# PAUL TRIGGIANI

## Distressed Credit and Special Situations with Paul Triggiani of Invesco

GUEST Q & A

**Stewart:** Welcome to another edition of the InsuranceAUM.com podcast. I'm Stewart Foley, I'll be your host. Today's topic is private distressed credit and special situations, and we're joined today by Paul Triggiani, Managing Director and Head of Distressed Credit and Special Situations at Invesco Private Credit. Paul, thanks for taking the time to come on. We certainly appreciate it.

**Paul:** Yeah, great to be with you today.

**Stewart:** We're thrilled. This is a great asset class. We want to learn about it. I've got lots of questions for you. Before we get going too far, we always ask our guest, where did you grow up? What was your first job? Not the fancy one, and what makes insurance asset management so cool?

**Paul:** The third one's tough. I'll have to think about that for a second. But the first two are easy. I grew up in the suburbs of Maryland, now very developed area, and my first job was as a produce boy at the Country Counter grocery store.

**Stewart:** There you go. Character building.

**Paul**: Yeah. Now what's so great about insurance asset management, lots of money to invest. Lots of ways to think about risk. Risk is a big part of what we do in terms of thinking about our investment philosophy. We'll unpack that I suspect a bit in terms of how we think about risk and manage risk. But one of the things that we always talk about investors in the insurance asset class about and we focus on is how we think about risk and how that integrates into our philosophy. So that's what's exciting about it to us.

**Stewart:** That's terrific. And I mean, I'm a fixed income geek, but not in the distressed area at all. So it would be helpful to just talk about an overview of your investment philosophy and approach when managing distressed debt. But I think before that, even, can you sketch us a definition of distressed debt?

**Paul**: Yeah, so let's talk about two different ways to think about this asset class because it can be a bit confusing at first, right? So thinking about buying into a company's capital structure, they have debt and equity. There may be various reasons their debt is, when issued at par, 100 cents on the dollar available to folks like us at 50, 60, 70 cents on the dollar. Some of that might be interest rate driven, some might be company performance, or it could be a mixture of both, could be refinancing issues that they're having. But we like to sort of segment it simplistically into two buckets.

There are those who trade distressed at meaning they're buying something at 40 cents and they think it's going to go to 100 and they're going to sell it. And then there are folks that do what we think of as distressed for control or special situations investing where we're accumulating a debt position, typically a majority position, and we're going to restructure the business and convert our debt ownership to equity ownership in the business. So we fall into that latter camp, which can feel a bit more like private equity in some ways. And there are some important distinctions which we can get into in terms of how we differ from that asset class. But simplistically think of it as trading versus debt for control.

**Stewart:** That's super helpful. What types of distressed assets do you specialize in? And the types that come to my mind are corporate bonds, loans, or distressed equity. So where are you focused?

**Paul:** We are focused on a pretty niche market in that our strategy targets small capitalization, lower middle market companies. So typical company for us is going to be a loan-only structure. It's not going to be big enough to have high yield bonds generally. There are some exceptions to that. There are some small high yield secured bond issuances in the Nordics, for example. You don't see them very much in the US anymore, but there are still some over in Europe and the UK. But we generally focus on smaller companies, think average EBITDA, and everybody has a different definition of small capitalization.

So we think generally companies with on the low end, $100 million of debt, a high end, maybe five, $600 million of debt. They tend to be senior secured loans and they're almost entirely private equity owned businesses. So the private equity firm would own all of the equity and they would go out and issue debt to buy this business. And when that debt becomes distressed, that's when we get interested.

**Stewart:** So can you talk about just the macro background of distressed investing, particularly as it relates to the growth of the loan, high yield direct lending markets over the last 10 years?

**Paul:** So if you think about one easy comparison to make is the size of the leveraged credit market overall, if you include loans and high yield is up anywhere depending on who's estimate you use, pre-GFC to today, 3 to 5 X. And a lot of that growth has come from private credit direct lending, which has become 1.5 to 2 trillion part of that asset class. And a lot of that growth has come from Europe where the growth and leverage credit has expanded dramatically over the last 10 years. So the market is much bigger today in terms of what we can address as distressed investors. But that in and of itself doesn't make something interesting just because it's bigger.

What's interesting is how it got bigger. There's still quite a bit of regional bank participation in these smaller loans to smaller companies in Europe. Regional banks generally sell pretty quickly when a company gets into distress, even if it's just financial distress because the capital charges they have to take if they hold assets that are non-cash pay or going to convert to equity are negative. And then there are obviously the vast majority of direct loans that have been made are going to be just fine. But there are some standalone managers and club deals that were done that don't have in-house restructuring capabilities. And those folks in particular as we live in a higher interest rate environment for a longer period of time, will run into some problems and they're going to need to sell their debt to folks like us.

What makes the next year or two so interesting from a distressed point of view is there's an old adage that distressed investors have used for years, which is that folks like us buy good companies with bad balance sheets. And the reality is that while that's a great marketing slogan for the past 25 years, it really hasn't been true. If you think about every cycle we've been through, '01-'02 was very tech, telecom, broadband-related, right? '05-'06, we had an auto cycle during the GFC, very industry-specific issues around mortgages, banks, home builders, building products, et cetera. We had an oil crisis in 2015. You could argue the last 10, 15 years have been an industry cycle in retail, as Amazon disintermediates every retailer, right? And even COVID vintage funds, '20 to '22 had certain industries that were drastically more impacted than others.

So the point we're making is that if you look back over the last 5, 6 cycles, 25 years, you've always invested during a cycle in industries that had some kind of secular issues to them. What's interesting right now is that there's no company that's immune from inflation. There's no company that isn't experiencing pretty dramatic inflation in their cost structure, not to mention 400 incremental basis points of borrowing spread that they have to endure, which equates to about 20% of EBITDA degradation.

So costs are up. We're starting to see the consumer pull back, industrial production pull back a little bit. And so what you have right now is really your pick of the litter, so to speak, rather than in the past you've had to enter certain industries that may have had some kind of secular distress. You don't have that issue right now. And it means as a distress manager, you can skew your portfolio in terms of the opportunities you look at, to really, really sound companies in sound industries. And it's the first time in this asset class that you've really been able to do that with the entirety of the opportunity set. So there's no reason to spend time on operating turnarounds or industries in transition, and that may generate higher returns, let's hope. But what's more interesting about that, particularly for your audience, I think, is that it means there's a lot less risk in this coming vintage of distress than we've seen likely in a long period of time.

**Stewart:** That's a really interesting assessment and helps me understand how you approach it in particular. How do you assess credit risk and determine the potential for recovery in distressed assets?

**Paul:** So when we look at a business, there's two initial thoughts we have. One is, and it's helpful just to think about it, what we're after is asymmetric return profiles. If investors want to find symmetric returns where you can make a lot of money but lose all your money, you can buy listed equities, you can buy private equity. There's lots of places to express that opinion. Our job as distressed investors is to find places where you have credit downside protection, but can make equity-like returns. So the first thing we're thinking about, is this a good business? Is it in a good industry? Does it generate a good return on invested capital? And is it a business ultimately we want to own? Because again, going back to your question a few moments ago. Everything we touch, we want to convert that debt to equity ownership through a consensual restructuring of the business, free up the company from a lot of leverage, reinvest in it.

So our exits are typically buying a business, de-leveraging it, reinvesting in it, growing it, and then selling it 2, 3 years later to private equity, to a strategic, maybe one of our companies gets big enough to go public. We have one that is large enough now to do that. And so it all comes back to fundamentally sound business that we can grow and sell onto someone who can take it to the next level. But it starts with thinking about risk and then thinking about the quality of the underlying business itself.

And the final point on that really is you think about how do you try to make money for investors? There's two ways. One is being extremely cheap. So buying distressed debt at a big discount to what you think the business is actually worth. That's the easy way. And then what do you do with the business once you own it, right? How do you add value?

**Stewart:** And it's interesting because I think that your focus on risk is music to the ears of the people who listen to our podcast. So how do you mitigate, I think this is what every CIO that I know of right now is thinking, is like if something goes bump in the night how do you mitigate downside risk? What measures can you take? And can you give me an example of one that we can talk through?

**Paul:** The easiest way to do that is the comment we just made, right? Buying something well inside the value of the business. So if the business is worth $200 million and you can buy it through the debt at a $100 million, you've created that investment at a 50% discount to its intrinsic value. Another way you can do it is I mentioned most of the companies we look at are small. They tend to be first lien senior secured only debt structures, or maybe there's a little bit of second lien or mezzanine, but our entry point 90% plus of the time is in senior secure debt. So top of the capital structure, least risky part of the capital structure and also the part of the capital structure that controls overstructuring. So that's a huge mitigate.

When we restructure a business, we don't convert the debt to 100% equity. So in that example I gave you of a 200 million company, we may take leverage down to $40 or $50 million through a restructuring, we'll take back that piece of debt and then own hundred percent of the common equity of the business. So we're still keeping a little bit of debt on the business that pays us a nice coupon, but we own all of the equity of the business as well.

The de-risking piece is actually the simplest from an explanation point of view. And that if you have a company that's over-levered, as $200 million of debt in our hypothetical example, is paying high cost interest on that and you snap your fingers and restructure the business and now it has $40 million of debt, you can redirect all that interest that was being paid on that over-leverage balance sheet back into growth avenues of the company. So that in and of itself, that financial de-risking we call it, which is sort of part one of our value creation, is another really simple, easy way to free up capital. And what management team doesn't want less debt on their balance sheet, more money to invest in their business, and by the way, their equity underneath a lot less debt as well.

**Stewart:** And I've heard this said by folks who are in the private credit space that, "Hey, these are floating rate assets and rates have reset and everything's great." And you go, "Okay, yeah, but..." That gets me to the question of, how are these small cap borrowers able to absorb the backup in rates that have happened over the last two years? Because not everybody, to your point earlier, not everybody's going to be able to deal with these substantially higher rates.

**Paul:** It's a great question and you might even add onto it. What about lapping another year of these rates and what does that do? So if you look at just the small cap universe that we target, on average fixed charge coverage ratios, so think of that as just simply your cashflow to coverage your interest expense, right? It's about 1.13 times right now on the cohort of 5,000 small cap issuers we look at in the private credit space. And if you look at how many are below one, it's about a third. If you proforma another year of rates where they are now in terms of base rates being north of 5%, you get to about just under half of that universe being sub one times.

So the answer to your question is many of them can't already, and a large chunk a year from now aren't going to be able to. And what I think many folks that make that comment are focused on is, there's been a bit of a myopic focus on how much more the Fed is going to hike. Is it another 25 basis point? When is it coming, when is the first cut? And until the last 2 or 3 weeks, you haven't really heard people talking about, well, the fact that it's going to be high for a lot longer at base rate, right? It's going to remain elevated for longer than folks thought. And when it reverts back, it's not going back to zero post-GFC levels, right? It's going back to, what, 3%?

So it's higher for longer, and when it does revert back it's going to be at a higher level than we've endured in a decade and a half. So it's a fundamentally different paradigm for the next 2 or 3 years in terms of thinking about how these companies are going to deal with that. Many folks will pick their interest. Many folks will find ways to extend the maturity of their facilities, but there are folks who will have maturities in '24 and '25 and they'll need to be proactive and find ways to restructure their businesses.

**Stewart:** That's very helpful. So what recent trends are you seeing in the distressed debt space and how have those trends influenced your decisions in distressed debt?

**Paul:** If you think about the simplistic view I painted of trading distressed debt and buying debt to own a company, that's generally been the MO, if you will, for the past 25 years in this asset class. The situation we just talked about, about a private equity firm owning a business that's over-levered, having maturity in '24 or '25, maybe even early 2026, these are very smart funds. They're smart individuals. They're looking at their capital structure and saying, "Huh, I may not be able in 18 months to grow into this capital structure and get a refinancing done. So maybe I should reach out to my lender group and talk about incremental liquidity, a way for a special situations transaction to come in and maybe provide rescue financing or incremental liquidity and at the same time potentially extend my maturities."

And so typically our funds or strategies would be entirely debt for control or catalyst-driven distressed credit. But what you're seeing more recently, particularly in the last 12 months, is the strategy being much more focused and evenly balanced between distress for control transactions and special situations transactions, rescue financings, liability management transactions, amend and extend transactions where the creditors are putting in more capital and earning good returns. So I think if you asked most folks in my chair what they expect for this next vintage is an overweight of special situations types of transactions versus distressed for control, which will be the first time we've really seen that part of the toolkit expressed in such a major way.

And private equity firms being proactive with their lender base to solve liquidity needs, is a very, very new phenomenon. That's not something that happened up until the last 12 months or so, and we think, and we're already seeing it, that that will continue to increase and become a large part of what we do in follow-on vintages for frankly the entire universe, large-cap, mid-cap, small-cap, distressed managers.

**Stewart:** That really helps. I mean, I'm learning and as we walk through here, I feel like I'm getting a good much better understanding of this market than I have when we started. Is the opportunity set limited to the US or are you seeing opportunities in Europe and elsewhere?

**Paul:** It's interesting. It's very broad based, and it really started a couple years ago in that, if you think about 2019, the end of 2019, take yourself back to pre-COVID times. And you think about how the US economy was doing then, you know, growing 2-3%. Asia Pacific, 6-7%, but Europe was on wobbly footing in 2019. You had a negative quarter in the UK and Germany, which are really the growth engines of UK and Europe.

And so Europe went into COVID, so to speak, on weaker footing. And if you look at the sort of recent economic indicators coming out of Europe over the last couple of quarters, if you were to bet and say, "What do you think is a more high likelihood of a recession UK/Europe or the US?" You would say UK/Europe right now, we're not macroeconomists, but we read the same information probably many of your listeners do, and we spend a lot of time studying these data points. And so you focus on the fact that you do have the growth engines in Europe slowing. A chance of a recession there is more likely, and it's quite possible, the US skirts one.

So the opportunity set is very broad. Our portfolio, when we look at it, our pipeline, I should say when we look at it, is pretty evenly balanced between the UK, Europe, and the US. And we expect that to continue and potentially even be overweight in the coming years, Europe and the UK, given the potential higher likelihood of a recession there.

Final point on that though is that in the end, whether these economies and individual countries have a recession or not is far less important than what your view on rates is, because we can skirt a recession globally, but if rates remain elevated at these levels for let's just say another year, which I think is very reasonable in our view, that's going to cause all of those issues you asked about a few minutes ago in terms of strains on coverage ratios and refinance ability for those that have maturities in the next 12-24 months.

**Stewart:** That's super helpful as well. So we've talked a little bit about downside mitigation. What are some of the features of this asset class that your insurance clients have found attractive?

**Paul:** So probably a few things. One is that because we're investing at the top of the capital structure in senior secured loans, they all tend to be current pay and they're current pay through restructuring and they're current pay once we restructure the company, because we do keep a little bit of debt on the company, we don't relever it until the company is very stable and growing and healthy again. And when we do put third party leverage on, it's at de minimis amounts. But that ability to keep getting a coupon out buys your basis down, de-risks you, gives you some of your bait back. And I think many of our insurance LPs find that very helpful.

I think the other piece of it is, senior secured debt is obviously a very protected part of the capital structure. You have a mortgage on all of the plant property equipment, IP, intellectual property, if that's applicable. You have a lot of control in the restructuring process in many jurisdictions. Take the Nordics as an interesting example, as a secured creditor, you can share pledge and force and restructure the company in 24 hours on a default.

**Stewart:** Wow.

**Paul:** So there are some jurisdictions that are incredibly... Everywhere we invest is favorable to secured creditors, but there are some that are extremely favorable. And so those things tend to resonate. I think the other thing that resonates with that client base is the fact that it is a nice hedge against other parts of the portfolio they have on because it does tend to have much more of an asymmetric skew than other parts of their portfolio, so to speak. And so all of those things sort of combined, each one in and of themselves is not a reason to invest or to be in distress. But combined, I think they make it easier, in our view, for insurers to wrap their arms around this as something that does have good risk mitigation in place if it's done correctly.

**Stewart:** That's great. And just on the wrap here, what are you most excited about as you've been in this business a long time, you know the market well. What are you most excited about looking forward?

Paul: I think the most exciting thing that we're seeing, and again, this is a generic statement that applies to anyone that's in the distressed business, but as an asset class, this is really the first time you're going to get to have a really wide open market to choose really high quality businesses that have nothing operationally wrong with them, that are all suffering from right side of the balance sheet issues. In other words, the over levered rates have gone up, challenges refinancing.

And when you look at the maturity wall, and we're not big fans of throwing up big maturity walls and saying, look, what's coming. When you look what's inside the maturity wall, the credit quality in terms of, there's a lot of lower rated credit that's embedded in that and a lot of challenges getting a lot of that lower credit refinanced in '24, '25, '26 in the cohort we look at, given where rates are today. And the ability for you to enter this asset class, thinking about it less from a return point of view, that this might be the greatest vintage. You hear a lot of folks talking about this is a golden age coming of distress from a return perspective. And look, we all hope that's true, but we think the better way for investors to think about is, is the reason it's a golden age potentially is you're going to take a lot less risk and your probability of making those returns with less risk is higher than it's ever been in this asset class. That's super exciting.

**Stewart:** That is a really compelling set of facts, and it's honestly the first that I've really been able to focus on this area. So I really appreciate the education here for both me and our audience.

On the way out the door, we have two fun questions. You can answer either or both. Lots of people take both, no pressure. The first one is, what's the best piece of advice you've ever gotten or given? And the second one is, who would you most like to have lunch with alive or dead?

**Paul:** Oh, the second one is such a hard question, but... I think the best piece of advice I've gotten is to be patient when you're looking at environments like this. I don't like to use other people's quotes, but I think Buffett has such a great quote on waiting for that fat pitch, and I feel like the pitcher is getting more and more tired every week here, and the pitches are getting slower and slower and fatter and fatter, and being patient and diligent and prudent in capital deployment and having a team that believes in that I think is something I learned from people I worked for over the years and continue to learn today. And I think it's a great mantra to have. There's no reason to rush in. It's a little bit like, "Do you want to be the first guy at the party or the last one thrown out to leave?" No, you just want to be right at the heat of it.

In terms of who I'd have lunch with, I'm going to give you a completely off-the-wall answer since it's a fun one. It'd be Jerry Garcia.

**Stewart:** Oh, very cool. My good buddy is a neighbor of mine, his name is Armand, and he is a huge Dead fan, and it's kind of halfway rubbing off on me, so what a great answer.

**Paul:** Yeah, I'd love to spend an hour with Jerry.

**Stewart:** Very cool. Well, I've learned a ton today and I really appreciate you joining us and giving us a great education on distressed credit and special situations. So thanks for taking the time, Paul.

**Paul:** Great. Thanks for having me. Wonderful.

**Stewart:** We've been joined today by Paul Triggiani, Managing Director and Head of Distressed Credit and Special Situations at Invesco Private Credit. If you like us, please rate us and review us on Apple Podcasts, Spotify, Google, Amazon, or wherever you listen to your favorite shows. My name's Stewart Foley, and this is the InsuranceAUM.com podcast.