Opportunities remain, even when the music stops

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The spread of Covid-19 from Asia to Europe during the first quarter of 2020 necessitated a series of national lockdowns that have paralysed the global economy. Governments and central banks have scrambled to implement fiscal and monetary policies with the aim of supporting economies sufficiently to keep them in "suspended animation" during containment periods.

At present, it is hard to predict with any accuracy how long it will take to fully bring the Covid-19 outbreak under control, nor how much damage it will do to the global economy. Much depends upon the robustness and effectiveness of governments' responses, the nature of the virus, and the capacity of health systems to manage surges in demand. Performance is likely to vary widely by both country and economic sector, in turn forcing uneven ramifications on the corporate sector.

In addition to a sharp fall-off in industrial production and related investment that is already evident in the data, the most destructive economic impact of this pandemic is likely to be the large decline in global private consumption of services. Travel, tourism, shipping and footfall-dependent businesses such as physical retail, restaurants, leisure and other services are the most vulnerable. Whether or not containment policies put in place in Europe and the US are effective, it seems likely that secondary waves of infection will occur until herd immunity or widespread vaccinations are achieved. With that in mind, any recovery is unlikely to be straight-line and we are likely to see wide performance variation between countries, sectors and companies. This presents promising opportunities for investors with a disciplined bottom-up approach and a long-term time horizon.

Past outperformance of distressed as an asset class

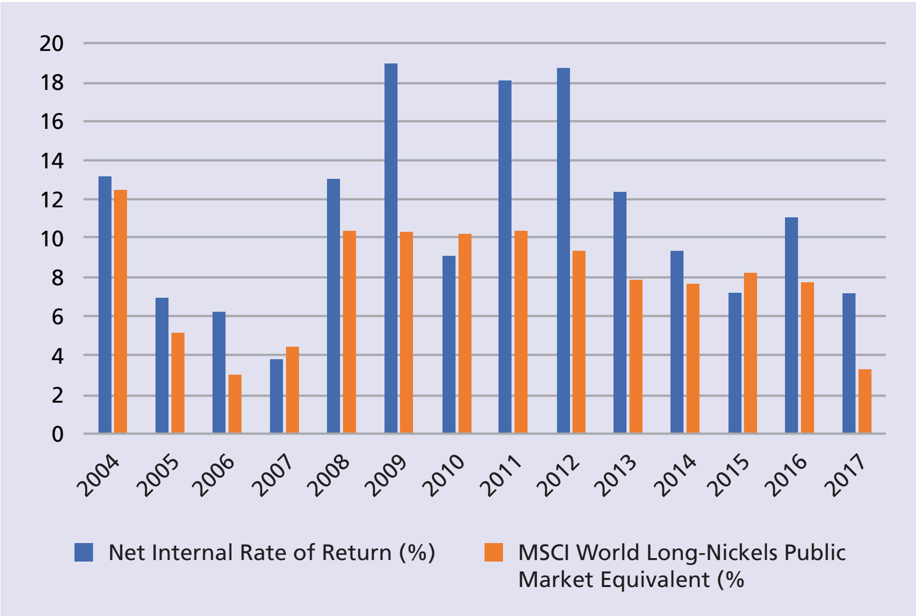
While investing in distressed assets is ordinarily a contrarian strategy, historically it has proven extremely successful for those who allocated to it in and around past dislocations or market downturns. After the oil price shock of 1990-1991, the dot-com bubble of 2000 and the global financial crisis of 2008, investments in special situations opportunities significantly outperformed global stock markets. While it can often be hard to compare private funds with public markets in a like-for-like manner, Figure 1 compares the net IRR of private funds versus a public markets equivalent of the MSCI World between 2004 and 2017. Clearly visible is the outperformance of distressed in the years of the financial crisis (2008-2009) and the Eurozone crisis (2011-2012).

In the past five or so years, the performance of global distressed funds has been mixed, in part due to the unprecedented response by governments and central banks that has continued long beyond the aftermath of both the global financial crisis and the Eurozone crisis. In setting ultra-low interest rates and undertaking sustained asset-buying programmes, they endeavoured to support vulnerable economies from further shocks. However, we believe maintaining these conditions over the longer term has contributed to the continued misallocation of capital, as traditional triggers of corporate stress have been absent. It is the imbalances that have arisen from this that are now contributing to some of the opportunities in the market.

Opportunities yielded by market dislocation

One area of focus for special situations investors is likely to be meeting liquidity needs for companies suffering from weak short-term trading but with fundamentally

Figure 1: IRR of distressed funds (net) vs MSCI World LN PME (gross)



Source: ICG, March 2020

intact business cases for the medium term. Additionally, some areas of private debt where previously heightened competition for assets has led to aggressively structured deals (such as the global prevalence of so called "Cov-Lite" deals) are now being offered on much more favourable terms for the investor. Commercial banks have retreated from capital markets, leaving behind opportunities in the void, and private equity sponsors are looking for off-market solutions to complete their M&A activity. In liquid credit markets, it is believed volatility is likely to remain elevated in the near term and will present multiple potential entry points for astute investors. There is also scope to potentially acquire illiquid private debt from banks or other market participants at notable discounts to fundamental value.

The significant amount of uncertainty around the longevity and economic severity of the current crisis is likely to cause assets to trade at a considerable divergence to underlying long-term value. In the secondary credit markets, fund outflows are prompting price volatility. Historically, this has tended to lead to an overreaction from a pricing perspective, creating attractive investment opportunities in the leveraged loan and high yield credit markets. There is also likely to be a substantial increase in financial restructurings, yielding investment opportunities throughout the capital structure. Hard assets in the commercial property sector are set to come to market at a significant discount to intrinsic value. And in the burgeoning direct lending space, many of the newer funds are yet to see a complete investment cycle and, as such, less experienced platforms and teams may well require support either in terms of liquidity or asset restructuring. Furthermore, European banks have a substantial number of bilateral and club bank loan deals on their books and are unlikely to be able to work out all these exposures in-house, leading to a possible increase in asset sales.

Selecting the right partner

In the alternative investment sphere a manager's market experience is crucial. It speaks to long-term industry relationships, one benefit among many being a likely advantage in the sourcing of deals. It also indicates first-hand understanding of a broad range of market environments, none more important at the present time than previous significant dislocations. Rigorous adherence to due diligence processes is also vital as it means that assets held are likely to show greater resilience in times of volatility with investment professionals having a detailed and comprehensive understanding of the assets that they hold. Insistence upon strong documentation also serves to reduce a manager's and thereby the underlying investors' exposure to risk. Ultimately it is the collective good judgement of a portfolio manager and their wider team, in many cases underpinned by the culture of the firm behind them, that defines the quality of an alternative asset portfolio and the likelihood that it will perform in both good times and bad. In these uncertain and unprecedented conditions, it is vital to select a partner with the experience, discipline and know-how to seek out the genuine opportunities available on the best possible terms, and unlock value at a time of market dislocation.