SYZ CAPITAL

INVESTMENT VIEWS

PRIVATE MARKETS

JUNE 2020

OPPORTUNITIES AHEAD

GET USED TO A POST COVID-19 WORLD

In January 2020, we published an article where we said: "In a late-cycle environment, fuelled by record amounts of leverage and debt issuances, we choose to build downside protection and diversification by including 'special situations' and uncorrelated strategies. We look, for example, at opportunities that we believe are more resilient to a macro downturn, such as litigation financing, royalties or distressed strategies."

We have been quite cautious around peak market valuations and excess cash invested in the system for some time already as evidenced again in the same article: "With many assets fairly priced, high debt levels, shallow liquidity and the increasing dominance of passive strategies, market conditions are not without risks"

Obviously, we couldn't predict the impact of the COVID-19 pandemic nor its timing, but were convinced that valuations were approaching dangerous levels. The higher they are, the more extreme the next correction would be. We designed our multi-strategy program last year to build a value-driven and very resilient sample portfolio across the market cycles. We therefore included special situations which would not only protect capital in a downtown but actually benefit in a crisis by using strategies such as distressed and secondary's, amongst others.

Nobody really knows yet how this will play out. In 1919, the world counted over 17 millions deaths caused by Spanish influenza, much higher than the casualties caused by the first world war that had just ended. The measures and means were different, but it is not yet possible to predict the outcome with any certainty. Dealing with a pandemic is not trivial. Until it is fully gone, it still burns somewhere, like embers in a fire, which could start again on a windy day.

While we have no crystal ball, and are obviously not epidemiologists, assessing the length of the lockdown, or future waves of contagion, remains a probability game. However, we believe that the economic situation will take some time to get back to normal, probably years, and that we all need to get used to a post COVID-19 environment. As we highlighted last year, a Japanification of the world is more than ever our central scenario, with various implication for portfolios, asset allocation, and investment strategies.

WHAT ARE MARKETS TELLING US?

As of writing, it appears that once again, credit markets are leading indicators to equity markets. While equity investors are pricing for hopes of a V-shaped recovery, despite being the riskier part of capital structure, credit markets instead are looking more closely at downside risks and a deteriorating credit environment in a recession, both from a default and recovery perspective.

At SYZ Capital, we have always been embracing an absolute and relative value approach. We believe that while unprecedented measures have been taken by governments and central banks globally to once again save the going concerns of our economies, these may succeed in keeping businesses afloat in the short term but may not solve longer term structural issues. The implications of social distancing, reduced economic activity, and loss of disposable income will lead to further depleted earnings, as well as an impact on business confidence, related capex initiatives and long-term investments. This will most likely hurt global GDP growth for the years to come.

Even if we find and commercialize a vaccine, it is hard to imagine that we would soon want to squeeze onto a budget flight for a long weekend to a Greek island, and difficult to envisage that long term capex plans will not be affected by an increased economic uncertainty.

In this environment, our focus is very much defensive, geared towards essential businesses, with strong foreseeable cash flows which we aim to acquire at reasonable prices.

GET USED TO A POST COVID-19 WORLD

As in all recessions, leverage is the major factor that could put you out of business when events are not unfolding according to plan. A real threat for levered investors, but an opportunity for those who hold cash.

Recently, I was hiking in the Swiss Alps. Everything was going well until we came to a very steep and icy slope, 100m away from the summit. It was a clear morning with other mountaineers on the same track. My question was not about the probability of falling because the other climbers did not perceive such risk to be high, and realistically the chances of falling were low. The risk was the consequence in case of a fall, with 500m of steep icy slopes covered by rocks below us, a fall would likely be fatal. Turning back seemed to be good risk management to me. However, all other climbers made it to the top. Leverage is quite like this climb. Most times, things will work out well, but if things do not work according to plan, you lose it all with no second chance.

Capital structures have become increasingly complex but also increasingly forgiving. We believe the key is to buy quality credit, offering a significant buffer or downside protection. Getting it wrong and targeting “hope trades” will hurt as recoveries will be lower this time around.

INERTIA AND OVERSHOOTING: OPPORTUNITIES AHEAD

During the bull market, consumers and businesses were taking on more leverage as times were good and they could plan on their future income to repay their debt balance. In period of uncertainty, consumers (even if they still get their full salaries) will spend less and save more in anticipation of potentially being laid off or being given a reduction in their pay slips. The same applies to businesses as they have less visibility on their order book. They will probably rethink capex plans, but delaying such investment decisions too long, and the loss of productivity will be felt as it is moving fixed costs into variable costs, which will hit their margins and competitive positioning. Not an easy decision.

But markets are not always priced on fundamentals. Quite the contrary, markets are often irrational because they are constant discounting machines anticipating forward outlooks as well as taking into account behavioural finance and liquidity. The recent negative price on WTI May 2020 delivery contracts is a good example where technical factors dominate the scene. It is hard to believe that a barrel of oil would be sold for a negative price given that oil costs money to extract, to transport, and to some extent should have some economic value as you can fill your tank and drive on it for miles. Despite the obvious value of oil there were not enough physical off takers with storage capacity in Texas on that day.

Things will eventually stabilize at a new normal, but it will take time. In the meantime, we are ready to take advantage of volatility and overshooting, by underwriting risk in a pragmatic way. Put the retail investor on a steep icy slope high in the mountains and most probably he will turn back before reaching the summit, like I did. With that backdrop, we shy away from moon shots and “if trades” and will continue to favour contractual returns with clear catalysts on the upside, or so-called special situations, benefiting from dislocations in a risk-managed way.

Olivier Maurice
Managing Partner

PRIVATE MARKETS - OUTLOOK

The longest equity bull market since the second World War lead to high valuations and increased total leverage. Since the foundation of SYZ Capital, we have been calling for the elevated downside risk created by such asset inflation. As the cycle turns, valuation multiples will inevitably contract and high debt levels will put pressure across the capital structure.

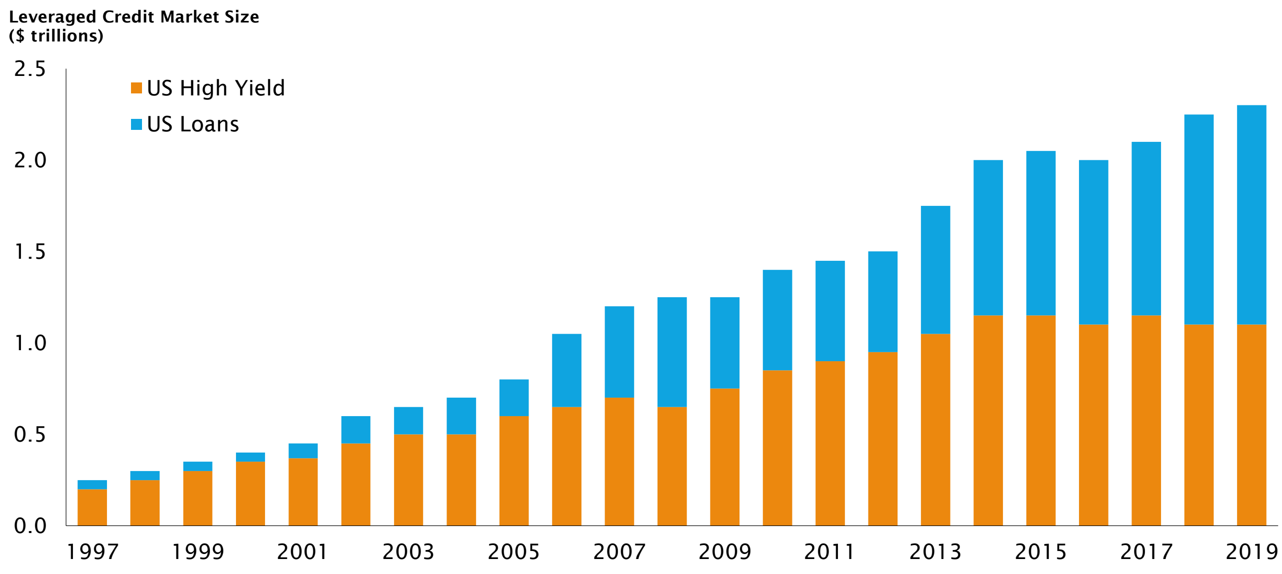
The weak structure of the credit markets, and reduced liquidity, will be prone to increased volatility, more downgrades, increased default rates, lower recoveries and stronger terms for new lenders in a post COVID-19 world.

We are sharing our views as to how the combination of deteriorating fundamentals and weak technicals will create unique opportunities and how we at SYZ Capital seek to seize them.

DETERIORATING FUNDAMENTALS

High corporate leverage: Since 2009, GDP has grown 47% (from $14.6tr to 21.5tr) while corporate credit markets have increased by almost threefold. While US household debt has marginally increased by 10% over the period, and housing related debt remained stable, the sub-investment grade market has vastly expanded, both in HY bonds and leveraged loans.

FIGURE 1: GROWTH OF LEVERAGED CREDIT MARKET



SOURCE: BANK OF AMERICA MERRILL LYNCH GLOBAL RESEARCH

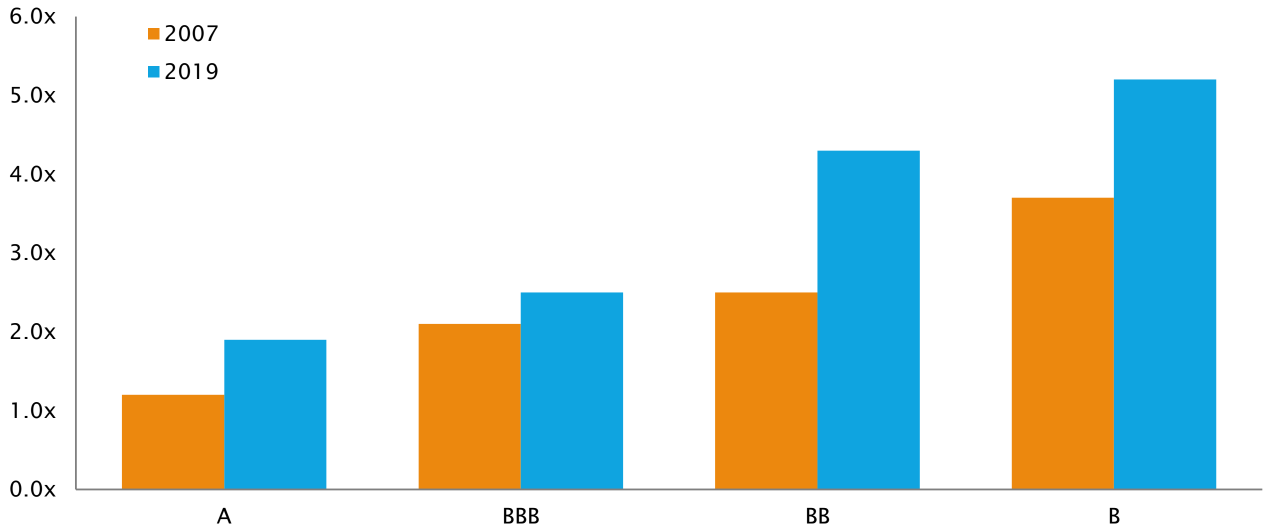
PRIVATE MARKETS - OUTLOOK

Complacent credit agencies: Since the last Global Financial Crisis (GFC), we have seen a sharp deterioration in net leverage across the board. As an example, BB rated bonds are now more levered than singe B bonds in the GFC.

The inevitable rating downgrade to come can therefore only be a lagging indicator.

Elevated leverage ratios: Leverage has gone up on average 1.5x across the board since the GFC, and even 3-4x for some cyclical sectors such as retail, travel & leisure. These will be the first to suffer.

FIGURE 2: NET LEVERAGE BY CREDIT RATING: 2007 VS. 2019

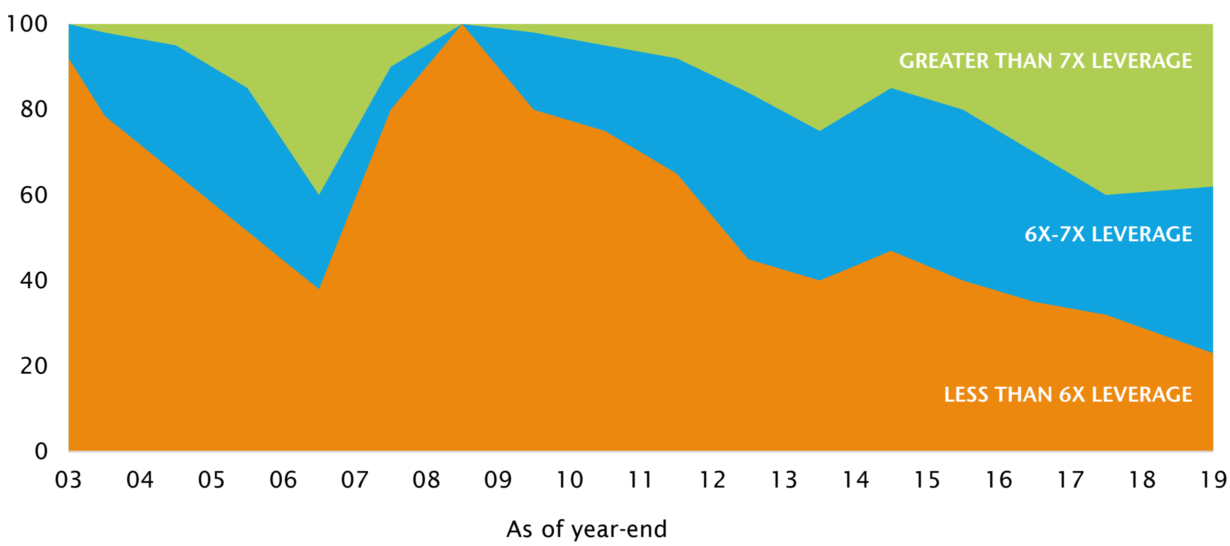


SOURCE: BANK OF AMERICA MERRILL LYNCH GLOBAL RESEARCH

Private equity under pressure: Looking at LBO loans, the debt level is also significantly higher.

The leverage for large LBOs is even more extreme, with a Debt/EBITDA ratio greater than 6x for roughly 60% of universe, double of its pre-crisis average.

FIGURE 3: SHARE OF US LEVERAGED BUYOUT MARKET, BY LEVERAGE LEVEL

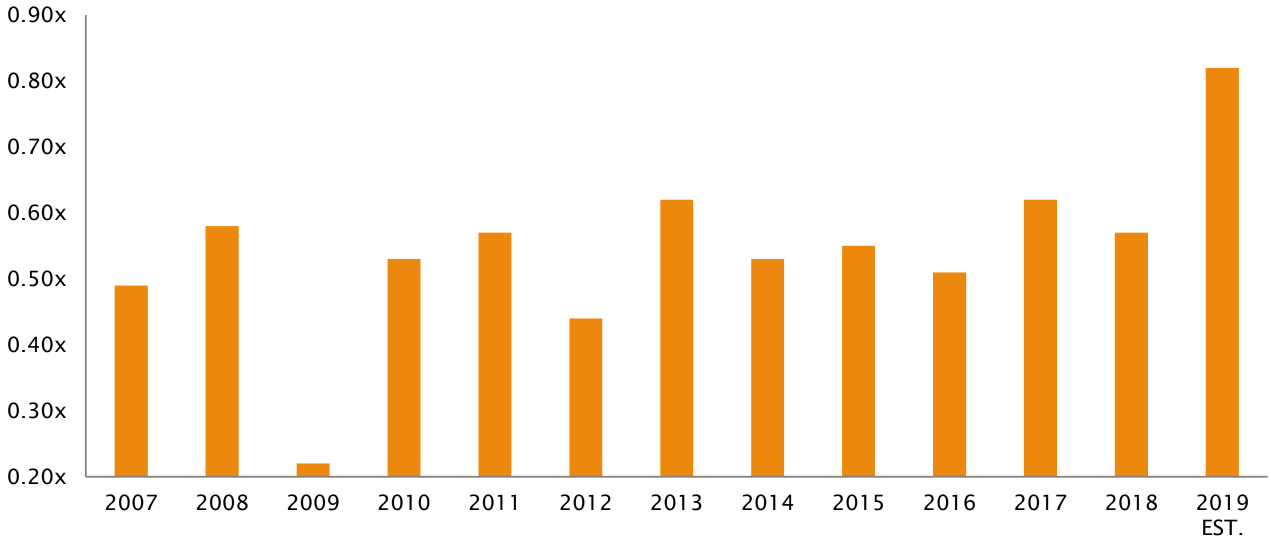


SOURCE: THOMSON LPC

PRIVATE MARKETS - OUTLOOK

EBITDA Adjustments: The published leverage ratios above may be misleading as adjustments (add-backs, proforma, etc) often account for 20% of published EBITDA, which leads on average to a 1x leverage increase from published numbers.

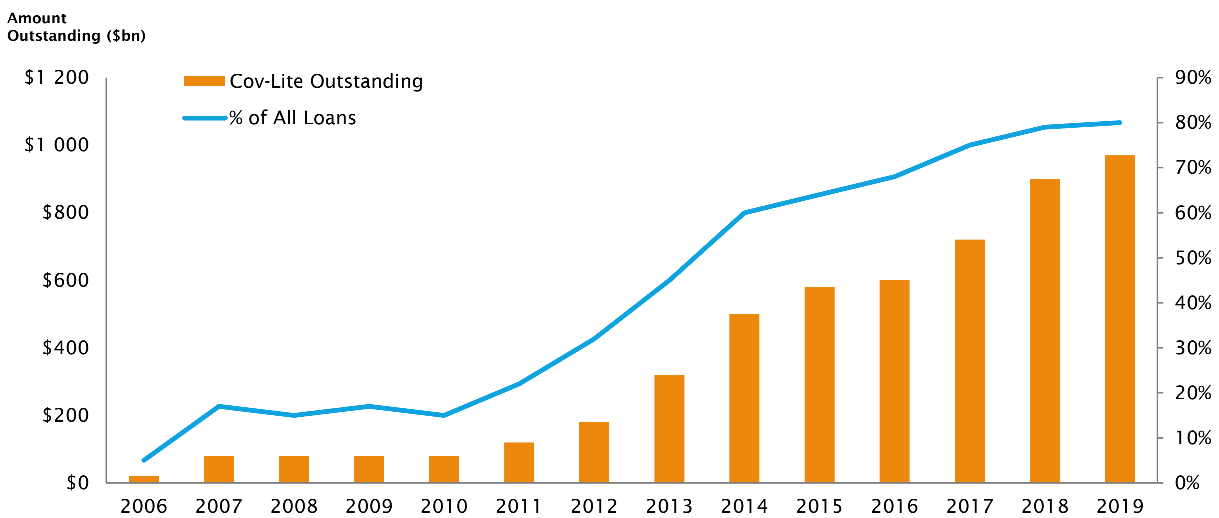
FIGURE 4: AVERAGE ADJUSTMENTS TO DEBT/EBITDA RATIO



SOURCE: S&P LCD

Poor covenants: Covenant-lite loans have increased significantly since the GFC and now represent over 80% of the $1.2 trillion U.S. leveraged loan market. Without these protections, company performance can deteriorate materially before triggering a credit event.

FIGURE 5: U.S. COVENANT-LITE LEVERAGED LOANS OUTSTANDING

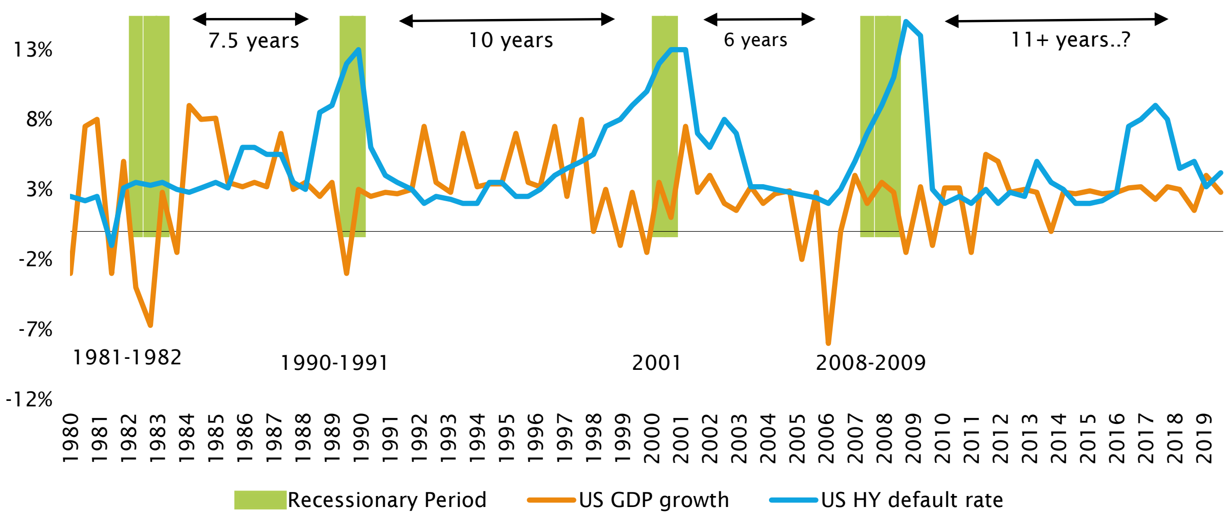


SOURCE: S&P LCD. AS OF NOVEMBER 2019

PRIVATE MARKETS - OUTLOOK

Default rate: Annual default rates peaked at around 10% in the last recessions. The annual default rate during the GFC peaked at around 13%. This time around, as a direct result of no or little covenants, we expect much lower default in the short term, but deteriorating metrics, and potentially higher default rates by the end of 2020.

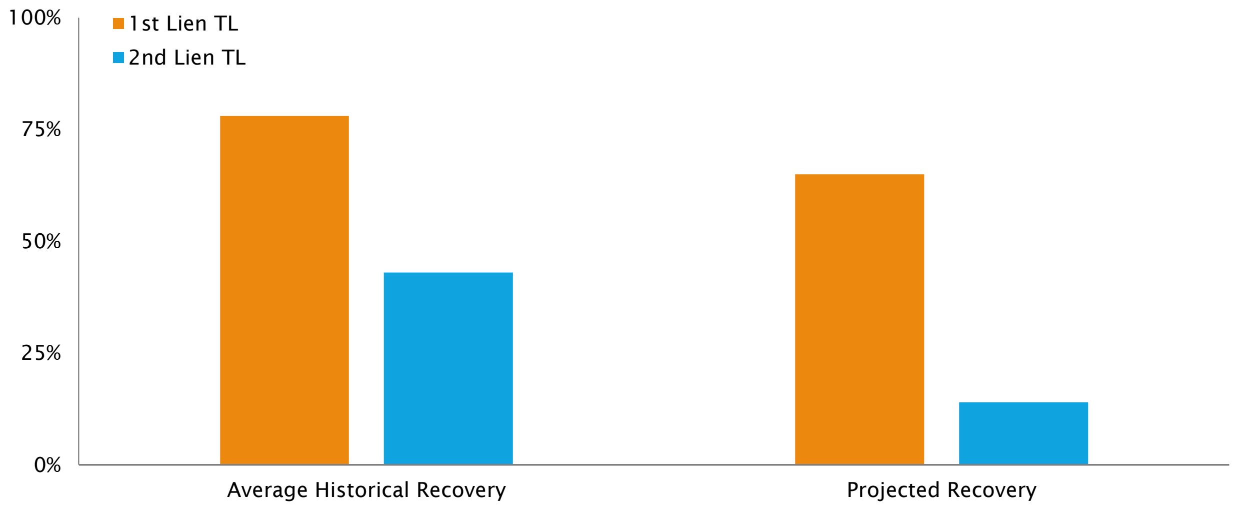
FIGURE 6: DEFAULT RATES THROUGHOUT ECONOMIC CYCLES



SOURCE: MOODY'S INVESTOR SERVICES, FRED ECONOMIC DATA. AS OF SEPTEMBER 2019. ANNUAL DEFAULTS RATES HAVE PEAKED AT AROUND 10%+ OVER THE LAST ECONOMIC DOWNTURNS. IN THE LAST GFC, PEAK ANNUAL DEFAULT RATES REACHED 12% WITH RELATIVELY HIGH RECOVERIES.

Recoveries: The absence of covenants allows borrowers to “kick the can down the road” as lenders do not have the possibility to exercise oversight and act before it's too late. This time around we should expect lower recoveries as the credit event will likely occur when the financial conditions and balance sheet of the borrower have materially deteriorated.

FIGURE 7: LOWER EXPECTED RECOVERIES



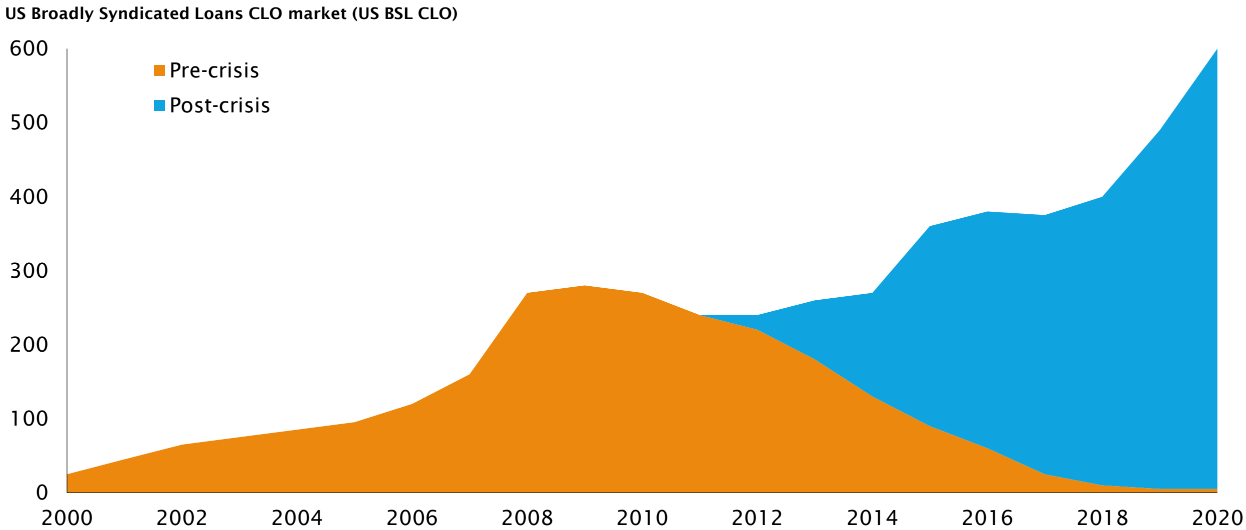
SOURCE: DEFAULT & RECOVERY ANALYTICS, MOODY'S

PRIVATE MARKETS - OUTLOOK

WEAK TECHNICALS

Passive investor base: Since the GFC, we have seen a tremendous growth in passive investment products (ETF, trackers,...) or actively managed ones with rigid investment mandates (CLO, mutual funds, ...), often associated with liquidity mismatch. As per leveraged loans, particularly relevant for the private equity industry, their ownership is dominated by CLOs, who in turn are owned by a variety of bank and non-bank lenders. Most of these passive investors have "bucketed" mandates and may become forced sellers upon a downgrade.

FIGURE 8: POST-CRISIS CLO MARKET IS NEARLY DOUBLE THAT OF PRE-CRISIS



SOURCE: LCD, INTEX,BLOOMBERG, REFINITY, KANERAI, BARCLAYS RESEARCH. AS OF 31 DECEMBER 2019

Lack of liquidity: Market making activities significantly declined since the GFC because many banks exited the business and those remaining had to shrink this business. As an example, dealers' High Yield (HY) inventories fell from $40bn to $3bn, and overall corporate bonds inventories declined from $250bn to $30bn.

Volatility: As the credit agencies catch up with downgrades, this will cause many distressed opportunities as some "passive investors" will be forced to dispose of securities that no longer fit their mandate. The weakest segment of the market is the lower investment grade BBB bonds. As these get downgraded to sub-investment grade in an environment characterized by limited liquidity and a much smaller natural audience for high-yield paper, the price drops of such "fallen angels" will be important.

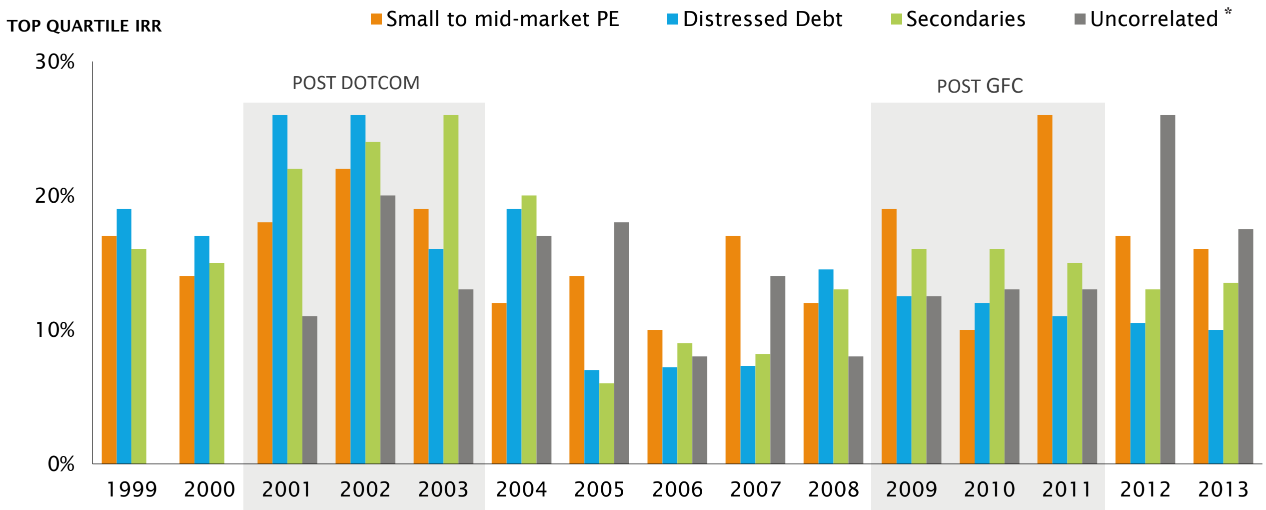
PRIVATE MARKETS - OUTLOOK

CONCLUSION

Weak fundamentals will lead to downgrades. Downgrades will trigger forced selling. Such forced selling will occur in a low liquidity environment, creating excessive price drops and volatility.

The current environment will create various opportunities for our flagship strategy across its investment verticals. Distressed investing, restructuring, litigation financing and secondaries appear to be well positioned, but also private equity as not all companies will be equally affected. High growth can still be found in a recessionary environment for patient, disciplined, diligent and selective investors.

FIGURE 9: RECESSION VINTAGES OUTPERFORM



* Simulated portfolio of litigation finance, music royalties and life settlements
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