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2020: A Year of Surprises (Part Three)

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We continue our special series with the third of our "Five Biggest Private Capital Surprises of 2020:"

Surprise #3: Where Are the Distressed Loans?

Last April as the pandemic crisis unfolded, the CEO of a $20 billion asset manager cited $1 trillion as the volume of potential distressed credit investments. COVID has presented, he said, "a massive and broad-based opportunity to deploy capital at a critical time for the U.S. economy."

Nine months later it seems as if the timing of that opportunity keeps getting pushed out.

The rapidity of the Fed's liquidity rescue minimized the time for larger corporate borrower problems to fester. Similarly, private equity owners jumped in quickly to provide both equity capital and strategic management assistance. In many cases they also directed their portfolio companies to supplement their liquidity by fully drawing down their revolving credit facilities.

Sponsors also worked closely with their direct lending partners to amend covenants in credit agreements where needed. This additional flexibility reduced the number of actual covenant defaults. These factors also lessened the number of distressed borrowers, or at least where lenders were looking to be refinanced out.

Our content partner Private Debt Investor has reported extensively on the dynamics affecting problem loans. Yes, private credit managers have worked to support medium-sized borrowers through the challenges of a live-and-work-from-home world. And in some cases, the effectiveness of this kick-the-can strategy will run out.

Certain sectors like airlines targeted early by government financial support may suffer once that liquidity is exhausted, which may offer investors a modest wave of workouts. The hope is by that time, vaccine immunizations will be completed. COVID-impacted businesses (e.g., restaurants) should then see a return to some normal.

As the economy grinds on, some suggest a nuanced approach to finding troubled investments. "We think the distressed opportunity will probably play out in a series of mini cycles over the next 24 to 36 months, so we've got a lot of firepower for that," one public fund strategist said in November.

Oaktree, Blackstone, Cerberus, and Apollo all raised jumbo distressed funds last year. According to Preqin $140 billion of distressed fund dry powder was available as of this month. About the same amount has been raised since 2007, with over $40 billion last year across 60-plus vehicles.

For this mini-cycle at least, whatever problem loans are on the way, may come soon. A recent PDI survey (see *Chart of the Week*) shows investors expect distressed loans to peak before the second half of 2021.

Next week – Surprise #4: Which Industries Mattered?