For Professional Investors Only

RBC Global Asset Management

Developed markets special situations credit

Harnessing the return profile of Europe's mid-market opportunities

Marketing Communication

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Executive summary

- Markets are facing a perfect storm in 2022 as companies grapple with supply dislocations, geopolitical tensions, inflation and the residual effects of the Covid pandemic.
- Europe is recovering from the pandemic more slowly than the US and will be disproportionately impacted by the conflict in Ukraine.
- The European mid-market has more opportunities and is less competitive.
- We believe the mid-market offers a rare high-return profile that stands out in the current fixed income landscape.

The past few quarters have seen changes of a historically significant scale. These changes inevitably lead to potential opportunities.

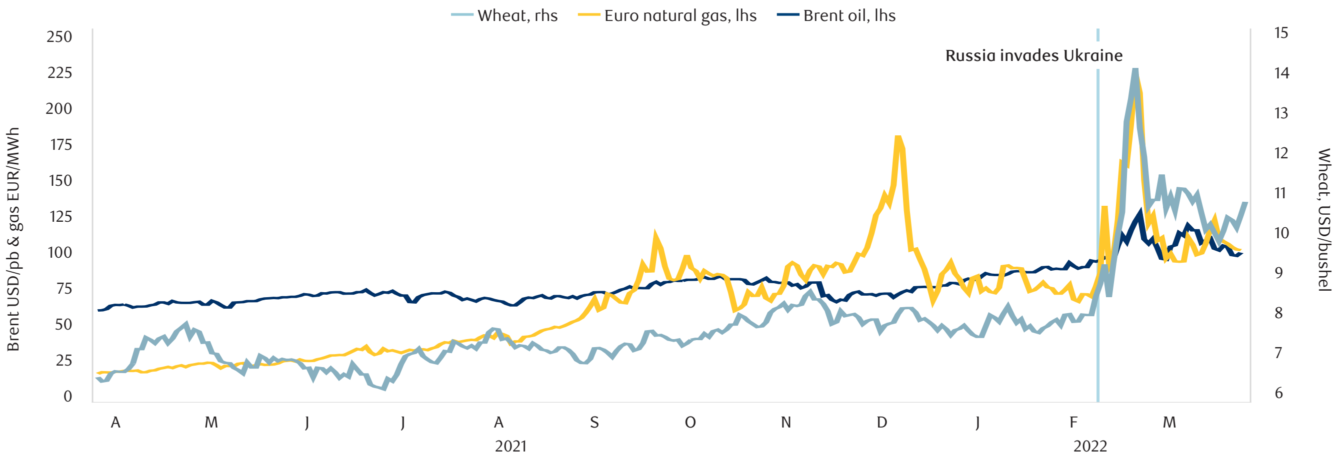
We know from experience that special situations in mid-market credit can present themselves throughout the economic cycle. However, we believe conditions in 2022 represent a perfect storm, creating a robust pipeline of potential investment opportunities.

In 2020, the Covid-19 pandemic turned the world on its head, with financial markets travelling through a volatile and headline-heavy journey of shock falls and spirited relief rallies. The fiscal and monetary response to the turmoil allowed many companies to successfully ride out short-term challenges.

Although the global recovery was robust, it was accompanied by significant inflationary pressures. These have been exacerbated by continuing lockdowns in China, which have disrupted global supply chains. More recently, the European recovery has lagged the US and this is set to continue as the effects of the war in Ukraine will be more significant in Europe than elsewhere.

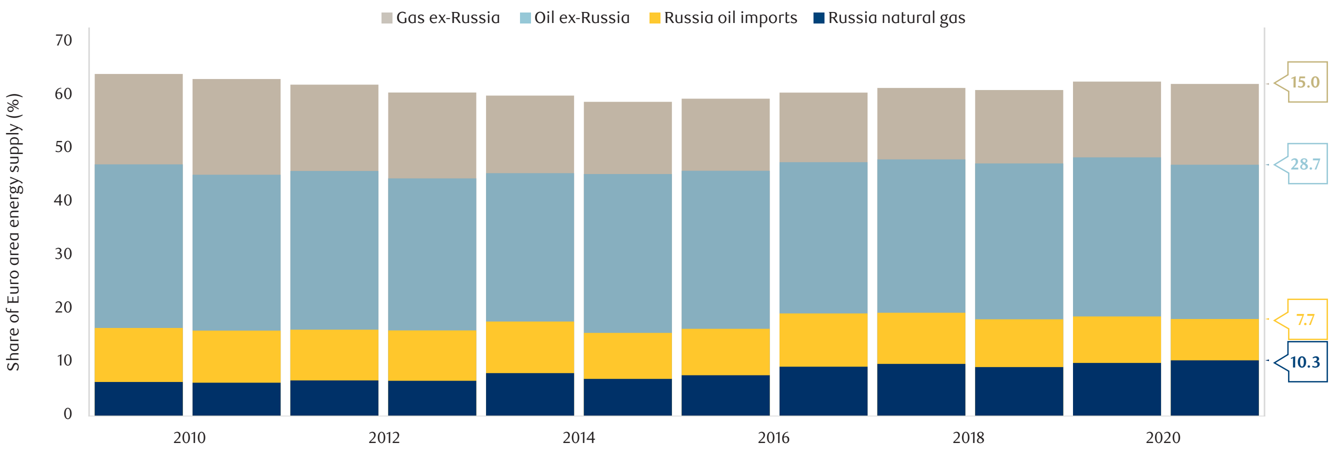
Consumer behaviour will change in the face of cost-of-living increases arising from increased fuel costs and the ongoing dislocations in food and commodity prices. Companies are facing significant challenges to their business models, which are showing up in their income statements.

Chart 1: Russian invasion pushes commodity prices higher



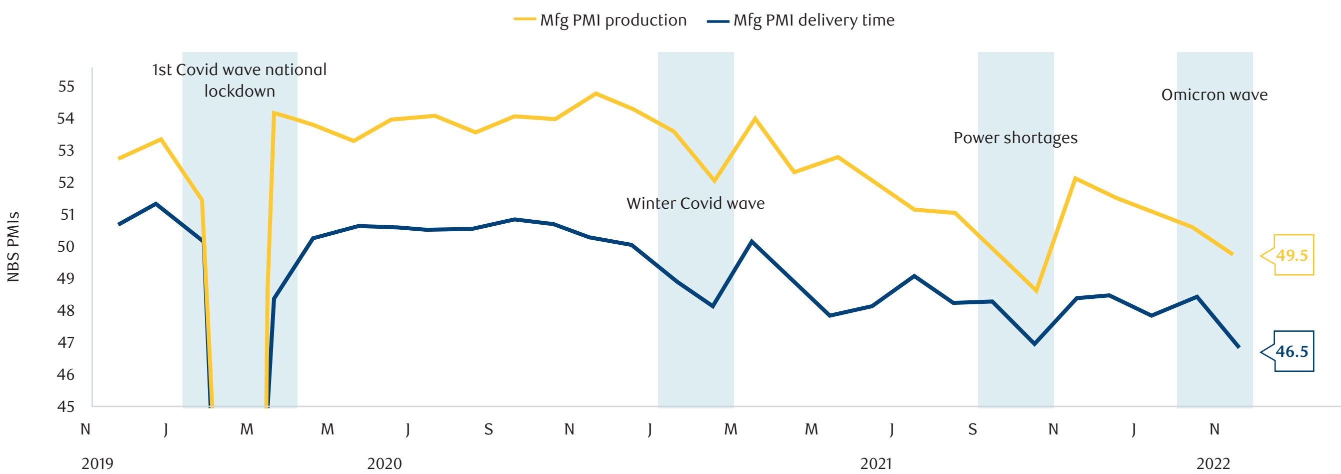
Note: Natural gas future, ICD Dutch, Euros per MWh; Brent crude oil, USD/per barrel; Wheat generic 1st future contract, USD per bushel.
Source: Bloomberg, latest data at 12 April 2022

Chart 2: Almost one-fifth of Euro area energy comes from Russia



Source: Eurostat and BlueBay calculations; latest annual data for 2020

Chart 3: Manufacturing production & delivery times

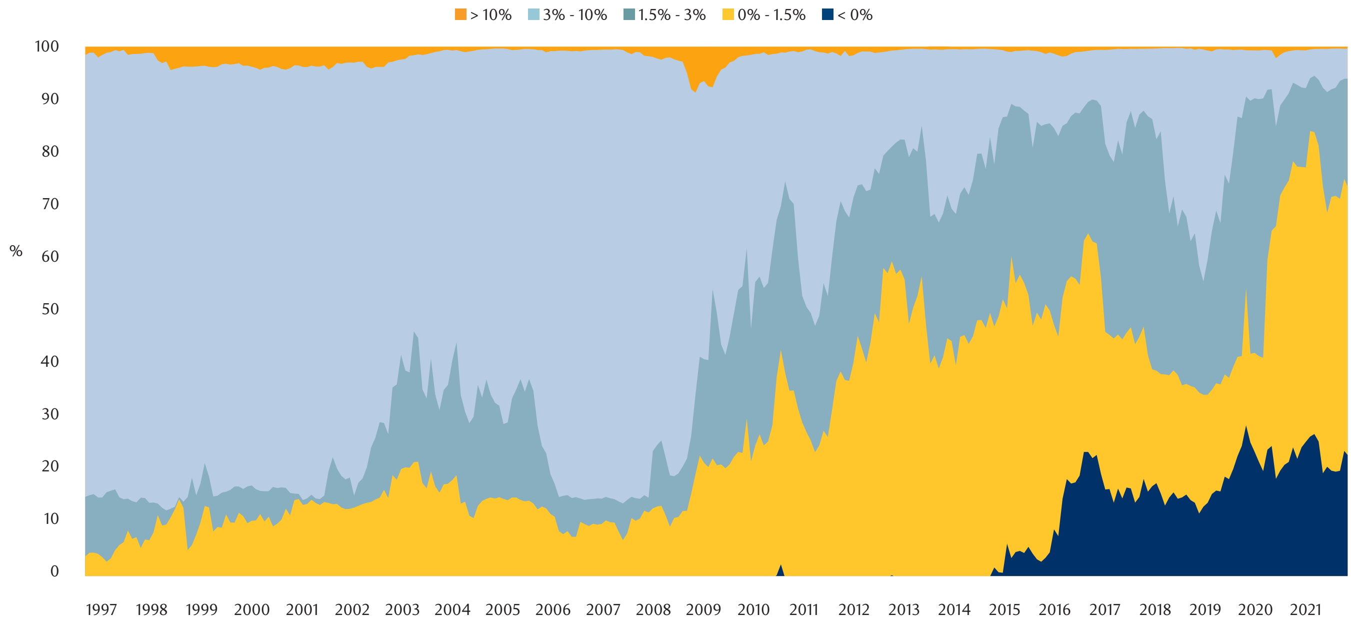


Note: NBS Manufacturing PMI; production below 50 implies contraction in production and lengthening delivery times.
Source: Macrobond; latest monthly data for March 2022

At the same time, fiscal and monetary support measures are being wound down. Consequently, vulnerabilities in Europe's public and private credit markets have become noticeable. With this comes potential opportunities.

For investors who have the flexibility to pursue a locked-capital approach with an investment time horizon of 3-5 years, the mid-market sector of the European special situations credit market presents an exciting opportunity set with the potential to deliver high-teens returns. We believe this market offers a rare high-return profile that stands out in a fixed income landscape characterised by rising debt levels, low rates and negative yields.

Chart 4: Global bond market by yield bucket



Source: ICE BofAML Global Fixed Income Markets Index (GFIM); latest monthly data for September 2021

The distressed landscape

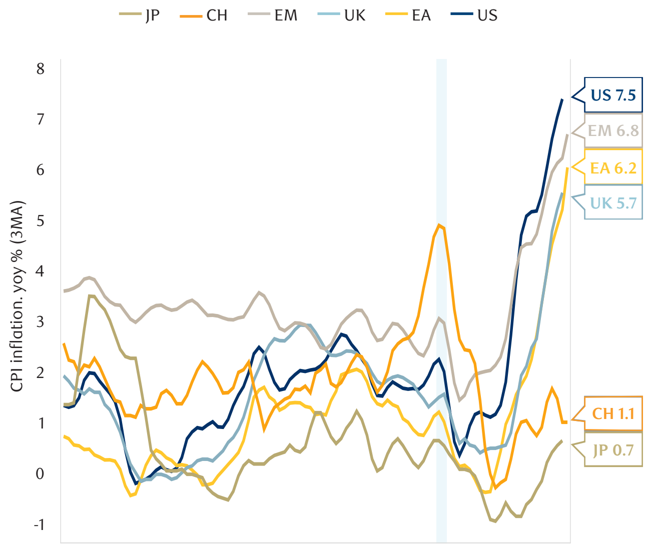
We have seen a steady stream of distressed opportunities in Europe. Pre-Covid, this trend was primarily driven by a decline in lending standards and deteriorating credit fundamentals. Growth in the opportunity set was particularly evident in the mid-market sector – a space broadly defined as companies with EUR30- 500 million in revenue.

In 2020, the world experienced a huge economic shock and an equally momentous policy response. Governments and central banks took rapid and coordinated action to support the global economy, tackling the threat of recession and economic collapse by providing unprecedented levels of fiscal and monetary support, creating a financial bridge for households and companies to the other side of the pandemic.

At the same time, not all sectors participated equally in the recovery. Many companies that now had higher leverage were facing reduced earnings as a result of changed consumer behaviour and lingering Covid restriction. Examples include companies in sectors such as cinemas, airlines, hotels, food service companies, autos/autoparts and commercial real estate – which in some cases we expect never to fully recover.

The impact on companies' income statements and balance sheets was exacerbated by the wage and cost inflation that followed the monetary stimulus and fiscal largesse. Through 2021 and into 2022, we have seen further inflationary pressures created by supply chain dislocations. Lockdowns continue to impact activity in various areas in China, notably at the time of writing at the Port of Shenzhen.

Chart 5: Global rise in inflation



Note: shaded columns denote NBER-dated US recessions. Source: Macrobond; latest monthly data for March 2022, three-month moving average.

Chart 6: Global supply chains remain disrupted

Note: Global Supply Chain Pressure Index combining transportation costs and PMI delivery times. Source: NY Federal Reserve; Macrobond; latest monthly data for February 2022

> "The Russia-Ukraine war will have a material impact on economic activity and inflation through higher energy and commodity prices, the disruption of international commerce and weaker confidence."

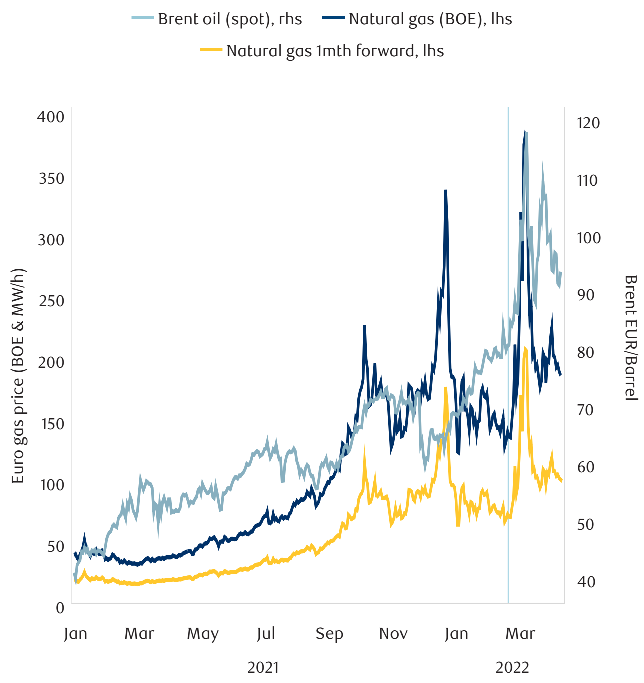
Christine Lagarde, ECB President, 10 March 2022

More recently and tragically, geopolitical conflict in Ukraine has dominated headlines in early 2022. This has directly affected commodity and financial markets and, even in the case of the swift resolution for which we all hope, there will be a profound impact on European economies in particular. Certain sectors and companies will face existential challenges. We expect this impact to be less severe in the case of the US.

Against this backdrop, the perfect storm is completed by central bank policy. In the UK and the US, central bankers have initiated rate hike cycles, with the European Central Bank set to follow suit later in the year. Balance sheet reduction will be taking place at the same time.

Mid-market companies specifically are less resilient to these shocks compared to their large-cap peers. Mid-market companies in Europe have less access to the capital markets and are more reliant on banks for funding. It is clear that European banks are tightening their lending criteria, which is likely, in our view, to reduce funding to mid-market companies.

Chart 7: European energy prices leg higher after Ukraine invasion



Source: Bloomberg; Macrobond; latest data at 12 April 2022

Our analysis suggests that the European distressed landscape presents a potential investment opportunity in excess of EUR500 billion as central bank stimulus is removed and monetary and fiscal life-support machines are switched off.

Sources of investment opportunity (3-5 year time horizon)

1. Public Credit Markets

Market and economic environment represent a perfect storm

Price inflation and supply chain dislocations are wreaking havoc on business models across multiple sectors and up and down the value chain. We have been reviewing opportunities in a diverse range of sectors including autos, autoparts, chemicals, food, agriculture, commodity traders, glass, fibreglass, paper and packaging.

In many cases, we are looking at companies that only survived the challenges of the pandemic as a result of liquidity provided by governments and central banks. Markets gave them credit for full recoveries, rallying aggressively through 2020 and 2021. However, their over-levered balance sheets mean that they are now ill-prepared to withstand the pressure on margins from reduced sales and higher costs. In many cases, these challenges are compounded by the ongoing (and potentially protracted) sanctions on Russia.

In our view, many of these companies will need to restructure their balance sheets or explore other capital market solutions to survive, at a time when the era of almost unlimited liquidity is at an end.

2. Private Credit Markets

Banks will look to sell problem assets

Private credit is impacted by the same macroeconomic drivers as its public counterpart. The European corporate funding market is dominated by banks, lending some EUR6.7 trillion to European companies – a figure 3x the size of the European investment grade, high yield and leveraged loans markets combined. This sets Europe apart from the US, where c.70% of funding originates from the capital markets.

Compared to an earlier era, banks have neither the appetite nor the ability to support troubled companies. Workout teams have been reduced in size and banks are penalised from a regulatory capital perspective for holding problematic assets on their balance sheets. We are aware of a number of situations when banks have pressed the eject button and called in loans when companies have faced challenges, even though an operational turnaround was possible.

As active investors, we look to implement strategic and operational changes, as well as balance sheet restructuring in such situations to create the conditions for companies to flourish.

Harnessing investment potential

Over the next 2–5 years, we are expecting a significant amount of European mid-market companies will need to restructure unsustainable capital structures. Some of these restructuring events will fail, triggering distressed asset sales and liquidations.

Through active, hands-on investment management fuelled by forensic credit analysis, we believe there is significant upside potential in targeting select opportunities where we can actively direct company restructurings and drive turnaround stories.

Our investment strategy

We believe there is significant investment potential in single-name European mid-market companies experiencing problems as a result of supply dislocations, geopolitical tensions, inflation and the response to the Covid pandemic.

Through a concentrated strategy targeting 15-30 positions over the next 3–5 years, we are looking to source the most attractive deals in the European distressed and special situations credit market.

These investment opportunities fall into four sub-sets:

Stressed Investments	Distressed Investments
▪ Intrinsically cheap bank debt or bonds ▪ Performing investments ▪ Price likely to revert to par ▪ Includes Covid-19 affected credits ▪ **Hold period 1–2 years** ▪ **Target IRRs 10–15%**	▪ Bank debt or bonds at deep discounts ▪ Financial/operational restructurings ▪ Debt-for-equity swaps ▪ Distressed private equity transactions ▪ **Hold period 1–5 years** ▪ **Target IRRs 20–25%**
Refinancing/Rescue Financing	**Other Investments**
▪ Refinancing of stressed companies ▪ Structural seniority ▪ Advantageous lending terms ▪ Warrants or equity kickers ▪ **Hold period 3–5 years** ▪ **Target IRRs 10–15%**	▪ Liquidations ▪ Orphaned situations ▪ Hard asset purchases ▪ Other special situations ▪ **Hold period 1–5 years** ▪ **Target IRRs 15–25%**

Our competitive edge

The European mid-market is less competitive than the large-cap market.

The majority of investment attention is aimed at large companies where trade sizes are typically EUR100-250 million.

The investment sweet spot

By targeting the mid-market with smaller trade sizes (typically EUR20-30 million), there is intrinsically less competition yet the universe offers a wealth of attractive potential investment opportunities. Smaller trade sizes also allow us to be nimble and fast to new opportunities, supported by BlueBay's streamlined investment processes that prioritise rapid alpha capture.

Market timing

Looking into the eye of the storm

We are seeing some signs of crowding in the large-cap distressed space, where many players are looking to deploy USD100 million+ per investment. Given the weight of capital looking to be deployed, it is not clear to us that this segment of the universe will produce the returns expected by investors.

We do believe, however, that there will be a plethora of opportunities in the European mid-market because, by their nature, mid-market companies are less resilient than large-cap companies, they have less access to the capital markets and they are more dependent on banks for funding. As government support measures are removed over the next 6-18 months, we expect the number of mid-market special situation opportunities to increase significantly.

Overall, we believe the European mid-market will offer up great opportunities with far less competition.

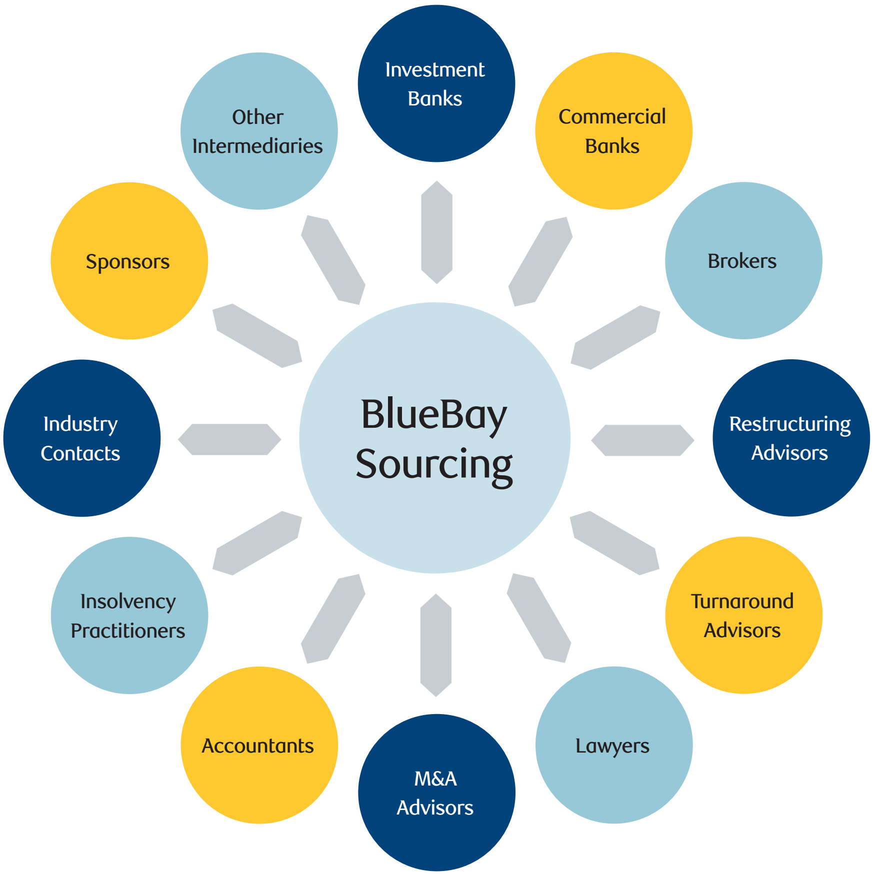
> "Just because the largest distressed investors can't find anything to do doesn't mean there's not a lot going on – there's just not a lot going on where they're looking. The more niche parts of the market are definitively presenting more lucrative opportunities."
>
> **Jason Mudrick, CIO Mudrick Capital Management, 30 April 2021**

Deal sourcing

Relationships are crucial to the sourcing of differentiated investment opportunities

The European distressed community is small and relationship-driven. Our team has over 110 years of aggregate relationship-building and investment experience in the space, with a deep existing network of professional counterparties, which means that we can source differentiated deal flow in the European special situations mid-market.

The value of the team's proprietary sourcing networks is further enhanced by BlueBay's broader research and trading capabilities. As part of RBC GAM, BlueBay is one of the largest global fixed income specialist with over USD123bn in AuM*, with broad research channels and market-leading intellectual capacity. The firm has an integrated investment and research function, where trade ideas and research are shared across all investment professionals. This integration enhances the team's sourcing capabilities and allows us to mine the most appropriate and attractive investment opportunities.



The BlueBay Developed Markets Special Situations Team

European presence for a geographic advantage

- Specialist country skillsets within the team for seamless local market connections and enhanced deal sourcing.
- Sector-agnostic approach – we follow distress, not industries.
- Three decades of experience in special situations investing through five major global recessions.
- Relationship-based approach – our strategy is powered by deep networks built over 30+ years.

Author

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BlueBay Fixed Income Team

Adam Phillips joined BlueBay in October 2020 as Head of Special Situations within Developed Markets. Adam has 30 years' experience in special situations and distressed investing having previously been Head of Investments at Blantyre Capital, European CIO of Marathon Asset Management and Head of European High Yield & Distressed at Lehman Brothers. Prior to that, Adam was Head of the Asian Distressed team at Standard Bank and he started his career at British & Commonwealth Merchant Bank in structured and property finance. Adam holds an MPhil in Land Economy from Cambridge University and BA in Economics from Heriot-Watt University.

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