BlueBay
Asset Management

Drowning in debt

David Riley
Chief Investment Strategist, BlueBay Asset Management

December 2020
Reading time: 5mins

Debt and defaults create 'fly or die' pressure on corporates, leading investors to potential opportunities in distressed and illiquid credit.

Summary

- Global debt is at an all-time high of 330% vs GDP.
- Corporate default rates are contained but elevated, with 'zombie companies' riding a lifeline of bailouts and easy financing conditions.
- This environment creates potential opportunities in distressed and illiquid credit.
- Companies that embrace reform and potentially restructure existing debt have the potential to prosper in the 'repair' phase of the credit cycle.
- Skilled and legal-savvy investors with an eye for business viability despite a stressed balance sheet look well-placed to succeed in the post-pandemic environment.

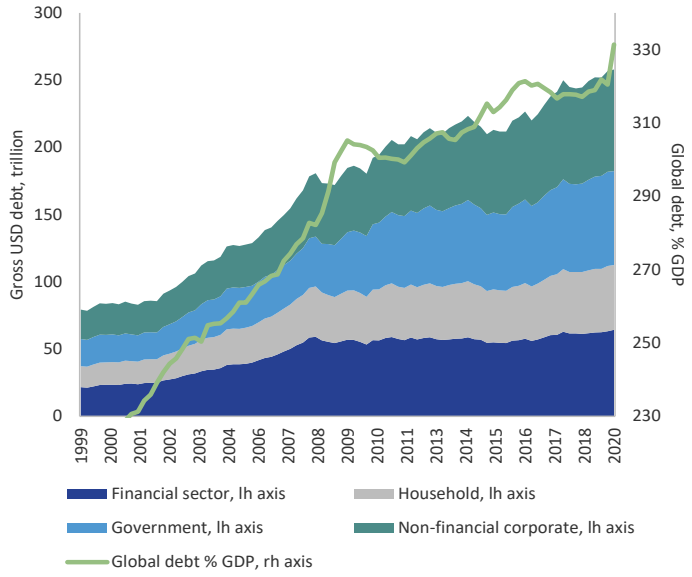
The global economy is awash with debt. The rise in debt levels across the world pre-dates the coronavirus pandemic, but the Covid-19 recession and associated policy responses have driven debt to new record highs. Ultra-low interest rates, central-bank liquidity and debt-financed government support for households and businesses has lifted the global debt-to-GDP ratio to more than 330%.

Despite the high debt levels and severe economic downturn, policy interventions have contained the rise in corporate defaults. Nonetheless, in our view, default risk will remain relatively elevated as so-called 'zombie companies' ultimately go bust and others are forced to adjust their capital structures. It is an environment that poses risks for investors, but also potential opportunities in distressed and illiquid credit.

Central bank corporate credit facilities and government support have allowed companies to access credit from capital markets, as well as banks, during the virus-induced lockdowns which have restricted economic activity. Ample liquidity prevented an even-bigger rise in business failures

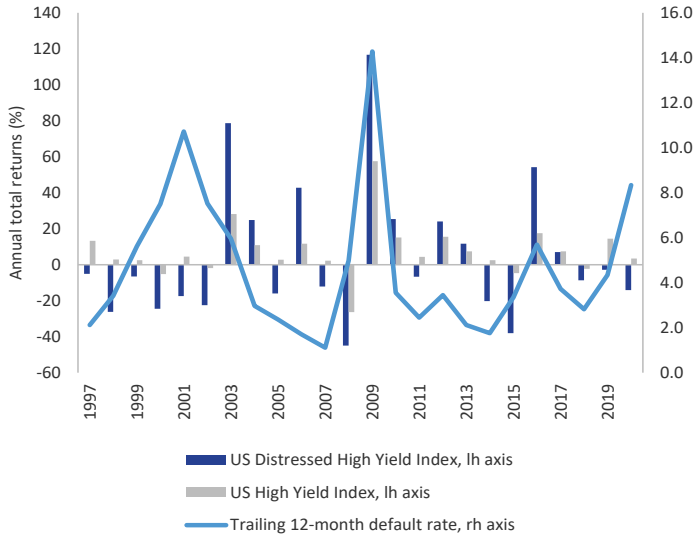
> "In our view, financial stress and default risk will persist as 'zombie companies' ultimately go bust and others are forced to adjust their capital structures. It is an environment that poses risks but also potential opportunities in distressed and illiquid credit."

Chart 1: Rising global debt



Source: Institute for International Finance, Global Debt Monitor; latest data for Q1 2020

Chart 2: US high yield & distressed annual returns and default cycle



Source: BoA US High Yield and US Distressed High Yield indicies; latest data at September 2020

and defaults. But the rise in leverage and structural damage to many businesses from the pandemic implies that financial distress and default risk will persist even as the global recovery gathers pace.

Extraordinarily low debt-service costs and easy financing conditions allowed viable businesses to survive the shock of the pandemic. But we also anticipate these economic support mechanisms adding to the number of persistently unprofitable companies, with assets that have a market value less than their replacement cost. These 'zombie companies' are unproductive and hinder the efficient allocation of capital and labour.

While some zombies can ultimately recover and gain profitability, other names will eventually go bust. For investors, the rise in 'zombies' and the pool of distressed assets poses potential opportunities, as well as risks.

Typically, distressed credit outperforms generic high yield after default rates have peaked and during the recovery and repair phase of the credit cycle. New money, sometimes accompanied by the restructuring of existing debt, allows some companies to survive and ultimately prosper as the economic recovery progresses. For investors with the patience, resources and flexibility to pick the right business with viable models but distressed capital structures, there are likely to be opportunities to extract value.

The economic and financial dislocation from the pandemic is a global issue. The reliance on bank funding and lack of dedicated pools of capital to support businesses with stressed balance sheets is especially prevalent in emerging-market economies, despite their typically lower leverage levels and the prospect of higher recovery rates in the event of default. We believe illiquidity and dislocation can create opportunities for investors. To succeed, they will require the skill set and flexibility to identify viable businesses despite stressed balance sheets and mispricing, alongside the ability to navigate a range of legal and political jurisdictions.

DISCLAIMER

Disclosure