Viewpoint

Beware – Things Are Not Always as They Appear

December 2018

A segment of the investment grade market has leverage multiples more in-line with high yield. We believe investors will be well served applying a credit-sensitive lense to this segment of the market.

The recent pullback in global equity and credit markets has been attributed to a variety of risks: concerns about slower global growth, global central bank quantitative tightening, overstretched valuations, trade tensions and weaker prospects for technology companies including the FAANGs (Facebook, Apple, Amazon, Netflix and Google). These are the known risks.

What about the lesser known risks that induce a false sense of safety? We believe select names within the investment grade market, an asset class typically associated with lower volatility, face real risks related to increasing leverage. Investors and rating agencies have been complacent, as rising leverage is assumed to be reduced by global growth and central bank backstops.

But what happens if these conditions are no longer present? We believe credit spreads are not adequately compensating investors for holding bonds that, based on their leverage, more closely resemble sub-investment grade counterparts. As we enter the final stages of the economic cycle with the potential for slower growth, we believe investors are best served by taking a credit sensitive approach to investment grade corporates.

While we do not expect an uptick in defaults, risk assets may reprice as investors become more aware of underlying credit risk and leverage.

Increasing Investment Grade Leverage

In the last few years, we have observed many investment grade companies borrowed excessively and used the proceeds of this borrowing for the purposes of share buy-backs (to bolster stock prices/dividend increases) and M&A (to engineer growth).

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Portfolio Manager

Prior to joining Muzinich, Anthony was an investment grade credit trader at Société Génerale for four years focusing on the consumer, retail and industrial sectors. Prior to that, he spent 11 years in debt capital markets at Barclays Capital and Deutsche Bank where he advised corporations on financing and solution strategies. Anthony holds a B.A. in Economics from Cornell University.

These companies borrowed at historically low interest rates and believed that, with an improving economy and strong growth, they would be able to gradually deleverage their balance sheets.

In a weaker economic environment, we believe that some of these credits could suffer leverage multiples more in-line with high yield (4.0 to 5.0x) and become downgrade candidates.

Fig. 1 highlights pro-forma leverage at acquisition, target leverage and current leverage for several investment grade borrowers. As you can see, most companies in the below table are still far from reducing their leverage to their target levels.

The majority of these companies have a BBB rating with expectations by the rating agencies of near-term debt reduction. Potential slower economic growth and/or allocation of cash to buybacks/dividends/acquisitions provides headwinds for these companies to reach their target leverage.

Fig. 1 - Deleveraging Paths of Highly Leveraged M&A - Related Companies

Ticker	Rating	Pro Forma Leverage at Acquisition	Target Leverage	Current Leverage
Anheuser-Busch InBev	A3	5.5x	2.0x	4.8x
Mylan	BAA3	4.0x	3.0x	3.9x
Newell Brands 1	BAA3	4.9x	3.0-3.5x	4.7x
Bayer AG 1	A3	4.8x	2.0x	5.4x
Cardinal Health	BAA1	2.6x	>2.0x	3.0x
British American Tob	BAA2	4.1x	3.0x	4.1x
Sherwin-Williams	BAA2	4.5x	2.0-2.5x	4.0x
Molson Coors Brew	BAA3	4.8x	3.8x	4.2x
Becton Dickinson	BAA3	4.7x	3.0x	4.2x
AT&T	BAA2	3.2x	2.5x	3.2x
Verizon Comm	BAA1	2.6x	1.8x	2.4x
Campbell Soup	BAA3	4.8x	3.0x	4.8x
General Mills	BAA2	4.3x	3.5x	4.3x
Keurig Dr Pepper	BAA1	5.5x	3.0x	5.5x
Discovery Comm	BAA3	4.9x	3.5x	4.3x
Danone	A2	4.0x	<3.0x	3.3x
Typical high yield company leverage 2		4.0-5.0x		

1. Gross leverage. Net Leverage shown for all other names.
2. Muzinich estimate. Leverage defined as Total Debt / EBITDA
Source: Barclays US Credit Research M&A Names on Notice, 4 October 2018.

Are Investors Being Compensated for the Risk?

Fig. 2 highlights steadily increasing leverage levels within the BBB segment of the investment grade market (blue line) at the same time that spreads decrease to historic tights.

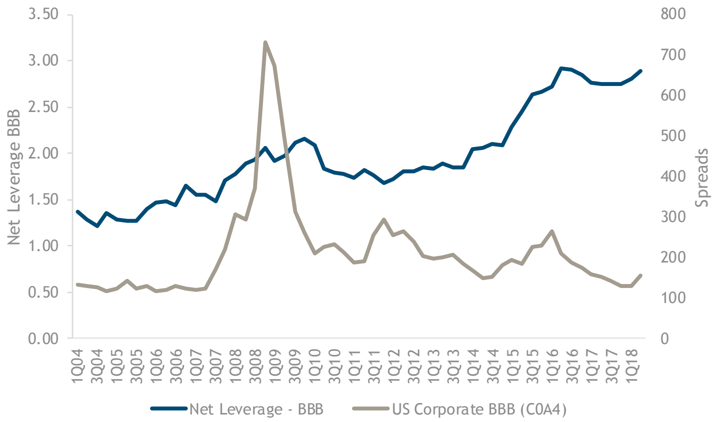
This implies that while leverage (risk) has been increasing, spreads (reward) have been decreasing since early 2016.

Hidden Danger: Downgrades/Potential for Downgrades could lead to ratings based forced selling and repricing within investment grade

A noteworthy feature of the corporate credit buyer base is that many institutional investors, like insurance companies, are limited in their ability to hold high yield, or are required to hold more capital against a high yield investment on their balance sheet for regulatory purposes.

Thus, when an investment grade company is downgraded to high yield, many investors become forced sellers. This brings increased market risk to investors as prices decline due to forced selling of the downgraded bonds.

Fig. 2 – Increasing Leverage, Tightening Spreads



Source: Net Leverage – JP Morgan. Spreads are ICE BofA ML BBB US Corporate Index (C0A4). As of June 30, 2018. The latest net leverage figures are only available as of June 30, 2018.

Hidden Danger: Corporate Hybrid Securities

The hybrid instruments of challenged investment grade issuers present significant pricing and duration risks to investors.

Investment grade companies issue debt-like instruments known as hybrid securities to receive equity credit for only incremental cost relative to senior bonds. Depending on the ultimate structure, equity credit of 0% to 100% can be attained.

A Fortune 500 company issued a perpetual security (on December 18, 2015) that received partial equity credit (50%) based on its features (non-cumulative dividend, no maturity), with an option to redeem. Many investors, accustomed to solely relying on the A rating, and not anticipating any financial difficulty from a bellwether name, bought this security for the incremental yield it provided, and held it in short maturity accounts given the expectation of a call. However, this security has come under significant pressure recently due to company-specific problems (high leverage, operational challenges, and questionable acquisitions).

"Things are not always what they seem; the first appearance deceives many; the intelligence of a few perceives what has been carefully hidden" – Plato in Phaedrus

As we do not forecast an uptick in defaults, we believe carefully selected credits, regardless of their ratings, represent real value at today's more attractive yields.

Given some of the hidden dangers discussed above, we believe investors are well served by an investment manager rooted in bottom-up fundamental credit research analysis. Fundamental research means that a company's finances are thoroughly analyzed and that leverage and growth prospects are properly understood.

As credit analysts, we must be able to determine whether a company, irrespective of its rating, is creditworthy – that is, will a company make its contractually stated coupon payment and pay back principal at maturity.

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Market Index Descriptions:

C0A4 - The ICE BofA ML BBB US Corporate Index is a subset of the ICE BofA ML US Corporate Index (C0A0) including all securities rated BBB1 through BBB3, inclusive.