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SPOTLIGHT

Birch Grove's Jonathan Berger on Opportunities in Catalyst-Driven Credit Investing in 2014

Jonathan Berger, founder, chief executive officer and chief investment officer at **Birch Grove Capital LP**, spoke to Bloomberg's Kelly Bit about opportunities in the U.S. and Europe and companies undergoing shareholder activism and other corporate change. New York-based Birch Grove launched its $300 million long-short credit hedge fund in August.

Q: What are your views right now?

A: Our view is credit is trading at very low yields and tight spreads. Not historically tight spreads, but very tight spreads. One big risk is the flows in and out of the retail mutual funds and ETFs. We've seen net outflows in U.S. high yield bonds in 2013. We see particular risk in long duration investment grade bonds. We don't think high yield is going to lose money this year, but we won't make much more than coupon and potentially less than coupon if rates go up. We don't see good risk-adjusted returns being long the credit markets, which is why we're positioned in a market-neutral way today. It's a perfect environment for catalyst-driven or event-driven investing.

Q: What specific catalysts?

A: First in lower quality investment grade companies and higher quality high-yield companies where spreads are very tight and the potential for credit deterioration is not priced in. A big theme in the market is shareholder activism. With activism, what you see in many cases is potential improvement for the equity investors, but maybe deteriorating situations for the debt holders. A good example would be an activist going after a company in order to increase the leverage on the balance sheet to fund a share buyback or dividend recap. That would create a negative credit event. We would express our view by being long the equity and short the credit. We have a very flexible mandate, we can invest across many different asset classes — loans, bonds, CDS, convertibles, as well as equities and options.

Q: Where are you seeing opportunity?

A: One big opportunity is the re-leveraging of non-financial companies in the industrial, consumer and health-care sectors. There's an opportunity given how tight spreads are to create trades where we are shorting the credit through either outright shorts, through the bonds or the CDS, or a pair trade, by shorting some component of the credit and being long the equity. One sector that we've been looking at broadly is the consumer sector. We are also long event-driven situations. We're using first lien or second lien loans to express that view. In the consumer sector, we've been looking to short companies that are susceptible to decreasing market shares — brick and mortar companies that are losing out to e-commerce could be one example. We're also seeing on the long side companies that are benefiting by providing value to the consumer or have a unique product. There are a lot of companies in the middle ground and they're losing market share — that's where we see a lot of shareholder activism.

Q: How do you capitalize on activism?

A: We're screening companies we think will be the subject of credit deterioration. It could be shareholder activism, companies that could be targets of a leveraged buyout and companies that want to make acquisitions and leverage up the balance sheet. Shareholder activism is just one opportunity in this market.

Q: Where else?

A: We're going to see a lot more event-driven opportunities in 2014. Rates are still relatively low and capital markets are open for debt issuance. There's been pent up demand by companies for strategic M&A as well as a lot of dry powder with U.S. and European private equity funds. We're in the earlier stages of this cycle in Europe than in the U.S. In 2014, we're going to see more issuance and more use of proceeds in the bank loan and high-yield market related to mergers and acquisitions and buyouts in Europe. That's going to continue to fuel the growth of the European credit markets, which is still at an interesting stage of development. We've been focusing on stressed bank loans in companies that are potentially the subject of mergers and acquisitions or other types of corporate actions like IPOs, or where there's going to be some type of refinancing of that particular part of the capital structure. In Europe, we're going to see these opportunities as a larger component of our portfolio. Today our portfolio is about 80 percent event-driven and maybe 10 percent to 15 percent of that is in Europe. The European component will increase in 2014.

Q: Where in Europe?

A: There are definitely countries that are outperforming. We've seen opportunities in the U.K. and in Germany. It's across many different sectors. A lot of these companies are sponsor-owned. There's a theme in that sponsors are either looking to take advantage of the credit markets by making acquisitions and taking them from middle market companies to larger companies that could be the target of IPOs or strategic M&A. That's where we see the best opportunity on the long side; smaller capital structures that are sponsor owned, in the early stage of their development, that have the ability to sell to a large PE firm, be the target of M&A or go public.

AT A GLANCE

Age: 44

Education: The Wharton School

Professional Background: President and CIO of Stone Tower Capital LLC. Partner and co-founder of Pegasus Capital Advisors LP.

Charitable Work: StreetSquash, a youth enrichment and mentoring program for public school students in Harlem, New York, and Newark, New Jersey.

Favorite New York City Restaurant: Donohue's