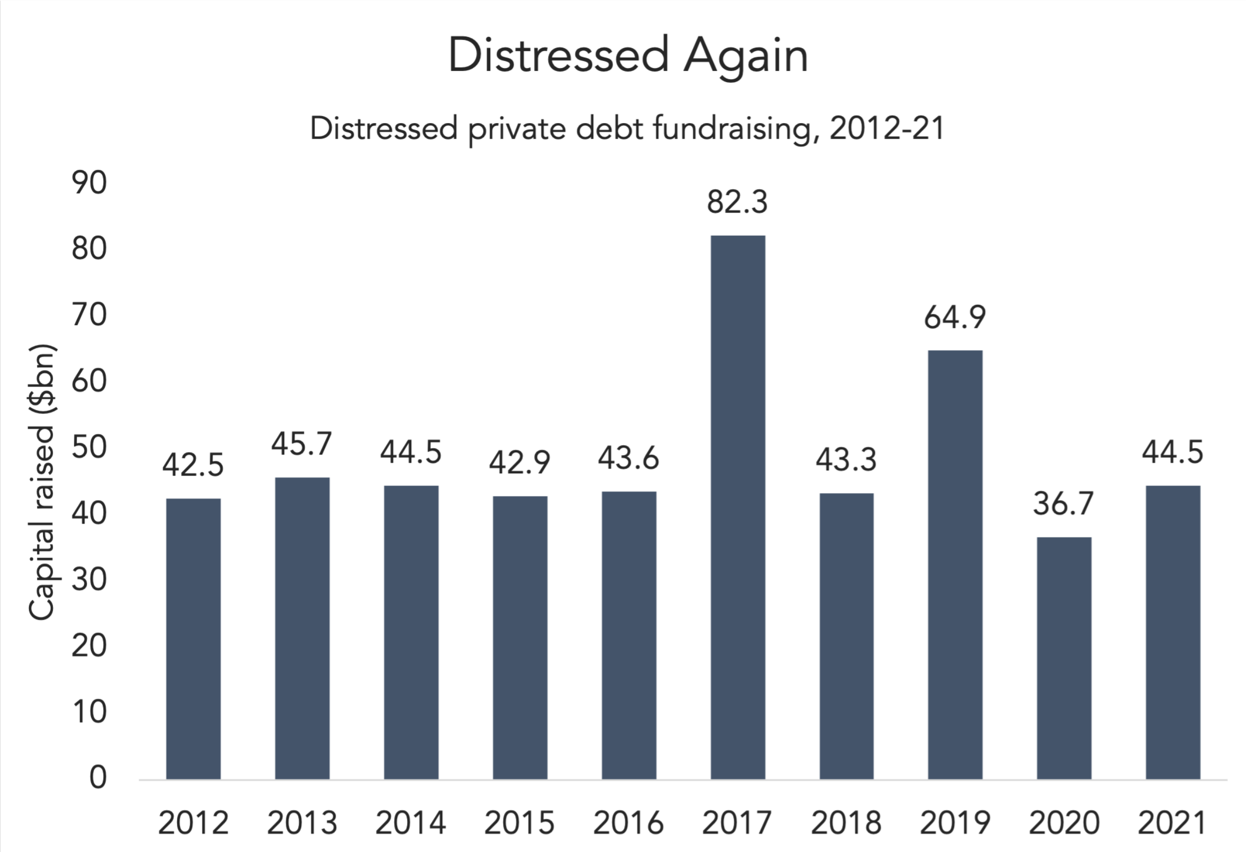

For big distressed debt funds, identifying sufficient dealflow has been a challenge. But do such investors now have a 'perfect storm'?

With the world in a state of flux, it seems an appropriate time to revisit the distressed market and see whether there is a sense that today's dramatic events – ranging from inflation and rate rises to war on the European stage – might produce a new wave of activity.

Having raised record amounts of capital in 2017 (see chart) and struggled to identify dealflow, it had seemed that investor sentiment had turned somewhat against the large, distressed funds. Under pressure to deploy, some have been accused of making concentrated bets in just one or two sectors which then failed to perform according to expectations. Special situations and capital solutions funds, with smaller and arguably more flexible mandates, have been more in favour.

However, backing for the smaller funds has been to an extent based on the assumption that distress would be more at the single company, operational level rather than being structural as companies sought help to refinance and apply some fixes to balance sheet difficulties faced as a result of the pandemic. But that assumption is being challenged by the new energy crisis – exacerbated by the situation in Ukraine – making inflation a bigger problem than it was originally perceived to be. Could we in fact be looking at an “old-fashioned” wave of distress after all?

One market source we spoke with suggested this may indeed be the case. He said: “In the leveraged loan market you have big issuers that raised money on inflated EBITDA and with high leverage. Some raised too much debt on loose terms. Will they be able to refinance that debt in a year or two if there’s a prolonged period of volatility? Before higher rates came into play, there was always a question around whether the refinancing environment might change. Now, with inflation and rate hikes, you have a perfect storm.”

As yet, there are only modest signs of an uptick in fundraising and activity levels for distressed debt specialists. But in such a volatile environment, that could change at any time.

(Past performance is no guarantee of future results.)