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High-yield scrapings

The trailing 12-month default rate on junk bonds will climb to 9% in September 2021, up from 6.3% in the September just passed, according to S&P Global Ratings. Given that 9% would be almost twice the 4.67% yield on offer in sub-investment-grade debt today, it would be well if the rating agency were only half-right.

Now in progress is a tour of what remains of the high-yield market after the Fed's yield-flattening intervention nine months ago. "Public debt has no yield, no covenants and no liquidity, while private debt has yield, covenants and no liquidity," says our friend Michael Lewitt, investor and author (see his monthly newsletter, "The Credit Strategist"). Our sentiments exactly.

Even so, if you turn over rocks, you still can find bonds (see below). Then, too, a fascinating debate rages between the mute Mr. Market, on the one hand, and the ratings agencies, on the other. So there's every reason to read on.

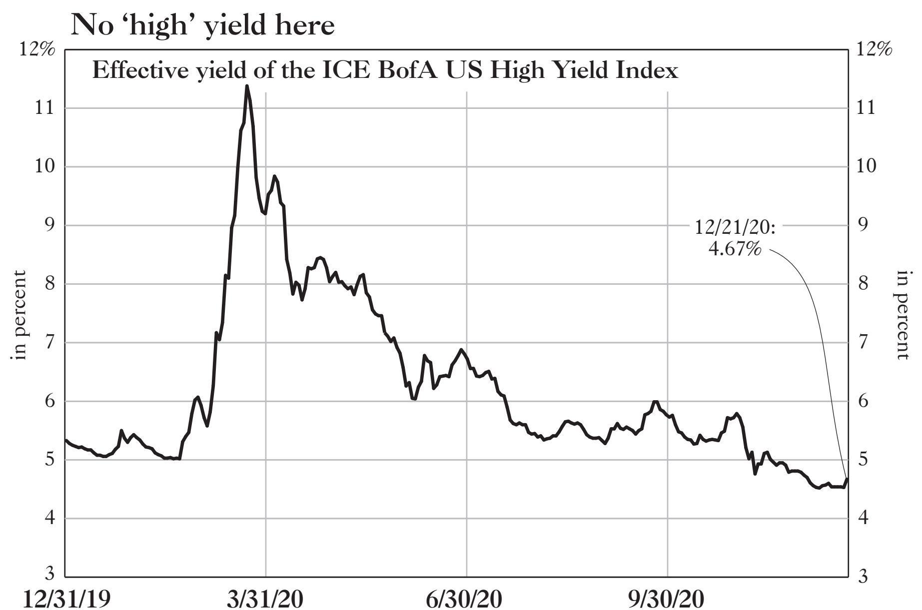
As to the outlook for defaults, Moody's Investors Service sees it the same way as S&P, while a third agency, Fitch Ratings, dissents with a 2021 default prediction of 5%–6%. Mr. Market is the bullish outlier. By examining the proportion of bonds now trading at distressed levels, a couple of credit analysts at BofA Securities, Eric Yu and Oleg Melentyev, have produced a market-derived average default prediction for 2021. It is just 2.6%.

"It would be highly unusual to see cyclical-low defaults coming off of cyclically high (and only moderately improving) leverage," the BofA pair allow, but they don't entirely rule it out. Two vaccines, one Federal Reserve and the blessed prospect of a reopened economy create a range of upbeat possibilities.

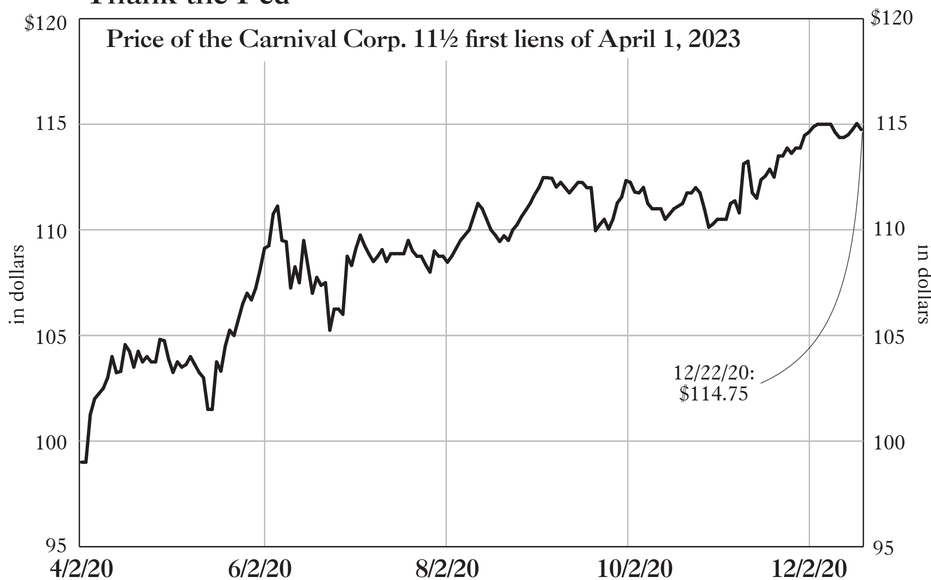
"Holders of junk-bond mutual funds and ETFs had better hope for that highly unusual outcome," observes colleague Evan Lorenz. "Thus, the iShares iBoxx $ High Yield Corporate Bond ETF (HYG), the largest junk-bond ETF, is burdened with a 0.49% expense ratio and sports a 30-day dividend yield of 3.7%. Assume, for one moment, that Fitch is correct (a 5.5% default at the midpoint) and that defaulted bonds will lose half their face value and total losses would sum to 2.75%. This would reduce the prospective yield on the HYG to 0.95%. Under such a scenario, investors would be better off owning the iShares iBoxx $ Investment Grade Corporate Bond ETF (LQD), which has a 30-day yield of 1.87%."

Struggling borrowers won a reprieve after the Fed heaved its kitchen sink at the credit markets on March 23. There'll be a bill to pay for that grand gesture, of course, but probably not until late next year or into 2022, says James Sprayregen, the founder of the restructuring group at Kirkland & Ellis. Nor will it be a 2009-level wave of defaults, he predicts: "I think this is sort of old-fashioned restructurings of over-levered companies that are going to need to adjust their capital structures such that both the equity and the more-subordinated debt tranches may need to be eliminated. And somebody higher up the capital structure will convert their debt to equity and be the new owners."

And there's something else to add



Thank the Fed



source: The Bloomberg

to the positive side of the ledger. To the rest of the world, borne down by sub-zero yields, America's junk market shimmers like an oasis in the desert. "We're still going to grow central bank balance sheets by 50% in calendar year 2021 and keep rates globally pinned at zero," David DePaolo, the CIO for U.S. and developed-market credit at the Brazilian hedge fund SPX Capital, tells us. "You just added another trillion dollars of negative-yielding debt over the last week or so, so that the global negative-yielding debt stock now stands at $18 trillion. When you look at that dynamic, there are a lot of pension funds and asset allocators that have income problems."

Thus, the world's income problem became corporate America's borrowing opportunity. For example, on April 1, Carnival Corp. sold $4 billion in first-lien three-year notes with an 11½% coupon at 99—not unreasonable terms, as cruise revenue stopped cold. As recently as June 29, the 11½s fetched more than 8%. Today, they change hands at a price to yield 3.8%—unattractive, perhaps, but still, it's a positive 3.8%.

Lewitt, for one, finds more to do in private securities than in public ones. In the private market, smallish, sometimes troubled companies negotiate with opportunistic lenders. What you can find, says Lewitt, are protective covenants (long since gone from the public market) and collateral, typically real estate. Yields range in the teens. To be sure, there's no liquidity in the private market (then, again, there isn't much in the public one, either, if you have $5 million's or $10 million's worth of bonds to move). "At least," says Lewitt, "in the private market you can—and the private market is probably bigger than the public market now—control your fate a little bit more."

David Sherman, founder and portfolio manager of Cohanzick Management, LLC, notes that defaults aren't the only risk facing the public high-yield market. Interest-rate risk, too, is prevalent nowadays, and with that in mind, he focuses on near-term maturities and on smaller, high-yielding off-the-run issues.

Consider, for example, says Sherman, the unrated Linkem S.p.A. floating-rate first liens of Aug. 9, 2022, of which €120 million are issued and outstanding. Linkem is a privately held Italian telecom provider. The bonds pay Euribor (with a zero-percent floor) plus 600 basis points and are priced at €100.845 for a yield-to-worst (to the Sept. 30, 2021 call) of 4.9%. "During Covid," observes Sherman, "the biggest problem of the business is that they couldn't get wireless broadband internet installed quick enough because their workers were sick."

While Linkem does not report its financials to the public, Jefferies Financial Group, Inc. owns 56% of its fully diluted equity. At the Jeffries annual October investor meeting, the investment bankers said this about their Italian holding: "The results of Italy's 3.6–3.8 GHz frequency auction that concluded on October 2, 2018 implied an estimated value of approximately €1.3 billion for Linkem's frequency, without ascribing any value to Linkem's growing operating business, customers or other assets." If so, the first liens would be well-secured on spectrum holdings alone.

Like Linkem, the Caa1/single-B-minus-rated HC2 Holdings, Inc. first-lien 11½s of Dec. 1, 2021 tick Sherman's boxes. Priced at 99¾, the bonds offer a prospective yield of 11.9%. Formerly Primus Telecommunications Group, Inc., the company took its current name in 2014 when Phil Falcone became the chairman of the board. The controversial financier left the company in June; Avram Glazer, who, through his fund Lancer Capital, LLC, owns 24.8% of HC2 shares outstanding, became the chairman and Wayne Barr, Jr., the CEO. Today, ex-Falcone, HC2 is involved in a hodgepodge of both majority-owned and minority stakes in businesses ranging from construction to insurance.

As of Sept. 30, HC2's balance sheet showed $646.4 million in debt, including $340.4 million of the 11½s. Over the past 12 months, the non-insurance businesses generated adjusted Ebitda of $84.2 million and the insurance operations earned $46 million in adjusted operating income.

The new corporate M.O. is to sell assets to repay debt and simplify the organization chart. A Nov. 25 rights offering raised $65 million, with Lancer buying $21.4 million's worth of shares. So far in December, Lancer has purchased an additional $10.1 million's worth; on Dec. 10, HC2 received a bid of approximately $90 million for its insurance operation.

"I think [the 11½s of 2021] are covered in [the event of a] bankruptcy," says Sherman. "And, again, you have a smart investor who has been putting equity money underneath recently."

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