Kempen

Distressed debt: the perfect time to invest?

With yields on traditional bond investments at all-time lows, now might be the perfect time for investors to branch out into distressed debt. Let's take a look at why.

What is distressed debt?

Distressed debt consists of corporate bonds trading at a significant discount to par, either because a firm has entered bankruptcy or the market believes that bankruptcy is inevitable. Firms that get into financial difficulties see their bond prices slump as investors in traditional bonds sell.

Investors in distressed debt are willing to allocate to these cheap bonds and lead the financial and operational restructurings necessary to get the company up and running again. Distressed debt investors need a long horizon as turning around a company's fortunes can take several years, but their investments can be highly lucrative.

Frontier Communications: a case study

What does a distressed debt investment look like in practice? Let's consider Frontier Communications, a US telecom company. It grew through acquisitions, buying parts of AT&T Telecom and Verizon, assuming it would generate enough profit to pay down the debt. But it didn't, and could no longer invest in its network like its competitors. So its network was of poor quality, it started losing clients, and it had to file for bankruptcy.

Thanks to distressed debt investors, it's now set to re-emerge from bankruptcy. It will have to roll out fibre in the 29 states in which it's active, and once it's done that it can go about attracting new customers again. This will all take years, but it's a visible plan – investors can work out how much money it's likely to make and the resultant investment returns.

Plenty of opportunities to incorporate ESG

Distressed debt investors are well placed to drive positive change: there can be much more scope to improve the ESG profile of companies in bankruptcy than of firms that are doing well.

Let's consider Pacific Gas & Electric in California, which went bankrupt after being forced to pay out billions in compensation for its role in starting wildfires in 2017 due to poor safety practices. Its distressed debt investors wanted to make sure safety issues wouldn't crop up again, so they hired a chief safety officer, a chief risk officer, made it much more socially responsible, and the firm is now playing a major role in the move to renewable energy that California is renowned for.

Meanwhile, major European car-hire firms that are in a distress are using the opportunity to sell some of their existing fleet and move to electric vehicles.

What's more, from a social perspective, the very process of restructuring rather than letting a firm enter liquidation saves thousands of jobs.

Why invest now?

Distressed debt is a highly cyclical strategy. There aren't many opportunities to invest in distressed companies when the economy is doing well, but after a recession there are lots, and big returns can be made.

The coronavirus pandemic could make it the perfect time to invest in distressed debt. The number of bankruptcies is likely to pick up in 2021, leading to fertile hunting ground for distressed debt investors. They'll

step in when they see a path for a firm to recover or when debt prices fall below the liquidation value of a company's assets.

What's different this time around is that Covid has hit some very strong companies. Even previously healthy firms in good sectors such as cruise lines have been hit hard. Normally only troubled companies in challenged sectors enter the distressed universe, but cruise lines had market caps in the tens of billions, operate in an industry with high barriers to entry, have lots of pricing power and are going to be highly popular options for holidaymakers once travel bans are lifted.

Historically, distressed debt has been a great investment after a crisis: we've calculated it's returned above 15% per year in the three years following previous crises[1]. Returns might be slightly lower this time due to the low risk-free rate and the huge amount of money in the system available to save companies due to stimulus, but we believe it could still provide 10–12% per year in the coming years[2].

Tune into our webinar on alternative credit

At Kempen we believe that now could be a great time to invest in distressed debt. To find out more about its benefits and those of other alternative credit asset classes, please register for our webinar on 5 March **here.**

[1] Source: HFR, Average annualized returns of HFRI Event Driven Distressed/Restructuring Index pre and post 7 crises: 1990-1991 recession, 1997-1998 Asian financial crisis, Dotcom bubble (2000), 9/11 aftermath (2002), Great Financial Crisis (2008), Euro crisis (2011), Energy crisis (2015-2016).
[2] Source: Kempen, expectations based on proprietary analysis, January 2021

Kempen

Disclaimer
Kempen Capital Management N.V. (KCM) is licensed as a manager of various UCITS and AIFs and authorised to provide investment services and as such is subject to supervision by the Netherlands Authority for the Financial Markets.

This document is prepared by the fund managers of Diversified Distressed Debt Pool ('the Strategy'), managed by Kempen Capital Management N.V. ('KCM'). The Strategy might hold position in the subject company. The views expressed in this document may be subject to change at any given time, without prior notice. KCM has no obligation to update the contents of this document. As asset manager KCM may have investments, generally for the benefit of third parties, in financial instruments mentioned in this document and it may at any time decide to execute buy or sell transactions in these financial instruments.

This document is for information purposes only and provides insufficient information for an investment decision. This document does not contain investment advice, no investment recommendation, no research, or an invitation to buy or sell any financial instruments, and should not be interpreted as such. The opinions expressed in this document are our opinions and views as of such date only. These may be subject to change at any given time, without prior notice.