RBC Global Asset Management

What to look for in a special situations deal

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> **"The ideal investment for a special situations or distressed debt investment team is a business with a sound underlying strategy that needs financial restructuring."**

Adam Phillips delves into how to identify potential deals in special situations and distressed debt markets.

Current market conditions are creating significant challenges for companies dealing with high levels of leverage, surging energy and commodity prices, high inflation and rising inflation rates. These conditions exist across the board and, alongside behaviour changes post-Covid, companies are also contending with changing customer demand trends.

It's a dynamic market

Within the market, we increasingly see companies need an overhaul of strategy and operational restructuring. We are prepared to roll up our sleeves for these opportunities. However, the ideal investment for a special situations or distressed debt investment team is a business with a sound underlying strategy that needs financial restructuring. These cases involve having the wrong capital structure, for example, in an otherwise good underlying business.

There are more participants, and the market is more dynamic. With the addition of private debt funds refinancing leveraged companies, which was less prevalent 10 or 20 years ago. And it is difficult to know what will come from the private debt market in terms of opportunity for special situations investors.

Liquidity considerations are key

Liquidity is also a key parameter in the investment decision-making process, especially concerning compensation. The European and US high-yield and leveraged loan markets currently stand at around $3.5 trillion, and this is where a lot of the immediate opportunity lies. These investments are typically more liquid, now a key area for us.

While liquid investments are a natural priority given the market opportunities today, we are also looking at illiquid situations. These do, however, carry a requirement for higher returns. Returns for liquid investments can be around 15-20%. However, to be compensated for more illiquidity, we would be looking for an internal rate of return (IRR) of about 25-30%.

Liquidity considerations within our portfolio during this cycle are aligned with historical norms. The time horizon for our liquid portfolio is generally between three months and two years. In contrast, more illiquid investments require an extended timeframe and could take two to five years to realise.

Identifying the right deals

Mid-market companies across sectors as varied as oil and gas, manufacturing, shipping, telecoms, cinemas, retail, food and real estate are particularly exposed to these challenges and have limited access to credit and refinancing. Within this opportunity set, we need to apply rigorous analysis to identify the right deals with the right returns.

Portfolio Manager Perspectives

Our experts offer their perspectives on the latest developments in global credit and the state of the markets.

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