The Frontier Line

The ‘new’ state of distressed and opportunistic credit

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About us

Frontier Advisors has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice on around $600 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Our purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

Jill Guan

Consultant

Jill Guan joined Frontier Advisors as a Consultant in 2021 and is a member of the Debt and Currency Team. Jill was previously at Citibank Australia where she provided relationship and credit coverage to institutional clients. She has also spent time in China with Citibank as a credit analyst.

Prior to that, she worked at HSBC Australia and ANZ within institutional banking across various client coverage teams. Jill holds a Bachelor of Law and a Bachelor of Commerce from the University of Melbourne.

Nam Tran

Senior Consultant

Nam Tran joined Frontier Advisors as a Consultant in 2017 as a member of the Debt and Currency Team and was promoted to Senior Consultant in January 2021. Previously Nam worked with NAB in the institutional banking area, undertaking industry and credit analysis in the Resources, Energy and Utilities sectors for ten years.

Prior to this, he spent three years with KPMG and the Sarbanes Oxley team at NAB, undertaking financial and operational analysis of clients in the financial services industry, and three years with HSBC in Vietnam in corporate and institutional banking. Nam holds a Bachelor of Business from Monash University, a Master of Commerce from the University of Sydney, and is a CFA charterholder and CAIA charterholder.

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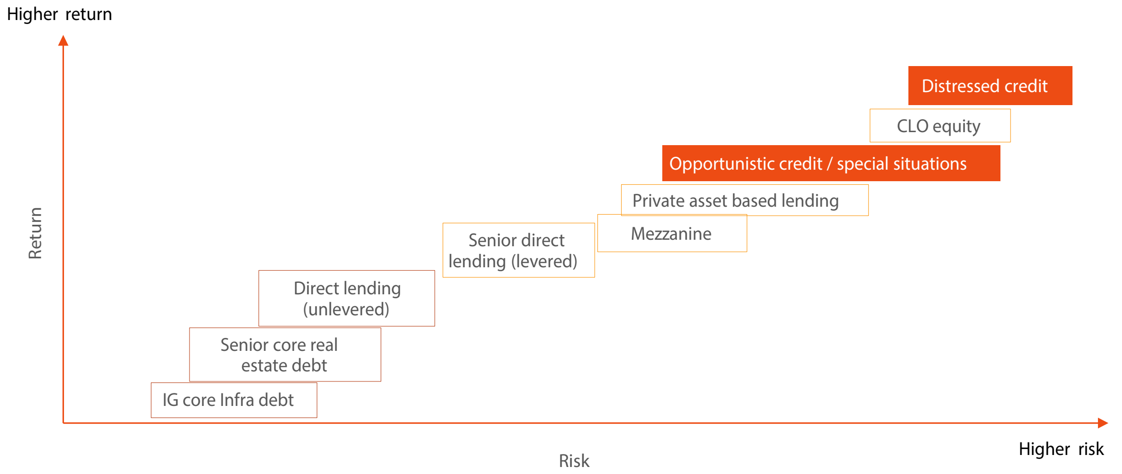
Introduction

Past periods of increased defaults, insolvency and market volatility, such as the GFC, have benefited distressed credit investments which capitalise on bankruptcy/restructuring scenarios. These periods of market dislocation contrast with a more recent period of a benign credit environment driven by large amounts of quantitative easing and supportive monetary policy from central banks. Dedicated distressed credit funds have almost 'disappeared' and been replaced by opportunistic credit or 'special situations' funds which typically target a much less cyclical opportunity set that is less dependent on a default cycle while retaining flexibility to invest in bankruptcy and restructuring scenarios. Tightening financial conditions, rising interest rates and supply chain disruptions are now placing enormous pressure on corporate balance sheets and highly geared assets. With this macro backdrop, distressed and opportunistic credit is looking attractive for investors with the right risk appetite, illiquidity and fee budget.

Defining distressed credit and opportunistic credit

Distressed credit and opportunistic credit are part of the broader private debt asset class, which includes other strategies such as infrastructure debt and direct lending. Chart 1 provides a stylised illustration of where they sit relative to other private debt asset classes. Compared to direct lending, both distressed and opportunistic credit sit toward the higher end of the risk-return spectrum given the more complex nature of the investments.

Chart 1: Private debt – risk and return spectrum



Source: Frontier Advisors, stylised representation of risk/return characteristics.

A key distinction between distressed credit and opportunistic credit is the nature of investments. Distressed credit strategies invest in distressed companies or assets with a heavy focus on restructuring and default/bankruptcy scenarios to drive a high return outcome, i.e. non-performing assets, securities or corporates that have defaulted. The opportunity set can therefore be more dependent on default cycles characterised by systematic credit distress resulting in an elevated number of defaults and bankruptcies, e.g. the GFC. For opportunistic credit strategies, restructuring or bankruptcy scenarios are not the predominant focus. While some strategies could include distressed investments dependent on market conditions (generally investments target performing, stressed companies or assets), the opportunity can be more idiosyncratic in nature and therefore less correlated to the market cycle.

Given the differentiating nature of investments, distressed credit investments can often take on a substantial amount of equity risk (as investors typically become an equity holder in the distressed corporate through the restructuring process). It can deliver a higher expected gross internal rate of return (IRR) in excess of 20% compared to a range of 12-18% of gross IRR targeted for opportunistic credit.

What’s found in the strategies?

The risk and return characteristics of the investments in the distressed and opportunistic investment universe can vary. The risk and return generally increases as probability of default for the underlying corporate/assets increases. For example, lending to a performing company seeking growth capital generates a lower return compared to investments in non-performing corporates/assets. Table 1 shows the various types of investments typically found across distressed and opportunistic credit strategies and their expected return profile. There can be significant overlap and in practice, a single strategy can access distressed credit as well as a range of broader less cyclical opportunistic lending. In Chart 2, we have provided selective examples of distressed and opportunistic credit investments which demonstrate the diversity of underlying exposure across industries as well as capital structure.

Table 1: Typical allocation across strategies

Nature of investment	Description	Expected return (gross IRR)	Expected holding period	Typical strategy: Opportunistic credit/special situations	Typical strategy: Distressed credit
Growth lending to performing business	Provide debt or hybrid (debt & equity) solutions for performing business to grow (M&A or capex) without raising common equity	10 – 18%	Medium term	✓✓	✗
Opportunistic purchase of assets	Forced sellers sell assets/investments due to regulatory pressures, liquidity requirements, margin unwind	12 – 20%	Medium term	✓✓	✓✓
Asset based financing	Acquiring portfolio of performing loans or receivables; specialty financing (litigation, royalty); opportunistic real estate lending	12 – 20%	Short-medium term	✓✓✓	✓
Stressed trading	Trading opportunities due to covenant breach, rating downgrades, earnings volatility, market dislocations	13 – 20%	Medium term	✓✓✓	✓✓
Solutions to stressed business (non-default)	Capital solutions for stressed business; i.e. rescue financing and/or restructuring of capital structure and balance sheet	15 – 20%	Short-medium term	✓✓✓	✓✓
Distressed (default or bankruptcy)	Distressed for control or with influence on a business undergoing restructuring and turnaround, likely require change in business strategy and personnel	20%+	Medium term	✓	✓✓✓
Distressed (default or bankruptcy)	Lending to companies in bankruptcy Purchase of non-performing loans	20%+	Short-medium term	✓	✓✓✓

✓✓✓ Main investment ✓✓ Some investment ✓ Possible investment

Source: Frontier Advisors.

Chart 2: Examples of distressed and opportunistic credit investments

Source: Frontier Advisors, media.

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The opportunity set has evolved since the GFC

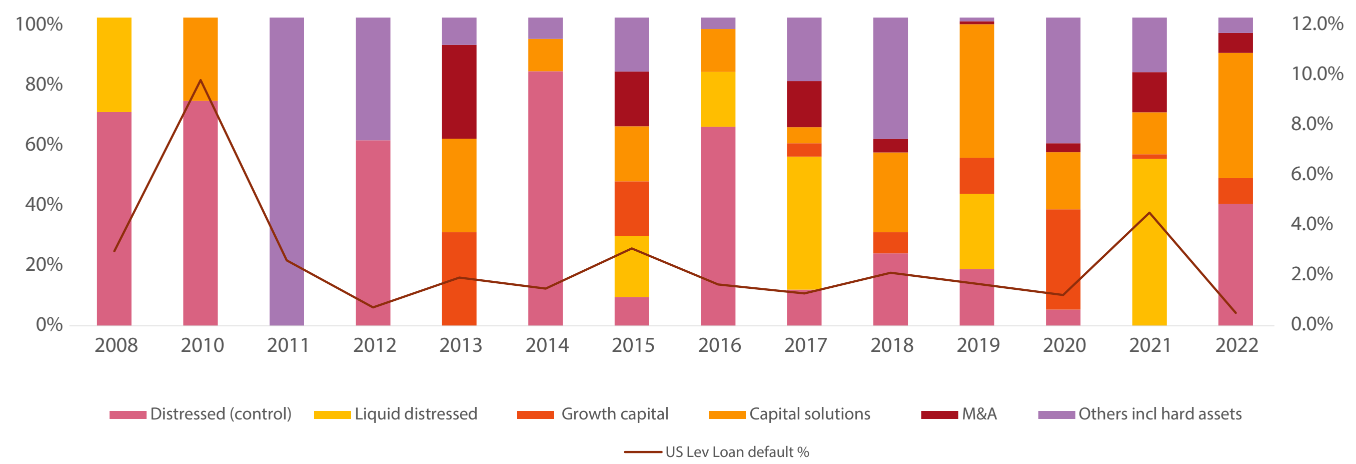
Managers have become more flexible

The overlap between strategies can be attributed to the expansion in opportunity set and a reflection of managers becoming more flexible in changing their investment mix to suit different market conditions.

Historically, the size of the opportunity set for distressed credit has been more correlated to the credit cycle with most earlier vintages (pre-2012) invested predominantly in non-performing assets or distressed liquid credit during periods of high defaults. A large proportion is in distressed for control where the managers invest in businesses facing bankruptcy or undergoing restructuring and turnaround.

As the credit environment has become more benign since the GFC, with the default rate for US leveraged loans averaging less than 1% between 2012-2022, the opportunity set for distressed credit has likely shrunk. A lot of managers have diversified their investment mandates beyond just distressed for control or distressed liquid credit. Less cyclical investments are also targeted by managers including non-performing hard assets which is more driven by changes in the regulatory environment or capital solutions driven by company specific credit events.

Chart 3: Investment composition by vintage (%)



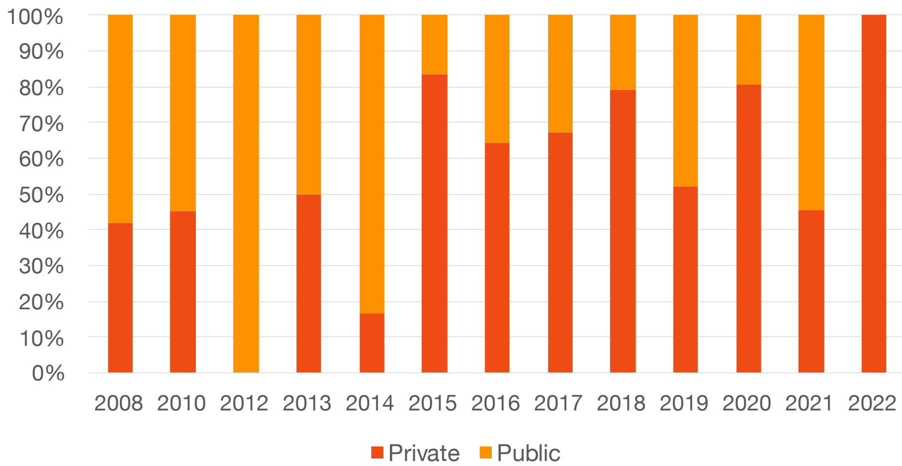
Source: Frontier Advisors, managers survey. Data as at September 2022.

Rise in private debt

The rise in private debt has also played a role in the evolution of the opportunity set. Chart 4 shows private transactions now comprise an increasingly larger proportion of the investment universe. Private opportunities, such as investing in companies with limited access to capital due to a variety reasons (i.e. growth based, stressed balance sheet) has become an important part of the overall opportunity set. These investments typically have bespoke structures and can provide attractive risk-adjusted returns. The flexibility in approach is evident in the post-COVID period where managers were able to source various investment opportunities from the private markets outside of just liquid distressed credit given the window of market dislocation was very short.

Investors can now invest in different opportunities across public and private markets and access distressed credit as part of an opportunistic credit strategy to benefit from a broader yet less cyclical opportunity set. However, it should be noted that market access is highly dependent on managers skills and capability.

Chart 4: Investment type (public versus private)



Source: Frontier Advisors, managers survey. Data as at September 2022.

Market environment

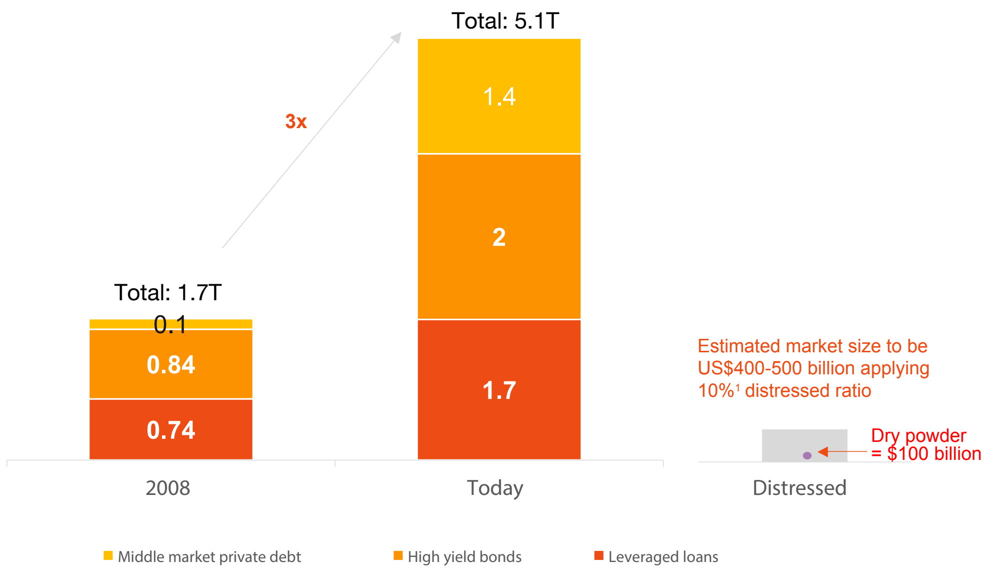
Challenging macro conditions coupled with a more levered sub-investment grade credit market is supportive of a growing opportunity set.

With the low current level of default, investors are closely considering the impact of challenging macro conditions on the sizable but more levered sub-investment grade credit market. The sub-investment grade credit market has grown significantly over the last ten years, reaching around US$5 trillion exacerbated by the growth in private credit. In the current environment, rising inflation, higher debt costs and slowing economic growth will continue to put pressure on corporate margins and cashflow, impacting the ability to service debt. As corporates look for flexible capital solutions to repair their balance sheet during this period of stress, demand for capital will increase, creating a larger opportunity set for distressed and opportunistic credit managers who have dry powder and can be flexible in deploying across public and private markets.

Total capital demand is well in excess of current dry powder.

The opportunity set is estimated to be about US$500 billion (based on 10%[1] of total market size of sub-investment grade credit and 10%[2] distressed ratio), well in excess of current estimated dry powder (about $100 billion)[3] of distressed and opportunistic credit/special situations funds.

Chart 5: Estimated market size



Source: Frontier Advisors, managers survey. Data as at September 2022.

[1]Based on manager estimate of cumulative default rate over the next three years

[2]Based on manager estimate of cumulative default rate over the next three years

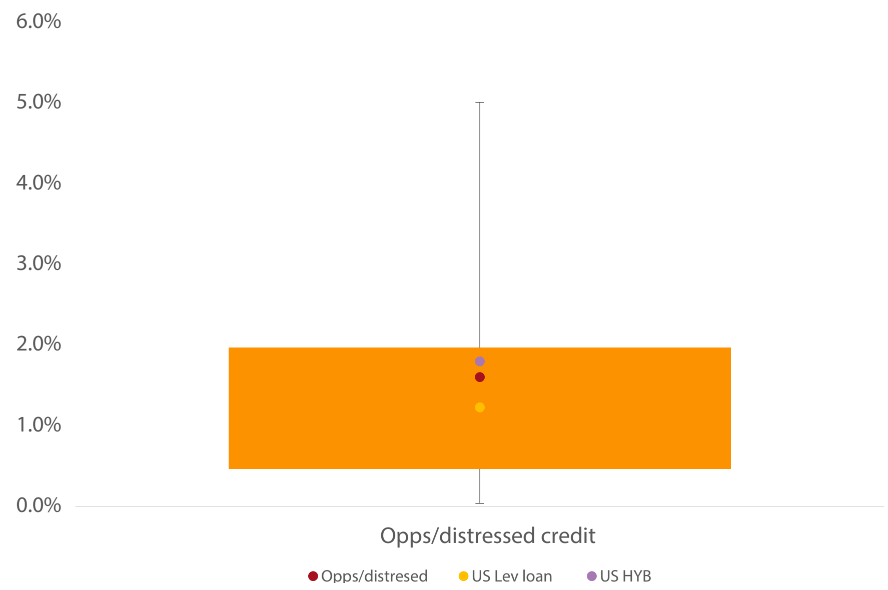
[3]Preqin

Why distressed and opportunistic credit can be attractive

Historical loss rates have been comparable to other sub-IG asset classes.

The quantum of loss across distressed and opportunistic investments can be hard to ascertain. Frontier conducted an annual survey of several opportunistic and distressed credit managers and vintages between the period of 2008-2021 to assess the level of risk and return. Based on the survey results, the average historical loss rate for vintages between 2008-2021 is around 1.6%[4] which is comparable to the average loss rates of other sub-IG asset classes such as US leveraged loans and US high yield bonds. As managers typically report on 'realised losses', loss rates can fluctuate from year to year during the life of the vintage depending on the timing of realised loss. Loss rates can also vary between vintages depending on the nature and type of investments. There can be a large dispersion in loss rates, shown in Chart 6, and losses can be well contained by managers with appropriate skill and experience, with many managers reporting an annualised loss rate on some vintages well below the average.

Chart 6: Historical loss rates (%) between 2008 and 2021*



Source: Frontier Advisors, managers survey. Data as at September 2022.

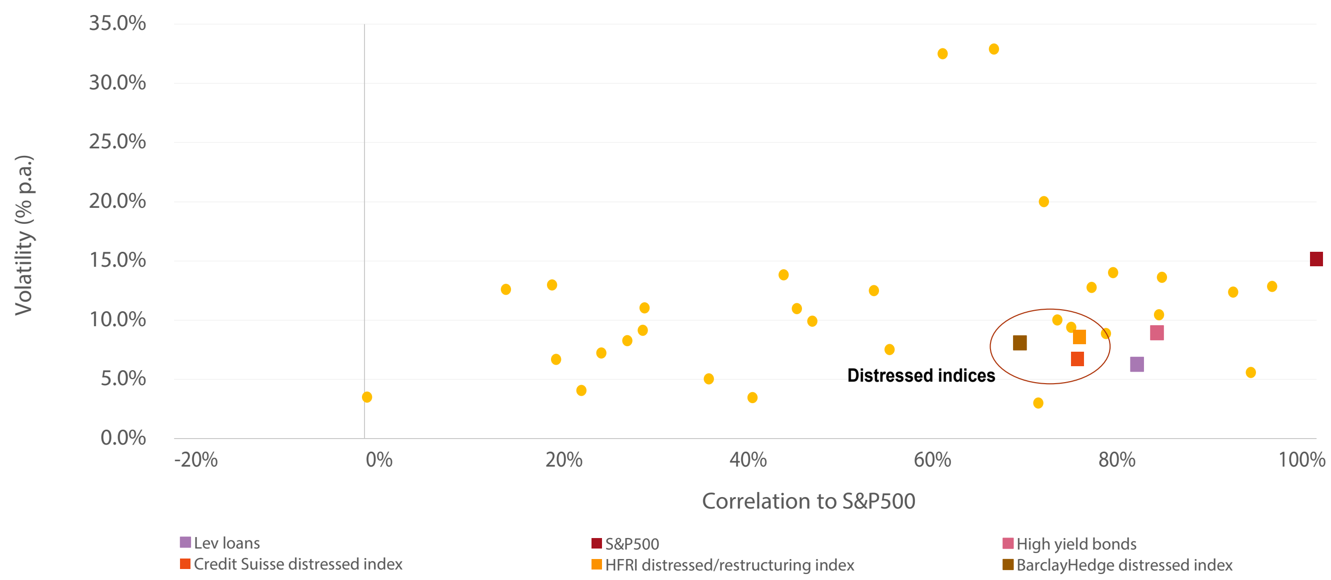
* Loss rate for distressed and opportunistic credit is the average loss rate based on vintages between 2008-2021 where data is available; loss rate data as of Sep 2022. Loss rate for lev loan equals the average of annual default rate multiplied by one minus the recovery rate of the Credit Suisse Leveraged Loan Index between 2008-2021. Loss rate for high yield bond equals the average of annual default rate multiplied by one minus the recovery rate of the BAML US Non-Financial High Yield Constrained Index between 2008-2021.

[4]This represents the average loss rate across all vintages as of Sep 2022

Low correlation to equities

Survey results also highlighted that when compared against other sub-investment grade asset classes, such as leveraged loans or high yield bonds, distressed and opportunistic credit can evidence lower correlation to equities while offering a return premium. Relative to high yield bonds and leveraged loans, the cohort of managers surveyed generated a higher median return and lower correlation to equities which provides a degree of diversification.

Chart 7: 10-year correlation versus equity



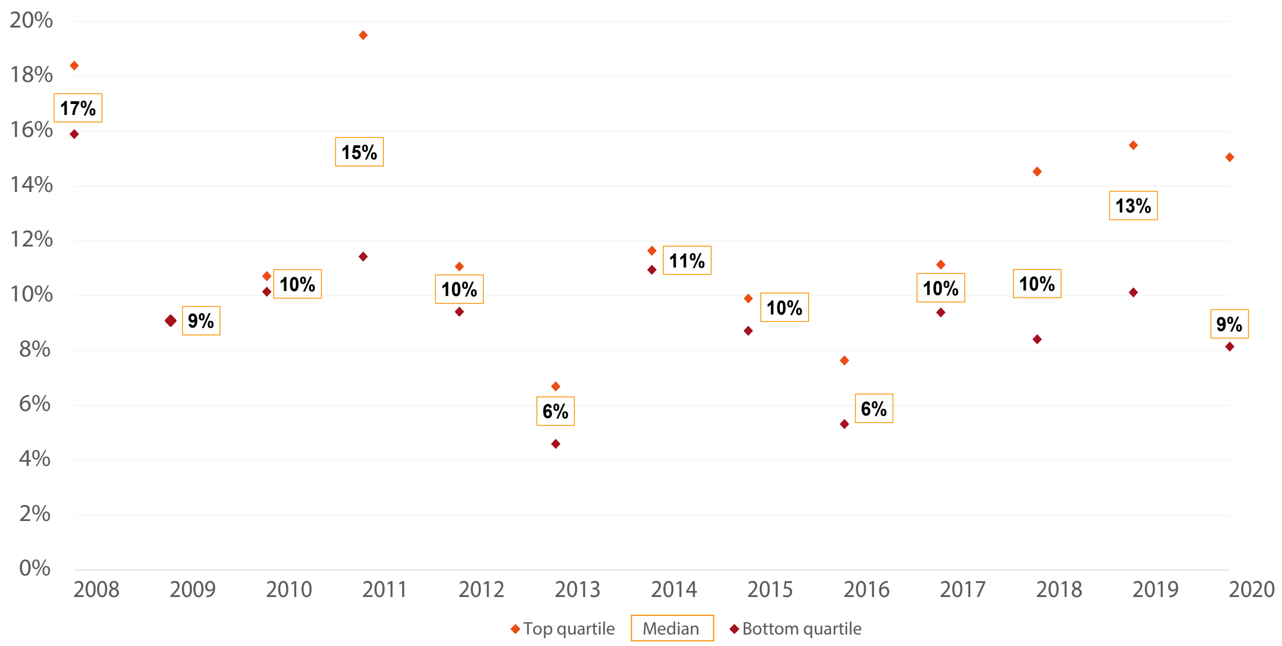
Source: Frontier Advisors, Bloomberg. Data as at 30 September 2022 with managers survey used to aggregate net quarterly returns across vintages. Volatility and correlation calculated using quarterly data over 10-year lookback.

Investor considerations

Manager selection is pertinent when investing in distressed and opportunistic credit as there can be significant dispersion of returns across managers and vintages.

Chart 8 shows there is great variability in returns depending on the underlying investments invested by the vintage and the year. For example, periods of market distress (e.g. 2008) have benefited vintages with a greater focus on distressed investments while recent vintages have benefited from the more diversified opportunity set. Established managers with strong market access and the ability to invest in both public and private markets throughout the cycle are preferred. As close ended trusts are invested over time and the opportunity set could evolve based on market conditions during the life of the vintage, it can be difficult to know what the vintage looks like at the point of commitment. Understanding a manager's historical track record of capital deployment is critical.

Chart 8: Net IRR by vintage by manager since inception



Source: Frontier Advisors, managers survey. Data as at September 2022.

Fees are expensive relative to liquid credit but can be improved.

Fees for regionally focused (e.g. US or Europe) or global strategies can be high relative to other private debt asset classes. The higher fees reflect the complexity of underlying investments which need to be supported by highly experienced professionals and bespoke structuring. In the context of restructuring, turnaround time can be lengthy and requires specialist workout skills and therefore close-ended structures are preferred. Investors are paying good managers for their ability to access the market as given the majority of the investments are privately originated. Australian strategies tend have lower fees, but investors should consider trade-offs such as smaller/less diverse markets and potential capacity constraints in those markets. However, fees can be significantly improved based on size, and we encourage investors to look for first close discounts, consultant negotiated fees and co-investment offers.

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The final word

Distressed credit strategies with a heavy focus on bankruptcy/restructuring have become less common in recent years while opportunistic credit strategies targeting a wider spectrum of investments across public, private, performing and non-performing markets have grown.

With the growing demand for private capital, the opportunity set has become more diversified and less dependent on the default cycle. We are supportive of opportunistic credit strategies which are broad and flexible. With the current macro headwinds, it can be an attractive time to access these strategies which tend to benefit from the level of rising leverage and corporate stress.

While the fee level is often perceived as a drawback for accessing this asset class, we think fees become more palatable when considered in the context of attractive risk-adjusted return and diversification benefits. Distressed and opportunistic credit has shown lower correlation with equities, and therefore deliver some diversification benefits within the growth exposure of the broader portfolio. At the same time, a good quality manager can have greater access to a market where majority of the investments are privately originated, minimise losses through restructuring/workout experience and deliver attractive risk-adjusted returns. Investors should look at the various ways to improve fees, such as size tiering, taking advantage of co-investment options and first close discount.

Want to learn more?

Please reach out to Frontier Advisors if you have any questions or visit frontieradvisors.com.au for more information.

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