EXPERT Q&A

You don't need mass distress to make compelling risk-adjusted returns in Europe, says Elad Shraga, partner and chief investment officer at Signal Capital

Positioning for sizeable pockets of opportunity

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Q How would you describe the current distress you are seeing in Europe? Is it different to previous cycles?
For context, our investment approach focuses on private, mid-market, bilateral investments underpinned by real assets. Our deals will typically have some special situation or complexity associated with them, where our capital offers a structured solution. We consider stressed and distressed opportunities, companies or assets with challenged capital structures, situations with time sensitivity, amongst other things. As such, we cast a broad net across sectors and geographies (predominantly in core Europe), and through cycles, have invested in many variations of dislocation, stress and distress.

Currently, there is definitely background stress in the market in the sense that there are real strains on the periphery, but it is not yet a broad-based opportunity set. In order to find real value, you have to get behind rather than in front of situations, accessing the risk in its various illiquid forms or via specific opportunities (rather than buying a broad swathe of the sector).

We have not yet reached a point where real stress has proliferated. There are some functioning parts of the credit market. However, there are specific sectors and themes that exhibit substantial dislocation. Still, generally speaking, our outlook is more constructive than consensus has been. We have maintained throughout the recent tightening cycle that if a recession does happen in Europe, it will be somewhat technical. Our view is that banking distress may impact the availability of capital and benchmark rates are probably not going to go lower as fast as the market is currently predicting, thus creating periodic pockets of capital dislocation.

We expect issues in over-levered capital structures (due to more restrictive financing terms) where the ultimate underlying businesses remain positive. If a business is doing well but the capital structure is stretched, that

is where our approach of customising debt solutions and underwriting on a deal-by-deal basis becomes attractive. You don't need mass distress to make compelling risk-adjusted returns.

This time is different, with the closest parallel perhaps being before the Greek crisis when everybody understood there was downside but that policymakers could save the day. Policymakers today are getting ahead of the curve but with a substantially reduced tool chest, due mainly to the inflationary environment.

Q How does the today's European landscape compare with what you are seeing in the US?

From a market structure perspective, Europe is substantially different to the US. In the US, the vast majority of balance sheet financing is provided by capital markets and alternatives, whereas in Europe, the majority of the debt stack comes from the banking system. That means that in the US things tend to get priced through the market, while in Europe, it is almost digital (depending on availability and price of bank balance sheet). At present, with banks tightening their lending standards, we clearly see a material repricing of capital taking place across our focus areas.

The way to access the special situations opportunity set in Europe is predominantly through bilateral deals. If you overlay that with geographic dispersion – meaning lending in Germany is not the same as lending in Spain – one's ability to originate deals is better rewarded in Europe than it is in the US, mainly with increased pricing-power.

In terms of the macro environment, Europe is definitely a slower growth zone for many reasons. The EU is very much an export-led block. That means economic growth gets imported rather than being consumer-driven (like in the US), which creates different sensitivities. It is important to understand that Europe does not have the same inflation profile as the US, where it is mainly demand driven; here it was an energy shock that is now flowing through to other sectors. Price inflation in the EU will not have the same half-life as in the US. We expect inflation to ebb faster in the EU.

Overall, we believe that the ECB is going to be persistently behind the Fed in this tightening cycle, letting inflation run hotter than in the US. One potential challenge on the horizon going into 2024 is the still uncertain energy complex in Europe. We are not sure that the energy threat in Europe is fully solved given that there was a lot of patchwork done through the winter; the problem is we may have married ourselves to high energy costs, making the European manufacturing engine somewhat uncompetitive globally. Long-term, Europe will need to construct an energy solution that will

Q Where do you see the most exciting opportunities?

One of the broadest opportunity sets that is beginning to show real stress is the commercial real estate sector in Germany and the UK. German commercial real estate has historically benefitted from broad access to cheap financing. Now the rising cost of financing and cap-rate widening are materially impairing equity and resulting in over-levered structures.

In the UK, the rising cost of financing is also a real issue. This, coupled with what is likely to be deeper recessionary pressures on the UK economy – compared to the rest of Europe and the US – creates a backdrop of scarce financing alternatives.

Away from commercial real estate, we continue to see dislocations due to financing availability. Notably, about 18 months ago, there was a sudden increase in the opportunity set across a variety of resource-based financings.

We entered into a few investments successfully, but understood that to fully capture the opportunity, we needed someone of true stature in that tight-knit community. In the summer of 2022, David Gallagher joined us from Morgan Stanley bringing over 25 years' experience in commodities, principal investing and derivatives. There has been a wholesale exit of the financing market for this sector, so the cost of capital has increased, forcing assets to change hands at very attractive levels to the acquirer. David is now focused on deploying capital into special situations financing opportunities across transitional energy and existing energy production assets. We think given the unlikely return of the more traditional lenders/capital providers that this opportunity set will persist well into 2025.

Finally, we see an opportunity in the ABS structured credit space, which could be securitised papers or CLOs. That market is very much risk on-off, and it tends to become very illiquid, very quickly. Given our type of capital, we can look at deep value and harness the illiquidity premium. This gives us an advantage in investing, particularly in periods of liquidity squeezes – like during summer's LDI crises.

allow its industry to remain competitive without state subsidies.

Q Do you find it harder to originate deals as uncertainty increases?

Our origination has been a strength at Signal because we have built a high-calibre, senior team, each with over 20-plus years of investing and structuring experience. Some even say that our team is outsized versus the capital we manage.

Our strong view is that, going into this uncertain environment, you need that senior risk lens in order to be efficient with time and resources. There is a risk of spinning wheels in the hunt for opportunities. The only way to avoid that is to draw on experience and know when something is going to work and when it isn't.

As uncertainty increases, you need to be tactical, you need to execute with speed and tenacity, and you need to be razor sharp. Critically, we feel that to execute effectively into specific sectors, one needs to penetrate the ecosystem; therefore instant credibility is key.

You also need to be able to address complexity with flexible capital. We have stayed away from concentrating into geographies or sectors, and instead maintain flexibility of origination. We don't zone in on a sector and hope to find opportunities. Rather, our approach is about looking through a geography, through a sub-sector, into a specific situation. This allows us to create a diversified portfolio of idiosyncratic deals with a common feature of downside protected risk-adjusted returns.

Q What will set successful credit managers apart in this kind of environment?

In this environment, we think that downside protection is the most valuable risk management tool that one can exercise. That has always been our focus and is even more keenly adhered to today. Downside protection can be achieved in many ways, using deep structuring, extensive and customised covenants, as well as focusing on real assets or uncorrelated assets on the balance sheet. In some cases, you have to rely on workouts and restructuring expertise for capital protection, so having a team that has been through multiple investment-cycles is going to be critical too.

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We also firmly believe that in this environment, success is achieved by treating your backers as your true partners. As much as we think about our counterparties on the deal side in that way, it is important to think about investors in the same vein. Being transparent, being available and being regular in your communications is going to be more important than ever. An approach based on leveraging seniority and expertise to navigate and avoid pitfalls will matter to them.

Finally, we need to be able to understand the underwrite scenario efficiently and blend that with the macro backdrop; this blend of micro and macro risk management is something we consider rather unique in the special situations investing sphere.

Q How do you expect your strategy to evolve in response to the changing climate?

We set out to be opportunistic in our capital allocation and in our focus on investment opportunities, overlaid with absolute discipline on how we position and manage risk. Over the last eight years we have seen the benefit of that opportunistic approach, as we have been able to adjust to the investing environment and seek out the best risk-adjusted returns. Going forward, we expect to see the continued ebbs and flows of opportunities, but we are well positioned if there is broader-based dislocation.

Our type of investing is all about focusing on bespoke crafting of risk and managing it through the cycle. This is ultimately a somewhat traditional investment approach largely based on human capital and experience, but one we think will prove invaluable in this investing environment. ■