

Opportunities in Dislocated Corporate Credit Markets

Corporate credit markets are undergoing dramatic transformations, and volatility is especially pronounced in the debt of lower-quality companies. Business challenges from sharply lower commodity prices and industry shifts alongside extraordinary policy and regulatory actions are exerting pressure on more leveraged borrowers. While this stress is consistently more acute in the less efficient middle market, we are observing increased prospects for debt restructurings across numerous industries and in larger companies as well.

In this interview, Sai Devabhaktuni, portfolio manager for corporate opportunities investing, and Neal Reiner, senior product manager for PIMCO's credit alternatives, discuss themes and trends in opportunistic debt as well as PIMCO's investment approach in this sector.



Sai Devabhaktuni
Executive Vice President
Portfolio Manager



Neal Reiner
Executive Vice President
Product Manager

Q: What is opportunistic corporate credit investing?

Devabhaktuni: At PIMCO, opportunistic credit investing focuses on companies whose businesses are undergoing challenges or change such that their existing debt trades in the public market at a significant discount to par value, and it also focuses on companies (often private) that cannot attract financing from traditional sources. Opportunistic credit investments tend to share one or more themes:

- Stress or distress emanating from external factors (economic, regulatory), internal factors (overconfident management teams, unrealistic business plans, inconsistent leadership) or other idiosyncratic factors
- Dislocation in the industry or a sector that is "out of favor"
- Transition that requires customized financing solutions (typically private transactions)
- Deep value in the liabilities of a company's capital structure

We primarily target public and private companies in the U.S. and Europe, and while we are able to seek opportunities in companies of any size, we often focus our opportunistic investing on the middle market – companies with debt outstanding of less than \$750 million, or whose EBITDA (earnings before interest, taxes, depreciation and amortization) is less than \$100 million. Although middle market companies can be more economically vulnerable than larger companies, evaluating their financial health is less complex and they are frequently easier to reorganize, with a greater likelihood for investors to influence developments. An active approach permits us to support business plans and customize plans of reorganization when appropriate as we seek to structure investments with credit downside protection alongside equity optionality.

Q: Why is opportunistic credit especially attractive now?

Devabhaktuni: A confluence of factors. The ability of larger companies to finance themselves at low rates has resulted in sharply increased financial leverage alongside significant industry changes (excess capacity in certain sectors, technological disruption, aggressive regulation), creating dislocations that we see escalating. Global policy divergence, a strong dollar, lower commodity prices, demographic shifts and a slowdown in China's growth, when combined with the tremendous growth in recent years in the leveraged credit markets, are all creating stress, and the Fed has not even begun tightening yet. We expect these uncertainties could prompt an increase in defaults and distressed exchanges, creating opportunities.

But our opportunity set goes beyond just investing in distressed companies. In the post-crisis global economy, many smaller businesses have limited access to credit and frequently pay a premium to gain financing in illiquid and less efficient markets. These smaller companies often provide opportunities to make direct hybrid investments (e.g., debt with warrants) and provide ample risk premiums, and many reach out to PIMCO directly: They see us as a constructive partner and a "solutions provider." In such arms-length negotiations, we establish safeguards via covenant protections and board participation.

We have to be mindful of the enhanced volatility and the considerably larger scale of the leveraged finance markets today (the combined market for high yield debt in developed economies plus U.S. bank loans rose from around \$2.1 trillion in 2010 to over \$3.2 trillion in 2015, according to Deutsche Bank). Also, the changing regulatory environment – Volcker Rule, Dodd-Frank, OCC rules limiting bank funding for highly leveraged transactions – is driving a decline in leveraged finance market liquidity, creating opportunities in illiquid and private credit.

The middle market in particular offers a steady stream of opportunities that is likely to increase in the years ahead. Indeed, stress is most visible today in companies exposed to natural resources (e.g., energy, metals and mining); however, we are seeing broader dislocation in suppliers to natural resource companies as well as opportunities in the aerospace and defense, agricultural infrastructure, basic industrials and consumer products sectors.

Q: How do you invest in opportunistic credit?

Devabhaktuni: Put simply, investors in opportunistic corporate credit seek to capitalize on companies undergoing adjustments due to the evolving nature of their business – refinancing, restructuring, recovery or the requirement of a customized financing solution. By their nature, investments in stressed and distressed companies tend to offer opportunities to purchase debt at meaningful discounts to par value allowing for low valuation entry points, and then they proceed along several possible paths:

- **Operating recovery scenario:** The situation at the distressed company improves fundamentally, and the credit trades to par. This can produce both a respectable multiple on invested capital and an attractive yield to maturity, depending also on the duration.
- **Reorganization scenario:** The company restructures either voluntarily or involuntarily. Restructuring typically involves trade-offs between cost, flexibility, mitigating contingent liabilities and managing holdouts. Though they depend on the forum of reorganization (e.g., in-court versus out-of-court), the potential benefits to companies include substantial interest expense reductions, renegotiations of unfavorable contracts, non-financial liability settlements, non-core asset sales and other operational changes. Opportunistic investors can realize

potential benefits as previously owned securities are reinstated or converted into new securities. And investors may become equity owners at favorable valuations of much-improved companies, with considerable upside potential. These features of reorganization may afford investors a second opportunity to generate return, or a “second bite at the apple.”

- **Liquidation scenario:** The company defaults and then liquidates, which could negatively affect stakeholders, though as creditors they may have priority on recoveries. With this scenario in mind, many distressed investors target a more senior position in the capital structure with the desire to create equity-like optionality at an attractive valuation. Also, the pre-restructuring current yield on debt instruments functions as a risk-mitigating component.

In addition to the analytical skill to assess a company's intrinsic value, the distressed investor should understand how the company may be optimally recapitalized and possess solid legal knowledge of indenture, bankruptcy, securities and corporate law. Capital structure positioning is important as there are often numerous creditor groups and other parties competing to realize value. We incorporate scenario analyses in determining the array of potential outcomes.

Q: What are the key risks?

Devabhaktuni: PIMCO monitors and manages several key risks in opportunistic credit investing:

- **Credit risk** requires a careful evaluation of downside recovery potential should a restructuring be required.
- **Liquidity risk** necessitates matching the investment horizon with funding duration.
- **Regulatory risk** can encompass changes in creditor's rights, changes in industry regulations (environmental, healthcare) and changes in the capital markets that restrict financial institutions' ability to hold certain types of assets.

More broadly, we monitor areas where excessive risk-taking brought about by extraordinarily accommodative central bank policies, imbalances in capital allocation toward riskier projects, and sharply higher leverage profiles may make companies more vulnerable to economic or market shocks.

Q: How do you evaluate whether a private credit investment adequately compensates, or offers appropriate return potential, in exchange for its illiquidity?

Reiner: We look at four factors when assessing the appropriate return potential for private credit: credit risk premium (the spread over comparable public issues), illiquidity premium (term dependent), complexity premium (more complex business models may limit buyers or financing sources) and structural protection (potential benefits of a comprehensive covenant package and/or direct involvement with the company). Views on these factors incorporate current market levels along with the underlying borrower's business, capital structure, access to liquidity and the likely timing and ease of exit.

In some areas of the private credit market, oversupply of capital is forcing pricing to less attractive levels. For example, private direct lending funds, public business development companies and collateralized loan obligation vehicles all compete to lend to similar borrowers, and the significant capital they have raised has largely eliminated any premium for private loans. Also, the competition among managers to deploy capital has encouraged excessive risk-taking, which in turn may erode the financial cushion of middle market entities (often seeding the supply of distressed opportunities). We pointedly look to avoid these areas.

Q: What role could opportunistic credit play within a portfolio's broader framework?

Reiner: This idiosyncratic segment of the market has historically tended to provide a performance premium relative to traditional capital markets and, importantly, exhibit a low correlation to broad market indexes and diversification from many traditional risk factors. However, we would note that opportunistic credit does come with its own set of idiosyncratic risks, as discussed earlier. Rising interest rates, which usually reflect improving economic conditions, can be supportive for opportunistic credit. Valuations can be attractive relative to traditional equities and bonds due to discounted purchase prices and generally higher current income. Finally, a significant cash coupon may help stabilize returns and mitigate risk.

Within a portfolio, investors often include an opportunistic credit strategy within any of several buckets: fixed income, event-driven investments, private equity or their own customized opportunistic or distressed credit segments.

Q: Why is PIMCO particularly well-suited to investing in opportunistic credit?

Reiner: Our broad platform allows us to be able to focus on what we feel are the most attractive risk-adjusted return opportunities across both the public and private markets. We believe this approach helps mitigate timing risk and provides a constant supply of attractive investments to evaluate. We have a dedicated, experienced and growing team that combines outstanding market sourcing capability, a clear grasp of the macro environment, deep industry research capabilities and broad restructuring experience.

Sourcing is critical, and as a large, global investor we have considerable access to deal flow across the public and private markets. PIMCO's investment breadth helps allow us the

opportunity to provide a broad range of capital structure solutions to borrowers that may provide a competitive advantage to us in sourcing. Also, we can often evaluate more complex strategies with the benefit of specialized insights from PIMCO's other in-house teams, including our real estate and commodities investment groups.

At its heart, distressed credit investing is about identifying and exploiting idiosyncratic bottom-up opportunities. But top-down themes help inform the search, and PIMCO is an industry leader in macroeconomic analysis of trends across regions, sectors and credit markets. We believe our specific skill sets and relationships, when combined with our global resources and macro views, provide a compelling platform to exploit the inefficiencies of the marketplace and target attractive risk-adjusted returns across a variety of investing environments.

Investing in **distressed companies** (both debt and equity) is speculative and subject to greater levels of credit, issuer and liquidity risks, and the repayment of default obligations contains significant uncertainties; such companies may be engaged in restructurings or bankruptcy proceedings. **Investing in distressed loans and bankrupt companies** is speculative and the repayment of default obligations contains significant uncertainties. **Investing in the bond market** is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk. **High-yield, lower-rated securities** involve greater risk than higher-rated securities; portfolios that invest in them are subject to greater levels of credit and liquidity risk than portfolios that do not. All investments contain risk and may lose value. **Equity investments** may decline in value due to both real and perceived general market, economic and industry conditions, while **debt investments** are subject to credit, interest rate and other risks. In addition, there can be no assurance that PIMCO's strategies with respect to any investment will be capable of implementation or, if implemented, will be successful. **Investing in foreign denominated and/or domiciled securities** may involve heightened risk due to currency fluctuations, and economic and political risks. **The current regulatory climate** relating to the strategy and these types of investments is uncertain and rapidly evolving, and future developments could adversely affect the strategy and/or its investments. Strategy availability may be limited to certain investment vehicles; not all investment vehicles may be available to all investors. Please contact your PIMCO representative for more information.

This material contains the current opinions of the manager and such opinions are subject to change without notice. This material is distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

PIMCO provides services only to qualified institutions and investors. This is not an offer to any person in any jurisdiction where unlawful or unauthorized. | **Pacific Investment Management Company LLC**, 650 Newport Center Drive, Newport Beach, CA 92660 is regulated by the United States Securities and Exchange Commission. | **PIMCO Investments LLC**, U.S. distributor, 1633 Broadway, New York, NY, 10019 is a company of PIMCO. | **PIMCO Europe Ltd** (Company No. 2604517), PIMCO Europe, Ltd Amsterdam Branch (Company No. 24319743), and PIMCO Europe Ltd - Italy (Company No. 07533910969) are authorised and regulated by the Financial Conduct Authority (25 The North Colonnade, Canary Wharf, London E14 5HS) in the U.K. The Amsterdam and Italy branches are additionally regulated by the AFM and CONSOB in accordance with Article 27 of the Italian Consolidated Financial Act, respectively. PIMCO Europe Ltd services and products are available only to professional clients as defined in the Financial Conduct Authority's Handbook and are not available to individual investors, who should not rely on this communication. | **PIMCO Deutschland GmbH** (Company No. 192083, Seidlstr. 24-24a, 80335 Munich, Germany) is authorised and regulated by the German Federal Financial Supervisory Authority (BaFin) (Marie-Curie-Str. 24-28, 60439 Frankfurt am Main) in Germany in accordance with Section 32 of the German Banking Act (KWG). The services and products provided by PIMCO Deutschland GmbH are available only to professional clients as defined in Section 31a para. 2 German Securities Trading Act (WpHG). They are not available to individual investors, who should not rely on this communication. | **PIMCO (Schweiz) GmbH** (registered in Switzerland, Company No. CH-020.4.038.582-2), Brandschenkestrasse 41, 8002 Zurich, Switzerland, Tel: +41 44 512 49 10. The services and products provided by PIMCO Switzerland GmbH are not available to individual investors, who should not rely on this communication but contact their financial adviser. | **PIMCO Asia Pte Ltd** (501 Orchard Road #09-03, Wheelock Place, Singapore 238880, Registration No. 199804652K) is regulated by the Monetary Authority of Singapore as a holder of a capital markets services licence and an exempt financial adviser. The asset management services and investment products are not available to persons where provision of such services and products is unauthorised. | **PIMCO Asia Limited** (Suite 2201, 22nd Floor, Two International Finance Centre, No. 8 Finance Street, Central, Hong Kong) is licensed by the Securities and Futures Commission for Types 1, 4 and 9 regulated activities under the Securities and Futures Ordinance. The asset management services and investment products are not available to persons where provision of such services and products is unauthorised. | **PIMCO Australia Pty Ltd** ABN 54 084 280 508, AFSL 246862 (PIMCO Australia) offers products and services to both wholesale and retail clients as defined in the Corporations Act 2001 (limited to general financial product advice in the case of retail clients). This communication is provided for general information only without taking into account the objectives, financial situation or needs of any particular investors. | **PIMCO Japan Ltd** (Toranomon Towers Office 18F, 4-1-28, Toranomon, Minato-ku, Tokyo, Japan 105-0001) Financial Instruments Business Registration Number is Director of Kanto Local Finance Bureau (Financial Instruments Firm) No. 382. PIMCO Japan Ltd is a member of Japan Investment Advisers Association and The Investment Trusts Association, Japan. Investment management products and services offered by PIMCO Japan Ltd are offered only to persons within its respective jurisdiction, and are not available to persons where provision of such products or services is unauthorized. Valuations of assets will fluctuate based upon prices of securities and values of derivative transactions in the portfolio, market conditions, interest rates and credit risk, among others. Investments in foreign currency denominated assets will be affected by foreign exchange rates. There is no guarantee that the principal amount of the investment will be preserved, or that a certain return will be realized; the investment could suffer a loss. All profits and losses incur to the investor. The amounts, maximum amounts and calculation methodologies of each type of fee and expense and their total amounts will vary depending on the investment strategy, the status of investment performance, period of management and outstanding balance of assets and thus such fees and expenses cannot be set forth herein. | **PIMCO Canada Corp.** (199 Bay Street, Suite 2050, Commerce Court Station, P.O. Box 363, Toronto, ON, M5L 1G2) services and products may only be available in certain provinces or territories of Canada and only through dealers authorized for that purpose. | **PIMCO Latin America** Edifício Internacional Rio Praia do Flamengo, 154 1o andar, Rio de Janeiro – RJ Brasil 22210-906. | No part of this publication may be reproduced in any form, or referred to in any other publication, without express written permission. PIMCO and YOUR GLOBAL INVESTMENT AUTHORITY are trademarks or registered trademarks of Allianz Asset Management of America L.P. and Pacific Investment Management Company LLC, respectively, in the United States and throughout the world. © 2015, PIMCO.

Newport Beach Headquarters

650 Newport Center Drive
Newport Beach, CA 92660
+1 949.720.6000

Amsterdam

Hong Kong

London

Milan

Munich

New York

Rio de Janeiro

Singapore

Sydney

Tokyo

Toronto

Zurich

pimco.com

P I M C O