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Crisis Talk — with Dan Zwirn of Arena Investors

By Owen Sanderson 21 May 2020

In the special situations arena there are few situations quite as special as a global pandemic, and few opportunities quite as large for investment firms that manage to navigate the sell-off in corporate credit, bank loans, CLOs and securitizations correctly. GlobalCapital spoke to Dan Zwirn, founder, CEO and CIO of Arena Investors, and a 25 year veteran of distressed debt and special situations investing about buying free volatility, where to play in retail, and why the CLO market has much further to fall.

GlobalCapital: At what point did you realise that this crisis was going to be quite as serious as it was? And what did you do about it when you did?

Dan Zwirn, Arena Investors: I guess the question is what would be the "it" that you might need to do something about. If the "it" was an unexpected thing that had a very good prospect of piercing the enormous asset and credit bubble that has been blown up by the monetary authorities over the last decade, then we were expecting "it". In fact, we were hoping for some form of "it," quite frankly.

But we had no way of knowing that the "it" would be a pandemic, rather than something else.

Looking back over a short period of time, the markets we've seen seem extreme, but the reality is that for the last several hundred years, every 10-15 years something happens which causes major issues in markets, and this is just another one of those.

These things are never anything that anyone would have expected, because if they had expected them, they wouldn't have had the effect that they did.

But I remember clearly getting a sense of it. We have a partner in Italy, and I spoke to the CEO, I think on our last day in the office in New York, and he said: "you won't have seen this before, there's nobody on the streets here. This is a big deal, and it's coming to you in two weeks".

Intellectually, I figured he must be right, as he is a solid guy with good judgment, but it's hard to internalise that until you see it. Then those first four weeks or so were high intensity — battening down the hatches and assessing what is happening across your portfolio.

On the positive side, for us, we had asked ourselves before every transaction, "how does this feel in an '08 scenario," and so we were left with relatively few issues to deal with.

How did you deal with operational challenges of moving from a trading floor environment to working from home?

Unlike a more conventional hedge fund, we're big process people. We've invested a lot in our infrastructure, IT and people. To that end, we've spent several tens of millions of dollars going back over a dozen years on all our systems and processes. We use systems to create as much homogeneity and repetitiveness in the process as we can, and those systems and workflow tools allowed us to transition relatively seamlessly.

A lot of what we're doing is more incremental funding with relationships we already have, so our investing focus continued at a strong pace as well. Now, as we're going into a new environment you get to issues like, 'how do we actually see the building that we might lend against?'. On the right side of our balance sheet, we have investors of ours thinking through how they can be rigorous about due diligence on Arena, without setting foot in the office.

Where are you seeing value in markets right now?

I'd start off with the places where, no matter whether the recovery is a 'U', 'W', 'V', an 'L', or anything else, we can all pretty much agree there has been tremendous permanent damage. Those include things like oil and gas credit, aviation, and retail.

In those areas, there's been significant shell-shock, so bid and offer are very wide, both in tradeable and purely private markets. But there's a lot of opportunity, a lot of work to be done, and we are transacting.

In all of our entities we are asset/liability matched, and we have no recourse financing on illiquid assets. That has been interesting in our corporate and property and structured finance-related investing, where there have been significantly fewer players because the financing many entities had is now withdrawn or diminished.

Whether that means entrepreneur-owned special situations corporate credit or high interest commercial mortgages, you have fewer BDC or middle market lending participants in the former and fewer warehouse securitization-related participants in the latter.

Through the entire world of structured finance, there are opportunities in lending against, buying, or facilitating transactions in financial assets, from residential mortgages, to autos, installment loans and charge-offs.

There's not only many more things to look at, but a lot of babies that are getting thrown out with the bathwater because those that otherwise might have financed these assets had other issues to deal with. That gives us room to engage with those counterparties at levels where previously they would have declined to work with us.

There's a tremendous amount of basically cheap volatility to hold both in tradeable convertibles and structured private convertibles for public companies.

You have this unique circumstance where asset values are diminished and cash flow is diminished, but equity values are sky high. So if I'm an issuer in that circumstance, I'm happy to give away upside in equity value that I don't actually think is real in order to finance myself as efficiently as possible.

And then there's a third bucket, the broad world of leveraged loans, ABS and mortgage-backed securities. In the throes of seven weeks ago, there were some liquidations that got done at levels that were still very far away from what you would look at as a '98, '01-02 or '08 low. You had to have a macro view to buy them at those levels, which we didn't have and won't have.

But those were worth a lot of work because a lot of the substantive information regarding these loans and securities is only now beginning to come out. April is the first full month of Covid, and the trustee reports relating to securitizations where the underlying collateral was highly exposed only just came out in the last few days. And as a substantive matter, those numbers can't be what they are, with those securities being at the levels they are. It just can't be.

So you would look to somehow short these?

Believe me, we would if we could. But no, we're looking to own them, but at levels much lower than where they are today, and in the expectation that the data coming out may force them to get there.

In those sectors you mention, oil and gas, aviation and retail, where in the capital structure do you see the best opportunities?

In oil and gas we're basically focused on lending against proved developed producing assets — the real stuff where you don't need geophysical knowledge to understand what your collateral is. So there we're able to lend at 60% or 70% advance rate and make 20%-plus, and we are requiring our counterparties to sell production forward so we can be hedged to the commodity prices.

We're also involved in some large oil and gas related capital structures on the secondary side, looking at bank debt and bonds where we can create cheap optionality. We might be long one piece and short another, or otherwise look to create cheap puts or calls. There are also capital structures where it's simply not as bad as it looks, and you can be in relatively near-term paper that's likely going to be OK and get paid quite a bit.

There are a lot of folks that just don't want to be near oil and gas, not only because of price volatility, but also because of things like ESG considerations. We're hedged and doing very short duration financings that don't take a view on those broader trends.

In aviation, there's a lot of pain in the ABS, but it's nowhere near where it needs to be. We're directly involved as financiers of the buyers of liquidating collateral.

Once you dig into it, you realise there's an enormous number of players at all different levels of the aviation ecosystem, from high quality airlines to secondary airlines to emerging markets, to cargo, military and others, none of whom really want to tell the others about what they're looking to buy or sell.

So there are compelling opportunities through a combination of engine, parts and airframe trading and liquidating, and short term leasing, where there are a lot of arbitrage opportunities available.

You have wide body airplanes, built to go 18 hours at a time, and they don't make a lot of economic sense unless they're filled up like a can of sardines. So there may not be a business model where you can use these planes going forward, but there may be parts that can be repurposed or put to uses that are more economic.

In retail, you had a 'last gasp' based on what was called 'experiential' retail — hosting a birthday party experience for the kids, or going to the movies or to the gym — which Amazon can't recreate. And this crisis really hit that right in the nose.

What we're likely going to see here is the final act of retail as we have known it since the advent of Sears and JC Penney and other things from the corner dime store and onwards. When we think of retail, we think of assets such as intellectual property, receivables, leasehold interests, and inventories. All of these need to flush through in various forms, and will ultimately be reprocessed into value which won't use nearly as much physical space. It's an area where we're super active and focused.

So hopefully that gives you a flavour, but there's just a lot of change happening. I think this environment is going to persist for quite a while, and we'll ultimately look back at the previous few years as the exception, not the rule.

To what extent are any of these trades becoming crowded? There are regular headlines about new multi-billion distressed funds from some of the largest players

There's a real line between folks who are in the business of marketing funds, and folks who are in the business of investing.

As an example, if you were buying leveraged loans in March, you might have seen decent businesses where you could buy the bank debt in the high 70s — meaning 'creating' the company at 3.75x when multiplying price times the face value of the debt and dividing by cash flow — where you were probably going to be OK. The issue is, at what price?

If it has a really long maturity and a low coupon and a bad structure, then you're probably going to make around 9%, very generically, because in the absence of a structural catalyst to force the realisation of value, the duration will stretch the return to par over a greater number of years.

If you compare that with an '08, '01-02 or '98, that would have been done at 1.5x cashflow for a current yield in the low teens. So if you do wait it out, you're effectively owning the beta of the market volatility for nothing. Alternatively, at that time you might have bought the bank debt of the same business noted above with either a nearer-term maturity or covenants that forced a restructuring and made 18%-20%.

The folks who bought that stuff at the levels I've just described in March really couldn't make our kind of return, unless they were presuming the market would swing back, and we're not in the business of predicting market beta or macro either implicitly or explicitly.

When you look at the statements of investors like Paul Singer, Sam Zell, Warren Buffett, or Stan Druckenmiller, what's common is that they're not looking to market a fund. They're just dispassionate investors, and none of them have been barrelling into markets with guns blazing.

Part of the issue is that there's a bit of reflexivity. If I need to raise a fund to do X, I can't really raise it unless I say that X is fabulous to do, even when it's not. If an opportunity is not yet great, but might become great, I won't have the money to participate in it unless I say that it is great right now.

So that muddies the waters between what is a compelling investment area today versus what might be in the future.

To what extent are you dodging the Fed and government support programmes in trying to find the most compelling opportunities? Are public funds squeezing value out of parts of the market?

Certainly that explosion of liquidity took away the opportunities where there were literally dollar bills sitting on the floor, which we did a bit of, but not nearly as much as we would have liked. But over the longer term, if you look at what the government wants to finance, they're not really looking to take risk.

For example, take [US Treasury secretary Steven] Mnuchin saying that his mandate is to facilitate the functioning of the economy, not to lose money — his point is that if Congress wants to mandate him to do that, it needs to get on board with the possibility that the money may not come back after it's lent out.

When you look at what is actually being financed by the government schemes, that capital is not really risk-bearing. And that's part of why so much of it has nominally been provided, but at the same time not actually funded.

Do you mean the Fed's potential purchases of high yield ETFs?

Look at the airline financing so far. Look at a lot of the PPP money. Management teams are looking at it and saying "this doesn't exactly help me, and if I use this, I might be subjecting myself to issues down the line. Maybe I'm just going to give this back".

That said, there's no question it's affecting markets, and it's affecting liquidity. It's helping the large scale long-only low yield focused investment grade folks. That's useful systemically because in a lot of fixed income entities there's a lot of asset liability mismatching which, without the government's involvement, might have really hung people up.

When you talked about sectoral opportunities, there were a few highly distressed sectors you didn't mention — cruises, leisure, gaming for example — was that with good reason?

Well partly because they're up a tree. We've definitely been active in some of the new issuance convertibles. In some of those very large-scale businesses, they were willing to issue convertibility at a level such that we didn't have to bear the risk of whether things were going to be okay in their businesses or not.

You've seen a raft of issuance from the likes of Carnival, Norwegian Cruises, Southwest, Delta — which all have the advantage of having a large-scale equity market caps. Even though they don't have earnings, that has allowed them to effectively hand out free volatility to investors in order to gain access to the primary proceeds.

But when you look at taking direct financial exposure to those entities, I think it's very difficult. What's common among these businesses is that 50% utilisation does not mean 50% of the previous profitability. It means zero or negative profitability.

So you're really talking about hoping they get to the other side of a vaccine, and there's a lot of hope and speculation involved in taking an actual directional view on that. We might be indirect beneficiaries, through the airlines using planes and needing parts, and that sort of thing. But restaurants, theatres, cruise lines in general are very tough, and for those reasons we have historically avoided them altogether.

How do you see the longer term outlook for CLOs? How does that market play out for the rest of the year?

Maybe the rest of the year is too short as a timeline, but CLOs are really problematic. Like many things that didn't do too badly in the '08 crisis, people used rearview mirror analysis to create a rule around those things being okay and then they overdid them, and basically disregarded the secular changes between when they were okay and now.

On the left side of the balance sheet, you have loans that were much more levered, of lower quality, with much less compensation, and a much worse structure. Today's average BBB was yesterday's average BB, and you've now seen that substantiated by this raft of downgrades, which are just a reversion to reality.

On the right side of the balance sheet, there's just a total misalignment of interest, where in many cases the owners of the equity, much less the securities above the equity, are not the investment managers of the CLOs.

There's a whole lot of incentive for very smart people to aggregate information about the loans that they might be able to ultimately use creatively when things become distressed, without the cost of actually having to be financially exposed to the outcome of the loans.

A number of people have touted the appeal of buying the subordinated structures of CLOs. We've done that historically, and we're excited to do that in the future. The issue is that they have yet to trade at a level that presumes a recovery on the loans that is different from the recovery seen in prior cycles. And the reality is that it's highly likely that recoveries will be materially lower, and so those securities haven't gotten to where they need to be.

In addition, you'll find that there will be a bit of a free-for-all, as people dig into the nooks and crannies of those securities. You might see people try to argue that certain CLO bonds are in default, try to shut down the waterfall to the people below them, make deals go static, kick out the manager and liquidate, etc.

On the lending side, we have seen situations where CLO managers are actually being proactively generous to the underlying borrower because they don't want to report to the securities owners of the CLO that there's a default.

It's all much more complicated than the marketing headlines that CLOs did well in the last crisis and currently offer high yields with strong downside protection.

Do you expect another round of CDS-driven manufactured defaults or net short debt arbitrage strategies as seen in Hovnanian, Windstream and so on?

Yes. I think we'll see a lot, but I do think it's a bit overdone in the media. The reason is because being active in CDS is a very dangerous thing, because the intermediation of CDS is done through the Street firms, and because it's virtually impossible to get appropriate term financing in order to facilitate CDS transactions.

So you could be right on a bet using CDS, and not be permitted by the dealers to realise your profit.

That applies — unless you're someone whose brand is so big that, when and if there's an issue, someone from way on high can call someone way up high in the investment bank to make sure you're not injured. There are counterparty and asset liability risks that are really difficult to manage in CDS land. As a result, I think there will be much less of that game played. There won't be zero, but there will be many more things out there that will be much more of an issue.

As I often tell my colleagues, I expect we will be spending the majority of the rest of our investing careers cleaning all of this up.

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