Private Debt Intelligence – 5/20/2019

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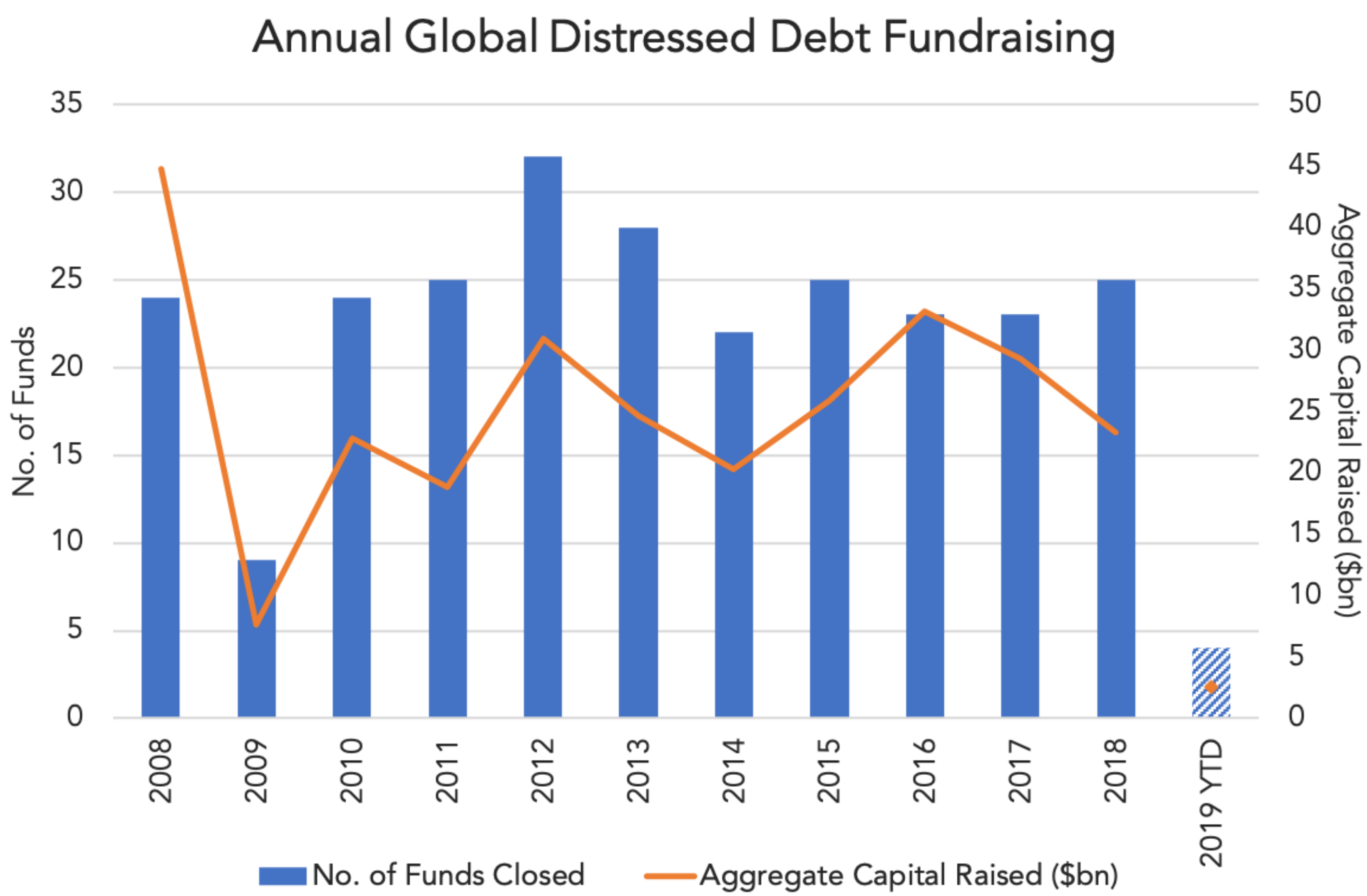
Distressed Debt Funds Stall in 2019

Chart



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Distressed debt has long been a major component of the private debt industry. Around the time of the Global Financial Crisis (GFC) in 2008, the strategy raised a record $45bn in capital – a level that has never been equalled – and performance of funds raised around this time has been strong. Fund managers were able to take advantage of distressed opportunities and provide counter-cyclical returns for their investors.

Now, the majority of private debt investors feel that the equity market is once again at a peak, and 35% expect a correction within the next 12 months. At the same time, 36% of them believe that distressed debt presents the best opportunities for investment in 2019, making it one of the most sought-after private debt strategies.

These conditions would suggest that distressed debt is again poised to see a spike in activity, but the expected surge has yet to occur. In fact, the strategy remains less attractive to investors than either special situations or direct lending funds, and so far in 2019 just 4 distressed debt funds have reached a final close, raising a combined $2.5bn. Performance has been lacklustre too, lagging both mezzanine and direct lending funds in the year to September 2018 with losses of 1.14% on average across the sector.

The lack of activity so far this year may be because investors believe that direct lending funds present a more attractive opportunity given the booming buyout deals market, or that distressed det funds will not be able to take advantage of potential opportunities as they did during the GFC.

But it may also be simply a question of capital buildup: over the last 10 years distressed debt assets under management have grown from $95bn to $226bn, but this has been weighted toward dry powder. While the unrealized value of assets held by distressed funds has grown by 19% since 2013, dry powder has ballooned by 82%. In addition, fundraising in 2016-2018 was strong, so investors may just be waiting for fund managers to deploy some of their $87bn in dry powder before making further commitments.

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