ROUNDTABLE – DISTRESSED DEBT

Discussing distressed debt

Earlier this autumn, **Tell Media Group**, in cooperation with **Oaktree Capital Management**, invited **Christer Franzén**, chief investment officer at **Ericsson pension fund** in Sweden and **Jimmy Lundby**, chief portfolio manager at **Pensam** in Denmark, to talk about investments in distressed debt. Tell Media Group founder Niklas Tell and Nordic Fund Selection Journal editor Caroline Liinanki moderated the roundtable.

By: **Niklas Tell**

The discussion started out with Caroline Liinanki asking the investors about their current allocation to distressed debt and experiences of investing in the segment.

CHRISTER FRANZÉN: "We have around 10 per cent of the portfolio within the private credit space. Today, distressed debt is a small portion of that compared to direct lending and private debt in general. We have one manager now in this area but have been holding off a bit as we've been waiting for a downturn in the economy. We thought that would happen in 2018 and then it didn't, so we've been waiting for a while to enter the distressed area."

JIMMY LUNDBY: "Our experience is similar. We were also of the opinion that the distressed cycle would come earlier and we did a distressed mandate back in 2016. But it didn't come. Then in 2019, we again thought that something where to happen so we did another mandate and that was in place in at the end of 2019. So we were sort of prepared to take advantage of any emergencies that might present themselves. In all fairness, we expected something to happen but it wasn't really a global pandemic."

NIKLAS TELL: WOULD YOU SAY THAT CENTRAL BANK ACTIVITY AND THE LIQUIDITY PUSHED INTO THE MARKET HAVE TAKEN AWAY THE OPPORTUNITY OR HAS IT ONLY DEFERRED THINGS TO A LATER DATE? I ASSUME THAT SOME OF THESE COMPANIES WILL BE IN TROUBLE FURTHER DOWN THE LINE.

JIMMY LUNDBY: "It very much depends on which sector we're looking at. Some sectors won't be that affected by what's currently going on, whereas other sectors will be exposed to a more severe downturn when you remove all these external funding lines from central banks or governments. So I think that there will be opportunities going forward. But I think these will be cases where you will need to roll up your sleeves and really do a lot of work. I don't think that there are many of the more trade-back-to-par investments to be made. I think it will be more about doing operational work in the specific assets."

CHRIS BOEHRINGER: "I agree that at the moment there's not easy money to be made by investing in publicly traded instruments and expecting them to snap back. That happened earlier this year but it was brief. We put quite a bit of capital to work in March and April and took advantage of that but now it's over. Where this cycle is very different compared to 2008, however, is that the real economy at the end of the day is going to be the driver. There are a number of sectors across the economy that are suffering and are fundamentally reliant on support and that can't go on forever. What we see in markets and what the data is telling us lead us primarily towards private transactions at the moment, rather than publicly traded distressed debt. Of course, for that you need to have some level of scale and patient capital. There will be some heavy lifting to be done but I think it's more a question of being disciplined as to how you underwrite these things and the risks involved – we need to understand that this economic weakness could go on for a while. It may end up not being one investment but several investments into a business before it bounces back. And as always, the most important thing is to pick the right businesses and the right sectors. You really want to be looking for quality businesses – not businesses that were already weak before the environment changed.

NIKLAS TELL: HOW WOULD YOU DEFINE DISTRESSED DEBT? IS IT A HARD DEFINITION, SO WHEN SOMETHING REACHES A CERTAIN POINT, THEN IT'S SEEN AS DISTRESSED?

CHRIS BOEHRINGER: "No, it's much looser. We're fundamental value-oriented and I think that's very important. If all you can do is invest in a single sector such as real estate or in a single asset class such as publicly traded corporate debt, it's going to be very tough. Being nimble, reactive and having the flexibility to operate across sectors and across asset classes is critical. If you want to find the best returns, you need to have that flexibility."

CAROLINE LIINANKI: IS THAT FLEXIBILITY A BIT OF A CHALLENGE WHEN IT COMES TO SELECTING MANAGERS? I ASSUME THAT AS INVESTORS, YOU WANT TO MAKE SURE THAT THE MANAGER INVESTS IN THE THINGS THAT YOU WANT.

JIMMY LUNDBY: "I guess that's always one of the questions you need to ask yourself. When you're selecting a manager to do investments on your behalf, you want to team up with a manager that has a strategy you believe in. You also want to see that it's something they've done before: you want a track record. You don't want a manager that all of a sudden decided to do something completely different from what they've done in the past. That's sort of point number one. Point number two is to do your search in a way where you make sure you know what you're looking for. We typically don't like to give managers too much flexibility – except for mandates within distressed debt. As Chris also pointed out, the distressed mandate should follow and find the opportunities, regardless of sector."

CHRISTER FRANZÉN: "We like flexible mandates because the worst thing that can happen is that you decide on a narrow mandate focusing on a specific opportunity. If that opportunity disappears, then you'll get nothing invested but you're still committed. Also, when you're talking about stress, it's not about the underlying asset so much as it's about the balance sheet of companies that we think could prevail and come back. There's a difference between stress and distress. I would say what we had in March was more about stress and you can, of course, try to play that game by buying things cheap. When we talk about distress, it's more about a sound company that has ended up in a situation where they have too much debt on the balance sheet. Then you can help them by providing finance to get out

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Christer has worked at Ericsson in different positions since 1991. He was named head of investments of the Ericsson Pension Fund in 2008 and has been chief investment officer since 2012. Prior to joining Ericsson he worked at Handelsbanken and Nordea.

JIMMY LUNDBY
Pensam
Jimmy is chief portfolio manager and responsible for the illiquid credit portfolio at the pension company Pensam. Prior to joining Pensam, he worked at Nykredit within acquisition & leveraged finance.

CHRIS BOEHRINGER
Oaktree Capital Management
Chris is managing director and head of Europe distressed opportunities at Oaktree. Prior to joining Oaktree in March 2006, he spent two years at Goldman Sachs in the European Special Situations Group.

of that situation. For us, it's crucial that the general business model is still valid. In 2008, it was more of a financial situation and then we jumped in with both feet. Today, it's different as you have geopolitics and technology that are fundamentally changing the market for companies. It makes it very difficult to figure out what will be a good business model going forward. I'm more hesitant today compared to 2008."

NIKLAS TELL: YOU MENTIONED JUMPING IN WITH BOTH FEET. HOW IMPORTANT IS TIMING WHEN IT COMES TO DISTRESSED DEBT?

CHRISTER FRANZÉN: "I would say you should have some allocation at all times because there are always balance sheets and corporations that are overextending themselves. If you're looking for a big downturn and you move too early, say in 2016 or 2017, the risk is that you have deployed too much capital too soon, so that's a timing issue. I think you should have the mindset of being involved in the area all the time but then size the investments over time."

CHRIS BOEHRINGER: "It's interesting how we see clients dealing with the question around timing and I completely agree that you can't time the market. I think the current pandemic does hammer home the point that you can't always see these things coming. And as you pointed out Christer, if you're just looking for those times when an investor is able to make high returns, you may miss it because the environment changes so quickly. The other thing that I think is important is to not expect the distressed manager to produce private equity-like returns when the economy is strong. If you do find a manager that produces high teens in returns in a benign economic environment, it's likely a private equity manager in disguise and you may not be getting the hedge you thought you were getting. Seeking to produce reasonable returns even when the market is not in our favour is down to discipline. It's down to having a very broad platform, so we have a wide variety of opportunities to look at."

NIKLAS TELL: HOW DIFFICULT IS IT TO ENSURE YOU HAVE JUST THE RIGHT AMOUNT OF CAPITAL AT THE RIGHT POINT IN TIME?

CHRIS BOEHRINGER: "We can't, of course, sit around and not invest at all. What we try to do is have enough capital available according to the opportunities that we see and we've been pretty good at that. Sometimes you get it a little bit wrong but in general, we've tried to be disciplined about that. We invest much more slowly when the cycle is not there and at those times we're pretty cautious. Investors make their own allocations, of course, but the amount of capital a manager puts to work is a signal about how we see the market opportunity."

CHRISTER FRANZÉN: "I just wanted to add that if you already have different debt managers in your portfolio, you might participate in distressed situations even if you don't add a dedicated manager. If we don't do anything, we're still participating to some degree in the market because the managers we already have are able to do that as well. Having said that, you need a manager that's able to take care of a workout in a proper way. It's very staff intensive, so I would never ever go with smaller manager for that.

CHRIS BOEHRINGER: "I agree but I would even take it a little bit further. There's a reason why banks separate their workout department from their lending group – workout requires a very different type of professional and it's a very different experience. The workout process is also becoming more complicated over time. Legal frameworks across Europe change from time to time and we have 27 different legal frameworks. It's quite different working something out in Spain versus in France or in Germany. Also, the personality of a person who originates well is, in my personal opinion, not the same as is required to be successful in a difficult restructuring. It's not just a question of resources. It's also a question of personality and experience.

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– Christer Franzén, Ericsson Pension Fund

It may be a generalisation but successful distressed investors tend to be glass-half-empty people: sceptics. When dealing with a distressed business, negotiations can be very tough. There may be skeletons in the closet and there may be a lack of information. There are reasons why companies may not want to share information when they're in distress. All of this requires a different skillset than originating a new loan to a performing business. I personally doubt that the typical direct lender is going to have the right skills or experience to be successful in the distressed environment."

NIKLAS TELL: WHAT'S IMPORTANT TO LOOK AT WHEN YOU DO DUE DILIGENCE ON A DISTRESSED MANAGER? FOR EXAMPLE, HOW IMPORTANT IS A TRACK RECORD GOING BACK TO THE GLOBAL FINANCIAL CRISIS?

JIMMY LUNDBY: "It matters, of course. I know that 2008 was different from what we're likely to experience today but we would still like to see that the manager is able to handle distressed opportunities and that they're able to do the work necessary to extract all the value from the investments in question. We also want to make sure that at least the senior people are experienced and that someone was on board when the historical record was made. Being a Danish investor, we must also focus on the cost level associated with making this investment. We need to make sure we get the most bang for our buck."

CAROLINE LIINANKI: "LET'S SAY THAT YOU FIND A MANAGER THAT YOU WANT TO TEAM UP WITH BUT THAT YOU WANT TO WAIT AND SEE WHEN OPPORTUNITIES ARISE. DO YOU ALWAYS HAVE TO PAY FEES DURING THE PERIOD BEFORE YOU'VE ACTUALLY FUNDED THE MANAGER OR BEFORE THE MANAGER HAS MADE INVESTMENTS? IS THAT POSSIBLE TO NEGOTIATE AS AN INVESTOR?

CHRISTER FRANZÉN: "In general, you commit a certain amount and pay a fee on that. I guess it's different from firm to firm but the fund manager has costs in the beginning when you're still at the beginning of the J curve.

JIMMY LUNDBY: "The way the fees are charged varies from fund to fund. Some funds use fees based on the commitment, which is more the private equity style and then we have others that charge a fee based on invested capital. Being someone that's cautious when it comes to cost, we strongly prefer to pay fees based on invested capital. Having said that, we obviously need to ensure that capital is not invested too quickly just for the manager to charge the fee."

CAROLINE LIINANKI: "THAT'S AN INTERESTING POINT. I GUESS YOU DON'T WANT TO INCENTIVISE THEM TO DO THINGS THAT YOU DON'T WANT THEM TO."

JIMMY LUNDBY: "There are always pros and cons with each approach. For us, it makes sense with an approach of fees based on invested capital, because we feel that we're able to work out a solution where we keep the discipline. We've also put a sizeable amount in that fund, which gives us a bit more room to negotiate."

CHRIS BOEHRINGER: "I would just add one thing. You've touched on a very specific point around fee structures but there's another important aspect, which is more general, and that relates to the compensation structure across the team. For us as asset managers, the majority of our incentive depends on how well the fund plays out. It should be important for investors that the compensation structure is set up correctly and investors should want the person who's investing the fund to be very aligned with them."

CHRISTER FRANZÉN: "I agree, because one of the largest risks we have as an investor is that an experienced team disappears. That's especially true in, for example, private equity because we don't know how to handle the underlying assets if the team walks away. Real estate is easier because we own a lot of real estate directly and we know how to handle that. For asset classes where the investment team is important, we try to figure out the best way to ensure that the staff get a fair share of the profits. If you're a public pension fund, you will have problems with politicians and media on these issues. We don't, so we can actually try to figure out how much we're willing to pay."

CHRIS BOEHRINGER: "I agree that you need to make sure you get the right team, the right structure and the right environment. That's probably more important than the amount of the management fee."

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> *– Jimmy Lundby, Pensam*

JIMMY LUNDBY: "I obviously understand what you're saying and it's not like I disagree with that. We fully recognise that if you want quality, you also have to be willing to pay. That said, I would rather pay a lower management fee and then add to the carried interest or see the link to the performance of the fund. What's important to me, which Chris also pointed out, is that the team that we've selected to do investments on our behalf is incentivised to do the best work they can each and every day. And then, they should be fairly compensated for that in five years' time or when the investments are actually realised."

NIKLAS TELL: I WOULD LIKE TO COME BACK TO ONE OF THE THINGS WE DISCUSSED EARLIER WHEN WE WERE COMPARING THIS CRISIS TO THE ONE IN 2008. BACK THEN, IT WAS A FINANCIAL CRISIS AND TODAY WE HAVE A LOT OF OTHER THINGS IMPACTING COMPANIES, SUCH AS GEOPOLITICS, DOMESTIC POLITICS, TECHNOLOGY ETC. IS IT MORE CHALLENGING THAN NORMALLY TO ASSESS COMPANIES OR IS IT JUST A DIFFERENT CHALLENGE?

CHRIS BOEHRINGER: "It's certainly different today but I think you have to put yourself back into the environment of October of 2008 and ask if it really did feel easier than it does today. Personally, I don't think it was easier. It was a different situation as you had asset prices leading the real economy. You had this dramatic volatility in the public market and you had a financial sector that came very close to the edge. The question that everybody was asking at the time was if we would have a great depression. It didn't happen – but you didn't know that in October 2008. Each crisis is different but each comes with its own challenges. The key in our business is to be able to value assets and buy assets, including companies, in periods of immense volatility and it's not easy. It requires you to stick to a fundamental value discipline. What's the highest quality asset I can find and how cheaply can I get it? Is that cheap enough, given the risks that I see? Whenever there's opportunity, there's always risk. Our job is understanding how to see through uncertainty and how to invest during periods of extreme volatility."

CHRISTER FRANZÉN: "As an investor, you also need to decide where on the risk spectrum you would like to be. If you're happy to be early when the uncertainty – and potential reward – is greater or if you would rather wait to get a smaller but more certain return. In the last crisis, you could buy loans from banks in Europe at 40 cent on the dollar if you had knowledge about it but it took us a while to find a manager. By the time we invested, I think we entered around 75 or 80 cent on the dollar. But then the crisis was about to resolve itself, so it was less risky."

JIMMY LUNDBY: "I would just like to add that there's no substitute to quality and we want our managers to look at quality businesses first and then see if there are any investment opportunity there."

CHRIS BOEHRINGER: "Unfortunately, many people in our industry subscribe to the idea that everything has a price. I think that's a red herring. There are many things that you don't want to be invested in at any price because you're not going to make money. Or if you make money, it's going to take so much work that it's really not worth it. In my experience, the best way to make money in this business is to find the right asset. Then you figure out how you can get it at a reasonable price. It doesn't have to be dirt cheap but it has to be the right asset."

CHRISTER FRANZÉN: "I think what makes it a little bit tricky today is that you have a number of businesses that you thought would always be there and suddenly the business model doesn't work due to the current pandemic. Of course, many will probably come back but the question is what it will look like at the other end. What's new this time around is that you might think that you have a very stable portfolio and suddenly that part of your portfolio is affected. What makes me a little bit uncomfortable going forward is that we don't know for how long we need to live with this pandemic and its impact on different business models. When it comes to distressed, the question is if it's an opportunity that we can see or not. You need to find companies that have business models that work but has the wrong kind of capital structure."

CHRIS BOEHRINGER: "I think that's exactly right. As an example, I don't love the airline industry but is it going to disappear? Will hotels disappear? They will suffer and some of them might disappear but if you can find the right assets, they may do particularly well because much of the competition will disappear."