What lies ahead: select opportunities for experienced investors in the post-pandemic landscape

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In the fourteen months or so since the effects of the pandemic first hit markets, investors have had to adapt to a volatile economic environment. Governments and central banks have deployed unprecedented levels of monetary and fiscal stimulus in an effort to support businesses as economic activity was severely disrupted. When the distribution of approved vaccines commenced at the end of last year, there was reason to hope for some form of recovery. With Europe and the US set to have immunised 50% or more of their respective populations by the end of Q2, a rapid improvement is predicted in the coming months. Central banks are likely to keep rates low in the near term, albeit that the threat of inflation is present. Meanwhile private consumption is set to rebound strongly as containment measures ease and people look to spend money saved during lockdown periods.

Stimulus keeping valuations buoyant

A wave of liquidity has flowed across Europe via such programmes as the UK's Covid Corporate Financing Facility and France's PGE scheme *Prêts garantis par l'état* whereby governments have provided huge amounts of capital for banks to distribute as loans to businesses. This has served the intended purpose of staving off pandemic-induced sclerosis in capital markets and offered a lifeline to companies struggling on the back of containment measures. However, there is now a great deal of money in the marketplace and as a result, valuations in many cases are quite fully priced. For businesses that were in good health prior to the pandemic and with a good case for recovery post-pandemic, investors seem to be prepared to look beyond the rigours by which they may currently be affected, such that opportunity for upside is limited.

Select (or niche?) opportunities amid current volatility

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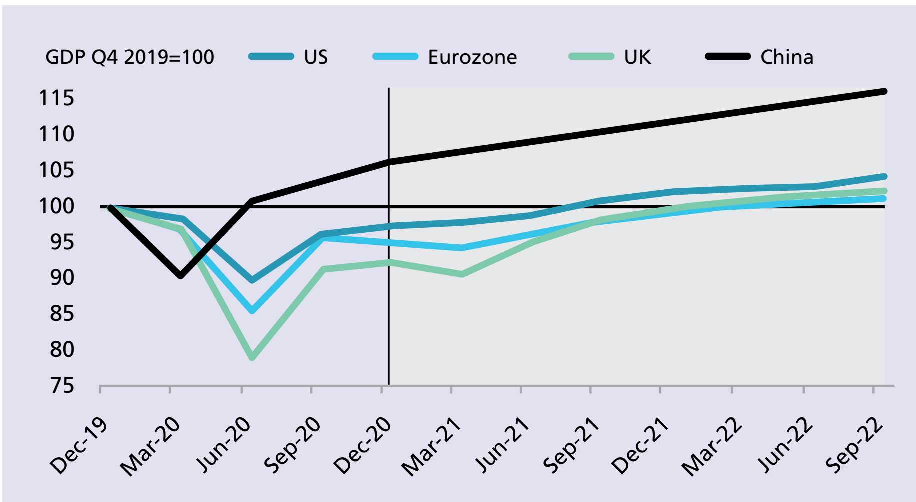
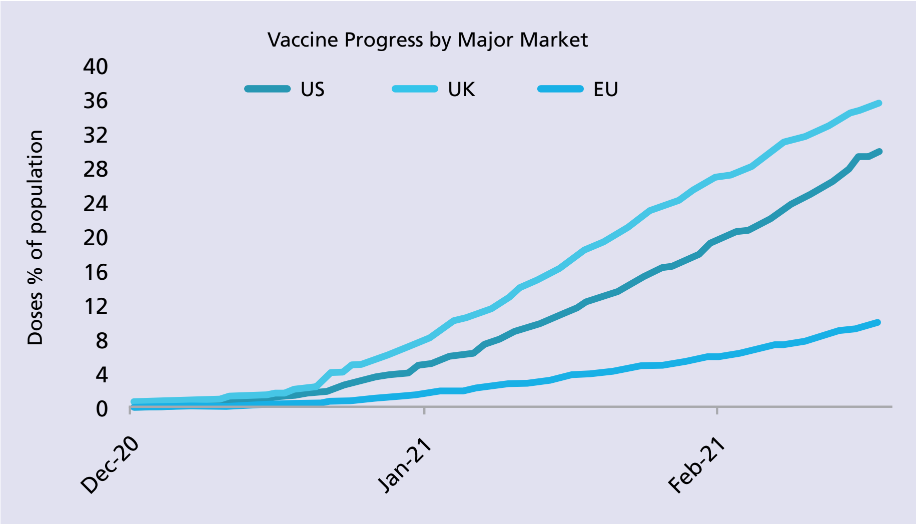
Figure 1: A fast-track recovery



Source: ICG Macro Views March 2021, Bloomberg Private Sector consensus forecasts

Figure 2: Rapid vaccine roll-out in major developed markets



Source: ICG Macro Views March 2021, Bloomberg

be selective and exercise investment discipline. In the near term, making use of relationships in the market to identify mid-cap leveraged buy-out (LBO) opportunities that might otherwise be under the radar is proving to be an area worth focusing on. Additionally, in what is currently quite a strong market for primary issuance, there are also un-syndicated LBO opportunities coming available on the back of Covid- and Brexit-related concerns. A corollary of this primary market strength has been the disposal of revolving credit facilities (RCFs) by investment banks looking to mobilise capital in order to invest in primary deals. In the past few months, opportunities to purchase RCFs have been coming available at meaningful discounts, albeit to a limited buyer universe given the complexities and restrictions attached to RCF transactions.

Expectations as Covid stimulus programmes ease

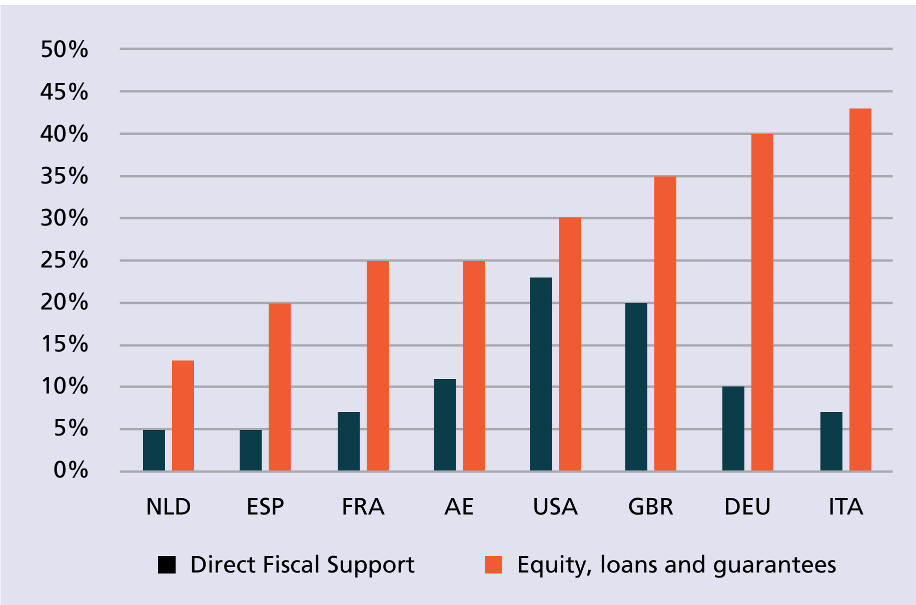
Beyond this, looking to the medium term, as national Covid-19 support programmes wind down, it is reasonable to anticipate that there will be a significant number of restructuring and rescue finance opportunities. The liquidity that has been made available in the past year has in many cases prompted companies that were already quite highly leveraged to add further layers of debt to their balance sheets. In many cases, excessive levels of debt will put an unsustainable burden on cash flows and values, prompting the need for a restructuring. In addition, as government funding tapers, it is private markets that will be required to step in to fund the recovery. Private market deal volumes are also likely to be boosted by growing sector consolidation, as better-managed companies with access to funding absorb those that don't. Finally, the government-backed Covid-19 loans are likely to add further complexity to capital structures. With the spectre of the state hanging over negotiations among competing stakeholders, debt restructurings are likely to become a thorny exercise, requiring partners with particular expertise and experience in the market.

Above and beyond bridge liquidity requirements, we are expecting to see an increase in rescue financing opportunities to address solvency issues as volumes of both financial and operational restructurings increase. It is also likely that hard assets will come available at a significant discount to intrinsic value, benefiting investors with the necessary real estate expertise to take advantage of this. There may also be direct lending opportunities as some of the less experienced players in that market find themselves either unable to provide new financing or forced into restructuring assets in their portfolios.

ESG playing an increasingly important role

Huge Covid-19 recovery packages have been allocated by governments in the wake of the pandemic, amounting to approximately

Figure 3: Government fiscal response to Covid-19 – % of GDP



Source: IMF Fiscal Monitor January 2021 update. *AE= advanced economies. Includes estimates from latest $1.9tr US fiscal package. Includes additional fiscal spending announced in UK Spring Budget 2021.

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US$1950 billion. This yields a valuable opportunity to incorporate environmentally positive measures as elements of the economy are re-booted. At present a total of US$336 billion of this funding has been earmarked for "green measures" sufficient to enable transformation towards long-term climate and environmental objectives. However, representing only 17% of total funding, there is understandably demand for more. With over-arching policy objectives in mind such as the EU's Green Deal (making Europe climate-neutral by 2050) and the "Net Zero" carbon emissions aims of many countries, more will have to be done to precipitate transformational change. Policymakers understand that the financial services industry has a crucial role to play in fostering sustainable investment practices and are endeavouring to harness this, through regulation such as the EU's Sustainable Finance Disclosure Regulation, the EU Taxonomy and the Task Force on Climate-related Financial Disclosures (TCFD).

Climate change mitigation is now such an imperative that demand from investors for better climate-related disclosure, also driven by amendments to the Pension Schemes Bill, is a key focus. Alongside this, borrowers are being incentivised to define their climate strategies and set improvement targets in order to access preferential pricing (ESG margin ratchets). Investment management companies are having to act with increasing diligence to ensure that they not only keep pace with these developments but that they encourage and monitor the adoption of similar behaviour in their own assets and on down the value chain. However it is not always the best-in-class ESG performers that offer the greatest rewards: relative underperformers with the potential to develop their ESG credentials and improve performance on climate-related metrics might offer the greatest opportunities in this area. Investment managers who have embedded Responsible Investing into their processes both at initial investment, in their monitoring and management, and at exit will be best positioned to spot those opportunities.

The spectre of inflation

From a macro-economic point of view, although we are of the view that both rates and inflation will remain low, these are genuinely unprecedented times in which governments have implemented stimulus programmes on a scale not seen since World War II. Indeed central bank balance sheet expansion of this size has never been seen before. With that in mind, it must be recognised that the threat of inflation cannot be discounted. Household savings are at record levels and the release of pent-up demand in the next year or two is likely to be significant. On the supply side, there is uncertainty as to how permanent the pandemic's impact has been on the global supply chains and international migration that have been so critical in keeping inflation at bay over the past 30 years. These factors, were they to be met with central bank complacency, could potentially trigger an inflationary spiral, but as previously stated, in our view this remains unlikely.

Choosing the right partner

In the alternative investment sphere a manager's market experience is crucial. It speaks to long-term industry relationships which in turn enable proprietary deal sourcing. 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 vital as it means that assets held are likely to show greater resilience in times of volatility. In times like these, a disciplined investor is looking at individual opportunities on a case-by-case basis. For selective investors, the pandemic has not yet necessarily accelerated the rate of deployment, but as state-sponsored support programmes ease, this is unlikely to remain the case for long.

Ultimately it is the collective good judgement of a portfolio manager and their wider team, 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 thereby unlocking value for investors.