RBC Global Asset Management

Developed markets special situations credit

January, 2023

Navigating the perfect storm in the European midmarket

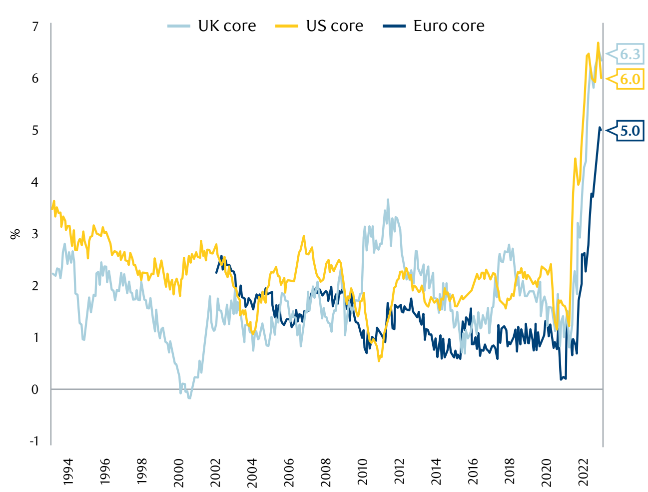
Executive Summary

- **The challenging environment of 2022 catalysed a once in a decade opportunity for specialist distressed investors.**
- **In Europe, the opportunity in the midmarket is unusually broad, spread across multiple countries and multiple sectors.**
- **Experienced distressed investors have the knowledge and the relationships to capitalise on situations offering downside protection and asymmetric upside.**

The distressed landscape: a perfect storm

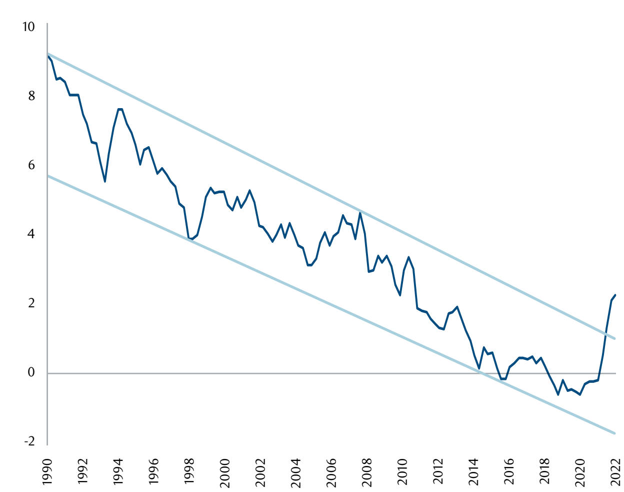
The past few quarters have amounted to a perfect storm for European corporates. Years of ultra-accommodative monetary policy and excess liquidity were followed by higher inflation and a hawkish response from Central Banks. Inflation turned out to be higher and longer-lasting than anticipated (see Figure 1). Central Bankers globally raised rates, translating to a breakout from a thirty-year downward trend channel (see Figure 2). The tone of debate remained hawkish at the end of 2022 in the US, the UK and Europe and even in Japan.

Figure 1: Core inflation rate – UK, US and Eurozone



Source: Macrobond, as at 28 December 2022.

Figure 2: Breakout from thirty-year downward trend channel in rates



Source: Bloomberg, as at November 2022.

The impact of these dramatic long-term changes was exacerbated by shorter term events including:

- the ongoing covid lockdowns in China
- the war in Ukraine
- the spike in energy prices
- a cost of living crisis
- labour force pressures and industrial action

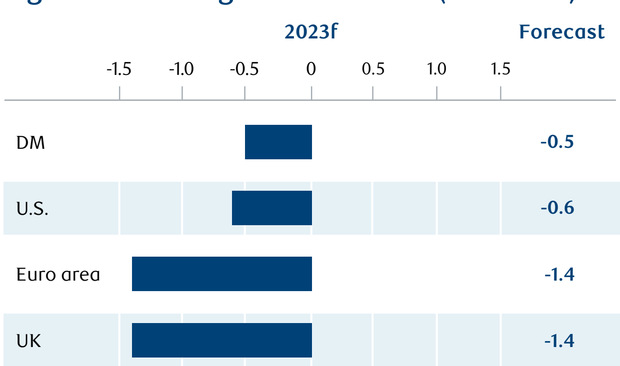
In combination these have created the conditions for recession in Europe in particular, and we expect this to be protracted. Even if one problem disappears, other challenges are likely to remain and, this time around, Central Banks will not be able to simply react with huge injections of liquidity given current levels of inflation.

So, what are the implications for corporates? We see this as a perfect storm as companies' business models are being hit by a weaker consumer, higher costs of goods sold and higher borrowing costs, as well as supply chain disruption - and it is hard to find a sector that is not being impacted by these factors. In many cases, after years of easy money, companies have become over-leveraged, and rate rises pose existential challenges to them.

It's worth noting that these challenges came at a time when economies had not fully recovered from the covid pandemic, with companies in various sectors still facing its residual effects and trying to cope with the withdrawal of the government support measures.

We believe that these macroeconomic factors will lead to an increased pipeline of opportunities for distressed investors which is likely to last a number of years. Distressed opportunities are seen at all stages of the economic cycle for company or sector-specific reasons.

Figure 3: Global growth forecast (annual %)



Source: Consensus forecast as reported by Bloomberg, 21 November 2022. RBC GAM forecasts, October 2022.

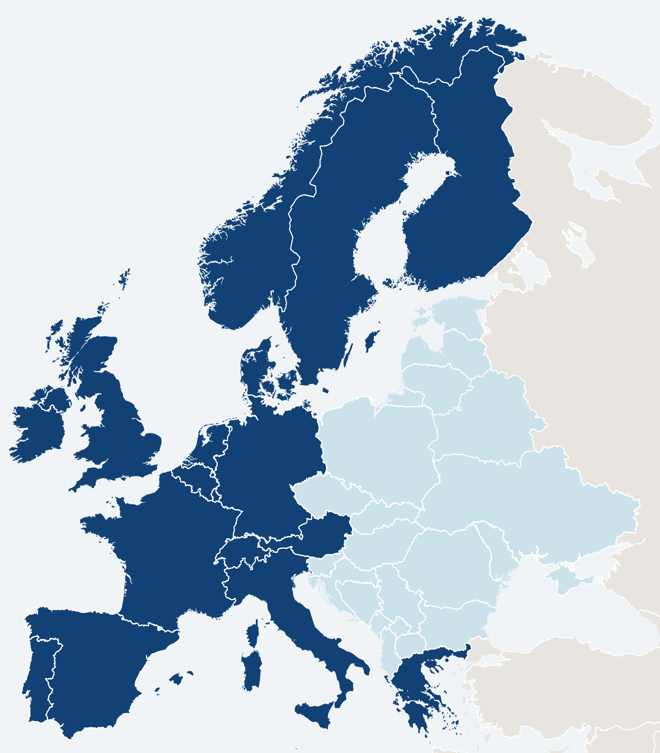
Why Europe? Why the midmarket?

We focus on single names in the European midmarket which we define as companies with enterprise values in the range of EUR0 to EUR500m. This represents a large investment universe and, although the rating agencies are predicting default rates lower than during the Global Financial Crisis, we make the point that the market is twice the size now than then.

Europe is the epicentre of global stress and distress. We have already seen a dramatic increase in the number of situations on our watchlist and this is likely to continue. Midmarket companies in particular are less diversified and less resilient. They have less access to capital markets and are more reliant on bank funding, leaving them vulnerable when banks' lending appetite decreases.

In our focus area we see only limited competition. We aim to deploy EUR20-30m in each investment and we are aware of only a small number of competitor firms. Our broader peer group consists of larger, multibillion dollar funds that need to focus on the smaller number of much larger capital structures.

To sum up, we believe that the European midmarket is characterized by many opportunities and limited competition. As a European based manager, RBC BlueBay is well placed to analyse, understand and capitalise on these opportunities.



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

Public Credit Markets
The European High Yield and Leveraged Loan markets amount to approximately EUR600 billion.

Both markets traded off significantly during 2022 and we have been reviewing opportunities in a diverse range of sectors; cinemas, shipping, healthcare, oil & gas, chemicals, real estate, retail, manufacturing, autos, autoparts, 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-leveraged balance sheets mean that they are now ill-prepared to withstand the pressure on margins from reduced sales and higher costs.

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.

In addition to high yield and leveraged loan names, we have seen opportunities in 'fallen angels' from investment grade markets, particularly in the real estate sector, where some business models are fundamentally unable to cope with increased borrowing costs at the same time as asset values are declining. The convertible bond market too has provided opportunities in the shape of busted convertibles which can offer asymmetric upside and high current yields.

Private Credit Markets
European bank lending amounts to approximately EUR7 trillion, a figure similar to 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.

Private credit is impacted by the same macroeconomic drivers as its public counterpart. Compared to previous recessions this century, 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. Consequently, banks will look to sell problematic assets and 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.

> **"I said there were storm clouds, big storm clouds. It's a hurricane... That hurricane is right out there down the road coming our way. We just don't know if it's a minor one or Superstorm Sandy."**
>
> Jamie Dimon, Chief Executive Officer
> JPMorgan Chase, 1 June 2022

Investment strategy

As a result of these factors, we focus on single name European midmarket companies. Over the next 2–5 years we are expecting that a significant amount of European midmarket 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 driven 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. At heart, we aim to generate attractive returns by buying at low prices while remaining senior in the capital structure.

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 midmarket for distressed and special situations.

For investors who have the flexibility to pursue a locked-capital approach with an investment time horizon of 3-5 years, the midmarket 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 asymmetric profile of attractive upside returns at the same time as a limited downside.

These investment opportunities fall into four categories:

Stressed 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 12–20%

Distressed investments

- Bank debt or bonds at deep discounts
- Financial/Operational restructurings
- Debt-for-equity swaps
- Distressed Private Equity transactions

- Hold Periods 1–5 years
- Target IRRs 20–30%

Refinancing/Rescue financing

- Refinancing of stressed companies
- Structural seniority
- Advantageous lending terms
- Warrants or equity kickers

- Hold period 3–5 years
- Target IRRs 12–20%

Other investments

- Liquidations
- Orphaned Situations
- Hard Asset Purchases
- Other Special Situations

- Hold period 1–5 years
- Target IRRs 15–25%

Deal sourcing

Relationships are critical for sourcing of differentiated investment opportunities.

The European distressed community is small and relationship-driven. Our team has over 130 years of aggregate relationship-building and investment experience in the space, with a deep network of professional counterparties, meaning that we can source differentiated deal flow in the European special situations midmarket.

The value of the team's proprietary sourcing networks is enhanced by RBC BlueBay's broader research and trading capabilities. RBC BlueBay, which represents RBC Global Asset Management outside North America, has over US$95[1] billion 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.

[1] Assets under management incorporate funds managed by BlueBay Asset Management and RBC GAM US which are managed within the BlueBay investment platform. As at 30 November 2022.

The BlueBay Developed Markets Special Situations Team

- European presence for a geographic advantage.
- Specialist country skillsets within the team for local market connections and 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

Adam Phillips

Partner, Head of DM Special Situations, 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.

Portfolio Manager Perspectives

Our experts offer their perspectives on the latest developments in global credit and the state of the markets.

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