E X P E R T Q & A

David Forbes-Nixon, co-founder, chairman and chief executive at Alcentra, and Eric Larsson, co-portfolio manager of the special situations team, discuss energy, retail and other opportunities amid economic strain

Where to ramp up in a slowdown

Q Are macro conditions a tailwind for the European distressed market?

David Forbes-Nixon: We are in the very late stages of the longest credit bull market in history, and whilst we do not forecast a recession, there is clearly a slowdown taking place. Christine Lagarde of the International Monetary Fund said recently that two years ago about 75 percent of the world's economies were growing, but now about 70 percent are slowing. Europe is seeing an economic downturn due to geopolitical risks and other factors with some countries suffering a great deal, such as Italy, where there is a large number of non-performing loans on bank balance sheets.

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Furthermore, the leveraged loan market is priced to perfection. Leveraged loan multiples reached 5.4x last year, compared with a peak of 5.2x before the Global Financial Crisis.

Eric Larsson: Because everything is priced to perfection, one does not need to see a big miss in performance relative to a borrower's target, before it can become stressed.

Q So, opportunities are increasing?

DFN: The market is very fragile. We witnessed this late last year, when there was enormous volatility on very little news. Taking 2018 as a whole, 135 European high-yield bonds traded down 10 points or more, but only five traded up 10 points or more, partly because of the announcement of the end of quantitative easing and the lack of dealer capital to support their deals. Compare this to 2017, when only 13 traded down and 63 traded up to a similar degree. Also, the European Central Bank currently holds about 10 percent of all European triple-B corporate bonds: this could create an enormous potential opportunity for investing in fallen angels – bonds that have fallen from investment-grade to high-yield ratings, perhaps in part because they are no longer supported by the ECB buying and also due to performance and market issues.

Another way of measuring the increasing opportunity is to look at the overall amount of stressed and distressed syndicated loans and high-yield bonds outstanding in Europe – securities trading below 80 cents in the euro or at a yield to maturity above 12 percent. We measure this every quarter. The total for the fourth quarter of last year was up 31 percent, or €23 billion, from the previous quarter, to €70 billion.

Q Which sectors have particularly interested you recently?

EL: Our biggest single industry exposure at the moment in our special situations business is in energy. We have been active in both exploration & production and services. We do not profess to have better knowledge than anybody else about what will happen to oil prices, so our first aim is to try to take this out of the equation. Then it comes down to valuations. We strive for entry points sufficiently low so that, on the basis of probability-adjusted outcomes, we are comfortable that we can at the very least sell the debt at the price at which we bought it. On the services side, we look for companies that will benefit from ongoing demand, even allowing for the fact that E&P activity will go up and down over time.

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> **DAVID FORBES-NIXON**
> **ALCENTRA**

Q How about retail?

DFN: We are not making primary loans to retailers in our direct lending or syndicated business, and we are pretty cautious about retailers in our distressed business too. However, there are certain companies that can be interesting, if you buy into the debt at an extremely low multiple and in some cases then convert that debt to equity. You have to cherry pick the best companies and may need to replace management teams and implement operational and financial restructuring measures.

Q What countries do you like?

EL: Generally, we focus on northern and western Europe, because the jurisdictions are more favourable to creditors. We do not exclude southern Europe, but the fact that they have less creditor-friendly restructuring and insolvency regimes is surprisingly often not taken into account in the pricing: a deal in the UK with certain leverage may be priced in a similar fashion to a deal with the same leverage in Italy, despite the fact that the process in the UK may take two months, but in Italy it may take two years.

It can be difficult to perform restructurings in France, but they do get done, and they get done in favour of senior creditors, though you have to be well-connected in that market to get the results you want. To explain, a handful of law firms and court-appointed people are involved in these interactions, and they do things in their way. If you know them, and have dealt with them in the past, as we have, you know how they work, which way they will push the cases and so forth, and you can anticipate and adjust your strategy accordingly.

DFN: We like to have local people who know the jurisdiction, and know the people to deal with when we are investing in a credit in a particular European country. We have the advantage that we can tap into the expertise of the 30 European analysts who work for the broader Alcentra group in Europe in addition to our dedicated special situations team of 10 professionals, plus our three lawyers, who are all experts in bankruptcy law and leveraged finance documentation. Alcentra has 17 years' experience of doing this, and I personally have been involved in the European leveraged finance market since 1987 and the distressed debt market since its inception in 1992.

Q So, the legal side of distressed investing is very important?

DFN: We spend as much time analysing the legal and documentation risk as we do on the credit and cashflow of a company. The UK is probably the best bankruptcy jurisdiction in Europe from a senior secured lender perspective and is similar to the US in terms of higher recovery rates. In the UK, if you are the senior secured lender, and you have fixed and floating charges on the assets and cashflows, you will not find yourself challenged successfully by other creditors in a UK bankruptcy court trying to subordinate your claim. As well as the UK, Germany, the Netherlands and Scandinavia are also quite creditor-friendly jurisdictions.

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> **ERIC LARSSON**
> **ALCENTRA**

Q Most recently, where have opportunities been increasing?

EL: We were interested to see, when compiling our Q4 2018 numbers for stressed and distressed debt, that German companies accounted for 11 percent of the total – the highest total for Germany in three years.

I think that reflects troubles in the German economy, including the existence of numerous sectors that export a great deal to China and other Asian countries, whose economies have been slowing down.

When it comes to sectors, we think there may be cyclical opportunities in the future in autos and industrials. It is illuminating that in the sell-off of debt in the last quarter of last year and first quarter of this year, a couple of auto companies entered our distressed universe – I do not think that is a coincidence, and I think some sectors will come back in a way that we have not seen for a long time. ■