Special Situations

Special Situations typically involve an event-driven catalyst (or multiple catalysts) to unlock value and drive capital appreciation of performing or stressed credit. Investments can involve complex, negotiated facilities and terms agreed bilaterally with borrowers and other capital providers. Other examples are credit assets purchased at a discount to intrinsic value that are facing financial stress due to near term challenges (e.g., debt maturity, liquidity crunch) or operational stress (e.g., supply chain disruption). Credits can also have strong business models but inappropriate capital structures. Investment managers might seek to influence a company via a board seat or a restructuring committee membership, but not to control it through ownership. Special situations can perform well across market environments given cyclical and noncyclical sources of borrower stress, though generally outperforms during periods of market volatility and stress given an expanded opportunity set.

Why invest in Special Situations

- Enhanced Returns: Higher perceived risks, potentially leading to higher returns than traditional fixed-income investments. Distressed situations and unique financing needs offer opportunities for capitalizing on market dislocations.
- Diversification Benefit: Provides diversification within a portfolio, with risk-return profiles differing from traditional fixed-income or equity investments, enhancing overall diversification.
- Non-Correlation: Exhibits low correlation with traditional financial markets, offering advantages for investors seeking assets with different performance patterns and reducing overall portfolio volatility.
- Opportunistic Investing: Allows investors to capitalize on specific market opportunities arising from unique circumstances, providing a degree of independence from broader economic conditions.
- Structural Flexibility: Deals can be structured to suit specific needs, including customized loan terms, covenants, and exit strategies, benefiting investors and companies.
- Downside Protection: Investments may be secured by collateral or have protective covenants, providing crucial downside protection, particularly in dealing with distressed or financially challenged companies.

What are the main risks of Special Situations

- Credit Risk
- Event
- Execution

What characterizes Special Situations?

- Industry/Sector: Typically, generalists across all industries and sectors, though some managers have an industry/sector focus.
- Instruments: Typically, First Lien, but could include Second Lien, Unitranche term loans, or equity/warrants, which blend elements of senior and subordinated debt into a single loan with a unified interest rate.
- Maturity Profile: Typically, medium term (1-5Y), but it depends on the situation. Rescue financing typically has a short to mid-term time horizon, whereas turn-around and corporate event-driven may need a longer time to implement strategic changes.
- Credit Quality: Moderate/Higher or higher risk. Borrowers typically have credit ratings that are below Investment Grade.
- Interest Rate risk: None (floating rates) / Moderate (floating/fixed rates). Typically, interest rates for these loans are priced as a spread above a floating reference rate. Until mid-2023 in the US, this rate was the London Interbank Offering Rate (LIBOR), and today, it is the Secured Overnight Financing Rate (SOFR).
- Borrower Size: Typically, Middle Market.
- Return Profile: Derived from contractual yield, capital appreciation from buying below par and/or warrants. Unlevered target net return would typically be 15 – 20 %.
- ESG: Impact / Positive Screening / Negative Screening. Depending on the strategy, though, most managers will not lend to borrows in the weapons, munitions, sin, and energy sectors.

Manager Q&A

"How would you describe the current landscape of available opportunities within Special Situations, and what factors contribute to the attractiveness of investing in this market during the investment period?"

Barings

The market opportunity for capital solutions is highly attractive today. Traditional lenders such as banks and public markets have retreated in the face of market volatility and capital constraints, while borrowers are facing increased leverage, higher interest costs, and looming maturities. This supply/demand imbalance of capital creates a lender friendly environment and the potential for compelling returns, which stems from sourcing and structuring bespoke financing solutions to meet what are often idiosyncratic needs of companies. We seek to deliver the "complexity premium" inherent in these solutions, which is typically +300-600 basis points over traditional direct lending.

Invesco

Invesco focuses our special situations effort in global small capitalization companies, emphasizing US and UK/European businesses. The opportunity set tends to be evergreen across different points in the economic cycle as smaller companies routinely experience challenges due to idiosyncratic reasons. That said, the special situations opportunity set amongst smaller companies has become substantially pronounced due to several reasons, notably: 1) the tremendous growth of leveraged credit markets, 2) recent issuance and maturity trends whereby borrowers took on significant indebtedness, often with lower ratings at issuance and 3) pressured debt liabilities given the floating rate nature of these loans and significant rise in base rates due to monetary tightening. As a result, we are observing an extraordinary opportunity set as a special situations investor whereby we are seeing companies which have little to no operational issues but are merely liquidity strained. This allows special situations debt investors to target equity like returns but with significant downside mitigations given these companies often simply require balance sheet repair as opposed to business model turnarounds.

“How does your team stay ahead of emerging trends and opportunities as the landscape evolves? Could you elaborate on your proactive approach to sourcing and evaluating potential investments in this dynamic market?”

Invesco

Invesco’s $40+billion AUM private credit platform is one of the largest global investors in corporate loans. The platform is entirely private side, which means that we are able to access enhanced levels of private information from borrowers and perpetually augment our proprietary credit library which follows 2000+ issuers in the market. We also maintain one of the largest credit research teams evaluating corporate loan borrowers in the market as well as a dedicated team of loans sourcers/traders with extensive relationships and market awareness given we are one of the largest counterparties of loans trading in the world. All of these features are of considerable value to our dedicated distressed & special situations team which is fully integrated into our broader private credit platform. While the special situations opportunity set in small capitalization companies is extremely attractive from a risk/return perspective, the space also has natural barriers to entry given the difficulty sourcing opportunities, challenges with diligence given the level of opaqueness of borrowers, and trouble executing positions given minimal trading of these loans. Our broader platform significantly assists on each of these considerations as our special situations team benefits from access to the dynamically updated proprietary radar of opportunities, our large sector-based credit analyst team provides extensive contacts at both borrowers but also competitors, suppliers and other industry contacts to assist with diligence, and our dedicated trading team has deep relations and ability to build positions in credits. This is particularly differentiated given the largely boutique competitor set we find in our target market.

Barings

Our Capital Solutions strategy takes an “all-weather” approach to credit investing with a flexible mandate to migrate with the market cycle to find attractive opportunities. The team leverages the broader Barings $350B investment platform to deliver the best of the firm’s private and public market opportunities. To deliver the complexity premium, it is critical to have the ability to originate deals that often are in short supply and/or difficult to source. An origination network able to access capital seekers, particularly those with needs that may be unconventional, often consists of a mix of banks and intermediaries; restructuring, advisory and legal firms; global sponsors; clients; and members of personal, company and affiliate networks. This level of breadth and depth is critical in our ability to access deals, ultimately positioning us to be highly selective in constructing our portfolios. We have been investing in this market since 2008 over multiple cycles and across a wide range of industries. We have deep experience digging deep into these types of situations, analyzing their inherent risk, and pricing it appropriately.