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Setting up to win in 2021 and beyond

David Nissenbaum and Samuel Roh of Schulte Roth & Zabel LLP assess the challenges 2020 has brought to the credit space and look ahead to the opportunities for positive rebounding in 2021 and beyond

At the end of 2019, a premier global investment bank touted that the US economy is nearly recession-proof.[1] Just a few months and one virus later, the US economy took an unprecedented downturn. It recorded the steepest drop in economic output on record, and over 30 million US workers filed for unemployment benefits by May 2020.

No one could have foreseen this black swan and its effect on the broader economy, albeit pockets of the economy have fared better than the rest. The federal government took swift action, and the economy was buoyed by the stimulus, which provided a level of liquidity that has been beneficial to many industries, including the investment management sector. The alternative investment industry is, in a sense, reflective of the unevenly affected economy – some managers have found their strategies and efforts gain traction while others have found returns and fundraising to be elusive. But there are steps managers, especially those in the credit space, can take to weather and even thrive in the current economic climate.

While there are some bright spots in the alternative investment industry (for example, fundraising for single asset and co-investment deals has remained healthy, especially in the context of facilitating syndications or acquisitions by a main fund), the broader private equity market slowed down in the summer. Accordingly, private equity sponsors are increasingly having to discover creative ways to extract more mileage out of capital, such as seeking greater recycling capacity, asking investors for greater follow-on investment capacity and requesting extensions to marketing periods. More so in the current climate than in the recent past, managers are clamouring for cash while investors increasingly see it as an attractive haven.

With liquidity in high demand, the private equity secondaries industry continues to build on the years-long momentum. According to Lazard, 2019 was a record year for sponsor-led secondary transactions with $28bn of deal volume across 58 transactions. Such developments in the secondaries market preceded the Covid-19 lockdown, and the crisis has only accelerated the growth in secondary fund restructurings.

Private debt funds and emergent opportunities

The strength of demand for private debt and special situation funds has been one of the private investment industry highlights. The surge in demand started before the pandemic and has sustained itself partly because of factors such as the diminishing interest rate on the 10-year treasury and the relative performance of direct lending funds.

With the volatility in the economy, managers and investors alike in the distressed debt space now find themselves asking, "Will the opportunities in distressed investments remain voluminous or will the recovery of the markets and low-cost borrowing choke demand?"

Data from Preqin show that significant capital is being raised in the distressed investment space, especially by larger managers. On the other hand, certain industry insiders have pointed to signals that warrant more muted expectations. Analysis suggests lowered interest rates and government intervention may result in fewer opportunities than initially estimated.[2]

Even with much uncertainty surrounding the market, some events seem more likely than not – the pandemic

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will continue to spur bankruptcy and restructuring activity. In contrast to prior recessions, this current economic climate has chilled many sectors of the economy (save for certain tech industries that benefit from remote work and social distancing). Therefore, it is likely that distressed investing opportunities will continue to be robust, and managers that raised distressed debt funds that are willing to seek opportunities across industries may be in a position to profit.

Despite the current economic conditions, because many nonbank lenders have entered into agreements with lighter covenants for years, many distressed companies have avoided renegotiations with creditors and have staved off bankruptcies. Many of these companies make poor candidates for debt restructuring. Moreover, unlike those seen in past downturns, recoveries in this climate may take the form of post-reorganisation equity, which is illiquid and requires significant time for recovery.

Fund structures to seize current opportunities

A sustained level of investor demand for distressed investments is far from guaranteed. However, managers today can start thinking about structures that can facilitate quick delivery of distressed assets product to market.

Structure one: closed-end funds with medium-length term

With a closed-end structure, not only do managers benefit from a stable source of money, but they can call capital only as needed, which such structure allows the added benefit of removing idle cash from performance calculation. With investors locked in for several years, managers can focus on investments and not worry about liquidity to address investor redemptions.

Such a structure may feature a two to four-year investment period from the final closing date (or in some cases measured from the initial closing date) as a shorter investment period may prove more marketable to investors. Moreover, the term may be shorter than a typical private equity product, keeping to a five to seven-year term. Shorter terms indicate to the investors an intention to deploy capital quickly into immediate opportunities and reap the benefits in a short or medium-term time horizon.

Structure two: single investment vehicles or co-investment vehicles for one-off opportunities

Another attractive structure to nimbly respond to the current market is a vehicle for a single investor or a small group of investors to exploit a discrete investment opportunity. This type of fundraising has become much more common in recent years, and it may allow a manager to raise money quickly when other types of structures may not.

Furthermore, for start-ups and less-established managers, a single investment vehicle can be a launching pad for a fuller investment strategy and can provide a runway for a manager to establish a track record in a particular sector.

Terms for such vehicles vary, but lockups are common with an abbreviated set of documents. The manager and investors often collaborate closely to determine the terms, with much of the energy spent on investment thesis rather than structuring the vehicle.

While it is possible to quickly launch a new product, managers looking to add a distressed debt strategy to their current program should examine whether they have the flexibility to do so under their current disclosures (or a strategy drift and its undesired consequences may result).

A new virtual reality

Besides the economic hardship, Covid-19 has brought with it an unprecedented acceleration of digitisation of human interaction. From virtual coffees and lunches to Zoom meetings, more of our communication has moved online. Raising capital and cultivating investor relations have also moved to the virtual platform. In this new environment, certain managers have not wasted the chance to connect more frequently with their clients, and investors, in turn, appreciate the new level of accessibility to their managers.

Some asset managers have even conducted virtual due diligence, working around allocators' requirements for in-person meetings with new managers before investing. But with the industry shifting to the virtual space, managers should continue to be mindful of the disclosures they make to investors, including, for example, that the investment teams conduct onsite due diligence before committing to material investments.

The pandemic and the subsequent economic fallout have led to many permanent and semi-permanent changes. Managers of all types will adapt to new market conditions. However, those who are diligent and plan with purpose will be able to capture more of the upcoming rebound and opportunities.

[1] See "Don't Look Now, But Goldman Sachs is Saying the Economy is Nearly Recession-Proof" CNBC, published December 31, 2019 and updated January 2, 2020.

[2] See, for example, "Not Everyone Sees Opportunity in Distressed Debt Mega-Funds," Institutional Investor, May 5, 2020.