Investment Opportunities Created by Liability Management Exercises

HG VORA
CAPITAL MANAGEMENT

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Parag Vora | Portfolio Manager and Founding Partner

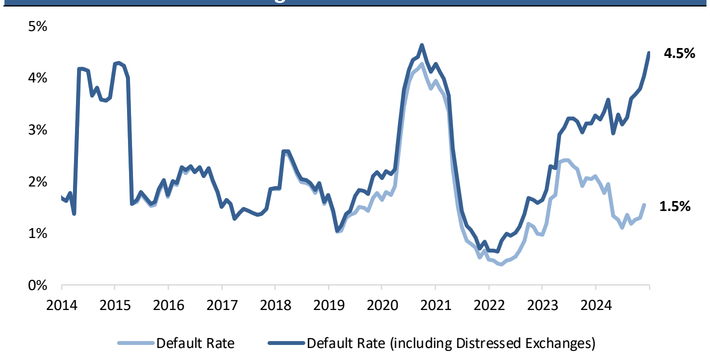
Parag Vora oversees the Firm's investment and strategic decisions and is a member of the Investment Committee. Prior to forming HG Vora, Parag was an investment professional at Silver Point Capital where he focused on investing across the capital structure of public and private companies with an emphasis on distressed and event driven situations. Prior to Silver Point Capital, Parag was a Vice President in Goldman Sachs' Investment Banking Division where he advised real estate and consumer-oriented companies on mergers and acquisitions and leveraged finance transactions. Parag holds a Bachelor of Arts degree from the University of Michigan and subsequently received a Juris Doctor and Master of Business Administration from New York University.

Default rates are understated due to Liability Management Exercises

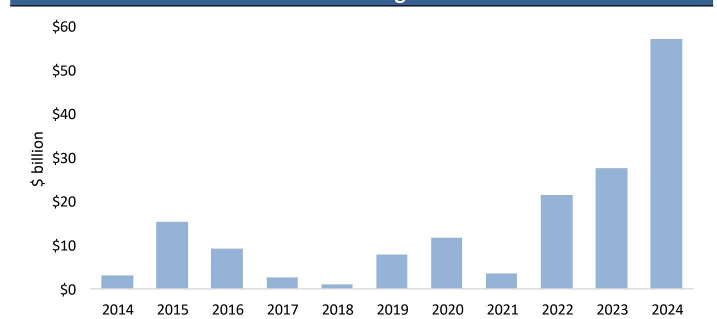
Headline default rates for leveraged loans ended 2024 at 1.5%, below their long term average of 1.8%[1]. However, traditional measures of corporate default activity substantially understate the true level of distress in credit markets as companies have managed to avoid payment default by proactively utilizing Liability Management Exercises ("LMEs") at an increasing rate. When including these transactions, the default rate on leveraged loans is 4.5%, nearing its highest level over the trailing ten years[1].

Total distressed exchange volume has ballooned from $3.5 billion in 2021 to $57.1 billion in 2024 following record leveraged loan LME volume in December[2]. LME volumes now represent over 68% of total leveraged loan default volumes. ***The increased use of LMEs has created a unique opportunity for experienced sub-investment grade credit investors to earn equity like returns by buying leveraged loans and high yield trading at a discount to par in the $3 trillion secondary market.***

Leveraged Loan Default Rate[1]



Distressed Exchange Volume[2]



What are Liability Management Exercises?

LMEs are transactions in which highly leveraged companies modify their existing capital structure by coordinating with a group of lenders to exchange or amend existing debt. Typically, borrowers seek to execute LME transactions to bolster their liquidity profile, extend existing debt maturities, and/or reduce their overall debt burden. A borrower whose debt trades at stressed levels can seek to exchange their existing debt at a premium to its prevailing market price (but a discount to par) for an amended credit. In return for providing the borrower with additional financial flexibility, the newly exchanged debt may offer a tighter credit document, an improved collateral package, fees and a higher interest rate.

Why are companies pursuing LME transactions?

We believe that several factors have fueled the recent rise in LME activity, including:

- In the wake of the COVID-19 pandemic, borrowers aggressively pursued refinancing activity at record levels to take advantage of near zero rates and historically tight spreads. The flurry of refinancing activity created a sizeable debt maturity wall in 2025-2027.
- The subsequent period of higher interest rates impacted borrowers' cost of capital, eroded interest coverage and ultimately, free cash flow.
- As debt maturities near, levered borrowers face pressure to find a near term capital structure solution.
- LMEs offer companies facing stress an alternative to avoid costly and time-consuming bankruptcy processes or the friction costs associated with a global refinancing.

Opportunistically Investing in LME Situations

There are several ways to source attractive risk adjusted investment opportunities in LME situations:

1. **Acquire short-dated debt in the secondary market in anticipation of LME outcomes.** We are focused on capital structures that are trading at stressed levels with near term debt maturities. A disciplined credit investor who acquires the debt at an attractive basis can generate double digit returns when the debt is either refinanced with the proceeds of newly issued credit or exchanged for an amended credit in a LME. Often, the new credit re-rates as a result of the LME creating a cleaner capital structure, longer dated maturity obligations, enhanced liquidity, and/or reduced leverage.

2. **Leverage relationships with sponsors to provide new capital in LME situations.** Over the past twelve months, 81% of LME transactions have been conducted by sponsor backed companies[3]. Financial stakeholders are more motivated to conduct LME and are familiar with the transaction's benefits on a borrowers cash flow. We have leveraged our broad relationships with the sponsor community to source opportunities to structure and provide flexible LME solutions. As a result of opening our balance sheet at a time of stress and uncertainty, we are typically able to structure increased credit protections and more favorable terms.

3. **Utilize LME as a tool in traditional distressed debt situations.** In many distressed companies we have sought to utilize LME to avoid costly and lengthy in-court restructuring processes. LME can be utilized to provide ample flexibility to distressed capital structures to improve their cash flows and ultimately increase recovery values for creditors as an alternative to traditional restructurings. Over the past five years, the recovery rate on first lien loans experiencing payment default was 50.2%, while the recovery rate on those in distressed exchanges was 67.5%.[2]

Recent Investment Example | Privately held Healthcare Services Company

- Provider of staffing services to hospitals faced operational headwinds as labor shortages pressured margins.
- The company's broadly syndicated first lien term loan came under pressure ahead of its' upcoming maturity.
- We acquired the term loan in the secondary market at stressed levels and proactively approached the company's equity sponsor with an LME solution to provide financial flexibility.
- We negotiated a deal to exchange our existing debt at par, a substantial premium to its' prevailing market price.
- We structured a newly issued first lien note which extended the company's debt maturity profile. In exchange, we received a step up in coupon, an amendment fee, strong call protection and an improved collateral package.

More Opportunities to Come

Elevated borrowing costs continue to pressure over-levered capital structures, driving higher volumes of distressed debt. With over $556 billion of debt set to mature through 2027 and $127 billion of US credit trading at distressed levels[4], we believe that many borrowers will turn to LMEs to solve their capital structure needs. HG Vora is well positioned to leverage our relationships with the sponsor community, banks and advisors to source select opportunities to invest in LME situations that offer attractive risk adjusted returns.

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Footnotes

[1] Source: JP Morgan, as of December 31, 2024. Reflects trailing twelve month average par weighted default rate of US leveraged loans. Long term average reflects trailing ten years.
[2] Source: JP Morgan, as of December 31, 2024. Refers to US leveraged loans and/or high yield as referenced throughout.
[3] Source: Pitchbook, as of November 30, 2024.
[4] Source: Pitchbook, JP Morgan, as of December 31, 2024. Defined as loans trading below $80 and high yield bonds with a spread-to-worst greater than 1000 basis points.