PORTFOLIO INSIGHTS

Global Special Situations

Private credit: Time to consider special situations?

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IN BRIEF

- Private credit direct debt gained popularity among investors searching for yield in the low rate environment brought about by extraordinary central bank easing.
- Now the unwinding of quantitative easing, a late-cycle economy, stretched valuations, rising rates and initial signs of weakness in credit quality point to the potential for market disruption, displacements and distress.
- Private credit special situations strategies, which combine distressed credit and event-driven/stressed debt strategies, are designed to thrive on such uncertainty. They can extract value from market disruption across the economic cycle and, in particular, in times of distress.
- Investors willing to diversify their private credit allocation may find the risk/return profiles of these opportunistic, return maximization-focused strategies to be a strong complement to private credit allocations in anticipation of market instability ahead.

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ARE YOUR PRIVATE CREDIT ALLOCATIONS POSITIONED FOR UNCERTAINTY?

Extraordinary central bank monetary accommodation since the global financial crisis has spurred and sustained a prolonged economic expansion, bolstered risk assets and suppressed interest rates. In this still-low rate environment, many investors have turned to private credit direct lending strategies in a search for yield. How should investors now be thinking about their private credit allocations? It's not a simple question.

Special situations strategies—extracting value from market disruption

In this late-cycle economy, equity valuations are stretched, the Federal Reserve has begun to raise rates, and the unwinding of unprecedented quantitative easing has begun. The normalization of central bank balance sheets is likely to create a sizable displacement in credit markets. There will be nothing "normal" about this normalization process.

At the same time, the seeds of a traditional distressed market are being sown, with over $4 trillion of growth in global credit markets since the last cycle,[1] a loosening of lending standards and an expansion of covenant-lite lending.

An environment of increased volatility and disruption is precisely one in which special situations strategies can thrive. Indeed, among investors surveyed, 48% see special situations/distressed credit strategies as having the best risk/return profile within private credit at this stage of the cycle.[2]

[1] J.P. Morgan Securities LLC, November 2017.

[2] Preqin Investor Outlook: Alternative Assets H2 2017. Special situations includes results for special situations and distressed credit.

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And industry data suggests that as of September 2017, aggregate capital raised in special situations/distressed credit funds accounted for 43% of the private credit total.[3]

Investors willing to diversify their private credit allocation and increase their targeted yield may find special situations strategies—at the more opportunistic and capital appreciation/return-maximizing end of the private credit spectrum—a powerful portfolio component.

PUTTING SPECIAL SITUATIONS CREDIT STRATEGIES IN CONTEXT

Private credit encompasses a spectrum of strategies, varying in their risk/return profiles, the parts of the capital structure they invest in and their investment objectives. Strategies can be classified as income/capital preservation (senior debt/direct lending, mezzanine debt); return maximization (distressed credit, capital appreciation); opportunistic (event-driven/stressed debt); and niche (e.g., aviation finance). Different strategies can be used to exploit market conditions at varying points in the economic cycle (**EXHIBIT 1**).

A closer look at special situations strategies explains why these strategies may be well suited to extract value across the cycle and particularly in periods of distress. Uniquely, these strategies' returns are driven by both income and capital appreciation.

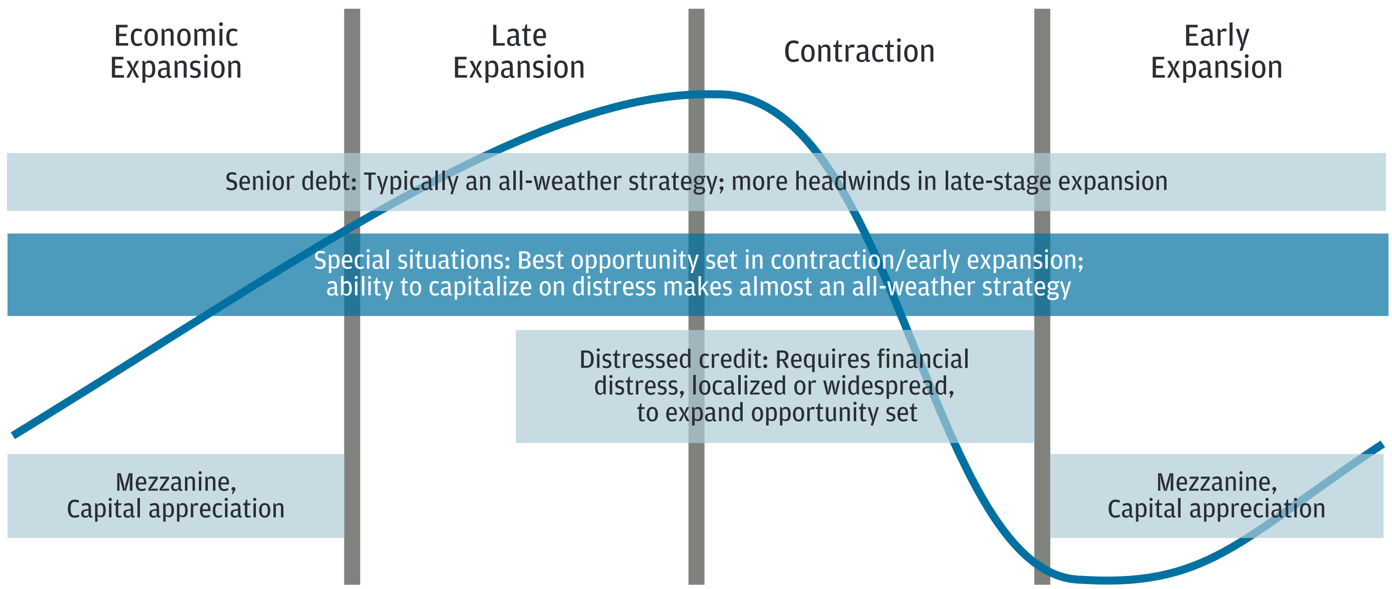
DEFINING SPECIAL SITUATIONS

Special situations strategies can source opportunities throughout the economic cycle by aligning with specific situational events, but their ability to capitalize on distressed credit opportunities when they arise truly qualifies them as all-weather strategies.

These strategies employ two sub-strategies (distressed credit and event-driven/stressed debt), both targeting fund-level returns of 15% to 20%—at the high end of the private credit return spectrum. They are inherently opportunistic strategies that offer flexibility across geographies, industries and all levels of the debt capital stack.

Special situations strategies create value across the cycle by flexibly shifting between two sub-strategies: event-driven/stressed debt and distressed credit

EXHIBIT 1: SELECTED PRIVATE CREDIT STRATEGIES ACROSS THE ECONOMIC CYCLE



Source: Cambridge Associates LLC and J.P. Morgan Asset Management.
Illustration does not take into account relative value across credit or relative value between credit and other asset classes. Specialty finance strategies will have different experiences during the credit cycle depending on the type of asset in which they are invested. Committing to drawdown strategies requires a longer investment horizon than investing in open-ended strategies that allow for immediate capital deployment and regular liquidity.

[3] Preqin Private Debt Online; data as of September 2017. Special situations includes results for special situations and distressed credit.

- **Distressed credit strategies** are return-maximizing, with returns driven primarily by capital appreciation of distressed, non-performing assets purchased at a deep discount. Investment selection is based on an in-depth analysis to assess the probability that a turnaround or a catalyst (such as a debt/equity swap) will help realize attractive returns and to gauge the balance between this upside and the downside of default. Ensuring the performance of these investments often requires a high level of fund manager involvement in working with the borrower through a turnaround or restructuring. These strategies perform best in the late-expansion through contraction stages, when financial distress generates an expanded opportunity set.
- **Event-driven/stressed debt strategies** are opportunistic. They seek out stressed but still-performing assets—often obligations of healthy companies—that are underpriced as a result of illiquidity, market disruption or particular issue/issuer nuances. It is also important that a catalyst to unlock value, such as a refinancing, is planned or can be negotiated with the borrower. Positions in these often-illiquid assets are built strategically over time. Event-driven/stressed strategies identify and creatively exploit these unique opportunities at all stages in the economic cycle.

Critical to achieving targeted returns is the flexibility to shift between the two sub-strategies as market opportunities dictate throughout the economic cycle.

THE IMPORTANCE OF MANAGER SELECTION

As with all alternative strategies, manager due diligence and selection are critical to investment success. Investors should consider the idiosyncratic and varied nature of the special situations these strategies invest in, the pool of potential opportunities to sort through and the extensive fundamental analysis needed to identify those assets worth pursuing. Think about the broad skill set and ingenuity required to structure these idiosyncratic transactions and actively participate in managing a turnaround or restructuring to ensure a successful exit. And this does not even address the ongoing risk management of the investment portfolio as these special situations unfold. "**An investor checklist for selecting special situations managers**" highlights the manager characteristics essential for extracting value from adversity and realizing the advantages of these opportunistic, return-maximizing strategies.

AN INVESTOR CHECKLIST FOR SELECTING SPECIAL SITUATIONS MANAGERS

- A highly skilled investment team with experience across the capital structure, geographies, jurisdictions and sectors, and through multiple market cycles
- A platform allowing access to global resources, knowledge networks and deal flow
- Fundamental analysis to evaluate the specific merits and nuances of each situation
- Ability to influence the restructuring process and take part in company management
- Flexibility to focus on distressed or stressed strategies as market opportunities suggest
- A disciplined, ongoing process for risk management and portfolio management

CONCLUSION

The economy is already in extra innings; central banks are unwinding quantitative easing policies; valuations are stretched; and banks are holding a store of underperforming assets likely to come for sale. Investors interested in positioning their portfolios for what is likely to be a period of market disruption, displacements and distress may want to consider special situations strategies.

Industry data indicates that investor commitments to special situations/distressed credit strategies are increasing, and almost half of investors interviewed see these strategies as having the best risk/return profiles among private credit strategies at this stage in the economic cycle. Investors seeking to diversify private credit allocations and increase targeted returns may find that they agree.

NEXT STEPS

For more information, contact your J.P. Morgan representative.

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