01

Finding value in vulnerability

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Alexander Rayden: Last year, the Fed claimed that rates would remain lower for longer, they probably wouldn't be raised before 2024, a recession was unlikely, inflation was transitory and not a problem and that it should fall to 2% in 2022.[1] This year has been interesting. It looks like there are some economic storm clouds on the horizon. How bad do you think the outlook really is?

Ben Brazil: It is pretty bad. The outbreak of inflation has wrong-footed most people. It is so severe that rather than being accommodated within the ebb and flow of our economy, it's wreaking havoc. Inflation is understandable as a product of a decade of money printing, the Ukraine invasion and the associated fall-out on energy and food and other supply shocks like China, but it has wrong-footed people because they are out of the habit of handling inflation. It hasn't been seen for a generation.

ARay: People are feeling the shift in the economy. It's being felt through political and social systems and day-to-day lives. How is it affecting investment markets and overall asset values?

BB: The most direct impact of inflation is on the cost side for businesses and consumers. This has spiralled beyond breaking point, beyond the resilience of many. The mandatory response of central banks is to raise rates to try to get inflation back under control. But this is actually the exact opposite of what's called for. Usually, inflation arises because the economy is robust, but here it's the harbinger of economic downturn. Exactly when central banks wish they didn't have to raise rates, they do.

The effect is a double whammy with unintended consequences. We have a pending downturn or recession (which might already be here), which is feeding into and being fed by an increase in borrowing costs: base rates, interest rates and credit spreads. The cost of capital increase hurts valuations at the same time as earnings forecasts are being revised downwards.

We've had incredibly benign and supportive credit conditions for the last decade, as a product of government intervention and complacency seeping in as good times persisted. And the longer that complacency runs, the greater the shock to the system as the pendulum swings.

ARay: How does this environment compare to peak Covid-19? Or is this much more akin to the financial crisis in 2008?

BB: It isn't much like Covid-19, which was an idiosyncratic, external event. That was sector specific. Government intervention and vaccines meant that the path forwards was clear. Today's problems are more systemic. It's nowhere near as bad as 2008, where there was a real risk of system breakdown (the risks were more existential). We survived but it was a close call and the wounds ran very deep. I don't see any real risk of the system not functioning over the coming years, as the foundations are much stronger. In other words, it's safe to be an investor, it's just that many investments are not safe.

It is of course healthy and good news for investors, looking forward, for there to be more return upside on the table across the board. But the return to healthier embedded returns does, of course, come at the expense of asset values that were set in the historically prevailing conditions of very low interest rates and risk premia.

ARay: Can you talk further about which investments you think are safe and which are not?

BB: The biggest consideration that can work for you or against you is inflation. With inflation, cash and fixed income assets represent the guaranteed erosion of real capital. For a certain subset of investors, this might be an appropriate price to pay. Meanwhile, investments that participate in inflation through the ownership of businesses and assets can perform very well, provided that they maintain their place in the world through any downturn. If the inflation phenomenon of the current times is working for you, it's a powerful force.

There are some sectors that are facing existential challenges, or at least structural challenges. For example, energy-intensive European manufacturing, which sells into a globally competitive marketplace and has, to an extent predicated on the availability of Russian gas, been suffering an extinction event. Businesses in this sector are not safe.

In this landscape, cyclical businesses need to think carefully about their mid-cycle earnings. Although you should always price in a downturn cycle for a cyclical business, at the moment that risk is a very clear and present danger.

In general, a lot of businesses have been afloat on benign conditions in the real economy and with credit availability and are going to rediscover the way that gravity pulls you back to earth. It's going to require some care to navigate within that landscape, which will from time-to-time feel like a minefield, and to identify where mispricings emerge.

ARay: Where do you feel there are mispricings in the market today?

BB: They are out there and there are more coming. The news here isn't all bad. This isn't a systemic threat. The sort of widespread real economy declines we're looking at can be absorbed by a system as resilient as ours, at least given the passage of time. The underlying drivers such as productivity and population growth will ultimately prevail. But in the meantime, the way that increased debt burdens and credit retraction are going to catch people out means that while the system will be resilient, individual companies and assets won't – they're going to break rather than bending and surviving. Those are going to represent mispricings. It doesn't just mean that assets will go down in price, but that assets will become wrongly priced.

That's where, case-by-case, this can get really interesting. Rates are going up just as

the real economy turns down. That's very unusual. Credit spreads always go up in these kinds of challenging conditions; a classic case of shutting the gate after the horse has bolted. Rather than provisioning for risk prudently during benign periods, everyone suddenly discovers a need to price risk only once the wolf is well and truly through the door. You can see this in credit markets today.

Debt service burdens are jumping dramatically, and that takes time to sheet home. Meanwhile, many people had become habitual about debt not really needing to be repaid because it could just be refinanced with more debt. Plus, Covid-19 of course, while generally not being fatal in and of itself, took a stretched leverage structure and added more debt in a kind of a "fool's paradise" of liquidity support. So many leverage structures weren't built to be, and are definitely not now, resilient to the changes we're in the midst of. In those cases, where otherwise a modest decline in operating earnings would be a kind of flesh wound, it can become amplified to the point that it overwhelms the equity of a company. The leverage structure, built to continue in supportive conditions which were being taken for granted, becomes its own worst enemy. Not all capital structures are going to prove so vulnerable to being stretched past breaking point, but many will.

ARay: So how do you go about finding those vulnerable targets? Surely there's a reason they're in that situation – does that make you nervous or pessimistic about their prospects?

BB: The first step is always to establish the defence: to ensure that the foundations of a quality business are there to build on. Capital structure stress and distress, when it arises not because of a business but because of system-wide increases in the cost of debt and credit availability, can throw up opportunities that have nothing to do with a company's or asset's long-term capacity to generate operating earnings. Where there are questions about this, we don't look any further. FitzWalter is a relatively small and niche participant in some big markets, so we don't have to force anything.

The great opportunities are where the owner is brittle and lacks resilience to the kind of environment that's now coming our way; or is burdened to such a degree that it gives up. It is a conventional wisdom that in the face of adversity people first deny, and then capitulate. That's the kind of context that we look for before becoming involved.

We can get involved in different ways: whether it's buying the original debt or perhaps injecting new equity. In some instances, the legacy owners that we stepped into the shoes of had originally invested solely for the tax benefits. For example, they were not prepared to be aircraft owners enduring the ardour of repossession, recondition, releasing etc.

In all cases, we bring the energy and resilience to handle adversity and ride it out. Management teams really appreciate that. The capital we deploy can often make a pivotal difference, and most importantly, everyone knows that we are there for the long haul.

ARay: Can you explain what's involved in the "long haul"? This is a key strength of FitzWalter. It's not just about reorganising the capital structure, you go further.

BB: Once you have found an opportunity, at the outset there are basic essential foundations that you need to build first. A classic case is to establish a new management incentive plan that's fit for purpose going forward, rather than an obsolete legacy. We've implemented new plans in every one of our investments. The legal nature of the capital structure often needs restructuring, so debt for equity swaps, liability management etc. There can also be complex and intensive legal arrangements involving multiple jurisdictions. These are all eminently fixable, but they require a lot of care and attention to detail. This is some basic stuff that can cause real problems if you can't do it.

Once these basics are re-established, the opportunity is to build the company and management team back to the positive, front-footed enterprise that so often falls to the wayside when capital structure issues (which are in many ways an artificial problem) emerge. Once you remove that artificial obstacle, the underlying strength and capability of the business can re-emerge – as has taken place with our first investment, Onyx Centersource, a global clearing house. Earnings have gone from zero at the time of our first investment back to around pre-Covid-19 levels, reflecting a fantastic multiple to our entry price.

Historic owners and lenders that experience capital structure issues will fall out of alignment with the businesses they own and their incentive structures stop working. Without the right incentives and alignment, businesses, assets and people suffer, and lack the support to be everything they can be. Our job is to be fresh legs, with fresh efforts and fresh capital, to be a constructive force and get everything back pulling in the same direction. When it works it seems obvious with hindsight – but the things that happen along the way – they don't just happen.

ARay: So FitzWalter is very hands-on and a driving force alongside management, partnering with businesses to get them back on the right footing. You're not trying to time markets or predict certain moments. You seem to have much more of a private equity approach to your strategy?

BB: We're not arbitragers. We harness and really lean into opportunities that come up so we can invest in a way that has a real edge compared to the average private credit firm. There's too much to be left on the table to be a hit-and-run merchant. If you're looking at things through a Bloomberg screen, you might be able to capture a good entry price, but where we can push for change is very often where so much of the value can be captured. We are risk managers of the macro; we are people who have the skills and wherewithal to really tackle and make the most of times where other people are fearful and ill-equipped. It's that perspective and capability which is what we are bringing, rather than some God-given talent to time markets.

ARay: In your view, while we're not at risk of the markets not functioning entirely, recent and anticipated dislocation will generate a plethora of opportunities that fall into your lens. What are the key things on your mind as you choose between these opportunities?

BB: Our expectation is that there will be plenty of idiosyncrasies, and it will take time for the pressures we see today to really set the scene for the good businesses to throw up opportunities for us to provide capital. What's on our mind is just making sure that we maintain the highest quality standard in terms of durable portfolio companies that will stand the test of time, and we are patient as opportunities emerge.

We will be looking to heavily maintain our standards so that this whole market can be made to work for us and not against us (with an oversupply of opportunities).

ARay: You've obviously had a hugely successful career and have seen various distressed cycles. What advice would you give to your younger self and younger workforce who haven't seen a cycle change?

BB: It's going to be worse than you're hoping for in the short-to-medium term. In general, we all face reality a bit too slowly so we'll be hoping for something too close to the best outcome. But the whole system is probably better than you're giving it credit for. In the long term, there is a lot to be confident about. If you have the patience to return great businesses and assets back to rude health, it is true that our economies and financial systems perform nicely over the medium-to-long term, which all helps. So provided you

can invest the time and effort, there is every reason, even today, to be confident rather than fearful. But you absolutely need to be able to make today's climate work for you and not against you. And we can.

It's too simplistic to say it's all doom and gloom – and fundamentally wrong. If that were the case, why would anybody invest anywhere? I will be trying to strike the balance between short-term pessimism and long-term optimism. Ultimately, we should still remember to lean in – as Warren Buffet says, "the less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs".[2]

1. Federal Reserve Board, Minutes of the Federal Open Market Committee, 16-17 March 2021
2. Warren Buffet, A Letter To Shareholders, 2017

Ben Brazil is the Co-Founder of FitzWalter Capital. *FitzWalter is a global private investment firm that provides capital in contexts of complexity, transition and other special situations, and supports management in the unlocking of a company's or asset's full potential. Ben was the Global Head of Macquarie's CAF Principal Finance business from its inception in January 2009 until his departure from Macquarie (announced November 2018). In this capacity, he became a direct report to the Macquarie CEO in 2012 and a member of its 12-person Executive Committee in 2014. Ben started employment with Macquarie in 1994. Prior to the inception of the Principal Finance business, he worked with Macquarie across a range of geographies and business lines. He departed Macquarie in June 2019. Ben is a graduate in Commerce and Law from the University of Queensland.*

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