A Game of Loans: Liability Management Exercises and Their Impact on Credit Investment Managers

For those unfamiliar with liability management exercises (LMEs), these are strategies that companies use to restructure their debt obligations—often by exchanging, repurchasing, or renegotiating terms—in order to reduce financial strain, manage cash flow more effectively, and improve their overall financial health as an alternative to bankruptcy. But why might this be of interest to an institutional allocator?

Troubled Companies Look to LMEs

Instead of bankruptcy, over forty percent of troubled companies are looking to restructure debts through liability management exercises (LMEs). In a recent study, Barclays found that defaults are near pandemic highs of 4.5% when bankruptcies and LMEs are combined.[1] LMEs offer company leadership an opportunity to retain control and avoid judicial authority. By selecting the LME path, "owners can prolong their control over ailing companies and postpone losses by playing the financial equivalent of Game of Thrones."[2] For credit investors, an LME could wipe out critical collateral and seniority protections, which may potentially create a loss of returns, increase risk, and potentially create unfavorable credit terms.[3] Institutional investors with significant allocations to public and private credit may want to engage with their investment managers to ask the question: do you have a strategy for navigating LMEs?

Liability management exercises can – through a series of incentives that provoke cooperation amongst lender groups in a Prisoner's Dilemma like fashion– collapse credit and seniority tiers forcing all debt holders to participate in prolonged legal battles

[1] Source: Barclays, C. Short et al., "LME Trading Through Prisoner's Dilemmas," July 29, 2024.

[2] Source: Wall Street Journal, M. Wirz, "Coming to A Cash Strapped Company Near You: Credit on Creditor Violence," August 19, 2024.

[3] Ibid.

aptly named creditor-on-creditor violence. Creditor co-ops form to dictate restructuring and asset control at the expense of other non-co-op creditors. The non-participating lenders can find they have suddenly been demoted from first-tier to third-tier creditor status without recourse to assets or collateral.[4] While LMEs are nothing new, the number of high profile companies engaged in LMEs are on the rise.[5] "Unlike opportunistic credit funds, which intentionally acquire debt after it already has traded at a substantial discount, par holders encounter distressed situations by accident…They have realized that unless they have a seat at the table, they will find themselves on the menu."[6]

[4] Source: King & Spalding, "How Did They Do It? J. Crew & the Original Trap Door," January 26, 2021.

[5] Source: Financial Times, R. Wigglesworth, "Creditor-on-Creditor Violence is Escalating," August 1, 2024.

[6] Source: Financial Times, S. Indap et al., "Big Asset Managers Adapt Vulture Tactics in Distressed Debt Fights," April 25, 2024.

The prisoner's dilemma is a classic example in game theory that demonstrates why cooperation in strategy may produce the best results. In the prisoner's dilemma, prisoners are encouraged to operate together or cooperate because doing so offers a collective benefit that could reduce their sentences if both make the same choice to stay silent.

Cooperation, in this scenario, creates a win-win outcome where both prisoners serve minimal time, leveraging mutual trust over individual gain.

This perspective underscores the value of cooperation, as aligning interests reduces risk for both parties and leads to a better outcome than competing against each other.

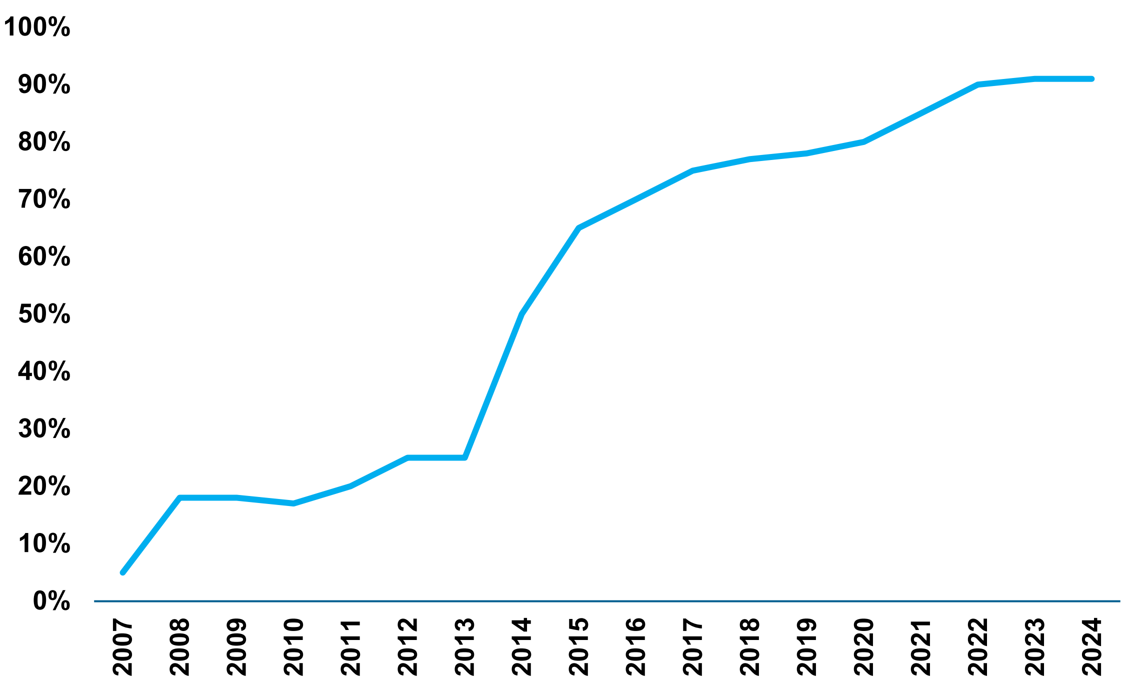

FIGURE 1
Covenant-Lite Loans Percentage of Morningstar Leveraged Loan Index

Source: Barclays, C. Short et al., "LME Trading Through Prisoner's Dilemmas," July 29, 2024.

LME's have generally been made possible by the weakening of covenant[7] documents in the years after the global pandemic, when institutional investors sought higher returns in lower quality credit products and private credit.[8] "Over ninety-percent of the Morningstar LSTA Leveraged Loan Index is now "covenant-lite" (i.e. lacking maintenance covenants), a metric that has increased sharply since the Global Financial Crisis."[9] In a recent study of 24 LMEs between 2017 and 2024, Barclays found that secured debt does not necessarily outperform and that nearest dated maturities may not outperform.[10]

Barclays warns that "As the credit cycle ages, balance sheets of highly leveraged issuers have become increasingly stressed. Nowhere is this more prevalent than in the leveraged loan market where the tail of CCC issuers are facing meaningful fundamental headwinds."[11] Investor demand for collateralized loan obligations (CLOs) and higher yielding credit surged during the pandemic when rates fell to record lows further exacerbating the issues now facing highly leveraged issuers. Rising creditor on creditor violence may offer returns through private equity or hedge funds while incurring losses in higher credit quality fixed income portfolios. (Figure 2)

[7] Covenants are conditions or requirements set by lenders to protect their investment by limiting the borrower's actions. These covenants might include requirements for maintaining certain financial ratios, limiting additional debt, or restricting asset sales.

[8] Source: Barclays, C. Short et al., "LME Trading Through Prisoner's Dilemmas," July 29, 2024.

[9] Source: Barclays, C. Short et al., "LME Trading Through Prisoner's Dilemmas," July 29, 2024.

[10] Ibid.

[11] Ibid.

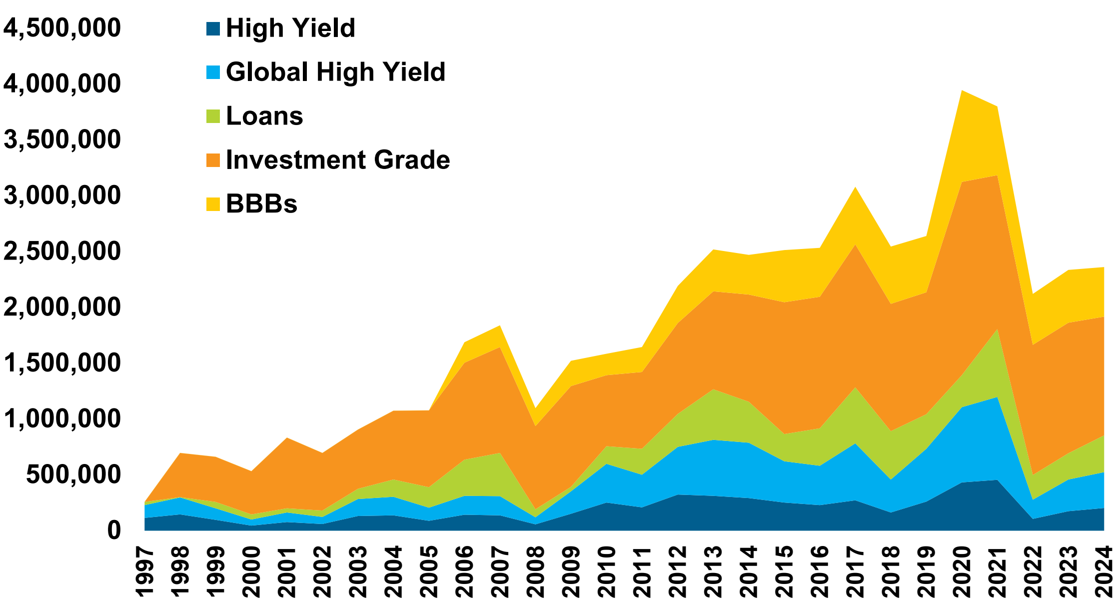

FIGURE 2
Annual Issuance by Credit Quality
Source: KKR data as of June 2024.

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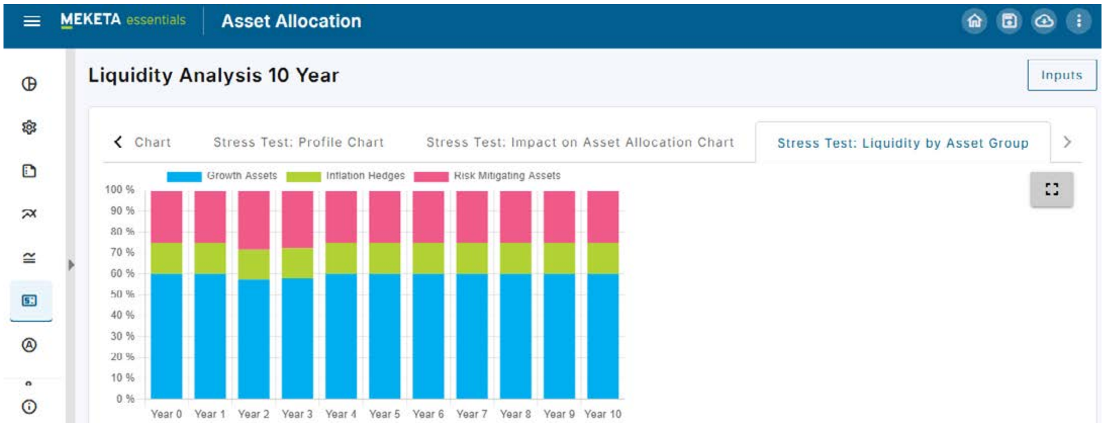

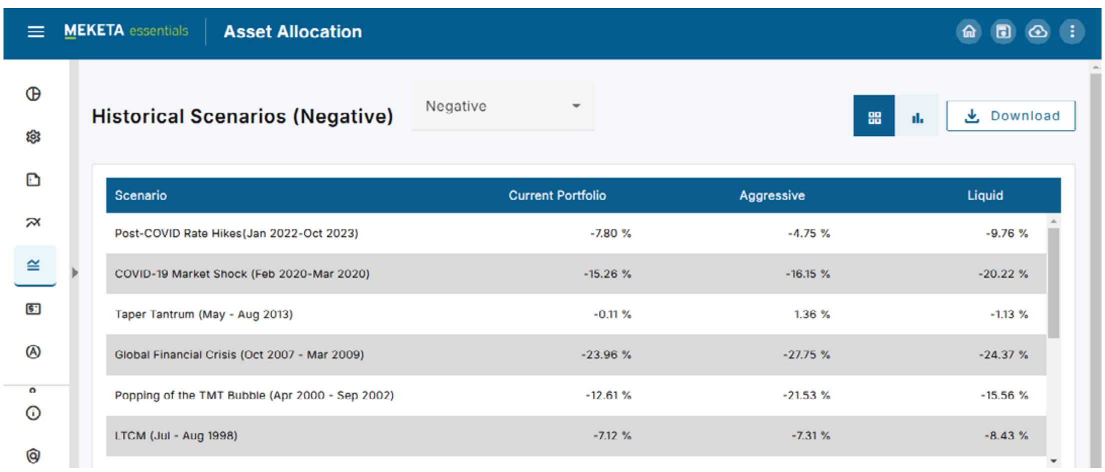

Scenario	Current Portfolio	Aggressive	Liquid
Post-COVID Rate Hikes(Jan 2022-Oct 2023)	-7.80 %	-4.75 %	-9.76 %
COVID-19 Market Shock (Feb 2020-Mar 2020)	-15.26 %	-16.15 %	-20.22 %
Taper Tantrum (May - Aug 2013)	-0.11 %	1.36 %	-1.13 %
Global Financial Crisis (Oct 2007 - Mar 2009)	-23.96 %	-27.75 %	-24.37 %
Popping of the TMT Bubble (Apr 2000 - Sep 2002)	-12.61 %	-21.53 %	-15.56 %
LTCM (Jul - Aug 1998)	-7.12 %	-7.31 %	-8.43 %

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