Transcript

>> [Background Music] You're listening to All the Credit, a monthly Podcast Series brought to you by PGIM Fixed Income, an active global fixed income investment manager. And now your host, Senior Portfolio Manager, Mike Collins.

>> Hello. Welcome to Episode 6 of All the Credit, PGIM Fixed Income's monthly podcast. I'm Mike Collins, one of the many investment professionals at PGIM Fixed Income and your host for All the Credit. I'm really excited today to introduce one of our newest teams at PGIM Fixed Income and a couple of our newest team members of PGIM Fixed Income Greg Cass and Carras Holmstead are members of our newly formed but growing high yield credit research team specializing in distressed credit and special situations. They've got years of experience handling distressed, special situations and their timing, actually and our timing to bring them on board couldn't really be better as the distressed credit opportunity set has really ballooned given all the downgrades, the faults and restructurings in the credit markets of late. In fact, we're actually in the process right now as we speak of hiring a third resource to this growing team who will actually work out of our London office. So I'm really excited to have them today to talk about this opportunity set. Greg, Carras and I are here to give you All the Credit. Welcome, guys.

>> Thanks, Mike. I appreciate it.

>> Thanks, Mike.

>> Yeah. And Carras, this is the first time we've actually seen each other over a screen here as we're doing this live or doing it via video internally. So welcome aboard. But Greg, let me start with you. You've been at PGIM Fixed Income a whole year. And I think we brought you on board. I remember a year ago when you came on, telling you based on all the research we've done on where we are in the credit cycle, hey, man in the next year or two, you're going to be really busy. I, of course, didn't expect this type of event to hit us. So just tell us about, you know, your background and what you've been doing during your career to bring it to this point, what brought you to PGIM Fixed Income? I mean, when you were a kid, did you say I want to be a distressed credit analyst [inaudible].

>> It's really funny. Thanks, Mike. Yeah. It's been a great year and one that's kept me busier, then I think we both expected out of the gate. COVID was not totally expected, but it was -- accelerated a lot of, I think, some problems that were latent in the credit markets and, you know, some over leveraged in the system. But growing up, I probably didn't predict that I was going to be a distressed analyst, as far as I know what that even meant. But, you know, some of the early frugality training my parents gave me adding the fourth Cana water to our frozen concentrated orange juice and having that kind of like value driven mindset from the beginning was probably a helpful way to prepare for the worst and then hope for the best, which is kind of what we do here on the distressed side. But, you know, I've spent the last 15 years in distressed. Before that, I was a -- you know, I grew up as a math geek and finance geek, but was a lawyer for a little while as well, and kind of used that combination of skills to try to advance the ball and help out our platform with kind of creative solutions as Carras and I both work towards -- in working with our existing portfolio positions across the platform and looking out for new opportunities that might be ways to, I would say, enhance our client returns.

>> And Carras, how about you? You're really newly joined just in the last month or two.

>> That's right. I think I might be on my eight-week anniversary now. So, I graduated from business school 13 years ago out in Stanford in California, and I turned down an offer for an unknown company called Facebook and decided hey, I'd rather do distressed investing. And about 10 years ago, I actually sat five feet away from Mr. Cass at UBS. We helped lead the UBS distress desk and we became great friends. We stayed in touch. I previous to joining PGIM. I was at a distress hedge fund and running a distressed book and Greg and I actually worked on some restructurings of a guitar company, and then some really, you know, off the run funky situations. And he reached out to me kind of of late last year and sort of gave me the pitch that we need more brain power. We need more bodies, and sort of laid out what PGIM offers. And it's actually quite phenomenal and rare that you can find a situation with the balance sheet, the depth of expertise, and also just the ability to really drive bankruptcy processes that you rarely get anywhere else. So we definitely -- you know, when we come into situations, we're usually quite big either in the loan or the bonds. And we have even the strongest voice or one of the most powerful voices. And that's just very unique from a career perspective, and was quite appealing.

>> Well, thank you. I know, we -- I've been, you know, at PGIM for my whole career, which is going on 35 years now. And we take a lot of pride here in the in the culture, the collegiality, the deep resources we have. And I just think it's fascinating to know that we have a hundred credit analysts in our shop before you guys got here. And we have experts in every industry in the world, which is really helpful. So Greg, what was your perspective on what you could bring the PGIM fixed income and vice versa and how you guys complement each other?

>> I think like -- yeah, the culture I think first and foremost, stood out to me at PGIM, and it was the place that I felt welcome from the get go. And I was almost like pleasantly surprised. Having worked in Wall Street a long time that you would start looking over your shoulder like, wait, where are the sharp elbows, you know, where the knives out. And to be at a place like PGIM that has such a fantastic culture, but also fantastic performance speaks volume because it shows, you don't have to be, you know, full of bad folks to generate outstanding results. And I think the collegial nature of people working together, having really kind of an open forum to challenge ideas and, you know, it moves the ball forward with, you know, a lot of depth of experience, knowledge, and I think specification [phonetic] in our space. And it's something that we think, Carras and I look at this opportunity as -- it's kind of adding maybe a slightly, you know, missing ingredient, but only to the extent that this was a firm that wants to focus on maximizing opportunities as you get deeper into the credit cycle. And as you play through situations, opportunistically that you find yourself and for better or for worse, and I think we were very close with a PMs and the analyst. Sometimes it's more -- we can lean on the fundamental analysis and some of the historical experience that's very complimentary knowing how the access to management, access -- the board's access to advisors that some of the existing analysts and PMs can bring and we can bring, you know, a depth of additional professional into the picture and a depth of additional, you know, focus and relationship. So I think that combination has been a winning formula from the get go. And I think it's, it's been very fun to see it play out as expected.

>> So just get into a little bit of the meat of your day to day jobs and how you determine which companies to work on, how you interact with the existing analysts, because every you know, sector, every bond, we have an analyst who has been following that company, and that management team in that industry. How do you work with them? How do you work with the PM? And how do you make decisions on whether to deploy more capital and focus your time? I mean, you guys are limited resources and now you're -- your universe of opportunities is clearly growing.

>> Yeah. And so, I think when I first joined, Greg and I put our heads together, and we kind of pulled down the entire portfolio of exposure we have in loans and bonds. And we did a simple screen, we said, look, what's trading at a real discount to par. And the names that Greg wasn't working on, we sort of prioritized and said which one of these do we think is either most likely to go through a restructuring soon, or needs new money and then we started to prioritize it. So I was brought in to a mattress company very early on. Right now, I'm heavily working with Megan on a healthcare out of court restructuring where it really was. What is going to need new money and because we're already an existing lender? How do we, one, protect our investment, but two, enhance the opportunity to deploy more capital, and to protect what might happen in and out of a bankruptcy situation?

>> Yeah. I mean, I'm excited. Again, having been here a long time, right, and the whole MO being kind of a generally a long only bond investors, you do your fundamental research, you buy the bonds you like, and hopefully they pay you off at maturity. And every once in a while we get into a situation where you do have the change in the fundamental direction of the company, and the prices go down, and there's a couple things you can do. One, you can, you know, cut your losses and get out. Or, two, you can try to stick with it and benefit from a rebound. And then three, is you can actually take advantage of those opportunities and add new capital and actually enhance returns as opposed to just cutting losses. And I think this is actually really great environment for the folks that have the skill sets like you to bring that last part to bear. So how does that work? And how do you anticipate generating those returns in this kind of marketplace, working with our other colleagues?

>> So I would say like historically, PGIM's done a great job of monitoring and obviously, we didn't get the level of success we have by accident. But I think that the watch lists have always been part and parcel of the business and understanding and anticipating downgrade, anticipating problems, closing monitor to, you know, very, very closely monitored. And I think that's obviously a, you know, alien weekly discussion point with analysts and with PMs. We're trying to be proactive. I mean proactive about how can we lead an exchange? How can we do something before there's problems? How can we put ourselves in an advantaged position? Because we are large bond holder or large lender, can we put ourselves in it in a more advantaged position based on understanding of the documents, where there are flexible levers the company can up here, give us better liens, better documents. Where can we lead a process to be not only defensive, but also opportunistic? And I think that process of evaluation is iterative and it's iterative with -- between Carras and I, between, you know, all the PMs and all the analysts. And we do, I think, sometimes hold situations through on a more of a hands off basis. And then when

things heat up, we can get very involved in an offending, you know, nice days, weekend, getting to the right result where we will go out and retain advisors, sometimes a financial advisor externally, sometimes a legal counsel, will represent an ad hoc group, and as a large member or steering committee, member of an ad hoc group of lenders or bond holders, we can be organized and proactive about what we can achieve in that class of bonds or loans. And I think in maximizing that, sometimes as you mentioned, that does require or can opportunistically include new money, which has, in many cases, incredible returns on that new capital committed. And that's one of the ways among others that we can be, you know, advantage our platform in our -- and these are scale and size and expertise to our advantage.

>> So Carras, what -- you know, Greg kind of -- you looked at it two ways. One, you can kind of just take the buy and hold and ride along approach, right? And I believe this day and age that's probably less advantageous than even it's been in the past. Or, you can take a very active approach through a restructuring as you're a big bond holder. And then finally, you can, you know, you can step in with more capital, we have a lot of pools of money in our shop, obviously, to be able to do that and benefit our clients. So what kind of improvement in returns or how do you think about it, Carras, in terms of the mitigation of the loss if you're more actively involved by utilizing resources like yourselves, and the expected return even going forward. If you're allocating new capital, what kind of numbers are -- do you guys generally think of in terms?

>> Yeah. And I'll speak a bit higher level that the first situation I really spent a lot of time on here was a top one or two play mattress manufacturer in America. And obviously, when you saw that enormous demand, destruction with COVID, every loan and security traded down considerably and what we found is the greatest short term opportunities are often, right, in this past credit cycle, the credit agreements or indentures are pretty loosely written. There's a lot of abilities to put new capital in. And by doing that, you can take collateral away from existing lenders or bondholders. And in this one particular situation, we were part of a group that approached the company. And we said, look, we will give you a couple hundred million dollars of new money, but it's -- but as part of that, we want to enhance the collateral for our existing loans. And so that was twofold. One, we were able to deploy money at the very top of the capital structure at what we felt was an above market rate. So that's a great investment in and of itself to do. But even more importantly, we really improved the value of the collateral that our loan would look to in the event of a default. And we did that to the detriment of some people who weren't in our group. So, you know, the new money we're putting in right now, you know, we think we can earn double digit returns, but also on existing positions. This new money is coming in and earning similar returns for the money we already have at work.

>> That's a great example. Greg, I know. You know, we've had retailers and these consumer products kind of companies and healthcare companies you talked about really struggled. But the energy sector jumps out as I sit in on our high yield meetings every day. Gary Stromberg, our lead, high yield analyst, you know, highlights of bankruptcy in the energy space, almost weekly, and typically follows it by saying and we aren't involved in that name, right, which is music to my ears as a portfolio manager and our client's ear. But in the energy industry, you know, the old days you look at all the reserves they have in the ground, put a value on them, but with this fracking community and oilfield services and the kind of the quicker drawdown of a value on the inventory side, how do you even evaluate a situation, a distress situation in the energy space these days?

>> Yeah. In short, very conservatively from our perspective, and which is one of the reasons why we've outperformed in that area by being under invested in situations and picking our spots which have I think better risk adjusted return profiles. And to Gary's credit and Brian Gallo's [assumed spelling] credit, they've done a tremendous job keeping us out of trouble in a lot of situations and I think when we do find ourselves involved, the analysis is, you know, it has multiple prongs to it. We try to figure out how this company can run more efficiently if that is an opportunity set, is there -- are there midstream contracts that can be re, you know -- either rejected or recut. So the economics work for future drilling prospects and but more realistically taking -- and for the companies that do hedge, we look at these on kind of an unhedged basis and a hedge basis and figure out what kind of -- what return profile makes sense. So a lot of folks that are looking at the smaller players that are actually being sold off in bankruptcy sales, they're underwriting to 20 to 30% type returns on new committed capital and sometimes trying to maximize that return profile through cost saves and, you know, reduction of lifting costs. But I think it's a space that as much as it's beaten up, we'll be providing some opportunities and we will keep a close eye on it. Because I think as much as babies get thrown out with the bathwater and other sectors that can leave some real value on the table when you're very cautious and conservative about the approach in which how we're pushing out there.

>> Yeah. Carras, I like to expand on a point you've touched on earlier about this kind of current environment. You know, for the last five years, all we've been talking about is these covenant light or actually lack of covenants in high yield bonds and bank loans. And there's two schools of thought, right? One is that if you don't have covenants, it doesn't force companies into bankruptcy, maybe they have a little more flexibility to survive, but it's an environment like this. When you get this sudden

draw down in the earnings and cash flow, that you kind of rely on those covenants. So how is this going through the restructurings, even though it's kind of early innings in this part of the cycle, how is it different than in past cycles with regard to the covenant protections you have, the relationships between different investors across the capital structure.

>> Yeah. Relative to the great recession in '09 that what I see is different this time is one, more aggressive equity owners and sponsors. So, before you might have had the most aggressive private equity fund, we'll look at every basket and see how they can hurt the lenders to the benefit of the equity. Now, we see it as every sponsor/equity holder, they view it as their fiduciary duty to try to maximize these baskets. And these are these new money opportunities where if you have a balance sheet, and you -- and you can come in and write new money, it's going to be at your benefit. On top of that, we're seeing -- the first time, I've seen a real lender on lender predatory tactics. So it's really a shifting of value away from lend -- They might even be in the same class, the same loan. But one lender is taking advantage because of their dialogue and relationship with the company and sponsor to carve out collateral. You know, you saw this with J.Crew. They have this IP transfer, and now we're seeing it with a bunch of other companies. So that is very prevalent that wasn't prevalent a decade ago. And I think that's what keeps Greg and I up at night, more than, are they bumping up against covenants? It's -- do they need liquidity? And if they do, do they have the ability to transfer assets away from me to someone new. So that's our priority. Every situation I'm brought into, that's my first concern is if they need new money, let's make sure we're at the doorstep unable to give it to them because they're going to transfer value from me and give it to someone else to raise that new money.

>> Yup. And we're even seeing this opportunistic behavior that used to be kind of left to the world of the aggressive sponsors, showing up in public companies as well. But the playbook is wide open. And, you know, we just kind of defended ourselves from an optimistic drive by for a large theater company that was kind of taking advantage of low dollar price trading levels for its securities, and tried to put a course of exchange out in front of holders that would have either forced you into basically a 50-cent haircut on your claim in to a senior piece of paper that had very few protections. Or, you would be left behind and primed by those willing bond owners to take the rotten carrot, if you will. So we had to organize and had to build the consensus and build a group and actually propose something that helped the company's liquidity issues, help, again, like not -- I'll do a different from what Carras was providing, built tighter documents on everything that we would be left with, materially better economics for exchange. And the market participants that were involved in our, you know, bond class were extremely happy with the result. The company was very happy with the result. And everybody can come out, it doesn't always work that way, but a win-win scenario from the standpoint of, you know, doing the right thing for the company, for our clients, and then from, you know, a PGIM perspective, we got disproportionately large chairs of economics because we put the deal together and backstopped it, and I think putting these, using our kind of size, clout and capabilities to our advantage to both play defense when we can or offense when we need to, to kind of improve returns at the end of the day is what we're shooting for.

>> Yeah. I know as we're talking to our clients on our quarterly update calls, we're reviewing guidelines with them in many cases to see if they'd be willing to give us more flexibility to take advantage, either hold something through default, maybe take an equity position on the way out, maybe putting additional capital in the terms of, you know, a dip type of financing or whatever the structure is, and they can be different in every case as you've laid out. So trying to take advantage of this, you know, opportunity set that limits downside risk, but also could provide upside risk. So, having more of that balance, that two-way exposure in fixed income is always a great thing, right, as opposed to just having that asymmetric downside risk. So let me -- let's wrap up by talking about, again, the platform here, how you guys see it and see it growing and how, you know, you see us well-positioned to take advantage of this and to, you know, to benefit our different client types.

>> Yeah. I'll start just because I'm the newest here and Greg can correct me if I say something amiss. But what, you know, is very unique about PGIM and the platform is one, we know so many credits. So a billion dollar hedge fund, there's no shot they can know the management teams, even if we're not invested. So we're up to speed on the situation on the industry and we know management teams. So we get early calls. A lot of management teams don't want to respond to hedge funds if you call them. They'll respond to us, sponsors respond to us. That's -- I can't overemphasize the value of that of our brand name. And people trust us, the second opportunity is we have a very large balance sheet, and we see more opportunities than we can actually deploy into. So, when you coupled both of those things, plus, we're able to really be on the steering committee of situations where that's driving outside economics to us and to our investors, if you put all those together, it's a very unique situation and something that Greg and I are -- and the rest of the PGIM team are super confident we're going to be able to take advantage of and really outperform during this cycle.

>> Yeah. I think that's completely accurate. I couldn't said it much better, so I think being the good guys reputationally, culturally or in the marketplaces is paying dividends. We're not going to do anything adverse to change that. We're solution providers as an institution. We're perceived as people that can be helpful from the company side and from another creditor

side. So we're welcome into groups, we're welcome into situations. And we have the balance sheet, the capital and the creativity to help us get to the right place. So in crafting outcomes that are obviously good for us, we're keeping in mind our market peers and those that might be smaller in the situation. We try to provide outcomes that are good. You know, we're positioned to win, because we're looking ahead, we're getting ahead of situations where we might have the wrong structure. We need to put the right accounts into the mix that will have the opportunity to perform and protect themselves. And I think we were very conscious of the future. And, you know, we know that there's going to be more opportunities ahead whether we have immediate COVID solution or not. There's a lot of companies they're going to have balance issues for a while. And I think we're going to be well-positioned to take advantage and defend our existing positions as well.

>> I think you guys have great job security here in the near term, at PGIM Fixed Income, you know, our base case, if you generally working with our macroeconomics team and our strategist is is even as we recover, it could be a slow recovery, kind of like what we had coming out in the financial crisis, maybe even slower. And maybe it's just a really tough slog here. And you will see, you know, the longer it takes to recovering, the slower the recovery is. The more companies just run out of the liquidity even as they've generated a lot through debt issuance or government programs. At some point, you'll run out, right? So you guys will be really busy. And I learned a lot today actually just talking to you and understanding more about how you look at opportunities. And I think it's really exciting. And I think it's a perfect timing, again, for you to join us for us to build this team, this capability, take advantage of these opportunities. So thank you so much. I really look forward to working side by side with you guys for a long time to generate value for our clients. So thank you very much, Greg and Carras.

>> Thanks, Mike. We're having fun. Thank you so much.

>> Thanks, Mike. We appreciate it.

>> And, of course, you guys, to all of our listeners to our podcast and I noticed a lot of loyal listeners it's, you know, you can get it on iTunes or Spotify or Stitcher, wherever you listen to your podcast is called All the Credit. You can also check out pgimfixedincome.com. And you can look at all of our different white papers and quarterly outlooks and other research. We actually just did a webinar that's available to watch on a replay where we talked with Nathan Sheets and Robert Tipp on the topic of inflation, which is other than, you know, credit problems, inflation is probably the second biggest concern that our clients have in the marketplace right now given all the monetary stimulus. So that should be another really interesting listen and watch for you, folks. So thank you very much and till next time.

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