SILVER CREEK
CAPITAL MANAGEMENT

MARKET UPDATE
CORPORATE CREDIT
SOWING THE SEEDS OF DISTRESS
NOVEMBER 2018

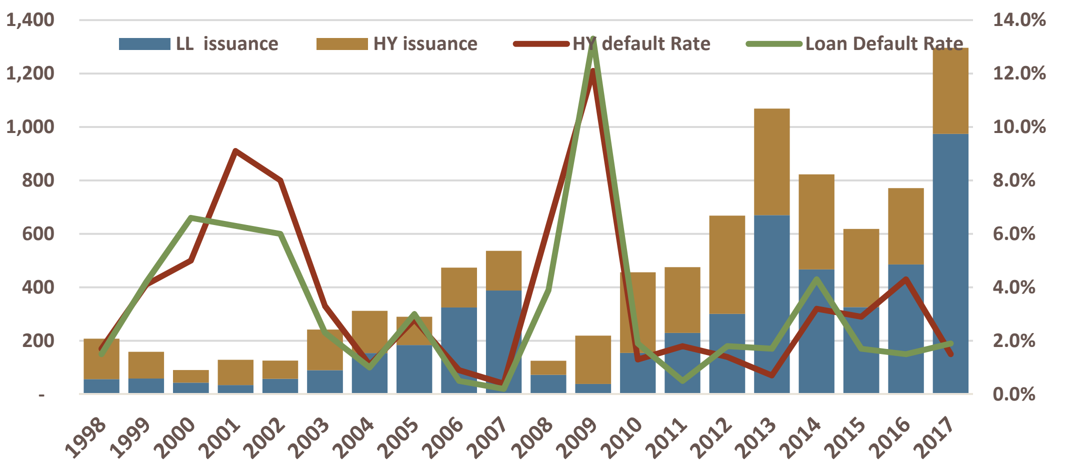
SUMMARY

When there is little distress across the credit markets, the opportunity for corporate distressed investments can seem counterintuitive. Despite the recent increase in volatility in the equity markets, credit markets have remained much more stable and defaults have remained low. It is times like these when we feel it is important to look around the corner for what is next. Despite continued relatively stable performance, Silver Creek has been closely monitoring the public credit markets for the past few years. We view this area to hold a high potential for future volatility and the possibility of a correction. We believe that the combination of low defaults, low interest rates and high demand for yield has aided in keeping the markets afloat longer than many would have anticipated. While the low cost of capital has been relatively successful in fueling growth and preventing large-scale defaults, it has also had the effect of creating a large, and arguably fragile, market that in our view is not sustainable in the long run. We believe that cracks are beginning to form at the base of the credit markets, and in some cases these cracks have continued to expand beyond expectations. While we are unable to predict exactly how the cycle will play out or the timing of a correction, we believe now is the time to begin positioning ourselves to take advantage of opportunities presented when the market corrects. This paper will outline some of the key statistics and figures to support our belief that a downturn in corporate debt markets is likely to offer sophisticated investors a robust environment for identifying compelling investment opportunities.

MARKET OVERVIEW

The current face value of the U.S. corporate debt markets (including investment grade, high yield and levered loans) is over $7.4 trillion[1]. The largest component of this figure is the U.S. investment grade corporate bond market outstanding which stands at ~$5.1 trillion[2] followed by ~$1.2 trillion in high yield bond debt[3] and ~$1.1 trillion in leveraged loans[4]. The expansionary monetary policy established by central banks globally has driven significant demand for yield which in turn has driven significant growth in the U.S. high yield and leveraged loan markets since the global financial crisis. Due to the attractiveness of floating rate instruments in the face of rising rates, the U.S. leveraged loan market has been a headline grabbing product after reaching record levels of $1.4 trillion of issuance in 2017[5], up 60% year over year. For context, these levels of issuance stand 24% higher than the previous full year record achieved in 2013. Issuance YTD through October 2018 stood at over $1 trillion[6] according to the latest report by Thompson Reuters, and while that is shy of the record set in 2017 it is already above the 2015 and 2016 issuance figures with two months left in the year.

FIGURE 1: U.S. LEVERED LOAN AND HIGH YIELD ISSUANCE IN ($BIL)



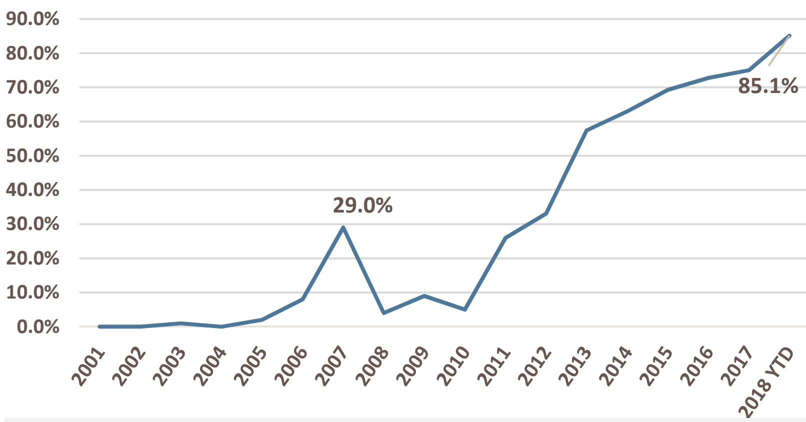
Source: JP Morgan

The issuance in the leveraged loan market is only part of the story. When we look further than just the public markets we see that the true size of the loan market has grown much larger than what public market data alone would imply. UBS estimates that when looking at the broader universe including bank C&I loans and middle market loans at CLOs, BDCs and private debt funds, the total size of U.S. speculative grade floating rate debt is closer to $3 trillion[7]. In addition to the floating rate debt market, while not at record levels, the U.S. high yield market continues to have strong issuance coming in at $281 billion[8] in 2017, up 24% year over year. According to S&P Global Market Intelligence, high yield issuance in the U.S. has come down to $161 billion through October 2018[9], down 32% year over year, as market volatility and a preference for floating rate loan issuance has put a damper on bond issuance.

One reason to closely monitor the levels of issuance in leveraged loans and high yield markets is the historical relationship between high levels of issuance in both of these credit markets and default rates. As you can see from Figure 1, periods of high levels of issuance in both leveraged loan and high yield markets have been followed by sharp increases in default rates. A major factor in this relationship is the propensity for credit markets to loosen their underwriting standards to satisfy such substantial demand leading to overall lower quality of credit. Such conditions do not necessarily directly correlate to higher defaults, especially if they are offset by other factors such as strong economic growth. But when the growth eventually subsides and the tide goes out, the lower credit quality rapidly becomes apparent.

CREDIT QUALITY DETERIORATION

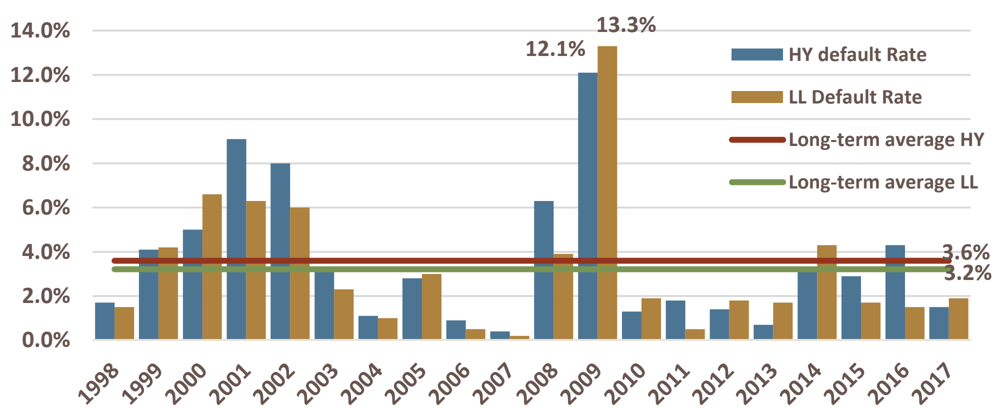
FIGURE 2: % OF ALL NEW ISSUE INSTITUTIONAL LOANS THAT ARE COV-LITE



Source: S&P LCD

The amount of growth we have seen in the credit market is staggering, but as we previously indicated, what may be even more relevant is taking a closer look at how the quality of underwriting and structuring credit have changed to meet such substantial demand for the product. One of the key indicators of looser underwriting standards and the overall decline in credit quality comes from the saturation of covenant-lite loans. Such loans lack restrictions related to financial maintenance tests or other performance indicators that provide creditors early indicators of financial instability. Covenant-lite loans as a percentage of institutional loan issuance has grown significantly in the past decade ending 2017 at 75%, up from 29% at yearend 2007[10]. This trend has only continued in 2018 as covenant-lite loans now make up approximately 85% of new issuances through Q3 2018[11.]

FIGURE 3: U.S. LEVERED LOAN AND HIGH YIELD ANNUAL DEFAULT RATE



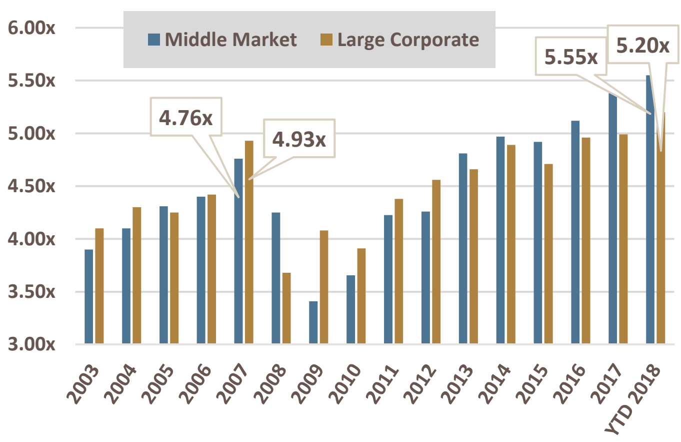
Source: JP Morgan, Silver Creek

Another challenge presented by the proliferation of covenant-lite loans is the lack of an early warning system for creditors that their borrowers may be beginning to struggle. Without the structural restrictions or tests that covenants provided for creditors, companies that may be starting to show signs of stress can go undetected leading to lower default rates and the appearance of strong performance despite potential stress. The last few years have seen default rates below their long term averages (see Figure 3)[12]. Much of this trend can be associated with strong economic growth, which in some ways justifies the use of covenant lite structures by borrowers. We believe that the lack of covenants in leveraged loans have also allowed higher risk companies to avoid defaults compared to previous cycles which potentially keeps default rates artificially low.

With the continued lack of systemic defaults, companies and corporate capital structures are also carrying higher risk profiles in the form of increasing leverage levels in newly issued loans. We are seeing increased leverage levels with both large corporate and middle market loans being issued at leverage levels that sit above pre-crisis levels. The number of loans that have less than 5x EBITDA multiples has also steadily decreased since the global financial crisis (see Figures 4 and 5)[13].

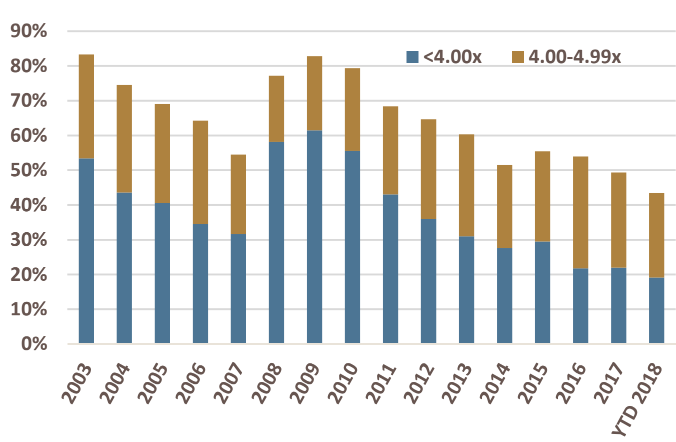
Many market participants have begun to point to the quality of earnings as an additional source for stress. One of the more recent trends we have seen in leverage and interest coverage metrics is the broad acceptance of adjustments to credit ratios for earnings add-backs (e.g., synergies, cost savings, restructuring charges).

FIGURE 4: AVERAGE DEBT MULTIPLES OF LOANS



Source: S&P LCD

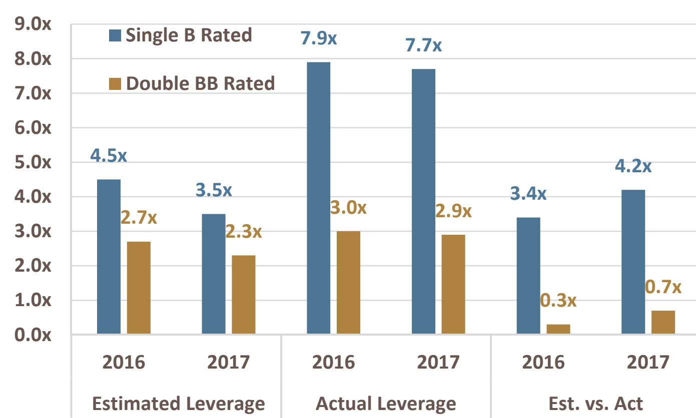
FIGURE 5: LEVERAGE OF LARGE AND MIDDLE MARKET LOANS



Source: S&P LCD

As an example, earnings adjustments in M&A and LBO related leveraged loan new issuances has become the market standard, approaching 25% on average and 50% in the extremes[14]. As a result, the total amount of leverage as it relates to a company's EBITDA for U.S. Leveraged Loans is closer to 7x on average when backing out those adjustments[15]. The early indicators are that the ultimate realization of these add-backs has been disappointing. A recently published study by S&P analyzing the ultimate realization of add-backs for 50 deals from 2015 concluded that projections in that sample appear aggressive with realized EBITDA on average falling 29% short in the first year and 34% short in the second year[16].

FIGURE 6: ESTIMATED VS REALIZED LEVERAGE OF B AND BB



Source: UBS, Covenant Review, S&P LCD

HIGH YIELD MARKET TECHNICAL SUPPORT

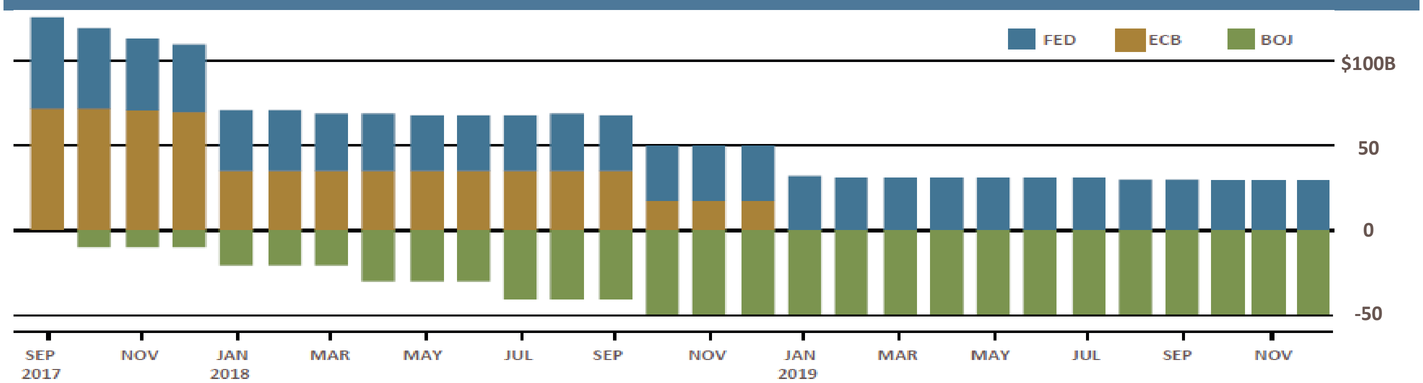
There are other factors we believe may be masking the true level where corporate debt should trade. In the high yield market low supply levels relative to demand for the debt has created technical support for high yield bonds as any new supply into the market is quickly bought up. The net issuance of high yield in 2018 has been negative as both called and maturing debt have outpaced the new issuance year to date. The last time this occurred was in 2008[17]. Some of the drivers of negative net issuance include M&A activity and increased use of levered loans by issuers. M&A activity cuts into the supply when larger investment grade companies purchase riskier businesses that had previously issued high yield debt. We have also seen a trend of issuers drawn in by debtor friendly features of levered loans, such as coupons that take advantage of historically low rates, lack of covenants and call protection. An issuer's preference for such terms may lead them to issue loans instead of bonds or in some cases replacing bonds with loans.

The impact M&A activity has had on issuance should eventually dissipate as the pool of potential targets becomes more and more picked through and the benefits from these mergers are challenged. That said, the impact of interest rate increases should continue to be more prevalent. As rising rates continue to push up the cost of capital, issuers will inevitably become less willing to raise capital through the floating rate and leveraged loan market. These factors point to an increasing supply of high yield bonds erasing the technical support that has kept the market propped up this year.

Earnings growth, which has been strong since 2016[18], is also expected to be affected by headwinds of rising input costs such as labor and materials. The Bureau of Labor Statistics recently reported that the Employment Cost Index for civilian workers rose 2.9% year-over-year, the largest increase since the 12 month period ending September 2008[19]. Because labor costs can make up to two-thirds of total costs for many companies, input cost inflation will also have an impact on output prices. Factors other than the higher cost of labor, including the effects of tariffs on goods, point to a more expensive cost of raw materials that will have a negative impact on profitability for companies.

In addition to the impact that rising interest rates may have on the demand for high yield products, we expect to see institutional investors that have been chasing returns targets shift their strategy towards the less risky investment grade space. We saw evidence of this in October when investors redeemed over $4 billion of capital from high yield ETFs, a record monthly outflow according to Oppenheimer[20]. Further, the end of quantitative easing will open up the less risky bond markets to investors that have been more or less forced into the high yield markets due to lack of opportunities. Bloomberg has reported that the U.S. Federal Reserve is now allowing up to $50 billion of bond holdings to mature every month without replacing them and Bloomberg is projecting negative net asset purchases beginning in 2019 for the U.S. Federal Reserve, European Central Bank and Bank of Japan in aggregate (see Figure 7)[21].

FIGURE 7: NET ASSET PURCHASES AT MAJOR CENTRAL BANKS



Source: Bloomberg Economics
Note: Fed estimates based on caps from FOMC. Runoff pace could be smaller, given limited amount of maturing securities

POTENTIAL STRESS POINTS

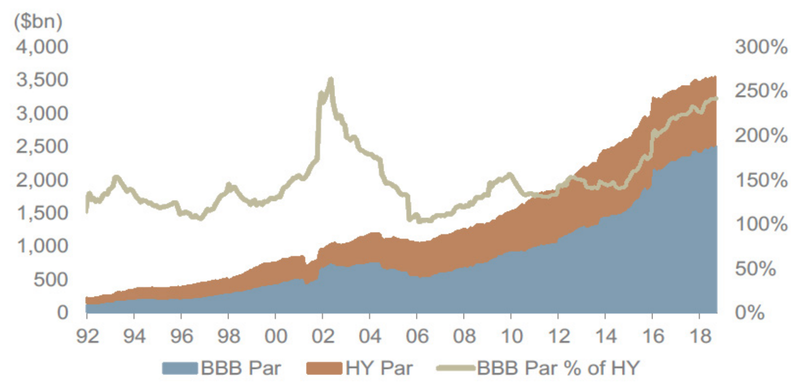
In addition to the increasing cost of labor and materials, increasing interest rates will also make it more challenging for companies to continue to service their debt. UBS reports that projected rate increases by the Fed will lower the average cash interest coverage ratios for all B+ and B rated firms to below 3x EBITDA/interest expense (or 2x EBIT to interest expense)[22]. This implies that the borrowing firms are allocating over 50% of their profits solely for paying interest. As noted earlier, corporate earnings have benefited from strong economic growth but should the economy slow down, it is easy to see how businesses could quickly run into trouble servicing more expensive debt. Guggenheim recently concluded that 5 of the 10 major industry categories will have to generate equal or higher earnings growth to maintain their current interest coverage[23].

BBB RATED INVESTMENT GRADE DEBT

As if many of the factors we have mentioned so far were not enough cause for concern, we find particularly worrisome the increasing levels of BBB rated investment grade debt (i.e. the lowest quality investment grade debt). According to their October 2018 report, Morgan Stanley places the par outstanding amount of BBB rated debt at $2.5 trillion[24]. This is a 227% increase from 2009 when there was just $770 billion of outstanding BBB rated debt[25]. This staggering growth has primarily come from two sources, new issuance (~$1.2 trillion) and downgrades to a BBB rating ($745 billion)[26]. The jump in BBB levels is not sector specific as the number of BBB rated issuers only increased 60% since 2009 and the growth has been broad based, including both large and small companies[27]. Morgan Stanley estimates that approximately 55% of the BBB debt outstanding would carry a high yield rating if the ratings were solely based on leverage levels – an increase from 30% in Q1 2017 and 8% in 2011[28].

The risk that stands out from this analysis is the sheer size of the BBB par outstanding bucket and how potential downgrades would impact the high yield market. Looking at the previous three broad downgrade cycles, Morgan Stanley found that ~7-15% of the investment grade index was downgraded to a high yield rating[29]. This time around, additional risks are posed as approximately half the market is already in the BBB bucket (again, the lowest rated investment grade bucket) compared to 27% before the 2000-2003 downgrade cycle[30]. Adjusting for this difference, Morgan Stanley estimates that approximately 11-22% of investment grade debt could be downgraded to high yield ratings during the next cycle[31]. This would represent total downgrade volumes of $550 billion to $1.1 trillion over the next cycle[32]. For context, such downgrades could effectively double the high yield market which currently stands at approximately $1.2 trillion[33]. This increase in supply could have a devastating impact on companies' ability to issue high yield bonds.

FIGURE 8: BBB PAR VALUE VS HY PAR VALUE

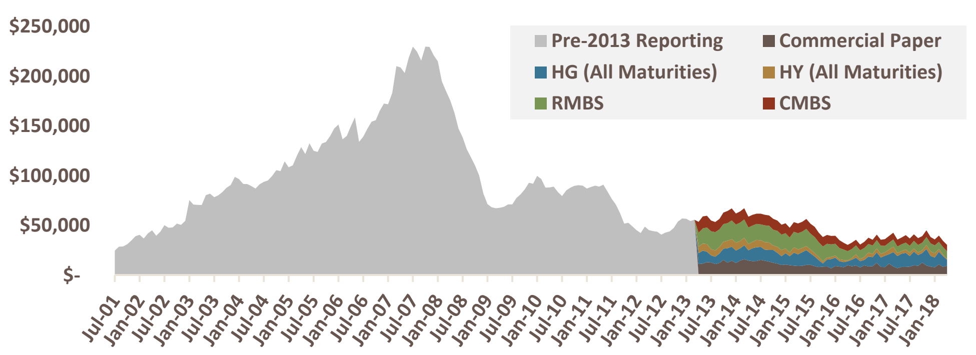


Source: Morgan Stanley Research, FTSE Fixed Income LLC

SHRINKING MARKET DEPTH

Another area of concern is the potential for a dramatic increase in volatility. Increased regulation on participants in high yield markets has resulted in dramatic declines in debt inventories on the balance sheets of U.S. banks which have historically provided liquidity as market makers. According to data from the Federal Reserve Bank of New York, U.S. banks held approximately $8.4 billion of high yield debt as of June 5, 2013 and approximately $1.6 billion as of October 24, 2018[34]. The trading desks of these banks that previously were active participants in the market have been limited in their ability to act as principals in transactions and in their market making capabilities for high yield securities. The lack of trading counterparties is not isolated in just the high yield markets. In total, the share of bank principal capital in the form of net dealer positions has decreased to approximately 20% of the levels they were pre-Global Financial Crisis[35].

FIGURE 9: PRIMARY NET DEALER POSITIONS IN $USD MILLIONS



Source: Market Axess and Federal Reserve Bank of New York. As of October 24, 2018

The severe reduction of counterparties that will be able and willing to bid on high yield paper in the market has created a more inefficient market that will likely result in more volatile pricing, especially in periods of forced selling. We expect that leveraged loan markets, which tend to be less liquid, are also likely to suffer as forced sellers struggle to find a counterparty willing to offer price bids at anything other than steep discounts to value.

CONCLUSION

Credit markets have grown rapidly since the Global Financial Crisis. While recent economic growth has supported the market, we have seen a dramatic decrease in underwriting standards for companies that are carrying higher risks in the way of weaker credit quality. While fundamentals appear to be stable today, we believe they only appear that way due to the recent surge in earnings growth and the long period of low interest rates that has effectively delayed the inevitable pain to come. The increased size of the market adds to the risks as we believe the corporate debt market has become bloated and fragile, making it more likely to result in a significant default cycle with more breadth and depth compared to the last. Current default levels are below their long term averages, no doubt aided by the positive performance of the earnings on the back of GDP growth, the lack of covenants and accommodating government policies. The defaults are not likely to come quickly and all at once since the issuers using leveraged loans with little to no covenants are shielded from the breaching of relatively easy triggers. But when defaults eventually hit the market, we expect them to present a substantial opportunity set.

We anticipate that the next credit default cycle will present attractive opportunities for distressed debt investors. Unfortunately, no one can predict when the credit cycle will take a turn for the worse. When taking into consideration that default cycles tend to lag economic downturns by at least a year, investors cannot afford to sit on the sidelines waiting to deploy capital into the wave of restructurings that arise in periods of high defaults. Outside of a default cycle, we believe attractive opportunities will present themselves in corporate debt markets in the form of price dislocations caused by downgrade activity and magnified by the lack of trading counterparties in the current market. The potential volatility of the high yield and leveraged loan markets is a theme that we are very closely monitoring and believe now is the time to strategize how to best position capital to take advantage of opportunities in both the short and long term.

Endnotes

[1] Bloomberg Article 7/10/18, S&P LCD Q3 2018
[2] Bloomberg Article 7/10/18
[3] ibid
[4] S&P LCD Q3 2018
[5] Thomson Reuters Leveraged Loan Monthly December 2017
[6] Refinitiv Leveraged Loan Monthly October 2018
[7] UBS Global Credit Strategy 8/15/2018
[8] Thomson Reuters Leveraged Loan Monthly December 2017
[9] Refinitiv Leveraged Loan Monthly October 2018
[10] S&P LCD Q3 2018
[11] ibid
[12] JP Morgan Research, Silver Creek Analysis
[13] S&P LCD Q3 2018
[14] Prospective manager commentary
[15] Ibid
[16] UBS Global Credit Strategy 8/15/2018
[17] Prospective manager newsletter
[18] Guggenheim High-Yield and Bank Loan Outlook
[19] Bureau of Labor Statistics
[20] OppenheimerFunds 11/6/2018
[21] Bloomberg Quick Take 7/8/2018
[22] UBS Global Credit Strategy 8/15/2018
[23] Guggenheim High-Yield and Bank Loan
[24] Morgan Stanley Research 10/15/2018
[25] ibid
[26] ibid
[27] ibid
[28] Morgan Stanley Research 8/10/2018
[29] Morgan Stanley Research 10/15/2018
[30] ibid
[31] ibid
[32] ibid
[33] Bloomberg Quick Take 7/8/2018
[34] Federal Reserve Bank of New York. As of October 24, 2018
[35] Market Axess and Federal Reserve Bank of New York. As of October 2018

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