# Investing in distressed debt in Europe: an overview

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## 1. Introduction

The concept of distressed investing in Europe is not new. We have operated in an environment of extreme financial volatility (both boom and bust) from a debt market perspective since the early 1980s, accelerated by the emergence of the European high yield bond market in 1997[1] which heralded a new wave of value investing in Europe. This volatility is not a surprise, one might argue, given the rapid growth of the leveraged buyout market, the subsequent failure of many companies in the mid-1990s and later the boom-bust cycle in the technology, media and telecommunications market at the turn of the 20th century.

Since the financial crisis in 2008 the European distressed debt market has become more dynamic as European and US banks, many of which made significant profits driving leveraged buyout volumes in the mid-2000s, were forced to unwind balance sheets of long positions in leveraged buyout loans, and some of the most complex structured products including mortgage-backed securities and collateralised debt obligations. Arguably US banks (operating in Europe) suffered more heavily than their European counterparts who held onto assets for longer, rather than completing a mark-to-market of their loan books and suffering catastrophic losses at the height of the crisis.

We have witnessed a substantial increase in non-performing loan portfolio trading since the start of the Eurozone crisis, as investors flocked to Europe seeking yield and targeting banks now subject to increasingly stringent capital adequacy requirements and more onerous regulation. The European Central Bank's asset quality review in 2014 identified €879 billion of troubled loans held by 123 banks in the Eurozone's 18 countries, prompting a raft of loan disposals and a flood of capital into Europe. This is hardly a surprise given the growth of the derivatives and securitisation markets in the mid-2000s, as assets on bank balance sheets grew from €18 trillion in 1999 to €45 trillion in 2008.

What is perhaps more surprising is the fact that the speed of bank deleveraging since 2008 (and therefore the opportunity for distressed returns) has not been as rapid as many commentators originally predicted. There has been a great deal of 'amend and extend', in contrast to previous cyclical downturns. However this is

1 Edward Altman, "The Anatomy of the High Yield Bond Market", September 21 1998: pages.stern.nyu.edu/~ealtman/anatomy.pdf.

more likely to have been the result of under-provisioning by banks and an inability to absorb losses on disposal of assets rather than through a lack of appetite itself, particularly since such lending ties up capital and prevents it from being recycled into other opportunities. 2015 witnessed a substantial uptick in activity with €140 billion of European loan portfolio transactions recorded, up 50% (in absolute value terms) on 2014, but this was largely driven by non-strategic performing residential mortgage portfolios in the United Kingdom rather than non-performing loans.[2]

On the other hand, deleveraging of Italian bank balance sheets accelerated, with €11 billion of unsecured/non-performing loans trading at large discounts to par.[3] In the context of an estimated €1,180 billion of non-performing loan stock held by European banks, less than 30% had traded by the end of 2015, but the speed of disposal is likely to accelerate in the coming years as lenders have continued to rebuild balance sheets and are now generating earnings capable of absorbing losses on non-core portfolios. In the last quarter of 2016 pressure is increasing on Spain's 'bad bank', SAREB, as well as its commercial banks, to recognise significant impairments in respect of their loan books, which in turn may lead to price alignment between buyer and seller, and allow for an uptick in transactions.[4]

The level of genuine distress experienced since 2013 has been relatively muted, driven by ultra-low interest rates and capital availability across a variety of markets, both debt and equity, which provided solutions (albeit including amend and extend in some cases) for the most stressed borrowers. At the same time, looser credit protection in loan documentation (driven by a shift towards covenant-light bond financings in Europe) suppressed distressed trading volumes as return-hungry investors enabled borrowers to avoid or defer complex workouts.

However, the current European distressed industry is one which still presents a raft of opportunities, given the volatility that threatens the European economic system and a general feeling of anxiety across global markets. The United Kingdom's vote to leave the European Union in the June 2016 referendum has triggered turmoil in the UK, European and global markets. Only time will tell what the medium-term impacts will be, with most market commentators predicting a period of uncertainty and in many cases recession. In the hours after the result was announced, the governor of the Bank of England sought to reassure the UK population, asserting the ability of the UK economy to cope with such shocks and to return to stability, yet before the vote he had predicted that recession was a possible outcome of a Brexit vote.

Indeed, such volatility is playing out during a period in which Europe has also witnessed the most extensive monetary policy stimulus in living history, through quantitative easing, which rather than establishing a robust economic platform has delivered only anaemic growth across the continent. As the Chinese market continues to slow down and restructuring activity picks up in the United States (largely driven by low oil prices) it is likely that the European market will again

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2 PwC, *Portfolio Advisory Group Market update* – Q4 2015.

3 PwC, *Portfolio Advisory Group Market update* – Q4 2015.

4 www.auraree.com/real-estate-news/bank-of-spain-puts-pressure-on-banks-to-speed-up-property-sales/.

provide significant value opportunities for alternative investors over the next five years, although the horizons on which such returns are achieved may necessarily be longer.

With an increasing absence of covenants in many large primary financings (and refinancings) which have closed in the last three to four years, it may be a liquidity crunch (or interest payment default) which ultimately brings distressed investors into play in the current environment. The steady flow of recent high-yield issuances (which has resulted in average annual issuances of €69 billion between 2013 and 2015, compared to €24 billion across 2006 and 2007) will ultimately increase the probability of future distressed opportunities, despite relatively weak volumes in the recent past.

Today's distressed-debt market participants are notably diverse and varied, ranging from more traditional investment banks and hedge funds to private equity groups who have raised 'special situations' or 'distressed opportunity' funds to drive returns through varied investment strategies from super-senior (debtor-in-possession style financing) through to deeply subordinated, payment-in-kind instruments which provide a route to borrower recovery or lender control. An example of the latter is Kohlberg Kravis Roberts & Co's investment in European vending machine operator Selecta in 2014[5] which, while positioned as a long-term refinancing, ultimately resulted in the fund acquiring a majority equity position from the incumbent private equity owner approximately 18 months later.[6]

## 2. Market development

Distressed-debt investing has been a consistent feature of the mainstream UK investment market since the 1990s and accelerated following the financial crisis in 2008. Following the crisis, US capital flooded into Europe attracted by the prospect of super-normal returns resembling those that were generated following recessions in the early 1990s and early 2000s. This influx of capital was also partially driven by a view that European banks would need to deleverage more aggressively than US counterparts, focusing initially on commercial real estate portfolios and then more traditional leveraged buyout positions. The reality is that the European market proved more complex than this, given the divergence in restructuring and insolvency regimes, the difference in accounting practices between European and US banks, and the relative balance sheet fragility of many participants.

Despite more recent reforms in Spain, France and Italy (the latter's regime was amended as recently as 2015 to focus on rescue rather than liquidation) the European distressed market was not as uniformly lucrative as many investors had hoped. As we have articulated, however, the European market remains a compelling investment opportunity, with over 70% of non-performing loans still notionally held by European banks, albeit this figure may be overstated by the multiple single asset disposals and 'bid wanted in competition' trades that have also filtered into the market since 2008.

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5 media.kkr.com/media/media_releasedetail.cfm?ReleaseID=855882.
6 www.selecta.ch/krrit/.

The secondary market itself, which allows for the sale and trading of debt after the original loan has been syndicated, has continued to evolve since the 1990s in order to provide market stability and to manage lender risk in a more systematic manner. As a result, single asset or sector concentration can be managed more efficiently by lenders, thereby ensuring frequent loan (or tranche) turnover (among participants). This ultimately acts as a catalyst to free up additional capital, in light of the stringent Basel III and CRD IV requirements,[7] and to maintain system liquidity.

With borrowers (and private equity owners) increasingly concerned by the threat of a potential loan-to-own investor suddenly emerging in a lending syndicate, and lenders themselves keen to retain transfer flexibility, it is now not unusual to see transfer 'white lists'[8] running to several hundred qualifying lenders in loan documentation permitting the sale or transfer of debt without borrower consent. Ultimately, this has not stopped aggressive hedge funds or private equity investors buying into situations where new money is desperately needed and a meaningful return can be achieved, but it has ensured that the secondary market operates in a more fluid manner.

More recently we have seen several private debt funds, having initially underwritten mid-market deals, exploit such flexibility post-financing in order to reduce portfolio concentration and to lay off single asset risk by selling down their exposure. The secondary market ultimately provides the mechanism to facilitate risk management in an environment where private debt funds have achieved market share gains over the last two years, forcing the major European banks to fight back with more competitive terms.[9]

Regardless, the European secondary market has become a relatively robust marketplace despite the absence of an automated system to facilitate trading of positions. This has been supported by the development of standard documentation by the Loan Market Association in the United Kingdom and Loan Syndications and Trading Association in the United States, which have helped standardise trading processes and accelerate the timeframe for execution. This has allowed debt to be traded in a commoditised market place, allowing investors to take short-term minority positions, or larger stakes seeking significant influence or even control, according to their mandate.

Funds such as Alcentra, Babson Capital and ICG, among others, have also benefited from the re-emergence of collateralised loan obligation issuance in the last two years, allowing them to deploy institutional capital across the market in a range of situations, supported by increased deal flow in the larger syndicated market. This represented a welcome return of collateralised loan obligation liquidity in Europe since issuance collapsed in 2009,[10] following a peak of €35.5 billion in 2006. While increased regulation has somewhat hindered the structuring of new collateralised

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7 www.eba.europa.eu/regulation-and-policy/implementing-basel-iii-europe.

8 A white list represents a schedule of defined lenders or institutions which is appended to the borrowers' financing agreement and which allows for subsequent transfer or assignment by the lenders of record at completion of their facilities (in the absence of a default). In the event of a default, the white list concept falls away and lenders are free to sell their debt to any party capable of holding the positon.

9 *AlixPartners Midmarket Debt Survey – 2015 (Europe); AlixPartners Midmarket Debt Survey – H1 2016 (Europe).*

10 Only €0.4 billion of collateralised loan obligations were issued in Europe during 2009.

loan obligations since 2012, and will fully manifest itself at the end of 2016 when new risk retention rules are implemented,[11] the re-emergence of the product in 2014 and 2015 (when €14.5 billion and €13.6 billion respectively of new collateralised loan obligations hit the market) provided ample liquidity across the market. The level of issuance softened somewhat in early 2016, with increased macroeconomic volatility linked to the depressed oil price, but rebounded in March. Year to date issuance for the eight months to August had reached €10.1 million and 2016 remains on track to deliver another strong period for new paper, despite the month of August itself delivering the lowest level of monthly issuance since August 2015.

The incidence of loan-to-own investment strategies, discussed in more detail below, has not been as prevalent as one might have expected since 2011. Instead we have seen more bespoke investment strategies employed by hedge, credit and private debt funds, investing on the basis of borrower and market fundamentals, rather than as a route to take control of the borrower itself. This is perhaps a function of the lack of genuine (dis)stress inherent in the system as funds have, outside relatively short term macroeconomic shocks (such as the Greek sovereign debt crisis), invested on a passive pull-to-par basis, where public market intelligence and sector knowledge have been used more efficiently to drive pricing arbitrage when debt positions are under-valued by the market. It also reflects the difficulties experienced in some jurisdictions of removing the incumbent equity holders, even when it is clear the economic interest does not lie with them (even if European jurisdictions are increasingly including mechanisms to disenfranchise shareholders within their local legislation). This was notable in the case of Codere, a Spanish multinational group operating in the private gaming sector, where the restructuring was frustrated for a long time by the inability to effect a debt for equity swap without shareholder consent.

Standard and Poor's European Leveraged Loan Index (ELLI) which tracks institutional loan defaults and restructurings has shown a progressive decline since 2011, with the ELLI distress ratio[12] declining from a peak of 31.5% in December 2011 to a low of 2.7% in June 2016, suggesting the market has simply not provided the volume of opportunities one might have expected for activist investors.

*This is an extract from the chapter 'Investing in distressed debt in Europe: an overview' by Tom Cox, Damian Malone and Mark Sinjakli in* Investing in Distressed Debt in Europe: The TMA Handbook for Practitioners*, published by Globe Law and Business.*

11 Risk retention regulation will require collateralised loan obligation managers to hold a 5% stake in each vehicle managed.

12 This ratio represents the share of credits in the ELLI by deal count that are marked below 80 cents/€.