Distressed Debt: Seeking Opportunity in Choppy Waters

This piece was adapted from an interview with Stuart Mathieson and Bryan High. The full audio podcast can be found here.*

Investors are increasingly looking to distressed debt as the credit cycle matures. But with a competitive landscape and significant growth in private credit and European high yield, this cycle could look different than those of the past. Stuart Mathieson, Head of Barings’ Global Special Situations group, and Bryan High, Co-Portfolio Manager of the strategy, discuss how the macro environment is impacting their outlook, and where they’re seeing opportunities today.

*Full podcast URL: https://www.barings.com/us/institutional/viewpoints/distressed-debt-how-this-cycle-may-be-different
Can you start by setting the stage for us, in terms of the macro landscape? From your perspective, how is the cycle affecting the behavior of high yield issuers, and what does that mean for the opportunity set in distressed investing?

Stuart Mathieson: When we look across the markets today, I would say it’s clear that we are in the late stages of the credit cycle, although we’ve been saying that for 12 months now. Fundamentals appear stable, and we’ve seen corporate earnings hold up reasonably well. But with the search for yield across the markets, we’ve also seen a rising number of aggressive structures with weaker covenants in the space, across both loans and high yield bonds.

One big change since the last cycle is that the markets have gotten significantly larger. For comparison purposes, if we look back at 2007, high yield credit markets were about $2.1 trillion—including both loans and bonds—and average pre-crisis default rates were roughly 2%. Today, the size of the markets is closer to $3.5 trillion, and average default rates are at a similar level. Overall, that’s a relatively low default rate, but inevitably it will increase—and given the larger size of the markets, even doubling that rate would add about $50 billion in distressed debt. So, the opportunity set is certainly there, in our opinion.

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**Distressed debt means different things to different people. Can you explain how you think about special situations and distressed debt investing from Barings’ perspective?**

**Bryan High:** At Barings, we’re focused on corporate credit. So that includes North American and European broadly syndicated loans, high yield bonds and private credit. Each of those represents a portion of the large funnel of opportunities we consider when we’re looking to deploy capital across our platform. There are varying degrees of how we can do that, but overall our strategy falls into two buckets.

On one hand, we might take a non-control position—or what we call a high yielding investment—which is often on the back of a price dislocation in the market. This allows us to either invest in the loan or bond and clip a coupon along the way, or buy it at a discount, with the opportunity for capital appreciation.

On the other hand, we might take a control position—or what think of as an enterprise value investment opportunity. In some cases, a high yielding investment could morph into an enterprise value investment. But in most cases, we take a control position from the start, in anticipation of a specific catalyst that can lead to value creation through a restructuring process. This often results in us forgiving some debt in exchange for a majority equity stake.

Each situation is different, but what remains constant is that we aim to implement change and drive an outcome—whether that’s through a management team change, a board change or a strategy change—and becoming part of the shareholder group can give us the leverage to accomplish that. Not only can this potentially generate attractive returns for our investors, but it can also, hopefully, right set and add value to the distressed company.

**Where are you seeing opportunities today, in terms of sectors and geographies? How are you approaching the space?**

**Stuart:** There are over 3,000 issuers across the global high yield loan and bond space—and with that kind of pool to fish in, there are going to be idiosyncratic opportunities across a range of sectors and geographies. So, we’re essentially agnostic in both respects.

The way we think about it, we’re first and foremost looking to invest in quality companies that usually enjoy strong positions in their core markets—who also happen to be facing trading difficulties, and need liquidity or additional capital to support a turnaround. That could be a company with a strong business plan, where management or the sponsor may have executed poorly. Or it could be a good company that was over-levered at the time of new issue, which ultimately resulted in a weak balance sheet. It could also be a sponsor that has rolled together several companies to create a larger company, thereby bringing integration risk alongside fully debt-funded acquisitions. In all of these situations, we can step in and take on the business risk at a much lower

**CASE STUDIES**

**High Yielding Investment**

During the commodity crisis in early 2016, the parent company of an offshore driller, with several attractive rigs, looked likely to file for bankruptcy. The driller had a nearly $3 billion loan that was trading in the 30s ($100 par value).

The Barings team conducted rigorous due diligence, gained comfort with the value of the rigs, and took a position in the 30s. As the price recovered, and the thesis began to play out, we continued to build our position into the 60s, becoming one of the top three holders of the loans.

Ultimately, after helping to negotiate a better collateral package, pricing and documentation, we exited the position, and it traded back into the high 80s/low 90s.

**Enterprise Value Investment**

In early 2014, a newly issued loan from a company in the health care space lost significant value, falling into distressed territory. When the original loan was issued to the market, our high yield team had underwritten it and ultimately declined investment—but, through the process, had identified a technology-focused segment of the business that appeared to be valuable in its own right.

This segment of the business had an outstanding loan tied directly to it—and as the parent company entered the bankruptcy process, we established a position in our Special Situations strategy. We grew conviction, increased the position over time, and ultimately became the second largest shareholder. We were then able to help effect change in the board and management team, and—over a five-year investment horizon—grew the technology segment into a large asset, ultimately selling it to a Fortune 500 company for a multiple of the original investment.

Inevitably, when investing in the distressed and special situations arena, the team won’t get everything right. So, it’s incumbent that we cautiously reassess our theses and re-underwrite credits. But in all cases, including the occasions when we sell out of assets, we operate with a mindset of preserving capital and mitigating downside risk.

Case studies are being shown for illustrative purposes only. These examples should be considered as a reflection of Barings’ investment process, and references to particular portfolio companies should not be considered a recommendation of any particular security, investment, or portfolio company. The information provided about particular portfolio companies is intended to be illustrative, and is not intended to be used as an indication of an investment’s current or future performance.
valuation point—assuming that we see a path to recovery—and, many times, bring in new management with fresh eyes to look at the situation, fix the balance sheet, and provide a cushion for the company.

**Bryan:** From a geographic perspective, the broadly syndicated loan and bond market in the U.S. is $2.6 trillion, relative to about $800 billion in the European market. So, when we look across our target markets on a day-to-day basis, the U.S. is naturally going to pose more opportunities due to its sheer size. But we’ve also found very interesting prospects in Europe in recent years, where there are fewer players and less picked-over opportunities—due in part to legal complexities like creditor rights and bankruptcy laws, which are especially nuanced in the region and differ throughout. Additionally, there have been secular changes, a weak consumer base and currency challenges that are weighing on businesses throughout. Additionally, there have been secular changes, a weak consumer base and currency challenges that are weighing on businesses and ultimately driving restructurings—particularly in the U.K. In this respect, managers who have longstanding experience in distressed debt have a marked competitive advantage, in our view. At Barings, corporate credit is the bread and butter of our business, and we’ve participated in over 100 corporate debt restructurings across multiple legal jurisdictions since 2008—experience that we believe puts us in a good position to identify, and capitalize on, opportunities as they emerge.

Overall, when we invest, the key factors we evaluate are the business model of the company, the region in which it sits, the outlook for the sector, and the underlying economic drivers that are going to determine earnings.

**We’ve seen tremendous growth in global private credit and European high yield since the last cycle. As you consider the development of those markets and the dynamics driving them, do you view them as potential sources of opportunity?**

**Stuart:** In our view, the growth we’ve seen since the last cycle in the European high yield and global private credit markets could ultimately lead to an interesting opportunity for distressed debt investors. Like all areas that have experienced explosive growth, defaults will naturally start to increase when these markets hit a rough patch. Given that it’s been a decade since the last true cycle, it’s worth noting that many investors in the European high yield market do not have direct experience managing bankruptcies and restructurings, and all of the nuances that go along with them across the various jurisdictions. This is a place where we believe we can add value when the time comes, given our team’s experience working through these types of situations over multiple cycles.

Within private credit, specifically, the growth we’ve witnessed should ultimately result in some attractive opportunities for distressed investors. Here, again, there is somewhat of a lack of experience in the marketplace when it comes to bankruptcies and workout situations. While this is less true of larger, more established participants, it is often the case among the many smaller participants who have entered the space—who tend to focus more on hiring origination professionals to help put capital to work, rather than taking on the cost of workout professionals. Managers will all handle this differently when the time comes—and some may even outsource restructurings if they don’t have in-house expertise—but we see several advantages to managing the entire process internally.

Additionally, by their nature, private credit markets are more opaque than broadly syndicated markets, where the price of a loan or bond is available on a screen every day. When it comes to private credit, the loans are often priced internally—in fact, in some cases, managers may not even know that certain loans exist, because they are privately originated and held. This is another area where we think having an integrated platform is extremely helpful, as it provides visibility into the loans that are out there, along with pricing and documentation trends. This is one of the primary reasons that our distressed and private credit teams at Barings work closely together.

**Shifting gears a bit, can you talk about how you’re sourcing these opportunities, and what that process looks like?**

**Bryan:** Being integrated into Barings’ greater high yield platform—and therefore having an extensive window into the market—is a big part of how we source opportunities. We benefit from more than 70 investment professionals located around the globe, who cover over 1,500 names across U.S. and European high yield loans and bonds. So, in most cases, our broader high yield platform will have tracked a credit throughout its life cycle—from the time of issue until, if ever, it encounters a distressed situation. That means we are not analyzing or conducting due diligence on the credit for the first time when it becomes a distressed credit. We’re already familiar with it, and are often re-underwriting it or updating an existing analysis, rather than starting from scratch. Similarly, having large, dedicated private credit and structured credit teams, with long industry track records, gives us a window into those markets, and often provides an early read on opportunities that may be in the pipeline.
Are there any final takeaways you might offer?

**Stuart:** From our perspective, the ability to deploy capital flexibly across the globe—in large or small investments, in control or non-control situations, and in the U.S. or Europe—is critical to identifying and accessing relative value opportunities as they emerge. While fundamentals in the high yield market still appear to be in relatively good shape, we believe the growth that these markets have experienced, alongside the growth in asset classes like private credit, will equate to a plentiful supply of opportunities for distressed investors in the years ahead—but selectivity and the ability to access these investments will be paramount.

**Stuart Mathieson**  
Head of Global Special Situations Investments Group

Stuart Mathieson is a member of Barings’ European High Yield Investments Group and the European High Yield Investment Committee. Stuart also leads the Global Special Situations Investments Group, where he is also responsible for representing the firm’s interests on restructurings and workouts, and managing high yield portfolios. Stuart has worked in the industry since 1999 and his experience has encompassed the sub-investment grade credit markets. Prior to joining the firm in 2002, he worked in the Business Recovery Services team in London at PricewaterhouseCoopers. Stuart holds a B.Sc. in Chemistry from Keble College, Oxford and is a member of the Institute of Chartered Accountants, England & Wales.

**Bryan High**  
Co-Portfolio Manager, Global Special Situations Strategy

Bryan High is a member of Barings’ U.S. High Yield Investments Group, co-portfolio manager for the Global Special Situations strategy and a member of the U.S. High Yield Investment Committee. Bryan is responsible for managing the stressed and distressed exposure across the broader Global High Yield Investments platform. He also focuses on generating investment ideas for the Global Special Situations platform and managing those positions through the lifecycle of the investment. Bryan has worked in the industry since 2002 and his experience has encompassed high yield loans and bonds, distressed debt and private equity. Prior to joining the firm in 2007, he served as an investment banker to middle market companies at Brookwood Associates LLC. Before that Bryan worked as a leveraged finance and restructuring advisory analyst for Banc of America Securities LLC. Bryan holds a B.S. in Business Administration from the University of North Carolina at Chapel Hill.
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