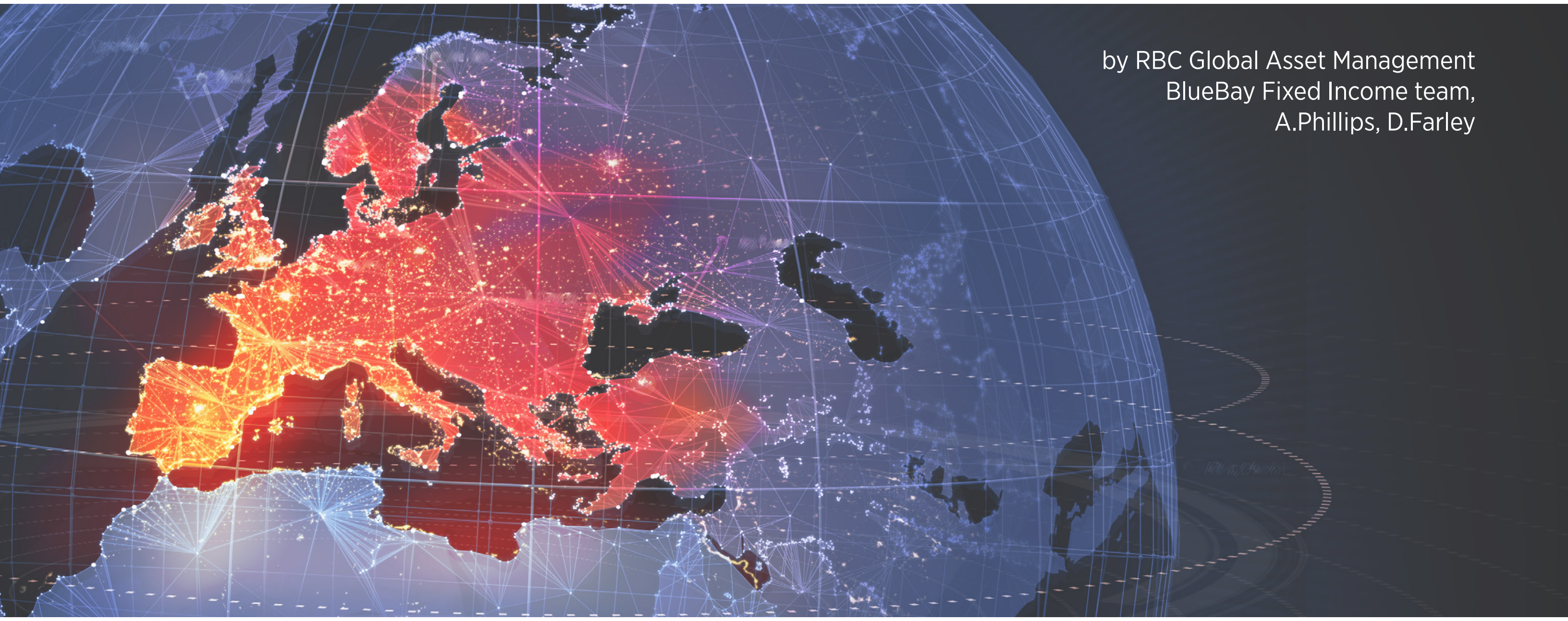
Special Situations

A Favorable Backdrop for European Event-Driven Credit



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With the second half of the year well underway, we look at distressed activity over the summer and highlight the ongoing market opportunity in the asset class.

Key points:

- Increased distressed and stressed loan activity this summer.
- The trend for increased Liability Management Exercises in Europe.
- Recent court rulings around minority creditors.
- The opportunity in the European mid-market space.

Distress heated up in the summer slowdown

The summer lull in European financial markets didn't extend to distressed investing this year, and August saw a flurry of activity. In particular it was the loan space which saw the uptick in activity which is typically quieter than the bond market due to the private nature of the loans market. There was a sharp increase in the number of loans classified as stressed or distressed from 75 loans from 43 companies at the end of July to 97 loans from 49 companies at the end of August[1].

Names such as Inovie, Biscuit International, Kloeckner Pentaplast and Merlin Entertainments made headlines in the financial press, making it clear that economic & regulatory headwinds and the recent perfect storm of issues for corporates (including the Ukraine war, supply distruptions, tariff uncertainty and lacklustre European growth) are sector-wide.

A particularly interesting story is Merlin, which was downgraded to triple-C by S&P on 20 August. The theme park operator made the headlines for the ratings downgrade itself, but also because it now impacts triple-C baskets of all affected CLOs with S&P as a rating provider. S&P cited "persistent high cash burn" and an "unsustainable" capital structure as the reasons the downgrade.

1 Top of the Flops — European Distressed Watchlist August 2025 (9fin).

Aggressive LMEs on the shores of Europe

Another recent area of interest has been court rulings around liability management exercises (LMEs). It has become apparent that it is no longer assumed that investors in companies that are restructuring (either operationally or financially or both) can sit on the sidelines and expect fair treatment. *Read more about LMEs below and on pages 3 and 4.*

The trend of aggressive LMEs first started in the US and it is now being seen on European shores, although current LME trends in the US show a shift from aggressive-style transactions toward more benign, whilst in Europe the opposite is true. ‘Violence’ associated with LMEs was considered to be less of a threat in Europe due to law generally providing more protection to minority creditors, more stringent restrictions on what a company’s directors may do, and risks to investor blacklisting.

LMEs have become increasingly prevalent as companies seek to manage their debt obligations without resorting to formal bankruptcy proceedings. In response to the proliferation of LMEs, creditors are actively seeking protective measures to safeguard their positions against future disadvantageous transactions. Protective measures can include cooperative agreements between lenders and the potential litigation threat from minority investors.

Recent court rulings in the UK have heavily leaned into fairness with respect to minority creditors, as seen in Waldorf and Petrofac, which is adding a level of complexity with respect to restructurings. Whilst complexities surrounding LMEs for larger capital structures will persist for the foreseeable, within the European mid-market we anticipate that conventional restructurings will continue to dominate due to simpler capital structures and the ability to influence restructuring proceedings. This can make achieving a consensual deal simpler in theory, which positions us uniquely to deliver meaningful results.

A mid-market focus: less competition

With continued macro uncertainties surrounding global politics, weak growth across many European sectors, cost pressures and tighter financial conditions, this is likely to lead to a continued uptick in opportunities as special situations investors. The size of this market opportunity and the fact that the European mid-market is less competitive has led to strong performance year-to-date.

For investors with the flexibility to pursue a special situations credit approach, the European mid-market presents an exciting opportunity, which we anticipate will be prolonged.

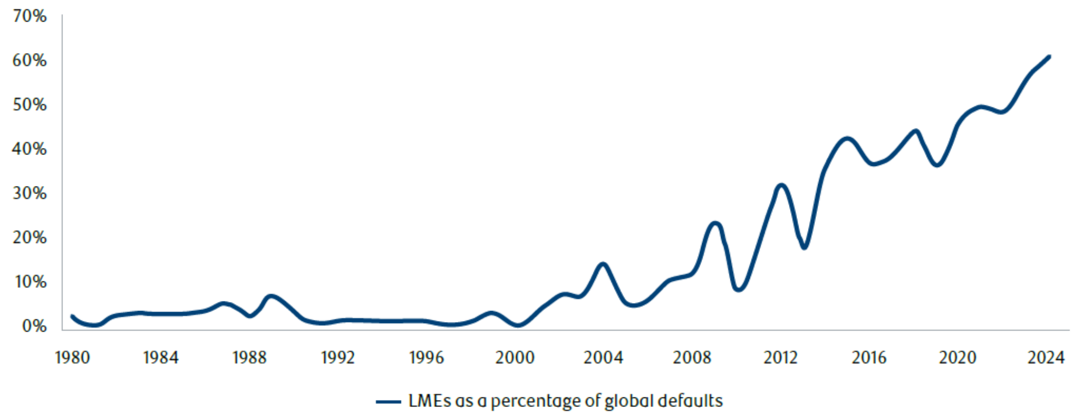
Distress Investing: The Rise of Liability Management Exercises

Key Takeaways:

- Distressed investing entails investing in companies that we believe will need to restructure, either operationally or financially or, in some cases, both. Recently it has become apparent that it is no longer assumed that investors can sit on the sidelines and expect fair treatment. This trend first started in the US with the rise of liability management exercises (LMEs), and it has now been seen on European shores.
- The following pages aim to educate readers both in terms of what LMEs are and the strength of our approach of investing in mid-market European companies due to the strength of legal dynamics, simpler capital structures, and the ability to have influence over restructuring proceedings.

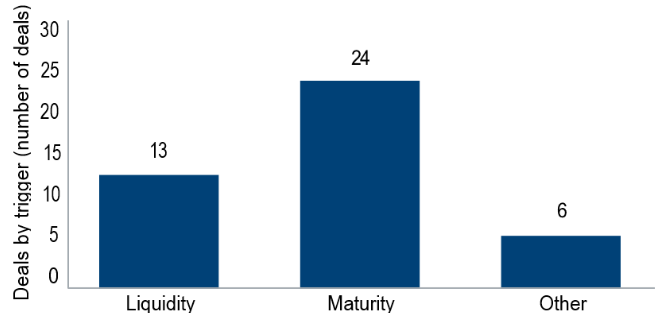
The rise in LMEs can be attributed to a combination of factors, including weak credit documentation, rising debt costs, impending maturities, and the efforts of resourceful sponsors seeking to unlock equity value. While much of the sub-investment grade credit market remains stable, the sheer volume of outstanding debt means that even a modest increase in distress levels can result in a significant uptick in LME activity (Chart 1).

Chart 1: LMEs represent over half of all defaults



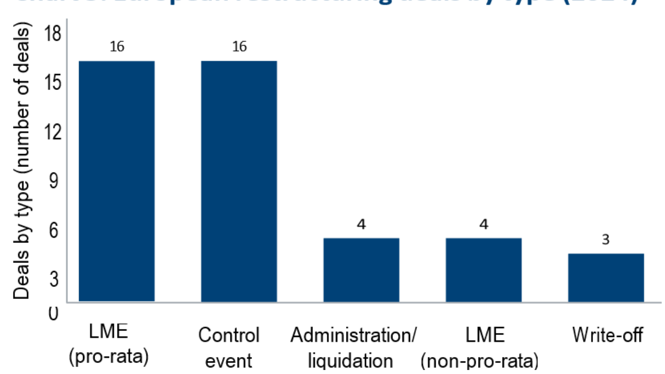
Source: Moody', Barclays Research, as at August 2024.

Chart 2: European restructuring deals by trigger (2024)



Source: 9fin, as at December 2024.

Chart 3: European restructuring deals by type (2024)



Source: 9fin, as at December 2024.

LMEs, though not rigidly defined, generally refer to measures taken by financially strained borrowers to restructure their debt outside of formal bankruptcy proceedings or to secure funding through unconventional methods to address liquidity challenges. As seen in Charts 2 and 3, the trigger for restructuring activity is primarily due to liquidity or maturities, while the solution can take many forms, with LMEs being one of the main avenues. These exercises can provide borrowers with the necessary breathing room to stave off or delay a full default. However, they often lead to varying outcomes for investors holding the same debt instrument. This can create opportunities for new money investments but also risks, such as the reprioritization of existing claims on a borrower's collateral. To successfully navigate the complexities of the LME market, investors must carefully weigh these risks and opportunities, leveraging strong legal expertise and industry relationships to position themselves effectively.

The current restructuring landscape reveals a complex interplay of trends, challenges, and opportunities across both U.S. and European markets. In the U.S., LMEs have become a prominent tool for addressing distressed debt, often involving distressed loan exchanges where creditors face valuation haircuts. The growing use of tiered debt structures in LMEs has also created significant disparities among creditors. Those providing fresh capital often take priority, leaving lower tier creditors with substantial losses and speculative, illiquid debt.

Private equity (PE) firms play a central role in these restructurings, frequently prioritising insider groups while sidelining smaller or outsider creditors, a strategy that has raised concerns about their reputation in markets.

Legal and market dynamics add another layer of complexity. While recent court rulings, such as the decision against Serta Simmons Bedding's restructuring, have offered some hope for creditors, companies continue to exploit legal grey areas. Meanwhile, private credit markets provide alternative funding options, keeping competitive pressure high. Outsider creditors are increasingly forming minority groups to resist unfavourable deals, though the dominance of large asset managers in negotiations often leaves smaller creditors at a disadvantage. These dynamics have contributed to rising borrowing costs and growing scepticism about PE firms' abilities to manage companies effectively, potentially dampening broader economic investment.

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These complexities highlight the importance of a thoughtful and strategic approach to restructurings and distressed investing. Our focus on Europe and more specifically mid-market transactions positions are based on the following observations:

1. A European advantage: stability in jurisdictional frameworks

While aggressive restructuring tactics, such as "divide and conquer" strategies by PE firms, are more commonly seen in the U.S., Europe offers a more structured environment. In many European jurisdictions, creditors within the same class (e.g. first-lien or second-lien lenders) are required to be treated equally. This legal framework reduces the risk of unequal treatment and fosters a more collaborative restructuring process.

2. Mid-market focus: simplicity and efficiency

Unlike the multi-layered capital structures often seen in large-scale restructurings, mid-market transactions are typically more straightforward. Smaller lender groups and tighter documentation reduce the number of stakeholders, streamlining negotiations and decision-making. This simplicity allows us to focus on delivering tailored solutions without the disruptive influence of hedge fund "gorillas" or overly aggressive creditor tactics.

3. Smaller cap structures: leading with impact

Working with smaller cap structures can offer key advantages and insight. By being actively involved as a leader or co-leader within ad-hoc groups or bank steering committees, ensures that key interests are front and centre. This hands-on approach allows an investor
to craft innovative solutions, drawing on insights from both European and U.S. restructuring trends, while avoiding the pitfalls often seen in more complex deals.

4. Proactive solutions for a changing landscape

The evolving restructuring market, particularly in Europe, presents both challenges and opportunities. From the emergence of U.S.-style tactics to the growing prevalence of creditor co-ops, we stay ahead of the curve by leveraging our deep market knowledge and strategic expertise. Whether it's addressing lender dissatisfaction through inclusive solutions or navigating intricate debt waterfalls, our approach ensures that all stakeholders are positioned for optimal outcomes.

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