



IS IT TOO LATE FOR DISTRESSED?

The distressed opportunity remains significant and compelling, with 2020 and 2021 vintages offering strong performance potential.

At the end of 2019, investors were benefiting from a relatively rosy economic picture: the U.S. stock market was in its longest bull run on record, U.S. GDP growth was slow but steady, and the economy was robust. The spread of COVID-19, however, brought this growth to a halt in 2020 and induced a deep global recession, with the IMF projecting global economies to shrink by 4.4% in 2020.¹

While the public markets reacted with a swift sell-off, and an almost-as-quick recovery driven by the extraordinary stimulus measures taken by the Fed, the distressed opportunity set in alternative investments (in both private equity and hedge funds) is, in fact, still in its early days. iCapital believes the scale of the opportunity – while undoubtedly smaller than initially expected in April 2020, with projected default rates having decreased from over 12% to roughly 8% – is still substantial.

U.S. COMPANIES ARE WEIGHED DOWN BY DEBT

Even with an end to the health crisis in sight, it will take much longer to recover from the current economic slowdown. Many companies have taken on significant corporate debt, which could create stressed scenarios in the event their revenues decline or fail to recover. In fact Bloomberg recently analyzed 3,000 listed U.S. companies and concluded that nearly 20% may now qualify as “zombies” with insufficient earnings to cover their interest expenses after adding an extraordinary \$1 trillion of debt to their balance sheets during the pandemic.²

Not only is it relatively early days for distressed debt, but the supply-demand dynamics for distressed investors also remain compelling, with the global opportunity set nearly 2.5x larger than the capital targeting it – there is approximately \$140 billion of capital targeting a \$320

Many companies have taken on significant corporate debt, which could create stressed scenarios should their revenues decline.

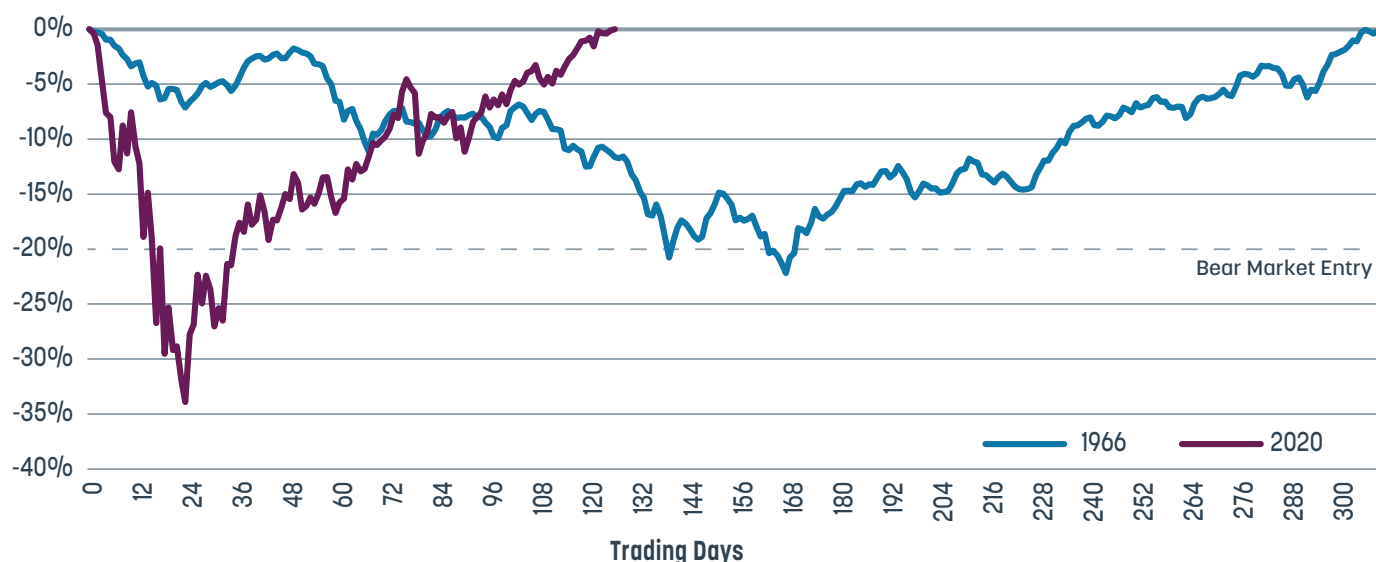
billion opportunity.^{10, 11, 13} Moreover, distressed funds that were raised during previous market dislocations, such as the Global Financial Crisis (“GFC”) and the dot com bubble bursting (“Dot Com crash”) have delivered historically high returns, suggesting that 2020, and even 2021, could be strong distressed fund vintages.

UNPRECEDENTED MONETARY STIMULUS HELPED DRIVE A PUBLIC MARKET RECOVERY

Let’s take a step back to early 2020. Unlike other cycles that are typically catalyzed by a market bubble bursting, COVID-19 is first and foremost a health crisis. Governments were forced to react with draconian measures to ensure public safety and, nearly a year after the U.S. government declared a public health emergency, business activity across nearly all sectors of the U.S. economy remains restricted – out of the 22 million Americans who lost their jobs when “non-essential” businesses shut in April 2020, only slightly more than half have returned to work.

To help mitigate the economic effects of these measures, the Fed, along with other governments across the globe, undertook unprecedented fiscal and monetary stimulus. This included implementing the \$2.2 trillion CARES Act, expanding the eligibility of quantitative easing and existing stabilization programs by over \$3 trillion, and cutting interest rates, taking short-term borrowing rates to near

Exhibit 1:
The S&P 500 staged its quickest recovery on record



Source: Factset, as of November 2020. For illustrative purposes only. Past performance is not indicative of future returns.

The supply-demand dynamics remain compelling, with the distressed opportunity set nearly 2.5x larger than the capital targeting it.

zero. Negotiations are currently underway on the second round of a stimulus package, likely to be worth another \$750 billion.³

The extraordinary scale and speed of these actions by the Fed led to a rapid recovery in the public markets, with few opportunities for distressed investors. In fact, after falling 34% by March 23, 2020, the S&P 500 saw its fastest recovery from a bear market on record – surpassing the prior record of 310 trading days in 1966 and 1967.⁴

Liquid fixed income markets rebounded similarly, buoyed by the Fed stepping in to buy debt in the \$10 trillion+ U.S. corporate credit market for the first time in history.⁵ Credit spreads reversed much of the widening that they saw in the first quarter of 2020, with the U.S. investment grade option-adjusted spread falling from 400 basis points (bps) to 170 bps by June 2020.⁶ Both the public equity and fixed income markets have also been lifted by early indications

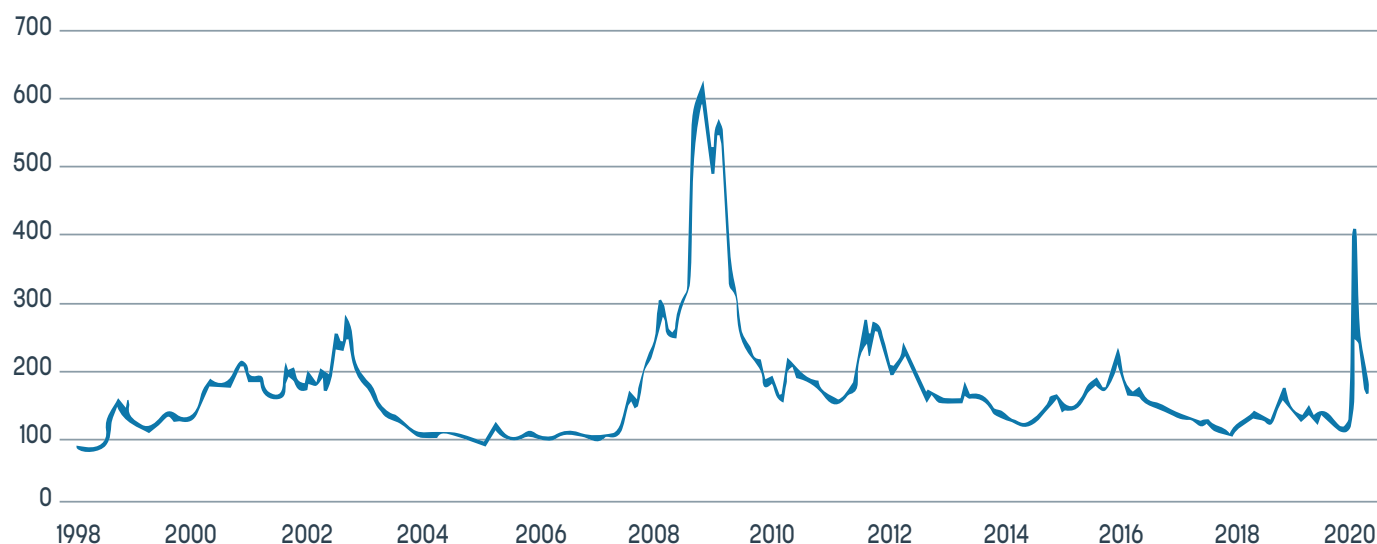
of an economic recovery – with U.S. GDP accelerating at a 33% annualized pace in the third quarter of 2020.⁷

COMPANIES LEFT OUT OF STIMULUS FORM THE BULK OF THE DISTRESSED OPPORTUNITY

Less liquid markets, however, have been slower to recover. Segments of the credit market that are privately held or thinly traded were not part of the Fed's stimulus package, including leveraged loans, B and CCC rated debt, and any companies levered above 6x debt/EBITDA, for example. Excluded from widespread stimulus, these companies are more likely to struggle in the future - with distressed investors then able to step in and provide rescue financing loans, or acquire a claim on a company's assets through a restructuring or distressed-for-control transaction. The former represents a new and somewhat different distressed opportunity set to the GFC, as it focuses on injecting fresh primary capital into companies that are troubled, rather than purchasing post-default debt in the secondary market (as was largely the case in 2008 to 2009). The overall potential distressed opportunity set is significantly larger than even an expanded Fed mandate, with the U.S. corporate credit market representing over \$10 trillion of assets.⁸

To date, both publicly traded and privately held companies have focused on fixing their immediate "liquidity crisis." On a corporate level, many businesses either drew down

Exhibit 2:
Credit spreads have narrowed after widening in the first quarter



Source: Refinitiv Datastream, ICE BAML indices, via Schroders. Data as of June 15, 2020. For illustrative purposes only. Past performance is not indicative of future returns.

on their revolving credit facilities or took out new debt to help weather the initial storm caused by the abrupt reduction in revenues driven by COVID-19. This provided many companies with a sufficient liquidity runway for the first or even second half of 2020 and delayed the onset of widespread distressed opportunities. However, many of these businesses may now find themselves over-levered, with difficulty servicing their additional debt load in the face of reduced revenue capabilities in 2021 and beyond. In other words, while the initial liquidity crisis was helped by the Fed's toolkit, businesses now face a deeper long-term 'solvency crisis', where their bolstered balance sheets may be insufficient to fix the impact of lost revenues caused by the pandemic. This solvency crisis is likely to drive the next wave of distressed opportunities.

It's also important to note that an overall recovery is likely to be inhibited by signs of market weakness that were already prevalent in 2019. These include a market characterized by weak covenants – with over 80% of the loan market deemed covenant-light⁹ – and a marked increase in EBITDA add-backs, where lenders transact based upon an EBITDA multiple that has been adjusted for projections, e.g. forecasted earnings or debt reductions. Even more importantly, corporate leverage is above levels last seen in the GFC: In 2019, over 75% of U.S. buyout deals were levered over 6.0x, which is the level the Fed has previously flagged as 'excessive'.¹⁰ with highly levered companies inadequately capitalized to withstand a prolonged downturn.

SIZING THE DISTRESSED OPPORTUNITY IN THE U.S.

Overall, distressed investors in this cycle are expected to benefit from compelling supply-demand dynamics. The lower-rated corporate debt market is vast, representing \$4.6 trillion of assets¹¹ (of which \$3 trillion is in the U.S.¹²). If one takes Moody's projected default rate of 7%-8%¹³ (down from an initial projected default rate of 11%-12%) – one can anticipate a default wave of approximately \$320 billion to \$370 billion (\$210 billion to \$240 billion in the U.S.). This represents a massive opportunity set, even taking into consideration that the default rate is lower than during the GFC. The pace of these defaults is expected to rise through 2021, with Moody's predicting a peak default

rate in March 2021. As of November 2020, 70% percent of U.S. corporate defaults have been in the consumer products, oil and gas, retail and restaurants, and media and entertainment sectors.¹⁴ Other sectors, however, have yet to see a meaningful effect despite the harsh reality of COVID-19's impact. Commercial real estate is one example that is expected to start seeing distress, as many office workers continue to work from home and businesses fundamentally rethink their real estate footprints.

This supply is expected to vastly outnumber the capital targeting these distressed opportunities. In addition to the \$68 billion of distressed dry powder as of June 2020, distressed funds in the market were seeking to raise an aggregate \$70 billion in capital, much of which has been closed on in the last few months.¹⁵ Together, this translates to approximately \$140 billion of capital targeting a global opportunity set of \$320 billion or more – an attractive imbalance in favor of distressed investors.

CHALLENGES LIE AHEAD THAT VACCINES CAN'T SOLVE

Despite the encouraging likelihood of a vaccine being widely distributed by spring or summer 2021, the potential distressed opportunity set may in fact increase in the coming months. Even though the public markets and the economy have seen a swift initial recovery, the U.S. is now in the throes of a third surge of infections – in many states, worse than in the first half of 2020. This could lead to another severe blow to the economy, with reduced business revenues and customer spending, leaving companies with a debt overhang that is increasingly more difficult to service – and one which an end to the health crisis will not solve for.

iCapital therefore believes that it is still early days for this developing market cycle, and a compelling time to invest in distressed debt. Historical data from past market downturns supports this view, as distressed funds raised during both the GFC and the Dot Com crash outperformed both distressed funds of other vintages, as well as other private debt funds – with 2008 vintage distressed funds generating a median net IRR of 15%.¹⁶ This suggests that 2020 is likely to be a strong vintage year for distressed funds. Moreover, it could be a strong vintage year for distressed funds in 2021, or even 2022, as we may be facing a multi-year distressed

opportunity set. If we look at the years following the Dot Com crash, the HFRI Distressed Index was up over 100% in the five years post-2000, compared to flat performance by the S&P 500.¹⁷ If one believes that we are entering a similar slowdown period that affects multiple aspects of the global economy, then we may be in the early phases of a distressed opportunity set that lasts for several years.



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END NOTES

¹ Source: IMF, "The World Economic Outlook," October 2020.

² Source: Bloomberg, "America's Zombie Companies Have Racked Up \$1.4 Trillion of Debt," November 2020.

³ Source: Deutsche Bank research, November 2020.

⁴ Source: Barron's, "The Stock Market Just Erased All Its Covid Losses. The Economy Is Still a Problem," August 18, 2020.

⁵ Source: S&P Global, "Credit Trends: Global Corporate Debt Market: State Of Play In 2020," June 2020.

⁶ Source: Schroders, "Should investors be wary about the fast recovery in the credit market?" June 2020.

⁷ Source: The Bureau of Economic Analysis, October 2020.

⁸ Source: Marketwatch, "Corporate Debt Soars to a Record \$10.5 Trillion," August 2020.

⁹ Source: Oaktree, "Investing in Distressed Debt," Q4 2019.

¹⁰ Source: Thomson LPC via "Bain & Company Global Private Equity Report 2020," February 2020.

¹¹ Source: Oaktree, September 2020. Represents non-investment grade debt outstanding.

¹² Source: Source: S&P Global, "Credit Trends: Global Corporate Debt Market: State Of Play In 2020," June 2020.

¹³ As of Q4 2020.

¹⁴ Source: FCCIB, "More firms to default on debt due to business slowdown," October 2020.

¹⁵ Source: Preqin, "Record Number of Distressed Debt Funds in Market amid Downturn," June 2020.

¹⁶ Source: Institutional Investor, "History Suggests Distressed Debt Funds Raised This Year Will Outperform," October 2020.

¹⁷ Source: eVestment, as of November 2020.



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