EXPERT COMMENTARY

Opportunistic credit pursues 'off-the-run' assets and complex funding transactions to stay active and invested in both good and bad environments. Aaron Peck and Kyle Asher of Monroe Capital explore the strategy

Why opportunistic credit is gaining ground fast with investors

In 2013, when the fundraising market saw a rush of new distressed investment funds – even eclipsing the number of distressed fund launches in 2008 – many observers took it as a sign that economic unrest would soon follow. Fast forward to today, and those that raised capital anticipating a market dislocation are still waiting for a bear market and probably remain largely uninvested.

Several factors have extended the current credit cycle. The Fed's accommodative monetary policy coupled with fiscal stimulus in the form of tax cuts have kept borrowing costs low while stimulating corporate growth. At the same time, the weakening of covenants and lender protections that might otherwise trigger early-warning signals have helped keep the leveraged loan default rate in check and largely confined to the energy sector.

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This favourable environment, cheered by most investors, has naturally created challenges for pure-play distressed and deep-value funds. Several high-profile contrarian vehicles were among the hundreds of hedge funds that shut their doors in recent years. But while dedicated distressed players lick their wounds, opportunistic lenders – with an affinity for complexity rather than distress – have recognised an opening in the market and are prospering.

The favourable market for opportunistic credit is being driven, in part, by the new crop of private debt lenders, which have rushed into the market over the past few years. These lenders favour more traditional cashflow and enterprise value-driven credits that are primarily driven by sponsor-to-sponsor leveraged buyouts. However, the rush of new entrants into the more traditional leveraged loan space – favouring 'plain vanilla' credits, usually in support of private equity deals for larger mid-market borrowers (above $50 million EBITDA) – has helped commoditise lending strategies across most of the upper mid-market. In the process, pricing and terms are being pushed ever lower, without necessarily rewarding those that would otherwise differentiate themselves through underwriting.

Opportunistic credit, including speciality finance and highly structured real estate lending, offers protection throughout all market cycles. With an emphasis on financial or hard-asset collateral to provide protection, opportunistic credit also aims for higher yields than traditional credit during a healthy market environment and has the potential for amplified returns during a downturn. Moreover, the flexibility associated with opportunistic credit investing – to become a provider of liquidity to buy performing first-lien loans at a discount amid market dislocations – further enhances yield opportunities.

From a lender's perspective, an opportunistic asset-heavy credit strategy can offer the downside protection of a more traditional distressed fund, but without the cyclicality-governing strategies that rely on credit deterioration in order to put capital to work. To be sure, opportunistic credit strategies have largely resided in the domain of hedge funds, whose open mandates allow managers to chase yield wherever they can find it. This can include everything from litigation finance and marketplace lending to structured settlements and loans against intellectual property or royalty streams.

Bifurcation in the market

But as the direct lending market has grown in scale, private credit managers with the requisite experience in lending against harder-to-value assets are in a position to pursue these opportunities as well. This has contributed to a further bifurcation between hedge funds that have embraced a loan-to-own philosophy and the longer-tenured private debt managers that have applied more of a relationship-driven model in pursuit of this complexity.

The common thread across opportunistic finance, ironically, is that no two deals ever look alike. This explains why most traditional, cashflow-oriented funds or even ABL lenders tend to balk at the intricacy involved. Opportunistic finance places a high premium on underwriting tailored to a specific need or situation. Private credit firms that have domain expertise and a deep bench are generally the only ones that can take advantage of this opportunity. Moreover, for the newer entrants without the resources of longer-tenured players, economies of scale incentivise them to stay focused on cashflow-driven credits supporting buyout activity. This also allows more traditional lenders to leverage the due diligence provided by their private equity clients.

This will not apply in opportunistic finance. One of Monroe's recent opportunistic finance deals, for instance, required detailed analysis of five separate asset classes, including structured-settlement servicing fees, pre-settlement litigation finance advances, loans to law firms, and other unique assets. The borrower, if it tapped a more traditional lender, would have had to obtain five separate credit facilities to leverage its assets.

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The ability to understand and quantify the different risks across each pool of assets, however, allowed us to offer one facility with multiple asset-specific advance rates. The borrower gained speed of execution, lower overall cost and financing certainty, while the lender earned a significant premium return for providing a financing solution. Importantly, from the perspective of the lender, this was achieved without absorbing a higher level of risk than more traditional asset-based lending credits but through creating a structure that simplified the financing arrangements for the borrower in the timeframe required.

In many ways, opportunistic credit relies on an underwriting skillset that should be a prerequisite for any lender, particularly as creditor protections in the upper mid-market continue to deteriorate for traditional cashflow lending transactions. Witness the recent litigation around J. Crew's effort to transfer intellectual property rights to an offshore subsidiary with the goal of placing this important collateral beyond the reach of its current term-loan lenders. A similar fight over asset leakage emerged in 2018, when PetSmart sought to complete an equity transfer of its Chewy Inc. subsidiary to a consortium of PE investors. PetSmart removed the crown jewel asset it owned from its lenders' reach shortly before it filed for bankruptcy.

The key point is that as the more traditional cashflow lending business has become commoditised in the upper mid-market – with both weakening spreads and credit protections – opportunistic lending presently represents a less congested and more compelling risk-adjusted return opportunity for the more discriminating private debt investors.

The focus on asset protection should help maintain returns through any negative credit cycle in existing investments, while higher-yielding opportunities will only increase for new investments.

The raft of hedge fund closures might imply that institutional investors are gravitating away from opportunistic strategies. On the contrary, interest in both traditional distressed debt funds and asset-focused opportunistic credit has continued to percolate. The former remains a timing bet on the cycle, however, while opportunistic credit is drawing interest as an uncorrelated strategy that can diversify traditional private debt allocations and complement distressed or special situations allocations.

Institutional investors, of course, are also drawn to the immediate yield available through credit strategies that can put capital to work quickly – thus moderating the impact of the J-curve often associated with other private market allocations – as well as the higher yields compared with traditional mid-market private debt.

But rather than representing a bet *on* the cycle, opportunistic credit instead provides protection *against* the cycle through asset coverage and the opportunity to enhance yields should market liquidity begin to dry up. The value orientation of most opportunistic credit strategies also offers a margin safety that should not be overlooked in an era of high asset prices.

The catch is that most of the newer entrants in private debt lack the requisite experience across market cycles, while specialisation is generally required around key sectors and end markets to understand the risks involved. But within complexity lies the opportunity to apply these skillsets and capabilities in one of the less trafficked, less competitive areas of the market, where alpha is discernible and where there is no risk of ever becoming commoditised. ▯

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