Rubrics Credit Market Update: Devil in the Detail

Introduction

Following the Fed's announcements of direct corporate bond and ETF purchases (high yield and investment grade), credit spreads have contracted sharply – over 500bps in the high yield space. With spreads now closer to their long-term average, and significant economic uncertainty remaining, we would posit that the scope for spread tightening is more challenging despite the Fed continuing to "underwrite" the market. We explore below some insights from the recent spate of corporate issuance with particular reference to the emerging risks for high yield investors.

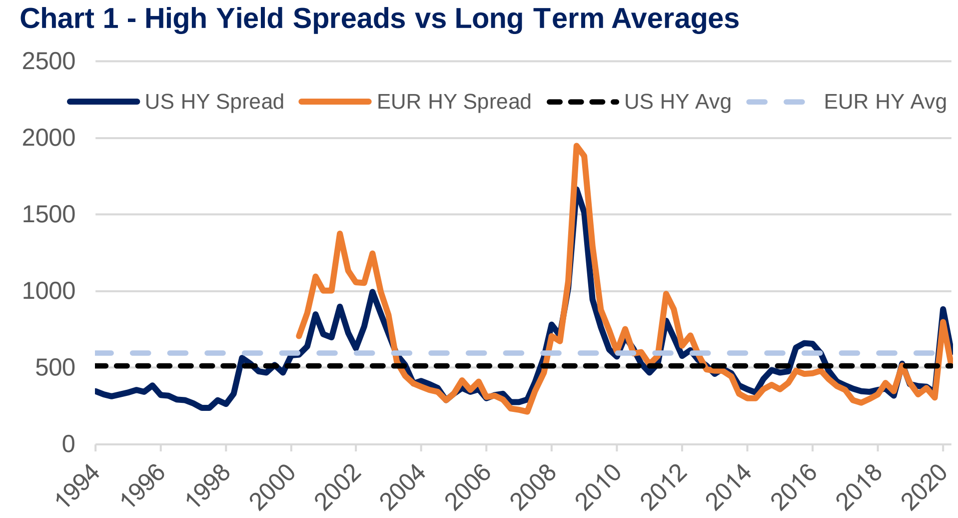
Record Issuance

Record inflows and the associated spread tightening have helped push corporate issuance to new records, enabling companies to refinance with relative ease. Charts 3 and 4 across (from Citigroup) reveal how much of the issuance proceeds seen in the European bond market have gone directly into firms' bank accounts. Unsurprisingly it seems many issuers have taken the opportunity to build up significant liquidity buffers in the face of the challenging environment. With so much liquidity it is likely the case that net debt has not risen all that much. However despite the low cost of debt firms will be earning negative carry on these considerable cash piles. It is quite possible then that we may see an increase in opportunistic tender offers from better quality issuers to retire outstanding debt. However that may be as far as it goes in respect of liquidity utilization, as plans for M&A and/or capital expenditure appear very limited over the coming months.

Involuntary Subordination

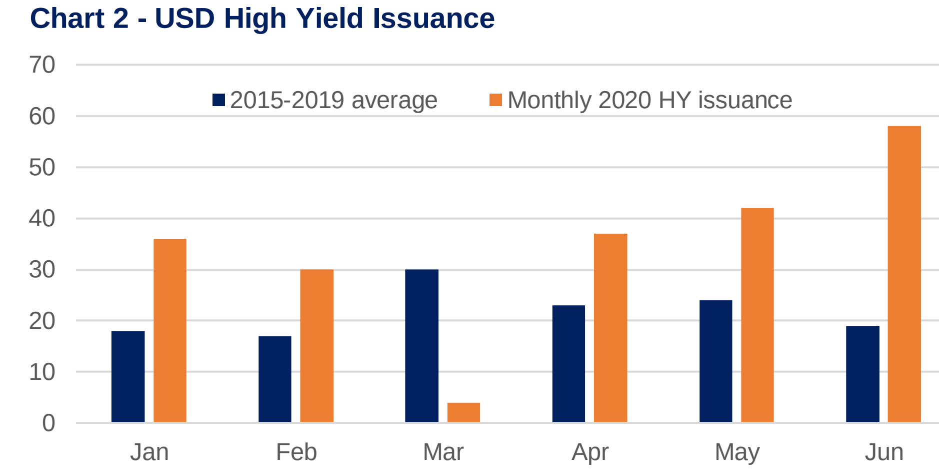
While the glut of issuance has helped companies continue operating during this difficult time, in many cases it has come at the cost of existing bondholders. This is most evident within the high yield market. Refinancing in this space is more technical than that of investment grade due to the relative complexity of bond documents.

Chart 1 - High Yield Spreads vs Long Term Averages



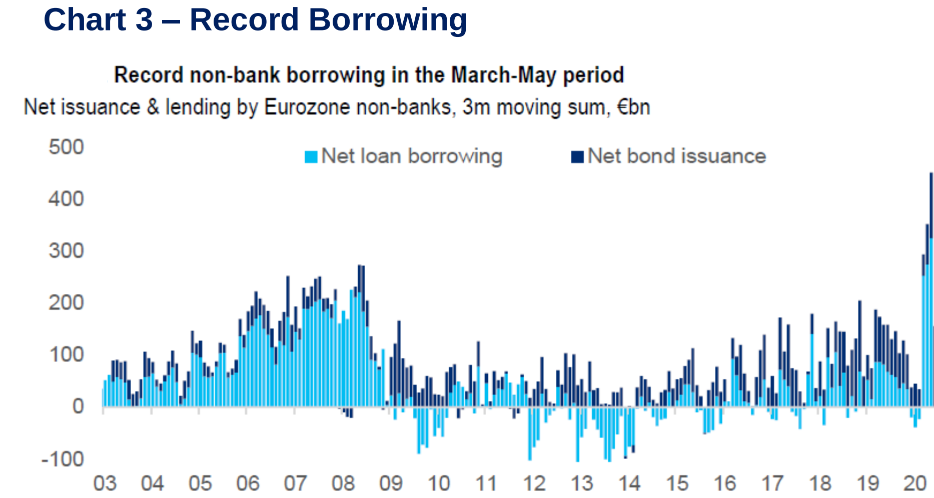
Source: Bloomberg to 3 July 2020

Chart 2 - USD High Yield Issuance



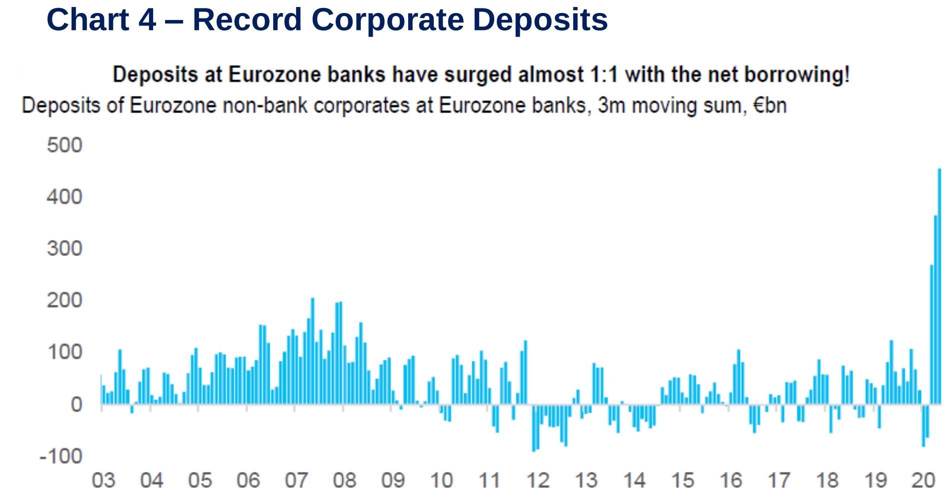
Source: Credit Suisse, Bloomberg to 3 July 2020

Chart 3 – Record Borrowing



Source: Citi Research, Bloomberg, Haver, ECB.

Chart 4 – Record Corporate Deposits



Source: Citi Research, Haver, ECB.

While there are generally more covenants in high yield issues this crisis has exposed the propensity for issuers and their advisors to find “loopholes” that can seriously undermine recoveries for existing bondholders. A deterioration in credit quality of high yield bonds issued pre-COVID19 has become evident with increasing risks of subordination due to new debt being issued higher up the capital structure.

Dedicated high yield/distressed investors outmaneuvering traditional long-only/passive

The high yield and leveraged finance markets are the greatest source of financial engineering within credit markets. It is at times like this when distressed debt specialists and seasoned high yield investors earn their performance fees. There are plenty of situations which appear to be zero sum - sophisticated investors maneuvering restructurings in order to earn superior returns at the cost of existing creditors. Dedicated high yield/distressed investors allocate more resource towards navigating the bond documentation and shaping the negotiation, whereas in most cases passive and smaller investors have to accept whatever has been agreed. This can lead to problems later down the line.

Examples of corporate actions

Two types of corporate actions currently en vogue are the “PIK’ing” of instruments and the issuance of new secured paper more senior in rank to existing bonds (or indeed subtle amendments to existing security packages). PIK is an abbreviation for Payment In Kind, i.e. where coupons are rolled up and promised to be paid at a date in the future (usually the maturity date), to conserve short term cash. For example, bond documents maybe loose enough to allow new investors to lend at "super senior" level, while existing bondholders may get “PIK’d” and further subordinated down the capital structure. Super senior lenders can include state backed schemes such as the CBILS in the UK or the CARES act in the US. Some issuers in Europe have been able to issue new super senior debt without having to get permission of existing bondholders e.g. *Selecta* (Coffee and Vending firm) and *CBR Fashion* (Fashion Retailer). Then there are issuers like *Matalan* (UK Discount Home/Clothing Retailer) and *Swissport* (Aviation Services company) who have had to carry out consent solicitation exercises to gain permission from bondholders to issue more super senior debt. Below we outline some specific corporate actions to demonstrate the potential risks and rewards to different investor bases, as well as the aggressive tactics being used by a mix of issuers, advisors and investors.

Waste Management Services Inc and the Federal Reserve

The Federal Reserve bought $3m of Waste Management Inc’s 2024 Investment Grade bonds at circa 105.0 cash price, but were redeemed at 101.0, resulting in a loss of $120k on the principal debt purchased on June 23rd. Since announcing in June that its acquisition of Advanced Disposal Services Inc. won’t close until a later date, Waste Management said it will redeem $3 billion of bonds that financed the deal at a price far below trading levels at the time. The bonds have a special mandatory redemption language that allows Waste Management to redeem them should the deal not close by a certain date. While the loss would be negligible for the Fed, it demonstrates just one of the hazards a “price-insensitive” actor can encounter in the credit market, without careful selection.

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Matalan (UK Clothing Retailer)

Matalan ensured its short-term survival by recently restructuring its debts, but it appears to be at the cost of existing bondholders. The latter now sit behind a UK CBILS[1] loan of £25m and new senior secured notes of £27.7m. These new notes which were issued at a yield of 20% rank ahead of the 6.75% 2023 notes with respect to the enforcement of collateral. Also the Matalan 9.5% bonds is now set to pay PIK coupons instead of cash coupons. While it is an overall positive that Matalan is able to limp along as a business, it is at the expense of cash interest coupons and the recovery potential for existing bondholders.

1 Coronavirus Business Interruption Loan Scheme

Carnival

Carnival, the Cruise operator will be the source of business school case studies for years to come. So far, it has managed to survive through a number of debt raises to counteract the devastating drop-off in customers and an uncertain future over the viability of its business. Carnival has successfully pulled several levers to ensure survival in a sector that has been one of the hardest hit by COVID19. The group famously raised new first lien debt with an 11.5% coupon for a bond maturing in 2023. This subsequently re-priced the Carnival curve and has reduced recovery potential for senior unsecured bonds.

Carnival was an A rated credit (by Moody's) pre COVID19 and has since seen all three agencies downgrade its senior unsecured ratings to junk. As a former high rated issuer, it was able to secure long term financing at very low rates, e.g. the Euro CCL 1% 2029 which currently trades in the 50s. While no-one could have predicted the Corona Virus, it was clear that a 1% coupon on a 10 year piece of paper for a Cyclical Investment Grade issuer did not offer much upside in capital terms and very little margin of safety on the coupon.

Chart 4- Carnival Senior Unsecured paper

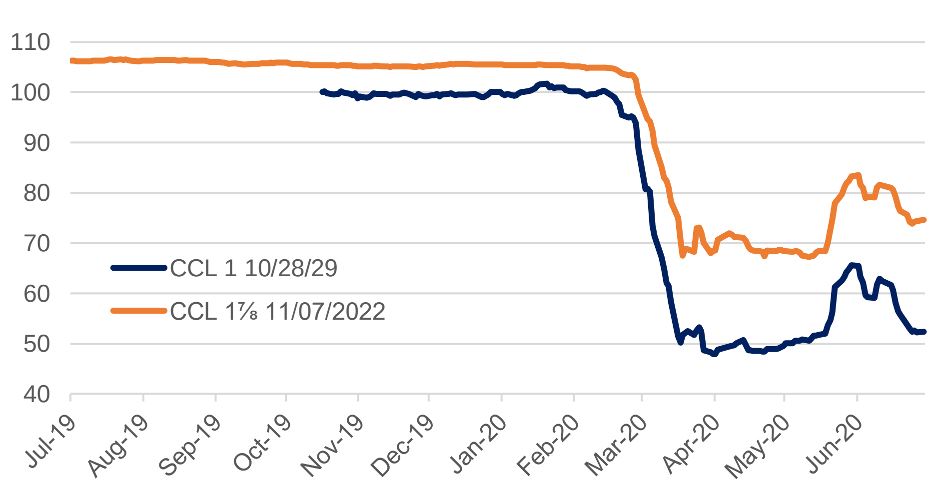
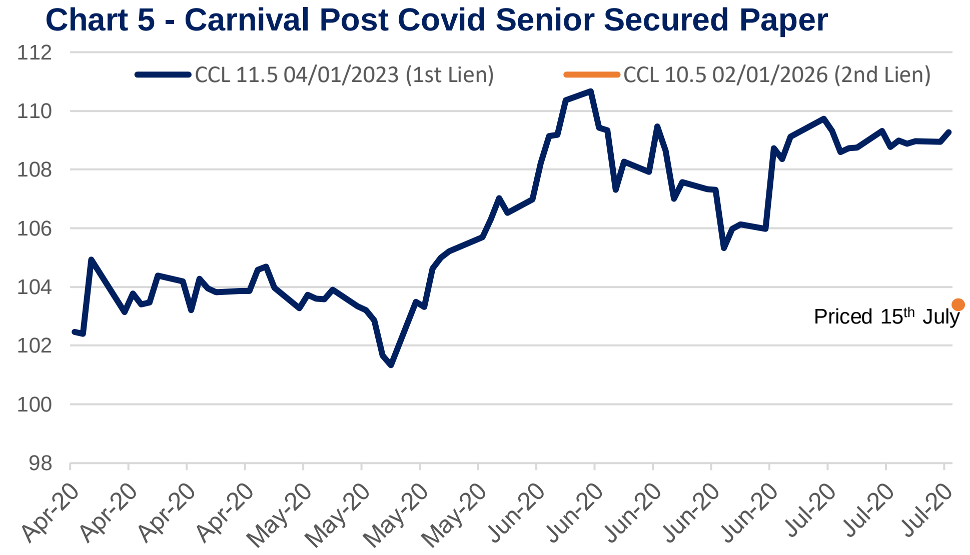


Chart 5 - Carnival Post Covid Senior Secured Paper



Serta Simmons – "Zero sum game"

Serta Simmons is the largest mattress maker in the USA. It has debt outstanding in various forms including a $2 billion secured, 1st lien loan that was widely held by mutual funds and CLOs. The notes dropped to about 39 cents on the dollar in April from about 67 cents in January. Serta is a highly leveraged company that looked to restructure its obligations following the impact of COVID19.

As is common in restructurings, bondholders clubbed together, in this case into two different groups. The first consisting mainly of hedge funds who put forward a proposal that would have lent enough new debt for Serta to continue operating, on the condition that the company pledged the intellectual property of its brands against these new debts. The deal would have moved Serta's most valuable brands away from its other lenders.

Sources: Re-Org, Bloomberg

This proposal was rejected by the private equity owner of Serta. The other proposal came from a group of mainly mutual funds. Their offer was to lend new money and look to exchange existing securities for new ones in a process that would reduce the company's overall debt and give these bondholders a first claim on all of Serta's assets. The company's owner decided to accept this proposal. Subsequently, the hedge fund bondholder group is seeking to block the transaction. In a recent filing it stated that the "unlawful scheme proposes to strip plaintiffs of those first lien rights without even seeking — much less obtaining — their approval, by subordinating their loans beneath more than $1 billion in new loans from a favored group of lenders who will be given 'super-priority' rights". So in simple terms, not all creditors received the same deal, there are "winners" and "losers". This is not unusual for a high yield restructuring situation, but the behavior from lenders, PE sponsors, companies and their respective advisors has clearly become sharper since the pandemic. This is a prime example of how such a restructuring can be so much more complex versus a vanilla refinancing in the investment grade space.

Sources: WSJ and Bloomberg

Closing thoughts

The proliferation of passive entrants to the high yield credit markets has resulted in an increase in less sophisticated investors competing with more seasoned HY and distressed debt investors. As demonstrated, this poses a risk to recoveries, due to increasingly aggressive stakeholder behaviour and the overhang of poor bond documentation. With spreads close to their long-term average, we feel they are not reflective of the multitude of risks to the overall sector. It is worth noting that despite the Fed's support for the high yield markets, this has not stopped the default rate rising above the historical average between 1998 and 2019, in June 2020.

Chart 6 - US HY Default Rate

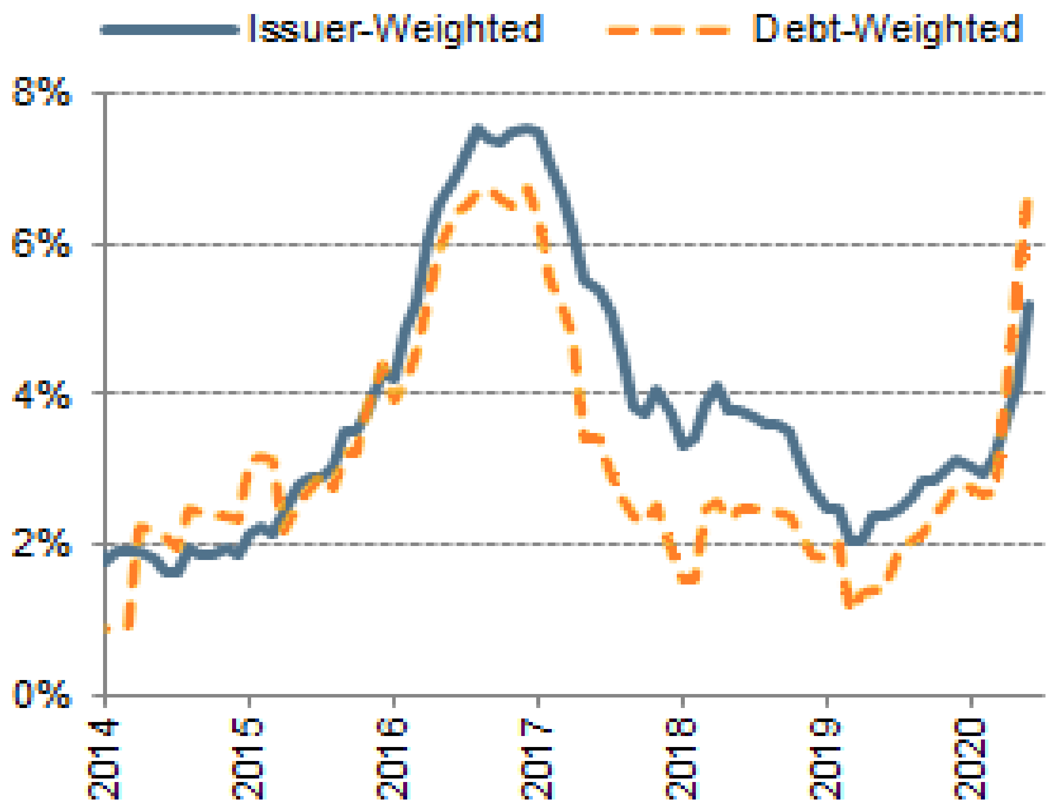
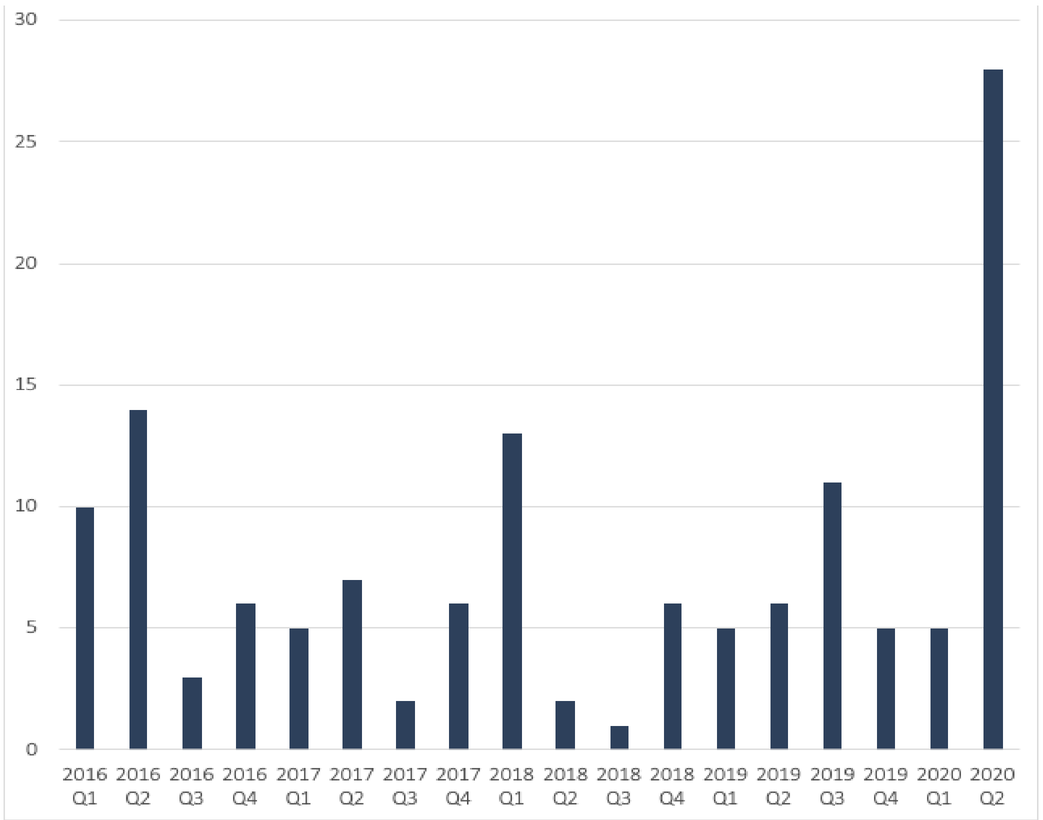


Chart 7- $1bn+ Ch. 11 filings Q2 2020



Sources: Bloomberg, Creditsights / Re-org

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