

# Distressed Credit Update

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## AUTHOR



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## AETOS AT-A-GLANCE

### Firm Overview

Aetos Capital is an independent firm, providing investment advisory services through Aetos Alternatives Management, LLC ("Aetos"). Since the firm's inception, Aetos has been a leader in constructing fully customized hedge fund solutions for a broad range of institutional clients.

### Founded

2001

### Firm AUM<sup>1</sup>

\$10.9 billion

### Leadership

Anne Casscells  
Co-President & Chief Investment Officer

Michael Klein

Co-President & Chief Risk Officer

### Locations

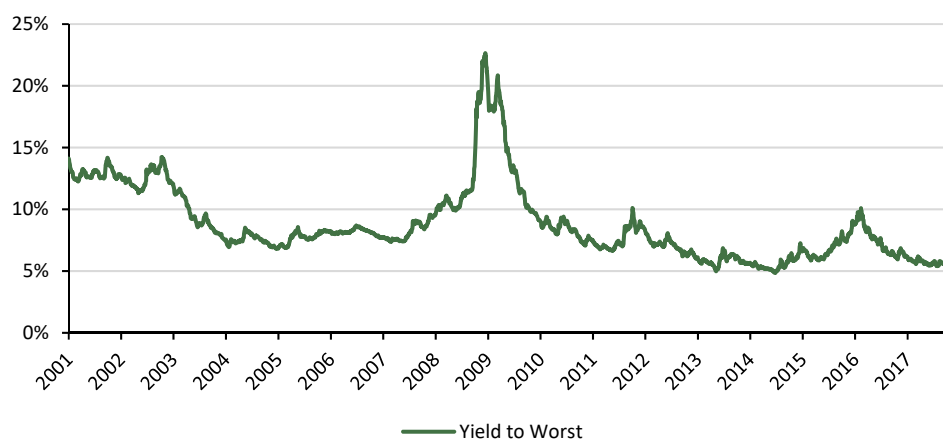
New York, New York  
Menlo Park, California

## THE CREDIT CYCLE

Credit markets tend to be cyclical in that they track the expansion and contraction of access to credit over time. While it is very difficult to call a top in the cycle, we do appear to be in the latter innings of the expansion phase. We live in a world that has grown accustomed to low interest rates and generally easy access to credit. This was a necessary step to heal the economy after the financial crisis; however, we appear to have reached a point where we have tipped over from rebuilding and are now heading towards excess. Looking at corporate credit markets today, we cannot help but see similarities to the later days of prior credit bubbles.

Simply looking at the yield an investor receives today in exchange for purchasing high yield bonds gives us cause for concern (*Chart 1*). High yield bonds are a reasonable, liquid proxy for the availability of credit in the market and useful for evaluating the credit cycle.

**Chart 1: BAML High Yield Master II Index**



Source: BAML  
Data as of October 31, 2017

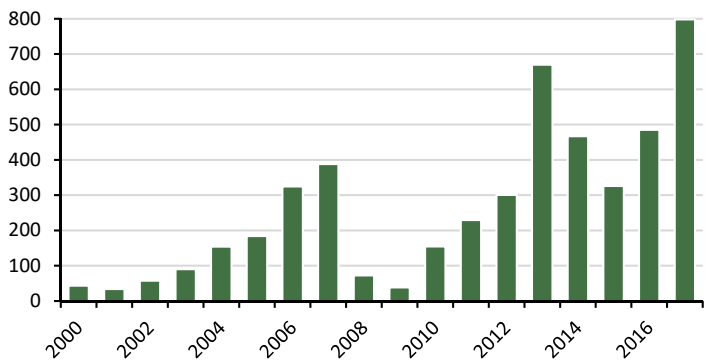
While these yields are not at all-time lows at 5.52%, it does appear that investors are not being adequately compensated for the risk they are bearing. After adjusting today's yield for average levels of defaults and recoveries, the expected return is even worse, with a loss-adjusted yield of 3.76%.<sup>2</sup>

Either investors are content with this low loss-adjusted yield, or they are assuming that defaults and recoveries will be more benign than in the past. While we agree that the default rate is likely to be lower than average as we move into 2018, it is highly unlikely to stay at that level throughout the coming years. However, by anchoring on the recent low default rate, investors have pushed yields lower and enabled a surge in new issuance in the high yield and leveraged loan markets. Of particular note is the record level of new issuance in the leveraged loan space (*Chart 2*).

<sup>1</sup> As of September 30, 2017

<sup>2</sup> Assumes an average annual default rate of 3% and recovery rate of 41.23%, per the 25-year annual average observed by JP Morgan. Source: JP Morgan Default Monitor, November 1, 2017.

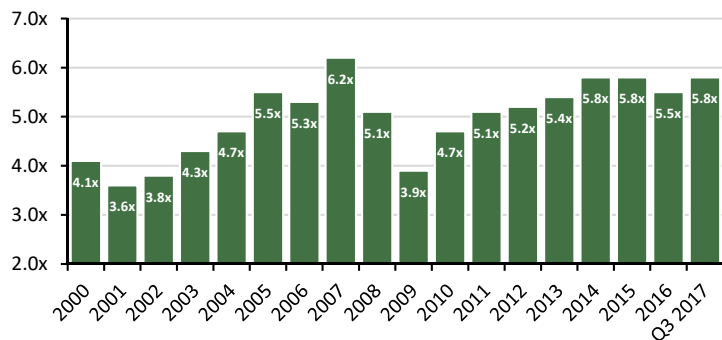
**Chart 2: Leveraged Loan New Issuance (\$ billion)**



Source: JPM  
Data as of October 31, 2017

This surge in issuance, not surprisingly, has been accompanied by a degradation in credit quality. This is most evident in leveraged buyouts, where the leverage employed to fund these transactions has been ticking higher and now stands near levels last seen in 2007 (Chart 3).

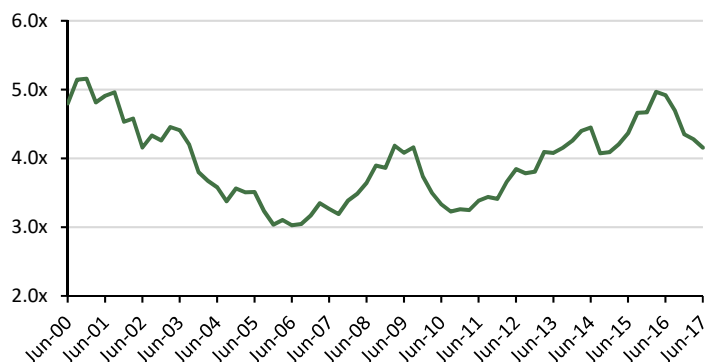
**Chart 3: LBO Total Leverage (Total Debt/EBITDA)**



Source: S&P Capital IQ, LCD  
Data as of September 30, 2017

Likewise, leverage in the broader high yield universe, although down from 2016 levels, remains at levels higher than 2006 and 2007 (Chart 4).<sup>3</sup>

**Chart 4: High Yield Ex-Energy Net Leverage (Net Debt/EBITDA)**

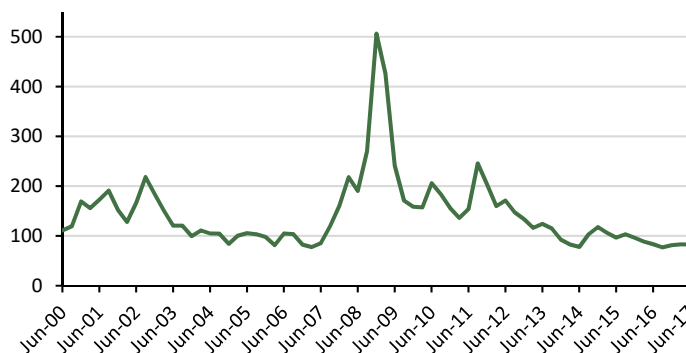


Source: BAML  
Data as of June 30, 2017

<sup>3</sup> Analysis excludes the impact of the energy industry on the BAML HY Master II Index. The energy industry represented approximately 15% of the index in 2014 and had an outsized impact on the leverage statistics when earnings in the sector began to decline in 2014 due to lower commodity prices.

Taken together, lower yields and higher leverage make us wary. By looking at the high yield spread per unit of leverage, we see that we are nearing prior period lows (Chart 5). At any level under 100 bps/unit of leverage, we believe that investors are not being adequately compensated for the risks they are being asked to bear. While we are not calling for a repeat of 2008, we do expect a correction in pricing as investors reevaluate the risk/reward in the broader high yield and leveraged loan credit markets.

**Chart 5: High Yield Spread/Unit of Leverage**



Source: BAML  
Data as of June 30, 2017

**AETOS' APPROACH TO THE CURRENT MARKET DYNAMICS**

In light of this market dynamic, Aetos and the managers with whom we invest have been actively repositioning the overall distressed credit allocation.

The most notable change is the change in our manager lineup, which was driven by a desire to reduce risk and take advantage of new opportunities. Earlier this year, we initiated a full redemption from our residential mortgage specialist. Given the spread tightening that we have witnessed across much of the credit markets, we thought that it was prudent to exit this investment as it no longer met our unlevered targeted return.

At the end of 2016, we initiated a new position in a short-biased credit fund and we have continued to add to the investment throughout 2017. This fund targets specific issuers that the manager believes are likely to experience material spread widening due to a range of operational and financial factors. In addition to seeking to provide alpha through credit selection, this investment also serves to reduce the net exposure of our overall portfolio. Taken together, the elimination of our long-biased mortgage investment and the addition of this short-biased credit investment moves our investors' portfolios to a more conservative posture.

The allocation shifts have not been limited to changes in the manager lineup. Across our portfolio, our underlying managers have remained disciplined in the current environment and are

taking a host of actions that seek to generate incremental returns for investors through: (i) harvesting legacy positions, (ii) building idiosyncratic investments and (iii) evaluating new or emerging themes.

### ***Harvesting Legacy Positions***

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Managers are keenly aware of the current pricing environment in the broader credit markets. Accordingly, they are taking advantage of this accommodative financing climate to refinance and exit restructured positions, which is perhaps the strongest indicator of our position in the credit cycle.

Across our portfolios, managers are exiting situations that have occupied their portfolios for several years. Often, these were issuers whose capital structures were over-levered going into the financial crisis. The companies limped along for several years after the crisis, but were eventually forced to face formal restructurings. In many instances, our managers played a key role in leading the companies through the restructuring and orchestrated an emergence from bankruptcy. Now that markets are awash in liquidity, new buyers for these companies have emerged, often using today's low interest rates to apply new leverage to the companies. Our managers are happy to exit these positions at today's valuations, leaving the financial engineering to the next owner.

### ***Building Idiosyncratic Investments***

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With low default rates and freely available credit, managers are focusing their attention on situations or issuers that play to their own strengths in specific narrow opportunities. Though each manager pursues a somewhat different opportunity set, their idiosyncratic investments tend to share some common traits.

For instance, some managers are more adept at focusing on legal and process oriented situations, where borrowers have violated the terms of the bonds they issued and must rectify the situation by making more cash flow available to service the debt our managers hold. Likewise, other managers have found opportunities in over-leveraged buyouts that have stumbled. These companies are struggling to meet their growth targets because of increased industry competition and a lack of financial flexibility due to the onerous amount of debt the sponsors used to purchase the company. This is setting the stage for several formal and informal restructurings that are likely to be complicated and, at times, contentious, which plays to the strengths of several of our managers who have a history of favorably resolving these types of situations.

### ***Evaluating New or Emerging Themes***

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Managers are also preparing for more volatility and dispersion across the credit landscape. Several industries are undergoing significant changes that are likely to produce some attractive

opportunities on both the long and short side of portfolios for the next several years. The retail sector is the most notable area under transition today, with companies forced to restructure their businesses to address evolving consumer shopping patterns and preferences. In addition to repositioning their business operations, many of these retailers must also address an unsustainable debt profile. While many of these brands may simply vanish and their inventory liquidated, certain subsidiaries and assets within the retail sector will survive, even in a world where more consumption moves online. This dispersion is an attractive dynamic for our fundamentally-oriented managers.

This dynamic is not limited to retail. More recently, we have seen high yield volatility increase in two of the larger areas of the leveraged finance universe, the healthcare and telecommunications sectors. Both of these sectors are capital intensive, resulting in large, complex capital structures, and both industries are facing a transition where the distribution of economics across the industry is changing. As with retail, there will be winners and losers in these sectors and our managers are keenly focused on both long and short opportunities within these areas.

### **CONCLUDING THOUGHTS**

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We are continually refining our investors' portfolios to both take advantage of the current set of opportunities and mitigate the potential risks we see on the horizon. There will be a time to shift our distressed credit allocation to a more aggressive posture, and we have done so in the past. However, given our view of the credit cycle and the abundance of liquidity in the market, we believe that a conservative stance is appropriate today. After all, distressed credit investing is, at its core, a liquidity providing strategy. Accordingly, it is best to protect capital when financing is easy and then deploy it when liquidity becomes dear.

**DISCLOSURES**

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Hedge fund investing involves substantial risks, including the risk of loss of invested capital. Hedge fund investments are typically made through investments in illiquid, unregulated investment funds that employ sophisticated investment techniques, often involving derivatives and leverage, in a wide range of financial instruments and markets. These investments entail a wide variety of risks, which remain substantial notwithstanding the risk management practices we employ in selecting and monitoring the funds in which we invest. Past performance is not indicative of future returns.

Certain information contained in this document constitutes "forward-looking statements," which can be identified by the use of forward-looking terminology such as "may", "will", "should", "expect", "anticipate", "target", "project", "estimate", "intend", "continue" or "believe" or the negatives thereof or other variations thereon or comparable terminology. Due to various risks and uncertainties, actual events or results or the actual performance of any particular investment or investment portfolio may differ materially from those reflected or contemplated in such forward-looking statements and no undue reliance should be placed on these forward-looking statements, nor should the inclusion of these statements be regarded as Aetos' representation that any particular strategy or objective will be achieved.

Not every client account has participated in each investment or investment theme discussed herein as each account is subject to individually-negotiated investment objectives and guidelines.