RBC BlueBay Asset Management

Distressed Debt: investor opportunities in 2025

For professional investors only | Marketing communication

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Published January 2025

Key takeaways

- European Special Situation markets have seen a rise in liability management exercises, which in turn has led to large co-op agreements between creditors.
- The European business cycle has diverged from the US, which is creating a strong pipeline of opportunities for European Special Situations investors.
- The outlook for 2025 in Europe is fraught with uncertainty due to economic weakness, political instability, and layoffs in key economies, yet sectors present opportunities.

European businesses have navigated a tumultuous landscape of late, characterised by a high interest rate environment, the lingering effects of Covid, soaring energy prices, and waning consumer confidence. Despite a slight improvement in 2024, distress levels across the continent remain elevated. The anticipated interest rate reductions have been slow to materialise, with inflation rates proving unpredictable. Companies continue to grapple with liquidity challenges that originated during the pandemic, while the post-Covid era has seen a significant number of corporates struggle with profitability, with many unable to return to pre-pandemic levels.

2024's key trends:

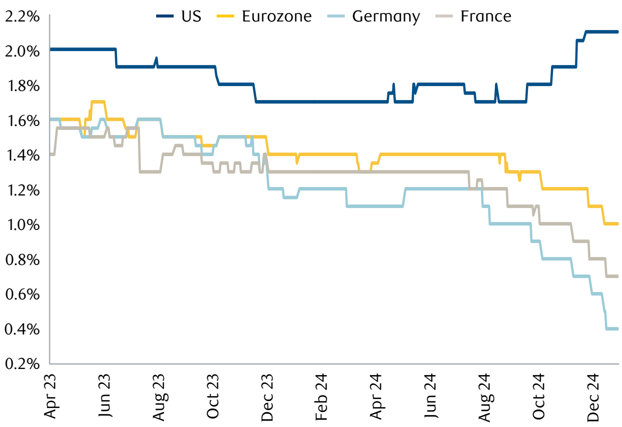
1. **Rise of co-op agreements**
   Co-op agreements have gained traction in Europe, particularly for large-scale restructurings, as a response to creditor-on-creditor and sponsor-on-creditor violence. Liability management exercises (LMEs) have historically been less popular in Europe, but saw a rise in 2024 as companies struggling to raise financing required more aggressive tactics for restructuring deals. In order for creditors to protect themselves, co-op agreements, where creditors within a class or across classes agree to behave by a certain set of rules outside of a credit agreement or indenture in theory, have been utilised as an added protection to the benefit of all creditors. 2024 was the year of the mega co-op between creditors of companies including Dish Network, Altice, iHeartMedia, Ardagh, and Bausch Health. This is a trend that we do not foresee slowing down in 2025.

2. **Economic divergence: Europe versus the US**
   Entering 2024, the debate across markets was whether the US economy would be able to achieve a soft landing. What transpired was a US economy that continues to grow at a healthy rate, has a grip on inflation, and a labour market that remains buoyant. This is in stark contrast to Europe, where most of the major economies are on the edge of recession, large companies are cutting staff, political turmoil abounds in France and Germany, and there is a continuation of conflicts on the borders of Europe, in Ukraine, and the Middle East. As a result, we have seen a stark divergence in the business cycle between the US and the Eurozone (Chart 1), with 2025 GDP growth expectations continuing to weaken and indicating lacklustre growth for the European region.

3. **Capital market activity: repricing and 'amend-and-extend' transactions**
   The capital market in Europe has been largely influenced by repricing efforts and amend-and-extend transactions (Chart 2). However, for the most leveraged and distressed issuers, these transactions have often required sponsor support to achieve a sustainable balance sheet. In some instances, equity owners have relinquished control to address financial challenges.

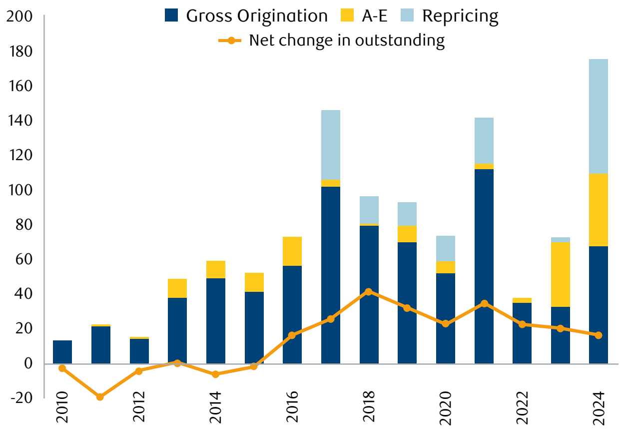
> **"The capital market in Europe has been largely influenced by repricing efforts and amend-and-extend transactions."**

Chart 1: Bloomberg 2025 GDP consensus forecasts



Source: Bloomberg, as at December 2024.

Chart 2: European leveraged loan capital market activity



Source: JPMorgan, Pitchbook LCD, as at November 2024. A-E data not available prior to 2017.

Outlook for 2025

We enter 2025 with huge question marks over the health of developed Europe, and we anticipate this to be a great source of opportunity for Special Situations investors. Late 2024 saw a flurry of company announcements coming out of the economic powerhouse, Germany, where major employers such as Volkswagen, Bosch, Thyssenkrupp, and Siemens seek to lay off thousands of workers in a bid to combat falling profits. German industrial production figures released in December dashed any hopes that the economy may slowly be turning a corner, with output decreasing 1% from the prior month versus an anticipated 1% increase, in addition to manufacturing PMIs showing no sign of recovery (Chart 3).

Additionally, there are political concerns across the European major economies. The UK is currently battling with a Labour government, which has caused a collapse in business and consumer confidence. At the time of writing, UK long-term borrowing has hit levels above those seen in 2023, following Liz Truss' government's mini-budget. In Germany, citizens will be heading to the voting box after the collapse of the coalition government, following a no-confidence vote in Chancellor Olaf Scholz. Finally, France is entering another turbulent year as a result of a snap elections in the latter part of 2024, which has left the country without a solid parliamentary majority. The result of this political instability is likely to be less investment, tighter lending standards, and higher interest costs.

Chart 3: German manufacturing PMIs

Source: Bloomberg, as at December 2024.

Further afield, the potential impact of US tariffs on European markets remains a concern, particularly for sectors with significant exposure to the US. Geopolitical tensions, such as those in the Middle East and Ukraine, continue to contribute to sustained high energy prices, which has an effect on most companies by reducing margins and decreasing profitability.

> **"The result of this political instability is likely to be less investment, tighter lending standards, and higher interest costs."**

The middle market, where our focus lies, is particularly vulnerable due to its lower resilience, lack of diversification, and a reliance on bank funding.

We believe that the sectors to watch in 2025 will be:

- **BPO:** business process outsourcing (i.e. customer service) companies have seen valuations drop due to fears of AI disruption. However, the transition to AI solutions is expected to be gradual, and this has created a number of investment opportunities over the past six months.
- **Autoparts:** autoparts companies are struggling generally due to lower vehicle volumes, plant shutdowns by large OEMs, increased competition from China, and the transition from internal combustion engines to electric vehicles. As a result, numerous companies are undergoing restructurings to right size their balance sheets.
- **Utilities:** in the UK, the water sector faces challenges due to very high leverage, political sensitivity around utility bills, and regulatory complexities. 2024 was dominated by headlines surrounding Thames Water, and we expect to see additional opportunities in 2025.
- **Energy & Shipping:** both sectors underperformed during 2024, on the back of lower oil prices and macro concerns. The energy sector and specific companies within the space may well benefit from delivery of improving profit and cash generation. In the shipping industry, companies could gain from tailwinds brought on by new international policies, which have blacklisted a larger proportion of the global shipping fleet.

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RE/0174/01/25

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