EXPERT Q&A

As companies emerge from lockdown, there is much demand for financing solutions. With the current state of capital markets, private debt will be the answer, says David Allen, AlbaCore Capital Group's founder and chief investment officer

The dislocation opportunity

Q AlbaCore has around $1 billion actively invested in dislocation opportunities and is raising more. What are the opportunities for credit?

One of the big themes for us is that we are seeing more value in higher quality credit, meaning secured, double-B or even investment grade credit. When all prices fall consistently, you can trade up in credit quality and get similar returns. In the past few months, we have done a high percentage of senior secured or higher credit ratings, which has reduced the risks we are taking without sacrificing return potential.

Our investment strategy is hybrid across both public and private markets, so we are currently seeing a combination of both secondary and primary opportunities versus almost purely secondary in March. There is now more interest in longer dated transitional capital to the companies coming out of lockdown.

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Q How long do you expect this dislocation opportunity to last?

We see it lasting a while. Companies will still be looking for capital in the next six or 12 months as countries reopen and business activity resumes. Even companies that are going to survive this will need support. Many have had no revenues for three months and for starters need working capital.

The focus of the dislocation changes over time. On day one the opportunity was entirely secondary, whereas on day 365 it will be much more primary. Companies will need capital to shore up their balance sheets, replace lost revenues, and then potentially expand or make acquisitions. This is a market where companies that survive are going to emerge even stronger – just look at the likes of Amazon and Netflix.

Q How does this differ between geographies, and how might that change over time?

We have a European-focused business but our coverage reaches further, with US issuers and multinationals. In the US with the Federal Reserve at the punchbowl buying Treasuries, then high-yield exchange traded funds and now corporate bonds, the impact has been both good and bad. The CLO market is also very much back up and running in the US pushing prices up. This is a vastly different landscape to that in Europe and does mean that the US market prices have recovered ahead of Europe.

In Europe, without the central banks coming to the table and CLO bids on the sidelines, there is a high-quality opportunity set for nimble investors to be active in bonds and loans and find undiscovered value. We don't anticipate the Fed changing course any time soon and so on a relative basis expect the European opportunity to remain compelling in this dislocation.

On the private side, where capital markets are not providing for the financing needs, we are also seeing interesting opportunities.

The other key difference between the two geographies is sector weighting and exposure. Specifically, in our case, we have an integrated environmental, social and governance criteria for all our investments, which means certain sectors are excluded from our investment universe, for example oil and gas. The US market is typically less stringent and so much more vulnerable to sectors we exclude, for example, energy price swings and subsequent binary outcomes. With our ESG investment framework, we eliminate some of these higher volatility industries from the get-go.

Q What lessons should managers be taking from recent months?

One lesson that will come out of this is on sector risk. The ESG overlay that we focus on means we avoid binary credits and that has saved us from a lot of issues in markets like energy. As an investment team, our portfolio managers Bill Ammons, Deborah Cohen Malka and I implemented this policy over a decade ago while managing assets for the Canada Pension Plan Investment Board. We felt there were certain things that were too risky to be in our portfolio, namely energy, minerals and anything commodity-related,

"Where capital markets are not providing for the financing needs, we are also seeing interesting opportunities"

where there is an input price that materially impacts cashflow.

Metrics other than EBITDA have also become pretty important, such as liquidity, business leverage and free cashflow. Where you have public companies, we have seen them really benefit from that access to liquidity, which is not always available to a family or entrepreneur-owned company with limited or no sponsor involvement. Business revenues going to zero is not a scenario we have historically had to focus on a great deal, but it is one of the scenarios we now must examine and consider.

Finally, this is definitely not a buy-and-hold market. We see a lot of opportunities to really sweat the portfolio by using a relative value approach to maximise returns while also reducing risk.

Q What sort of response are you receiving from investors to the fundraising?

Investors see the punchline here, when market spreads get to 800-1,000bps over base rates. It is a great time to invest in credit and secured debt. Those of us that went through the crisis in 2008-09 saw that in the recovery returns. Lots of people were underinvested coming out of 2008-09 and, now in decision-maker roles, they don't want to make that mistake again.

We have seen many investors who were actively avoiding credit in 2019-early 2020 and are revisiting their views here, especially with equities back near all-time highs, and credit markets still in the recovery phase.

The difference is that in 2008-09 people thought the financial system was going to collapse and bank liquidity was struggling. Now, the banks are all trading actively, committing capital and doing new issues, so the financial system is not in question. Those two things mean that most people want to talk about credit and want to find a way to invest responsibly.

Q Do you see competition in this hybrid area between liquid and illiquid approaches? What are the barriers to entry?

We like to say we want to be big enough to be relevant but not so big we have to buy the market. We currently have around $5 billion in assets under management and the market in Europe is worth about €600 billion, so we are just shy of 1 percent of market share. We are comfortable here as we can partner with our LPs and underwrite and arrange very large private transactions for our PE partners.

We have completed investments as large as €1 billion and yet are not forced to take a bit of everything in order to put our investors' money to work. There are not many players that can complete these very large private financings and still manage less than 1 percent of their market.

We also have a team with a pension fund mindset, and so capital preservation is front and centre, with the experience of working through many dislocations. Be it the dotcom crash of 2000-01, the global financial crisis, the European sovereign debt crisis of 2011-12 or the oil crash of 2014-16 – we have experience built over decades of credit investing and now is a time to stick to what you know and do it well. Being able to be agile and maintain a strict focus on capital preservation is critical – we see this as a credit pickers' market. ■