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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.

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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.

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