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Liquidity-driven dislocations and central bank distortions: Opportunities in European credit markets

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Introduction

Allocators are wrestling to understand how they should respond to an investment landscape reshaped by a global pandemic strangling economic activity and unleashing powerful public policy responses. By sharing our insights, this paper is designed to help investors navigate the current dislocated credit markets as they look to determine which strategies are the most appropriate for their particular circumstances. This paper will examine the merits of investing in investment grade corporate credit via credit default swaps, of investing in dislocated European real estate-backed bonds, leveraged loans and senior secured corporate bonds and in capturing the rapidly evolving opportunity to provide rescue liquidity in both the corporate and real estate markets.

Uncertainty Reigns

The cone of uncertainty is wide. Some, such as the UK Treasury, are hanging onto an expectation of a v-shaped recovery while the more realistic are debating both the shape of the recovery and the likely permanent changes in consumer behaviour. Many are hanging their hopes on a vaccine, scarcely acknowledging that there are viruses for which no vaccine exists. The right response in these circumstances is to position portfolios to withstand the downside while simultaneously using this disruption to generate attractive returns to either rebuild capital or to meet required rates of return. The most attractive risk/rewards can be captured by investing at the senior point in the capital structure. Such an approach establishes a powerful convexity where the investor has the visibility of a high yield to worst while gaining substantial upside potential from a stabilisation of the capital markets and an eventual return to normal economic and social life.

In addition to the uncertainty surrounding changes in consumer behaviour and the economic outlook, investors are likely to have to contend with lower interest rates for a much longer time. Interest rates will need to be kept low to keep both countries and consumers solvent. Rising debt servicing costs would swamp national budgets at a time of swelling fiscal obligations and a shrinking tax base. The debt servicing capability of consumers was already stretched before this crisis and would quickly collapse if mortgage payments were allowed to increase.

At the same time, investors are right to ask if the most pressing concern is deflation or inflation. Conventional wisdom suggests that deflation is the greater concern given the collapse in consumer demand, widespread unemployment, a sharp decline in oil prices and the growing slack in factory utilisation. It may be prudent to take a page from the 1970s and consider if the virus is the type of supply side shock that could trigger a period of stagflation. Prolific monetary easing and fiscal expansion could combine with an increase in costs from broken supply chains, enforced social distancing and limitations on labour mobility at a time when policy makers cannot credibly signal that they will control inflation at any cost.

Equity Markets look Optimistic

Investors will also have to assess a widening and reweighting of the definition of stakeholder interests. The objective will move further from profit maximisation and place a greater emphasis on the ability of corporates to be resilient and to meet social goals. The fragility of dividends has already been exposed by income oriented blue chips, such as BT and Shell, cutting their payouts. It is likely that company boards will be forced in the future to take into account a wider range of downside scenarios, and therefore be more conservative when setting stock buybacks, dividends and leverage. Inventories will have to be higher in a world where just-in-time deliveries and long supply chains have been shown to be so vulnerable to exogenous shocks.

Equity markets have responded the quickest to the fiscal and monetary support programs. Their valuations appear to be supported by the most optimistic scenarios and appear to be increasingly detached from the harsh economic reality on the ground. Equity investors seem to be able to rely on current low interest rates to justify valuations while conveniently

ignoring the accelerating economic weakness which is leading to lower rates in the first place. Rather than raising the discount rate at this time of great uncertainty, equity investors have concluded that it is better to buy equities than lock in low or even negative long-term interest rates.

Not Everything is Distorted

Public policy has created other distortions beyond just artificially low interest rates and inflated equity valuations. Central banks on both sides of the Channel and of the Atlantic provide direct support for investment grade corporates, including fallen angels that were still investment grade rated just prior to the crisis. This has undoubtedly driven in investment grade credit spreads, although it is this unequivocal support, ironically, that probably means that investment grade credit still discounts a higher cumulative default rate over the next five years than is now likely to occur. The European investment grade credit default swap index, for example, discounts a 7.0% cumulative default rate against the worst ever five-year cumulative period of global investment grade defaults of 4.4%. The policy response at the start of that period, which began in 1930, was to reduce rather than to increase liquidity. Indeed, since 1970, the worst five-year cumulative default rate has been just 2.3% while the average five-year cumulative default rate is only 0.9%.

Certain asset types and certain specific segments of the markets have been excluded from receiving public support. In both Europe and the USA, public support mechanisms have been structured so as to either exclude or severely limit the ability of companies owned by private equity funds to participate in the financial support programs. As they did in the aftermath of the GFC, European central banks appear unwilling to provide support for asset-backed securities. The USA, by contrast, has relaunched the Term Asset-Backed Securities Loan Facility ('TALF') program.

Investors are going to find the best-risk/reward opportunities in those segments of the market least exposed to these uncertainties and in those segments that have been least distorted by the initial floods of public money. Investors will be well served to understand when their money is being rewarded for meeting short-term liquidity needs and when their money is actually needed to shore up solvency. With this understanding, it is possible to set the correct pricing and to ensure that each investment is structured appropriately. By looking at below-investment grade corporate credit and real estate-backed credit in turn; this whitepaper will argue that there are certain segments of the European credit markets that provide compelling risk/reward opportunities.

Leveraged Loans and Senior Secured Corporate Bonds

Pre-crisis, high yield bonds and leveraged loans were characterised by falling underwriting standards and leave a legacy of poorly protected instruments. The widespread use of aggressive EBITDA add backs means that most leveraged transactions were already going to struggle to meet projections before the crisis damaged the economic outlook. With pre-Covid crisis leverage back to levels last seen before the GFC, investors were counting on a benign economic environment. The lack of financial covenants gave investors a false sense of security by artificially suppressing default rates. Now these absent covenants provide both the Achilles heel for current holders and the route for fresh investments to achieve superior risk/rewards.

Selective investment in high yield bonds or leveraged loans, which are exhibiting distressed pricing but not distressed fundamentals, provided the initial investment opportunity in this latest crisis. Leveraged investors and managers facing redemptions were forced sellers and could only find liquidity in the least economically sensitive credits. By and large, the pricing of these investments has normalized quickly and the easy money has been made. However, further selling pressure could build once again if the fear of increasing defaults, and consequent widespread rating agency downgrades, grows in the face of evidence that the global economy will take longer to restart, triggering a market capitulation.

The behaviour of private equity managers will play a greater role in the more economically exposed credit. Greater selectivity is therefore required. Here the lack of covenants gives the private equity owner more leeway in managing the credit during this stress. In some cases, the private equity manager will choose to provide further funding, usually with additional third party funding, to support their equity. In other cases, the private equity manager will decide that it is either not worth it, or beyond the means of the relevant vintage fund, to invest further and may seek to inject debt at a level more senior to the current outstanding loans or bonds. This so-called priming will structurally subordinate existing debt and likely greatly extend its expected life by delaying repayment.

Super Senior Rescue Financings

Investors are likely to find the most attractive risk/reward by investing at the super senior level and avoiding altogether the risk of being primed. This positioning can be achieved by either investing in a drawn revolving credit facility or by structuring rescue financing to fit into a further super senior allowance that most covenant packages allow. Those companies that are private equity-backed will have the least ability to seek alternative funding sources and are therefore most likely to pay generously for liquidity. These loans will be, in our view, structured as super senior secured facilities and will typically be leveraged at less than 1.0x pre-crisis EBITDA and be priced to generate gross base case unleveraged

returns of around 15%. With a contractual term of 12 to 24 months, these loans can generate significant upside if refinanced earlier.

The opportunity to provide the funding to fully recapitalise mid-cap European corporates will restart once the economic outlook is more visible and when it is possible to conduct on site due diligence once again. The opportunity pre-crisis was already substantial in the €1 trillion of current, but underperforming, non-core loans that had swollen European bank balance sheets since the GFC. The implementation of IFRS 9 was designed to put an end to the 'extend and pretend' approach of the previous decade and, by forcing banks to reserve against the economic risk of these loans, motivate the banks to sell them. This opportunity set has been significantly increased through all the borrowers that have broken their covenants due to the loss of earnings caused by the lock down. These types of bilateral deals require extensive on-site due diligence as well as face-to-face discussions needed to achieve the consensual restructurings at the heart of these transactions.

Collateralised Loan Obligations ('CLOs') are not an immediate source of selling pressure on loans. With their term financing, these leveraged vehicles are not subject to margin calls. The deterioration in the fundamentals of the underlying loans, though, is going to cause difficulties, particularly as the credit rating agencies catch up and start dropping more credit into the CCC bucket. Restrictions on the ability to rebuild par coverage through purchasing deeply discounted loans introduced after the GFC to keep asset managers from gaming the structures, is going to make it difficult for managers to avoid triggering over collateralisation ('OC') tests. This will, in turn, start triggering the covenants that will ultimately put these vehicles under the control of the most senior class of bondholders who are likely to liquidate the portfolio if they find that they have the control and that their class of notes is sufficiently covered by the market value of the loans. While European CLOs do not have as much exposure to the energy sector as their counterparts in the USA, European CLOs suffer from a much greater degree of overlap of credits in their CLOs. This suggests that the European CLO market is more exposed to systemic weakness.

European Real Estate-Backed Bonds

The European real estate-backed bond market has not been swamped by government largess. Not only is this a market that has been explicitly excluded from public support programs, it is a segment that is being hit by governments encouraging rent holidays. While lowering rent obligations improves the near-term solvency of both individuals and companies, and reduces the amount governments need to pay out, the knock-on impact will be defaults on loans and on CMBS. The combination of rent collections and rent reserves in the March/April cycle was enough to keep most loans current and to avoid triggering defaults in CMBS. With the rent reserves depleted and the lock down remaining largely in place, the June/July cycle is likely to lead to defaults which will trigger a broad based round of downgrades by the rating agencies. These downgrades will, in turn, lead to buying opportunities as some investors will no longer be allowed to hold onto lower rated securities.

A range of factors make European real estate-backed bonds more attractive than those in the USA. The typical US CMBS is effectively a multi loan conduit with exposure to a broad range of borrowers and underlying tenants. In Europe, by contrast, most CMBS contain a single loan backed by either a single building or by a fairly homogenous portfolio of properties. This makes it easier to develop a tenant-by-tenant valuation of the property and makes European CMBS less of a beta play on either regional or nationwide real estate markets. In addition, most CMBS in Europe are held by a small number of bond holders which makes it easier to develop a consensus when working through difficult market conditions such as the present. US CMBS are more widely traded, making achieving a consensus amongst bondholders harder to achieve. Finally, there is a better balance of capital and expertise in Europe, notwithstanding that the European market is smaller than the US market.

Senior European real estate bonds offer a compelling risk/reward. A diversified portfolio of real estate-backed bonds and CMBS today offers investors a high single digit yield to worst while offering investors the opportunity to generate 15%+ returns from a normalisation of markets over the next 9 to 12 months. This return potential compares well with pre crisis yields on the same bonds of 2% to 3% and the yield on real estate equity in the order to 4.5% to 5.5%. The convexity afforded by a high yielding, senior ranking and low LTV exposure represents an attractive risk/reward not seen since just after the GFC.

Direct European Real Estate Lending

The real estate debt opportunity will shift to providing rescue financing to stalled projects. While projects still on the drawing board will either be postponed or cancelled entirely, sponsors of developments that are only partially completed will seek rescue financing to complete works. A completed project is typically worth substantially more than a property that can't yet be occupied. With banks already constrained from financing property development prior to this crisis, those lenders now willing to provide financing are in a good position to secure both a high contractual yield at a senior secured position along with a profit participation. With senior development, refurbishment and transitional loan pricing in Europe

already touching 12% unleveraged pre crisis, we believe that the provision of rescue completion financing in current market conditions will be priced at an even higher contractual return before including the upside potential from the free equity kickers. The delay, or even outright cancellation, of those projects still on the drawing board will help the tone of the market by depressing the future supply at the time that the rescued project is completed.

Conclusion

In sum, while segments of the markets are clearly distorted, there are other segments left behind. Through judicial security selection and effective loan origination, it is possible for investors to capture attractive risk/reward opportunities. Focusing on senior credit gives a high degree of visibility of a high yield while providing the convexity to generate further upside. There is less capital and expertise chasing opportunities in Europe with most large multi billion dollar US credit funds viewing Europe as a distraction from their home market. We view Europe as our home and believe the opportunity set to be most compelling.

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Stuart Fiertz CFA, CAIA – Co-Founder, President, Director of Research & Executive Committee Member



Stuart Fiertz is the Co-Founder, President and Director of Research of Cheyne Capital Management (UK) LLP. Cheyne currently manages \$7 billion and invests across the capital structure from the senior debt to the equity of corporates and real estate. With a philosophy grounded in rigorous fundamental analysis, the firm's investment strategies are: Real Estate Debt, Impact Real Estate, Investment Grade Corporate Credit, Strategic Value Credit and Equity-Linked Investing. From 1991 to June 2000, and prior to establishing Cheyne Capital with Jonathan Lourie, Stuart worked for Morgan Stanley where he was responsible for the development and implementation of customised portfolio strategies and for credit research in the convertible bond management practice. Prior to joining Morgan Stanley, Stuart was an equity research analyst for the Value Line Investment Survey, and a high yield credit analyst in Boston at Merrill Lynch and in New York at Lehman Brothers. Stuart is a CFA® charterholder and a CAIA designee. He is a council director of the Alternative Investment Management Association (AIMA), chairman of the AIMA Alternative Credit Council, a founder & trustee of the Standards Board for Alternative Investments and a former director of the CFA Society of the UK. Stuart was educated at the International School of Geneva and at Dartmouth College where he was awarded a BA degree in Political Science and Economics.

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