TCW

INSIGHT

VIEWPOINT

# Beware of Relying on Promise and Hope

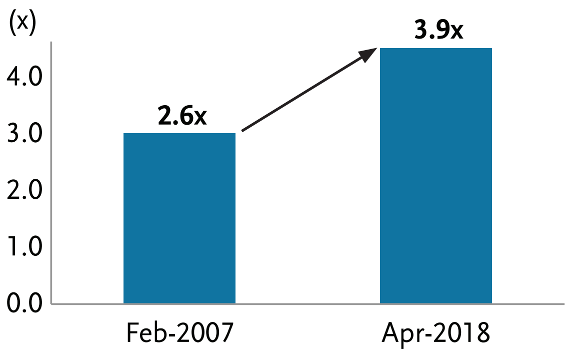
**JAMIE FARNHAM** | APRIL 24, 2018

Dangers lurk both in the open and hidden in shadows. Often such perils are overlooked, as complacency cultivates a sense of safety. In the credit markets danger doesn't arise overnight however the *perception* of that danger can magnify suddenly. Risks build over a period of time during which observers look casually past, insulated by a sense of safety. These hazards include both credit risks and macro risks with each presenting varying magnitudes of potential danger. The current credit cycle's search for yield has facilitated a dramatic expansion of corporate debt creation, particularly in the lower edge of investment grade credit. Also, competition among lenders has substantially weakened covenant terms, leaving creditors with weaker ability to protect their senior capital-structure position. Both facets leave creditors in both the investment grade and leveraged finance segments open to dangers that are clearly evident but currently disregarded. One day soon the credit markets will awaken to the perils lurking, both in the open and in the shadows.

## Promise

On a relative basis the investment grade corporate segment of the credit markets has grown significantly more than the high yield market over the course of the current cycle. The U.S. Investment Grade Corporate (U.S. IG) segment currently is almost 4 times the size of the U.S. High Yield (U.S. HY) segment, compared to being 2.6 times larger in February 2007.

**Size of IG Corporate vs. U.S. High Yield**



Source: Bloomberg, TCW

**Jamie Farnham**
Managing Director
Director of Credit Research
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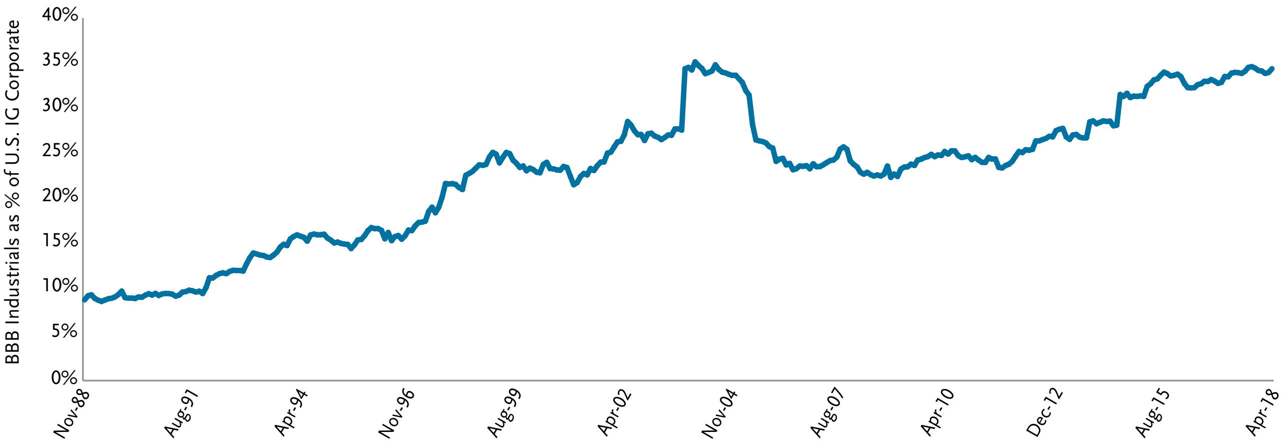
Mr. Farnham joined TCW in 2009 as the Director of Credit Research and a Specialist Portfolio Manager in the Fixed Income group. Previously with Metropolitan West Asset Management LLC (MetWest), Mr. Farnham served as a Portfolio Manager where he led a team of credit analysts and oversaw the firm's proprietary credit research process within the corporate, high yield, and leveraged loan markets. Prior to that, he was a Private Equity Investor at Primus Capital after working as an Investment Banker at Merrill Lynch in New York, focusing on new issue origination of equity and fixed income securities, as well as mergers and acquisitions. Mr. Farnham holds an AB in Economics from Princeton University and an MBA from the UCLA Anderson School of Management.

At the same time, the credit quality of the U.S. IG market has eroded significantly. The BBB rated industrial segment of the U.S. IG market has grown from 23% in 2007 to nearly 35% currently. In fact, the only other time BBB Industrials were as large a part of the U.S. IG market was following 2002, a period during which several large "fallen angels" transitioned from the U.S. IG to U.S. HY markets.

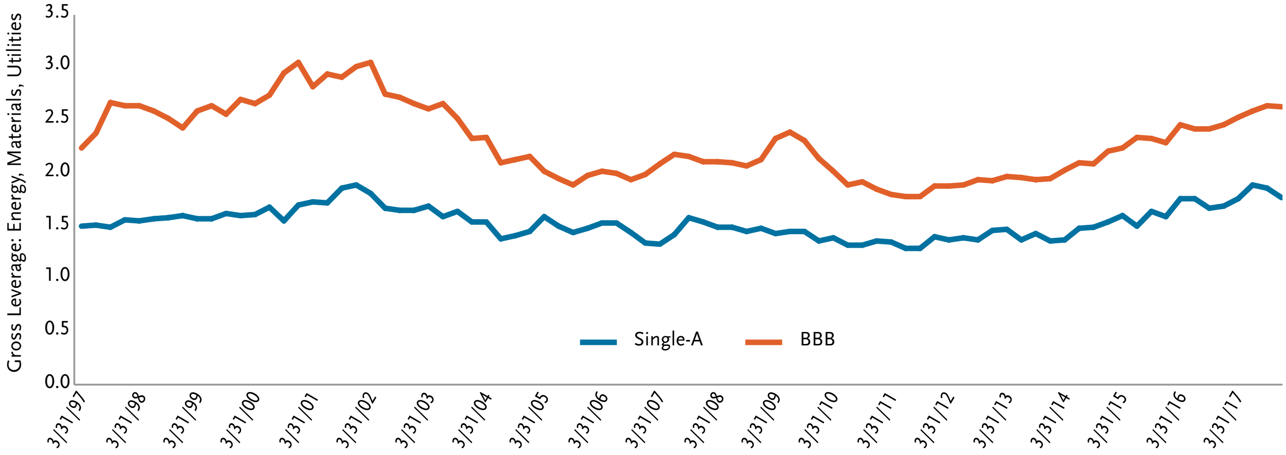
**Substantial Expansion of BBB Industrials**



Source: Barclays

This is important as BBB rated issuer credit balance sheets are weaker than their single A counterparts, as shown below, with at least 1x higher leverage over time. Current BBB industrial leverage statistics are also at levels last seen in 2002.

**Gross Leverage**

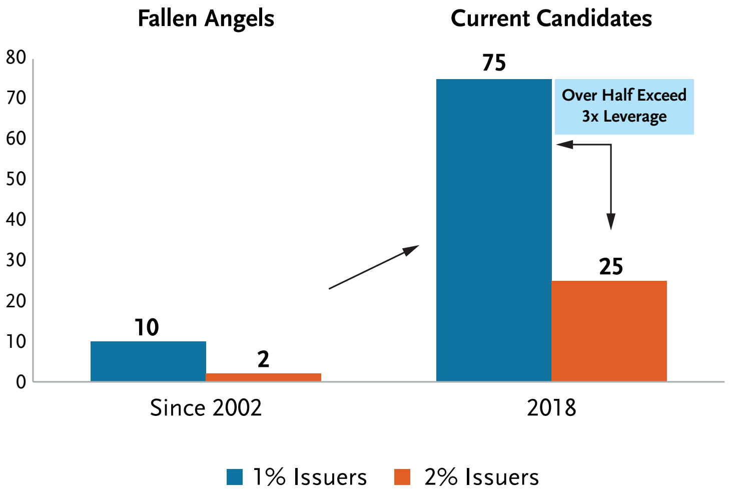


Source: BAML

Not only is leverage high from a historical basis but the weaker group (i.e., BBB) now comprises a significantly higher proportion of outstanding U.S. IG debt.

The accommodative U.S. credit markets have facilitated what we perceive to be one the defining characteristics of this credit cycle: debt funded strategic mergers. Simply put, in the absence of organic growth opportunities, companies merged with competitors via cheap debt (helped by central bank quantitative easing policies) with plans to extract operational synergies. The result is balance sheets among IG issuers that stretch from the typical 1-2x leverage range to the 3-6x range (historically more indicative of a below-investment grade rating) with simply a promise to investors and ratings agencies to reduce debt over the subsequent few years.

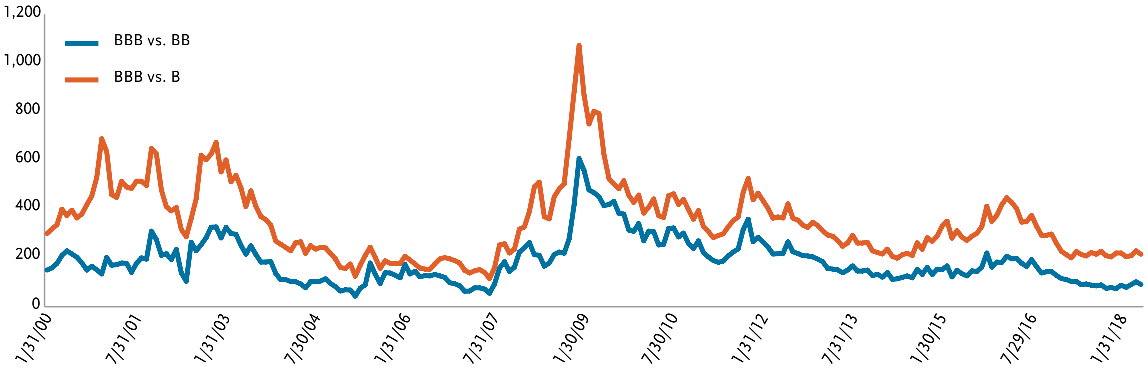
Should deleveraging following a debt-funded merger not occur due to (i) inability to reduce debt, (ii) unwillingness to delever or (iii) rating agencies' changes to their methodology, the credit could become a fallen angel. Another reason this dynamic is so concerning is the sheer size of these companies' balance sheets should they transition to U.S. HY. If an issuer that accounts for 1% of the U.S. IG market were to transition to the U.S. HY market it would become a 4% constituent in that market. Since 2002, there have only been two instances (F/GM) of fallen angels being at least a 2% pro forma constituent post downgrade to U.S. HY. Currently there are 25 U.S. IG issuers that if downgraded would be more at least a 2% constituent in the U.S. HY universe. More importantly, over 50% of those credits have leverage exceeding 3x, mostly driven by debt-funded acquisitions.



Source: Bloomberg, TCW

A fallen angel transition can be disruptive as bonds change hands from U.S. IG investors to U.S. HY investors. Generally speaking, a credit transitioning from BBB to BB can exhibit more volatility than its rating would suggest as new high yield investors become familiar with the fallen angel. As a result, risk premia (spread and price) often overcorrects during the changing of hands. The chart below compares the historical spread differences of BBB vs. BB and BBB vs. single B over time. Notably the difference in spreads becomes more pronounced during periods of market-wide volatility. Hardened credit investors might recall the pronounced volatility that falling angels GM and Ford bonds endured.

Potential Fallen Angel Spread Widening



Source: Bloomberg, Barclays

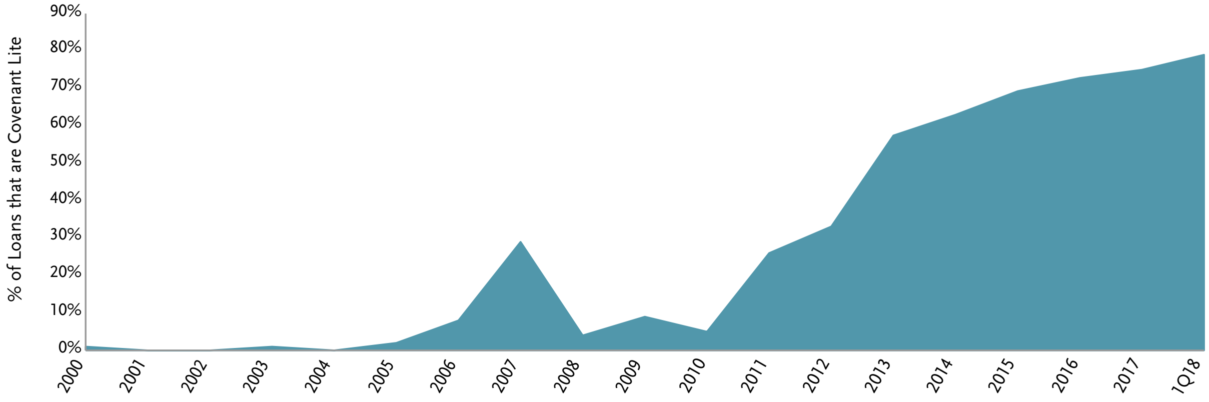
The lower rung of the U.S. IG market is larger than in previous cycles and that's important as the promises that support it are predicated on stretched balance sheets. Though plain for the eye to see, this danger has not garnered adequate concern as of yet.

## Hope

*"Don't lock the stable door after the horse is stolen." ~Proverb*

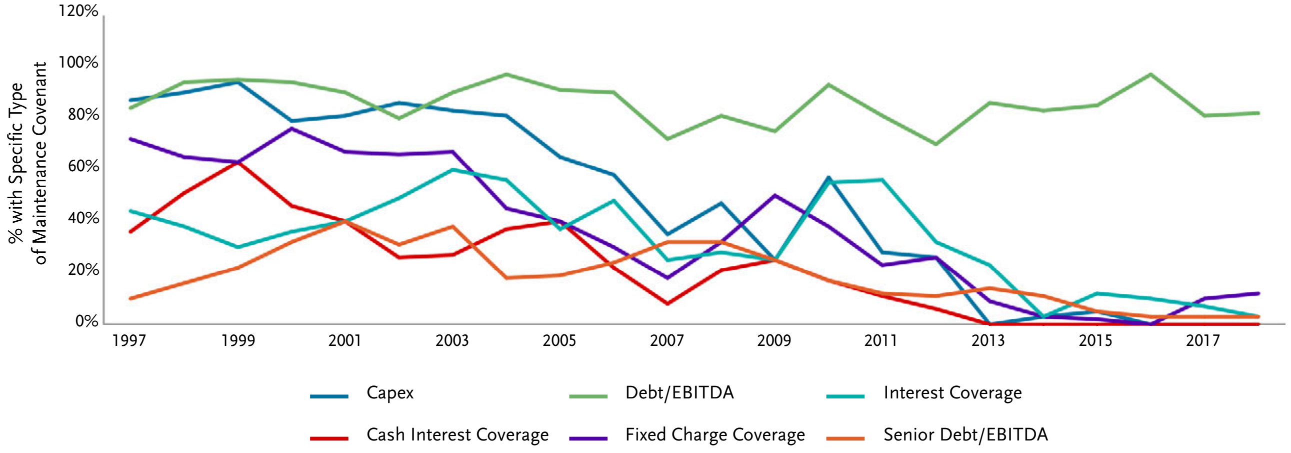
Credit market complacency has lulled investors to overlook some potentially egregiously weak covenants. Barclays analyst Brad Rogoff recently highlighted how pervasive covenant quality has deteriorated along with citing some credit-specific examples of creative transactions. The charts below show that the lack of quarterly financial maintenance covenants, has dramatically expanded. Also, when financial covenants are present, the number of specific covenant tests has fallen significantly. For example, in 2002 the typically leveraged loan capital structure had four specific covenant tests whereas now only one test remains. Bear in mind that in 2002 almost all capital structures contained maintenance covenants whereas currently only about 21% now contain any.

### Expansion of Covenant Lite Loans



Source: S&P LCD

### Fewer Maintenance Covenants

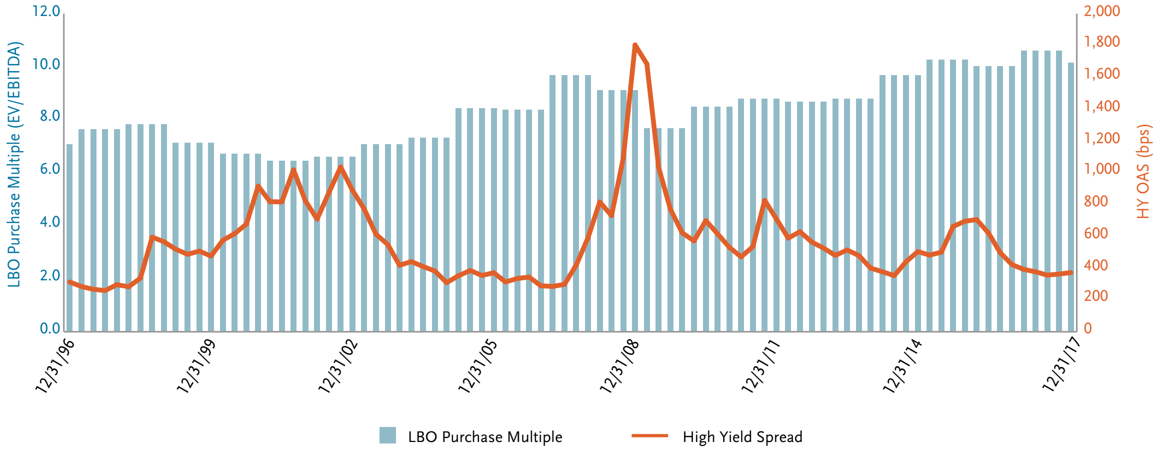


Source: S&P LCD

TCW previously highlighted some covenant dangers that some private equity sponsors might aim to utilize covenant trap doors in the future. (https://mytcw.tcw.com/en/Insights/Viewpoints/09-22-17_A_New_Shell_Game).

As LBO purchase multiples have escalated this credit cycle and with balance sheet leverage limits (i.e., ~6x pro forma leverage) from the U.S. regulator Leveraged Lending Guidelines, private equity sponsors look for sources of available value to meet their IRR targets. Leveraged finance investors are selling this ”equity cram up” option to private equity sponsors precisely when spreads are compressed, indicating meager compensation to investors to bear such risk. Previous late cycle dynamics of escalating LBO purchase multiples and compressed spreads were also clearly evident from 2005-07 during the prior credit cycle.

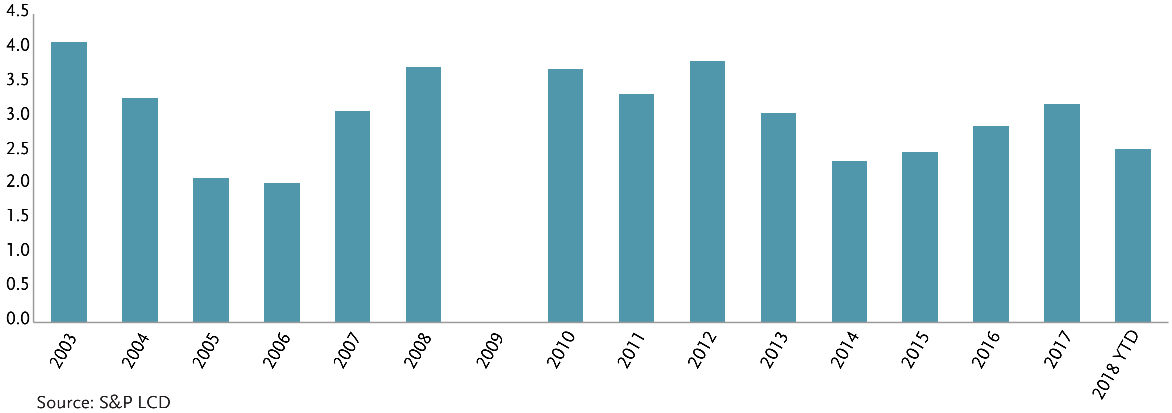
**LBO Purchase Multiples vs. High Yield Spreads**



Source: BAML & Barclays

Tools in the ‘cram up’ tool box include, among others, targeting dividends sooner and setting covenant traps to be able to try to utilize, extract, or steal value or assets from creditors in the future.

**Years from LBO to Dividend**



Source: S&P LCD

Permitting historically weak covenants late in the credit cycle is akin to going to sleep at night with the door unlocked in a crime-ridden neighborhood. One knows it's probably a bad idea but does it anyway figuring: What are the odds that prowlers will choose their house rather than another on the block? In other words, security relies on hope instead of proper security such as locked doors or an alarm service such as ADT.

*Credit market reliance on promise and hope is a dangerous proposition. Even notwithstanding potential default risk development, dangers lurk both in the open and hidden in shadows.* ■

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