

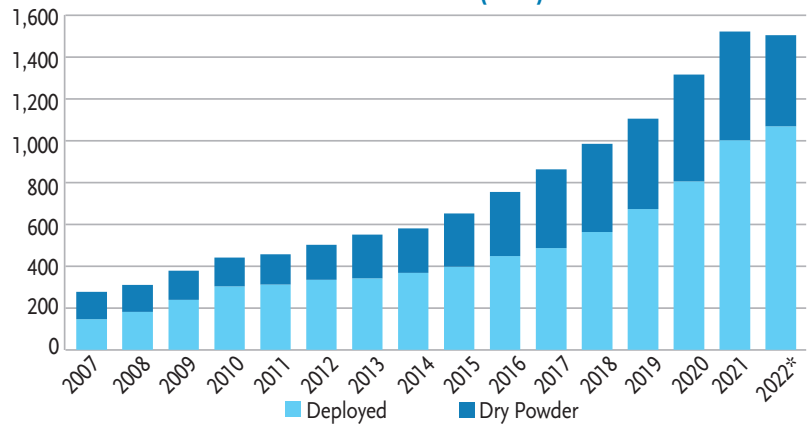
## DECEMBER EUROPEAN CREDIT UPDATE

### PIK, Your Poison

MICHAEL R. CARRION, CFA | RUSSEL HIGGINS | 30 JANUARY 2024

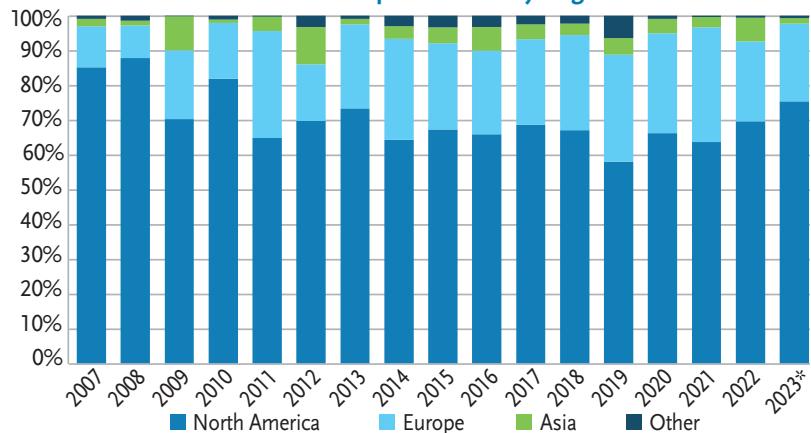
Public credit market participants in Europe and the U.S. were hard-pressed to avoid the topic of private credit during 2023. As a credit investor, you would need to be living under a rock not to appreciate the growing significance of the private credit market, starting with the statistic that the total AUM in global private debt has grown to somewhere between \$1.5 tn to \$2 tn (comprised of deployed and dry powder combined), based on third-party data providers who track this data. That is a substantial amount when you consider that this statistic puts the total AUM of private credit nearly on par with the size of the current outstanding U.S. high yield (HY) or broadly syndicated loan (BSL) market.

Private Debt AUM (\$ bn)



Source: Barclays

Private Debt Capital Raised by Region



\*As of 30 June 2023  
Source: Barclays



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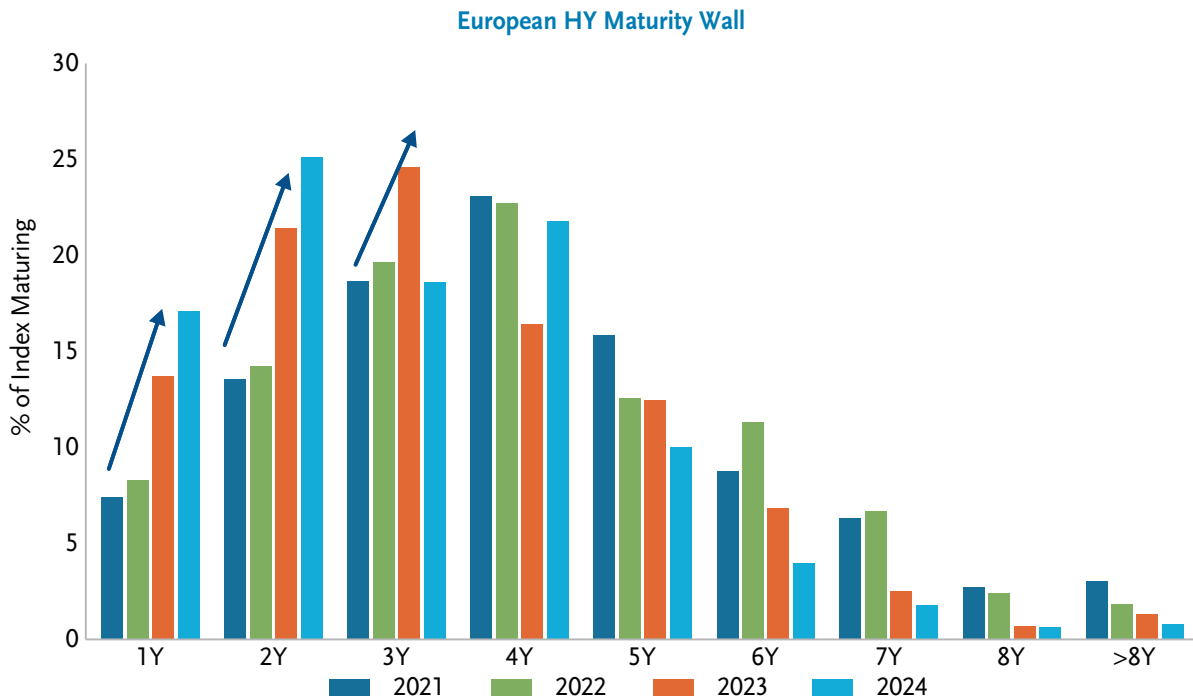
## PIK, Your Poison

A great deal of recent analysis has attempted to contextualize the growing influence of private credit on the public market. Analyzing the market-level data is a worthwhile top-down exercise but not one that we will spend too much time on in this month’s piece. Instead, we will share our bottom-up perspective and some developments that we, as public investors, are already observing in real time in Europe.

Before we get to what’s happening, let’s identify the why.

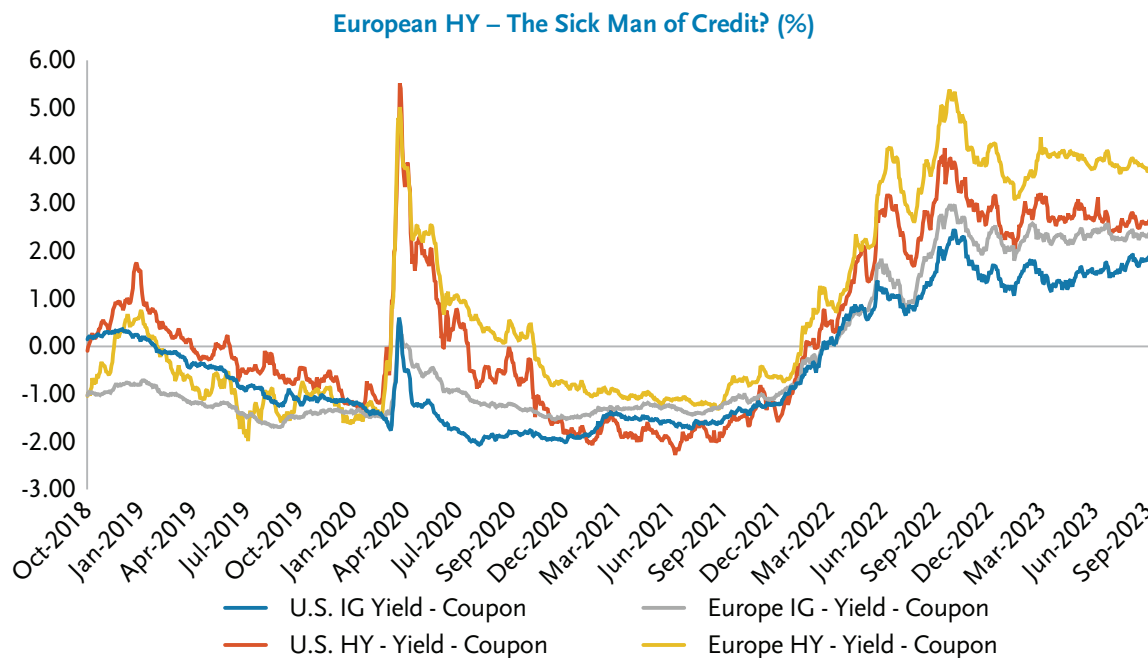
If we reduce the last two years’ fundamental pressure on European companies to one theme, it would be that European companies faced the consequences of decisions made during the prior decade of zero to negative interest rates. As discussed in November’s piece [Lessons in Consequences](#), many financial decisions, business models, and acquisitions temporarily made sense when financed with near-zero coupon bonds sold into a public credit market starving for yield. While the market’s fear primarily drove the volatility in the credit market over the past two years that many of these business models might break or severely bend in the new rate regime under the weight of their excessive debt burdens and ill-advised business models (and often an overreaction that we discussed in [Leveraging Opportunities](#)), upcoming maturity walls are where the proverbial rubber meets the road.

It’s easy to observe that the “maturity wall” for corporate debt is creeping forward. As expected, issuers are holding on to pre-rate-cycle interest rates for as long as possible. At the same time, they are attempting to adjust by passing through higher financing costs, wage and input pressures, and the ongoing structural market changes still intact post-pandemic. And the longer companies wait, the more they extend the time value of the option that they get relief from lower rates in the future. This dynamic has been particularly evident when looking at the high-yield market, which, by definition, is comprised of businesses that employ a higher leverage strategy and are typically more sensitive to the impacts of interest volatility.



Source: Bloomberg

Average sector yields are still meaningful above the outstanding average coupons, with European High Yield standing out.



Source: Bloomberg

The combination of a near-term maturity wall and the potentially unaffordable cost of refinancing would, in a normal environment, elevate the risk of corporate defaults. This occurs as capital providers are forced to decide if they still believe a company's balance sheet and business model are viable, and if so, what level of compensation is now required to remain or become a new capital provider by choice. However, a more optimistic view of underlying demand and, just maybe, some lessons learned in 2020 on the benefits of kicking the can down the road have encouraged stakeholders to come together and find collaborative solutions to bridge to a normalised environment. However, the growing complexity of the required solutions has not been a natural fit for the public credit market, which has now further opened the door to alternative capital providers.

Historically, the most common liquidity solution has been to create secured structures on out-of-scope assets or business carve-outs. Typically, this is a distressed solution as corporates create tiered structures on defensible assets within the restricted group, subordinating the existing stakeholders, often through overlooked terms in the existing facility agreement. The question for those subordinated in the process then becomes, does being primed enable the company to live to fight another day, or is it a bridge to nowhere?

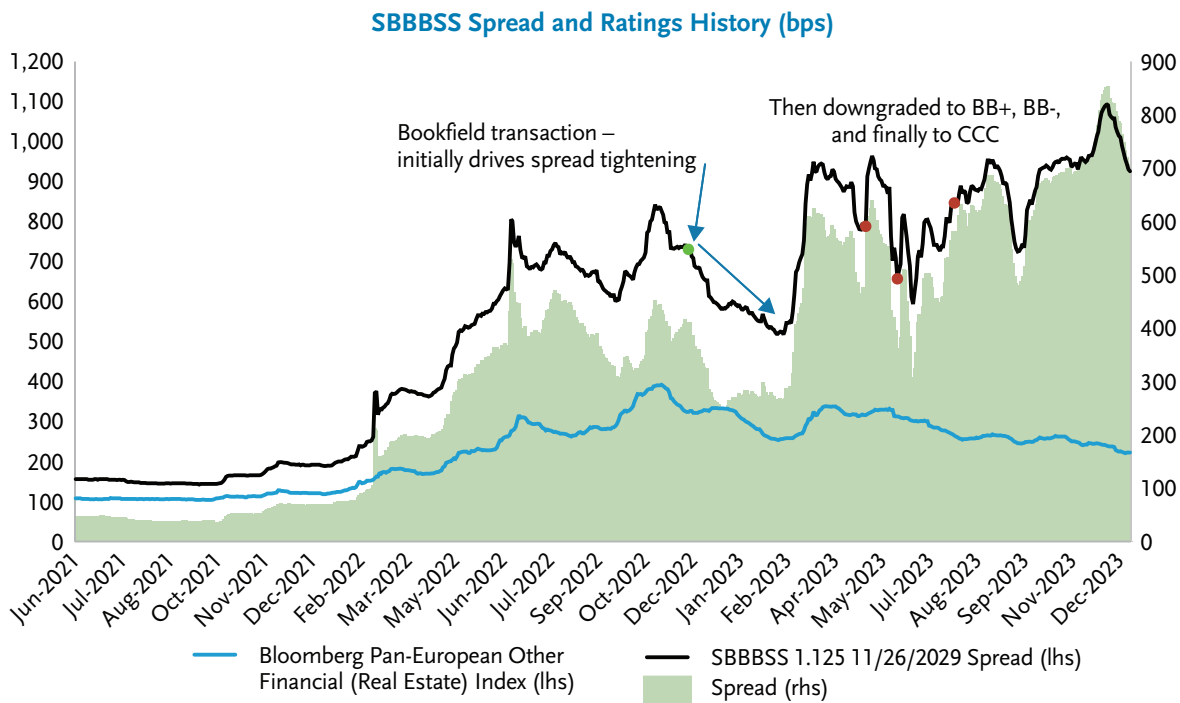
More recently, we have seen "performing businesses" attempt to use similar structures but with a clear attempt to play down the existing capital structure subordination. New debt is instead labelled "preferred equity" or even "common equity," despite the shareholder agreement reading much in the way of a senior secured indenture. In other words, these "equity" structures have very bond-like, first-in-line recovery positions for owners, with protections around governance and asset control that you would typically see in a secured bond structure. Such a creative structure and labelling convention enables companies to list new secured debt as "equity" in their consolidated financial statements. The net result is no increase in reported leverage and a nod from rating agencies that implies that they are more encouraged by the additional liquidity than they are concerned by the risks related to subordination.

Perhaps the most notable name that pioneered such a structure in 2023 was Samhallsbyggnadsbolaget i Norden AB, more commonly referred to by its bond ticker "SBBBSS." SBBBSS is a Nordic residential real estate group that came into focus after a series of short-seller reports that highlighted governance concerns related to the founding shareholder, much of which has been

## PIK, Your Poison

subsequently disproven. SBBBSS’s business focuses on regulated residential and social infrastructure properties (e.g., schools, healthcare, personal care), which we view as the most defensive asset types in European real estate. The company’s problems stemmed from the liability side of the balance sheet as they employed a hyper-aggressive debt-funded acquisition strategy through the last decade, increasing properties under management from SEK7.5 bn to SEK 135 bn over the six-year period from December 2016 to December 2022. Net debt increased from SEK4.5 bn to a SEK98 bn (by our calculation). This pace of growth prevented the company from building out a defensive balance sheet and resulted in an over-levered, short-dated, and inflexible capital structure. SBBBSS became both the poster child of troubled European real estate companies in 2023 and the perfect candidate for a creative liquidity solution.

In November of 2022, the company issued a press release which read, “SBBBSS sells a 49% stake in its social infrastructure portfolio...in cash.” The knee-jerk reaction of the rating agencies clearly took this at face value as one revised its outlook on the company’s BBB- rating to “positive,” encouraged by the “sale” of assets, and another reaffirmed its BBB investment grade (IG) rating. In reality, the details of the transaction revealed that rather than a sale, the economics of the deal meant that a prominent private credit investor had just primed the existing unsecured bondholders on a group of core assets that represented close to one-third of the business! The game was up by the time the company announced a second similar transaction shortly after, and within some six months, the outstanding unsecured notes were downgraded to CCC with the company’s hybrid instruments trading at a cash price of <10 cents on the euro. All the while, the performance of SBBBSS’s underlying defensive assets remained resilient.



Source: Bloomberg

We are now observing private credit investors providing similar creative solutions to companies outside of real estate and even outside of companies that have hard assets. For example, Air France-KLM notably created a structure around the company’s engineering and maintenance components business. Likewise, anyone who listened to a recent Alstom call (a struggling French locomotive manufacturer) should have noticed the company preparing, or maybe soliciting, the market for an “equity-like-instrument” to provide the necessary liquidity solution to maintain its existing IG rating. The flexible aspect of private capital has enabled different flavors of support, with the flexibility to co-create more complex solutions that are much easier to accomplish

## PIK, Your Poison

bilaterally. The flexible nature of this capital has enabled a growing theme of payment-in-kind (PIK)/non-cash pay structures. While this is arguably the natural evolution of a rate cycle, we do find it fitting that capital markets have found a way to lean into what was always the most obvious medicine for companies still sick from decisions they made when rates were at zero – i.e., more zero-coupon loans via PIK financing! In a sense, PIK financing is to a company what printing money is to an economy. Both are forms of kicking the can, and both can be an appropriate solution that provides short-term relief at the expense of longer-term consequences. At the same time, the costs and benefits of such solutions are not distributed evenly across stakeholders. We view this as a growing risk that unsecured bondholders in the public market need to be acutely aware of as we move through the next phase of this credit cycle. ■

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