DISTRESSED

Distressed debt: An expanding opportunity set

Continued selling by European banks and a possible negative turn in the economic cycle in the US suggest opportunities could be rife. **Rich McKinney** and **Marianna Fassinotti** of the D. E. Shaw group discuss various factors driving these developments

Q We are now over 10 years out from the credit crisis that began in 2007, and yet it continues to reshape markets and economies. What's your sense of investor appetite for private debt given the evolving landscape?

Rich McKinney: In both the US and Europe, we see investor flows increasingly shifting to distressed private debt strategies, but for different reasons in each market. The post-crisis clean-up in the US has largely been complete for some time and corporate defaults now are subdued by historical standards, so the flows designated for the States feel more anticipatory in nature. Put simply, investors seem to be positioning themselves for a negative turn in the economic cycle. The flows earmarked for Europe, on the other hand, continue to target the clean-up of legacy bank assets and business units, a process that has lagged for a combination of structural and temporal reasons.

Marianna Fassinotti: That's right; to date, non-performing loans (NPLs) have been the main focus of the European banking sector's divestment activities post financial crisis. However, addressing NPLs will not address all that ails the region's banks. We believe they face regulatory and market pressures to divest a broader universe of assets in order to improve profitability. Accordingly, market participants – governments, banks, regulators, shareholders, and investors – now increasingly refer to these legacy assets as non-core assets (NCAs), which includes NPLs as well as loans and other assets that may be performing but are now peripheral to banks' core businesses.

"PUT SIMPLY, INVESTORS SEEM TO BE POSITIONING THEMSELVES FOR A NEGATIVE TURN IN THE ECONOMIC CYCLE"
Rich McKinney

Q What motivated the D. E. Shaw group to enter the space?

RM: Many of the trades we were looking at when I arrived here in 2008 were associated with complex, esoteric, structured products. Prior to the credit crisis, bank proprietary trading desks would have seized most of these opportunities, but that was no longer possible given the evolving regulatory landscape for banks that followed the crisis. As a result, we launched the first in our series of intermediate-duration distressed credit funds specifically to target these assets.

MF: We have always looked for opportunities that lend themselves to our data-intensive, systematic approach. Given the current landscape, we find that many such opportunities exist in distressed bank loans and related assets in Europe. To address this, we have significantly expanded our team in order to operate more locally in the region while leveraging the firm's proprietary analytics systems.

Q How do investment approaches vary among distressed debt players in the space?

RM: Many participants in the space are seeking higher exposure to operating company risk – in general, we would characterise this approach as having more desire for various forms of financial leverage and probably more active use of liability management. By comparison, we believe our background in analysing asset behaviours and measuring asset risks lead us to a different set of objectives and exposures.

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MF: Yes, we believe it's possible to identify asset-specific mispricings related to asset complexity, market opacity, or localised dislocations that can generate attractive returns not reliant on general economic improvement or an illiquidity premium *per se*. We attribute our proficiency in asset-backed loans to the same distinguishing characteristics that established us in asset-backed securities: (1) our ability to quickly reconcile collateral-level insights with a deep understanding of secondary market dynamics and capital structuring and (2) the strength of our local sourcing network. To support the former, we have developed a set of bespoke technology platforms to analyse and manage these holdings.

Q Does the restructuring process for European banks still present interesting distressed investing opportunities or has it mostly played out?

RM: It's important to note that banking crises generally play out over long timelines (as long as eight to 15 years) and that the range of asset sales and business consolidations can be substantially greater than in more asset-specific crises. The situation in the European Union is exacerbated by the fact that the banking sector consists of more than 6,000 banks spread across 28 countries, all of which have varying rules and customs for resolving bad debts, not to mention differing levels of willpower for enforcing them. In short, despite positive developments, especially for the largest banks in the sector, the overall asset quality of the EU banking sector remains problematic, and NCAs will not get back to pre-crisis levels anytime soon at the current rate of reduction.

Q What else do investors need to know about the European debt markets?

RM: The size and scope of the issues facing the European banking system are much more significant than is generally appreciated. While approximately €600 billion worth of deals have concluded in the 2010-17 timeframe, banks still hold an estimated €2 trillion in NCA balances. Some of these assets will be resolved internally by the institutions, but most of this risk will need to be transferred to the private markets. This makes this crisis equal to or even larger than similar crises that we have seen in other developed economies.

"MANY QUESTIONS REMAIN UNANSWERED REGARDING HOW THE BANKING SYSTEM IN EUROPE SHOULD FUNCTION THROUGH A MORE EXPANSIONARY CREDIT CYCLE"
Marianna Fassinotti

MF: In addition to solving for adequate levels of capital and risk in the current market, many questions remain unanswered regarding how the banking system in Europe should function through a more expansionary credit cycle. Ultimately, we believe that European capital markets will need to evolve and grow to support the European economy and to provide better sources of funding for businesses rather than banks growing their balance sheets again.

Q Where do you think growth in distressed debt will come from?

MF: The overall stock of non-core assets in the European financial system remains substantial, suggesting these assets will play a prominent role in secondary debt markets for the next few years. More specifically, we think Southern Europe will continue to be a primary source of distressed debt activity given that, as of 2017 year-end, banks in that region continued to hold a disproportionate amount of the region's NCA exposure. Also, while small- and medium-sized banks have steadily improved asset quality, their NPL ratios lag those of large banks and are materially above the targeted threshold set by banking supervisors, suggesting that this non-Single Supervisory Mechanism segment of the banking sector will profile more prominently in asset dispositions. Lastly, we believe the emphasis of NCA sales will shift from commercial and residential real estate loans to a mix of smaller and more complex assets that more closely resembles the balance sheets of Southern European banks and of smaller banks in general. ■

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