It's Worth Getting Stressed

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Credits that become stressed, trading at 800-1200bp of OAS, do not tend to linger in that condition, with 80% migrating to either a tighter or wider range within 12 months. That migration has a strong bias toward improvement, with two credits moving into a tighter range for each one that moves wider toward true distress. In our view, that combination of volatility and improvement bias makes the stressed range a good place to look for investment opportunities in a low-yielding market.

At the moment, retail and consumer credits are well represented in the stressed pool, with JC Penney (JCP), Sears (SHLD, SRAC), and Toys 'R' Us (TOY) in the top seven stressed names (by market value of debt), along with smaller issues from Gymboree (GYMB), Visant (VISANT), and Sun Products (SUNPRD). We retain long-term concerns about many of these companies, but see opportunities to get long certain parts of the capital structure of these names to take advantage of the typically positive return profile of this bucket: selling 1y CDS in SRAC and JCP; pairing a long position in JCP 6.375s of 2036 or JCP 7.4s of 2037 with a short in the 7.95s of 2017; improving convexity by swapping out of the TOY 10.375s of 2017 and into the TOY 7.375s of 2018; and buying the SUNPRD 7.75% senior notes due 2021 and VISANT 10% senior notes of 2017.

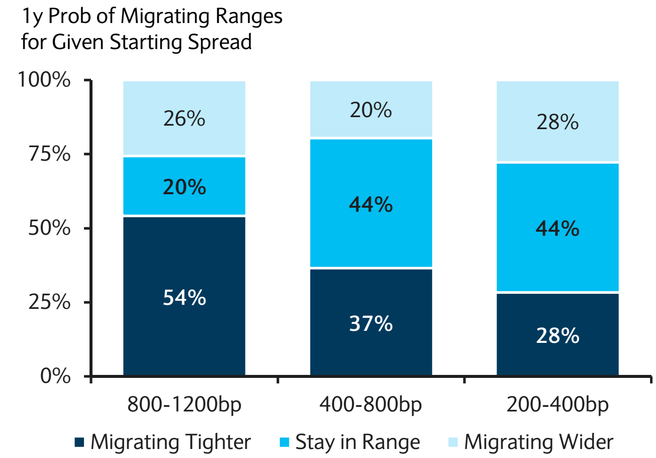
Stressed Credits Do Not Stay That Way Long

Within the credit market, performing and distressed are well-understood states for issuers. Stressed, on the other hand, is a more nebulous and transitory condition that we think creates unique opportunities for credit investors.

For this exercise, we define stressed issuers as those for which the cash capital structure is trading at an average OAS of 800-1200bp. In rough terms, the bottom end of the range is where investors begin pricing a medium-term default to be more likely than not; as an illustration, 5y CDS at 800bp with a standard 40% recovery assumption implies just over a 50% probability of default in five years. The top of the range limits us to credits where default is far from assured; names in that range frequently continue to trade on yield, not necessarily transitioning to the dollar price/recovery value that is typical of distressed firms. While the

FIGURE 1

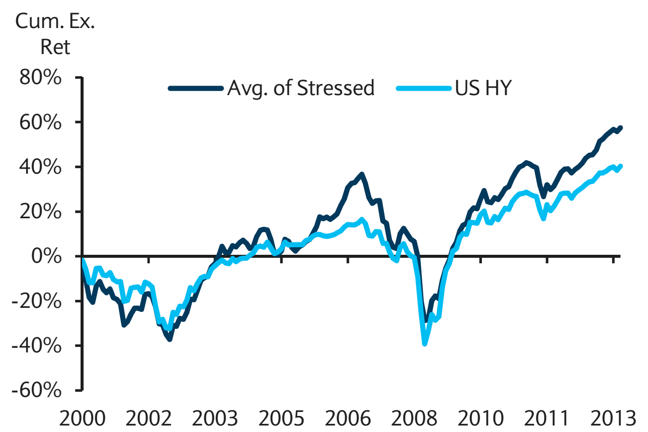
Stressed Credits Have an 80% Chance of Getting Much Better or Much Worse, with Odds Favoring Improvement



Source: Barclays Research

FIGURE 2

The Average Stressed Credit Outperforms the High Yield Index (Although It Is Also Higher Beta)



Source: Barclays Research

range is useful for analytic simplicity, it should not be considered a strict cut-off: using an issuer-average OAS blends away the subtleties of the underlying capital structure in terms of seniority, security, maturity, and default/recovery expectations. Some credits have bonds in that band even if the average overall spread is lower. Other issuers could be considered "stressed" on different quantitative or qualitative criteria even if their full capital structures remain outside our 800-1200bp range, and we believe that views on stress should extend to those firms.

Stress Is an Unstable Condition

Stress is an inherently unstable state for companies: starting in any month since 2000, 80% either improve and migrate into a sustainable lower spread range or get worse and move toward distress within a year (Figure 1). Of the stressed issuers that migrate ranges, odds favor improvement, with two firms moving into a tighter range for each one that moves wider. This contrasts with the relative stability of firms starting in tighter buckets: those that start any 12-month period trading in tighter ranges are twice as likely to end in the same range. In addition, the moves in the tightest spread names are less likely to be favorable, with a better balance between the number that move markedly tighter and those that move wider.

The relatively high volatility, combined with the bias toward improvement, makes stressed credit an especially good place to look for opportunities, in our view. This is supported by the baseline performance of issuers, with the average stressed credit outperforming the High Yield Index by nearly 2pp annually in the past decade (Figure 2).

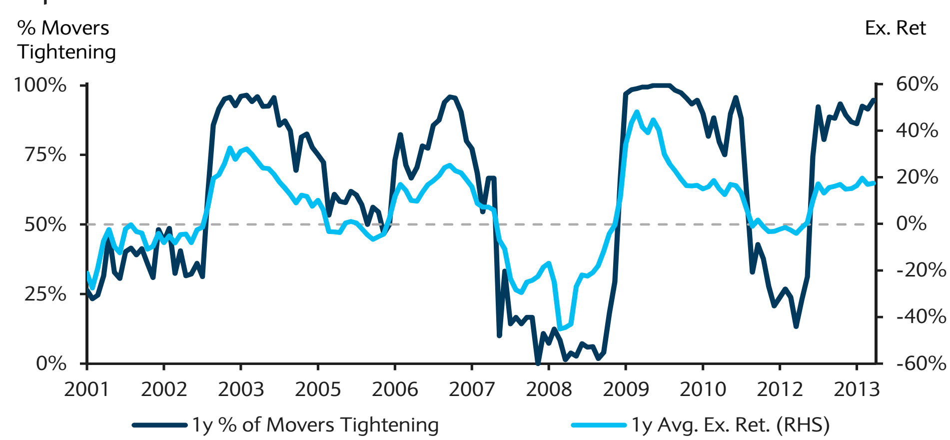
Stressed Names Move Together

There is also a clear cycle to the process, with a majority of names improving or worsening together much of the time (Figure 3). The worst performances for stressed names were tightly tied to sharp market sell-offs, when stressed names migrated en masse toward distress. One explanation of this behavior is market access: stressed issuers are frequently at the margin with respect to issuance. When the market is "closed" to more difficult deals, they are likely to move together toward a higher probability of default, and when the market reopens, they become less stressed together.

Another factor driving the tendency of credits to move in unison is industry concentration. As cyclical or structural factors weigh on an industry, many of the issuers within it tend to become stressed together. If those industry-level pressures ease, those same names will tend to rally together as well.

FIGURE 3

Returns for Stressed Issuers Are a Function of the Migration Cycle, and Both Are Worst in Sharp Sell-offs



Source: Barclays Research

The concentration of movement suggests that simply owning stressed names across the board is not the optimal strategy. Instead, this pool of issuers should be seen as a pool for selecting credits. While the bias should be to look for the names with significant upside, the volatility means that, at times, it is also a good place to look for groups of names with downside.

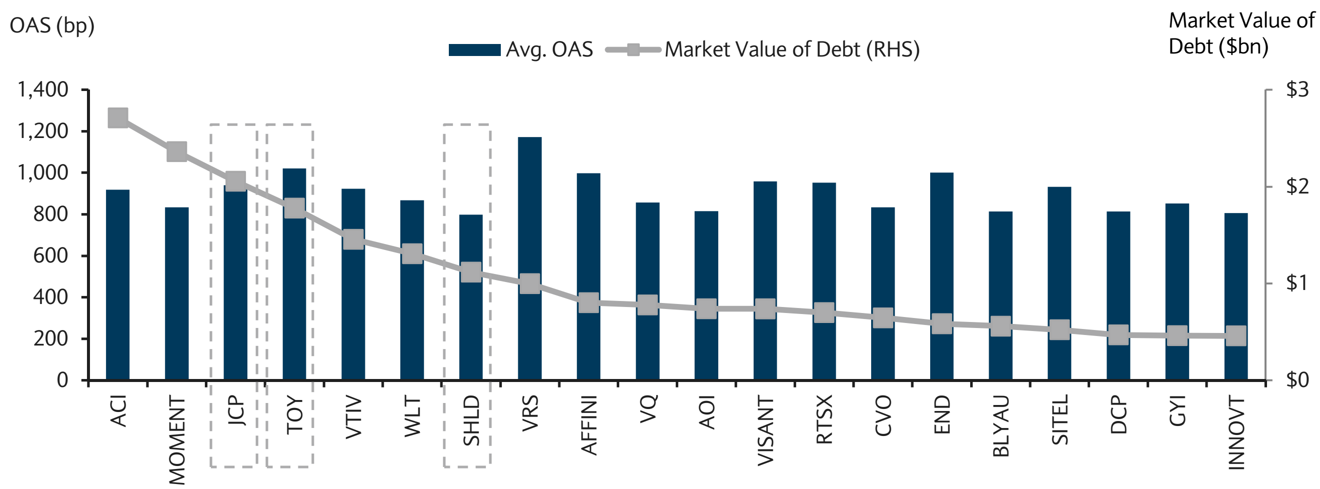
Current Crop of Stressed Names

On average since 2000, there have been about 75 stressed names at any given time, making it a reasonable, but limited, pool of potential investments. At the moment, there are 60 companies in the range – fewer than normal, but consistent with the broad risk rally that ended 2013.

One of the most notable industry concentrations is retail and consumer credits (Figure 4), including JC Penney (JCP), Sears Holdings (SHLD), and Toys 'R' Us (TOY) among the seven largest stressed names and smaller bonds from Gymboree (GYMB), Visant (VISANT), and Sun Products (SUNPRD) in our stressed range. We examine this sector in greater detail to look for trades that take advantage of these historical trends.

FIGURE 4

Of the Current Stressed Names with More than $500mn of Debt (by Market Value), Three of the Top 10 Are Retailers



Source: Barclays Research

It Is Hard to Fight the Headlines

In a market where fundamentals are strong for most industries, there are more than enough bonds that high yield investors can own and consider lower risk. Many of these higher-quality bonds come with less credit risk, but other more benign concerns, such as significant interest rate risk. While the effect of a move higher in interest rates will pale in comparison to the negative price action on a default, it will make it difficult for investors to earn a coupon return in high yield bonds in 2014. With the upper bound of our forecast for total returns at 4%, investors will need to call some of the larger stressed credits in Figure 4 correctly in order to outperform.

The majority of our views on stressed retail credits are negative following a very poor start to 2014 and an abundance of guidance reductions. Specifically, since the start of the year, the following high yield companies have released holiday sales below expectations and/or reduced guidance: Toys 'R' Us (TOY), Sears Holding (SHLD), Limited Brands (LB), Fifth & Pacific (FNP), Bon-Ton (BONT), PVH (PVH), Wolverine (WWW), Best Buy (BBY) and JC Penney (JCP). While not part of the high yield universe, Family Dollar, HH Gregg, Target, and Lululemon also lowered their guidance. Macy's was one of the few retailers to surprise to the upside.

The negative tone to 4Q holiday results has caused the retail index to underperform significantly at the start of the year and led higher-beta credits including Bon-Ton, Toys, Claire's, and Best Buy to underperform.

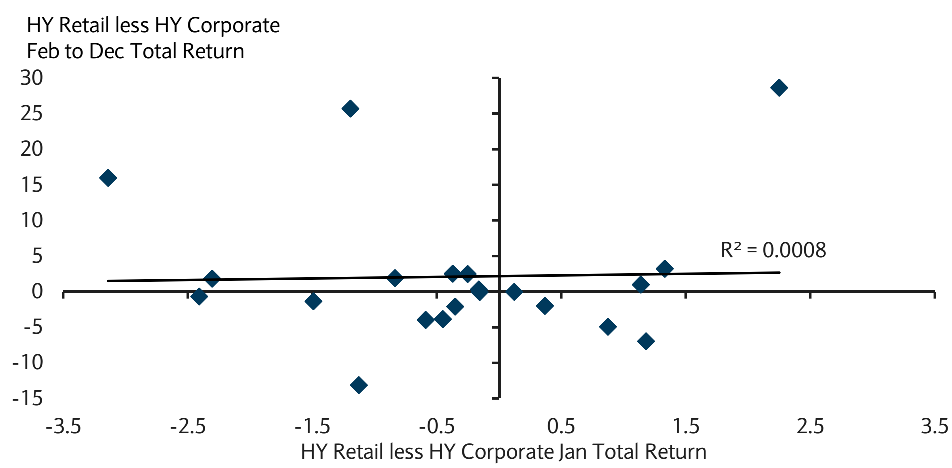
What History Tells Us

A regression analysis between high yield retail sector performance in January versus that for the rest of the year (Figure 5) explains little of the relationship between the two. In our view, the data support what we think is intuitive: January performance is driven by backward-looking results from the year before, while the rest of the year is driven by forward expectations.

A linear regression of high yield retail index total returns above/below broader High Yield Index total returns in January versus the subsequent February-December period shows a low correlation and accounts for little of the relationship between the two (R^2 = 0.0008). Of the 14 times that the high yield retail index has underperformed the High Yield Index in January, it has underperformed for the rest of the year only seven times. Notably, the retail index underperformed in January every year between 2002 and 2012 with the exceptions of 2005 and 2007.

FIGURE 5

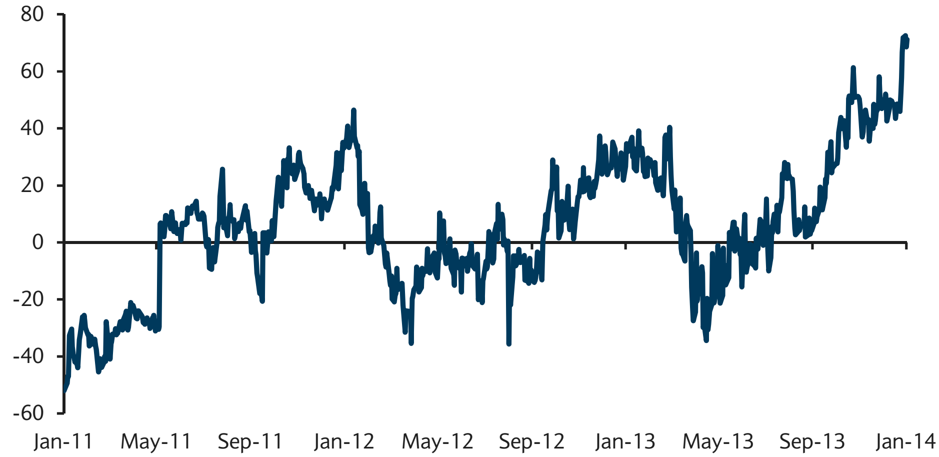
High Yield Retail Total Return Less High Yield Index Total Return: January versus Rest of Year



Source: Barclays Research

On an OAS basis, the high yield retail index is currently 73bp behind the High Yield Index (Figure 6), which represents a three-year wide and compares with a three-year tight of 52bp through (January 2011) and a mean of 5bp behind.

FIGURE 6
High Yield Retail Index Less High Yield Corporate Index OAS (bp)



Source: Barclays Live; *Chart Link*

We understand the secular shifts that should continue to have a long-term effect on brick and mortar retailers, but fundamentally, we think that 2014 will be better for many of the reasons that 2013 was worse for retailers. If anything, the macro indicators have become only more bullish over the past several weeks. Last week, Barclays' economics team raised its 4Q13 GDP growth estimate to 3.0% from 1.5%, despite the slowdown in job growth. The team expects a pickup in real consumer spending to 2.5% annualized in 4Q13, up from 1.9% LTM, as the negative effect of the early 2013 tax increases begins to roll off. Barclays also recently raised its estimate for 2014 U.S. GDP growth to 2.8% from 2.4%, versus a 1.9% forecast for 2013.

Headwinds from the payroll tax increase and the ACA should turn into tailwinds (or, at a minimum, easier comps) in 2014. Concerns about the U.S. federal government shutdown and debt have faded into the background, and combining this with easier comps from 2013, we expect a more bullish tone to eventually benefit the group.

Where to Add Exposure

We think investors should look for ways to gain convexity or limit downside through shorter maturities or higher recoveries. We focus on liquidity and free cash flow to determine whether we would prefer to seek lower dollar prices out the curve, shorter-dated bonds, or CDS. While a credit such as Toys 'R' Us could be forced to restructure because of its maturity wall in 2016, the more likely cause of default will be negative free cash flow. This is especially true for the retail sector, where working capital swings can be significant and suppliers can change terms quickly.

Although our fundamental analysts remain Underweight the stressed retail names, they do not believe that any of them are 2014 restructuring candidates. As a result, short-dated CDS could be an attractive way to gain exposure to the credits. In particular, SRAC 1y CDS @ 7pts and JCP 1y CDS @ 10pts (which mature on March 20, 2015) appear attractive, especially compared with where 1y Caesars protection is trading (@ 11.75pts). In the case of Sears, there are a number of levers that the company can pull (access revolvers, issue additional second-lien debt, sell unencumbered real estate) to improve its liquidity position and offset cash burn. And for JC Penney, our fundamental analysts believe that the 2015 holiday season is likely to be the fulcrum point, making a 2014 or early 2015 restructuring unlikely. We believe Sears deserves the current premium, and while we find the double-digit returns for one-year risk appealing in both credits, we have a slight bias toward being long Sears at these levels.

In cash, for investors looking to gain exposure to Toys 'R' Us, we believe the holdco 2018 notes @ $76 offer greater convexity than the holdco 2017 notes @ $86. Although the 2018s mature 14 months after the 2017s, they trade 10pts lower and therefore have less downside in the event of a 2016 restructuring event ahead of the maturity wall at Toys Delaware. There could be up to 6pts of coupon difference in this time frame, but we do not think that the additional carry explains the entire difference in dollar price. Finally, the 2017s are callable in 2015, but we believe that by the time any call could be executed, the path to safety on the 2018s would be clear as well and investors would benefit from the convexity of those bullet bonds.

For JC Penney, a strategy of going long the longer-duration bonds (6.375% senior notes due 2036 or 7.4% senior notes due 2037) @ $73 and shorting the 7.95% senior notes due 2017 @ $86 could be an attractive way to gain exposure to the credit. We believe that if a restructuring event were to occur, it would take place following the 2015 holiday season and certainly prior to the 2017 maturity, in which case the trade would keep the points collected up front and not have any default exposure. In a best-case scenario, in which the business stabilizes and there is no restructuring event, we believe the 2036s/2037s would have greater upside than the 2017s, given their higher duration. The same principles should hold for investors looking for outright long or short exposure.

For Sears, the second-lien 2018 notes (currently @ $88.88) are getting close to levels where our fundamental analysts believe the market will begin to refocus on recovery. The bonds have sold off sharply over the past two months, dropping 5pts since early December. While they could still face some near-term pressure due to headline risk, they remain well collateralized, with likely recovery close to par. The potential to shrink inventory or issue additional pari passu debt could hurt asset coverage to some degree and might be a reason to wait for a slightly better entry point. However, for longer-term investors, we do not believe any of these actions will ultimately impair the bonds. For investors who would prefer to be higher up in the capital structure, the 2018 first-lien term loan with a L+450bp spread and 1% Libor floor is a more conservative way to gain exposure to Sears.

In the case of Gymboree, we are Underweight the 9.125% senior notes due 2018 and believe there are more attractive opportunities elsewhere in retail. For example, we prefer the Claire's second-lien 8.875% bonds due 2019, which fall just shy of the 800bp spread for our screen, but look attractive with no liquidity concerns and a pickup of almost 175bp versus the first-lien bonds and a $7 lower price. Among the stressed consumer names, we are Overweight the Visant 10% senior notes due 2017 and consider them a top pick in the consumer space for 2014. We are also reasonably constructive on the Sun Products 7.75% senior notes due 2021, with improvement in levels likely to be weighted toward the back half of 2014.

FIGURE 7

Fundamental Summary and 2014 Estimates for Select Stressed Names

	LTM							2014 Estimates		
Company	Revenue	Adj EBITDA	FCF	Net Total Leverage	Net Rent Adjusted Leverage	Cash	Revolver Avail.	Revenue	EBITDA	FCF
Toys 'R' US	13,046	800	-262	6.6x	7.2x	417	1,402	12,356	623	-202
JC Penney	11,961	-977	-2,596	N/A	N/A	1,227	483	12,293	-245	-892
Sears Holding	37,855	80	-1,016	51x	11.9x	607	1,729	34,711	-569	-1,186
Gymboree	1,291	142	34	7.9x	7.9x	19	166	1,335	158	25
Visant	1,126	285	105	6.6x	N/A	33	146	1,105	279	84
Alliance One International	2,394	175	-13	7.8x	N/A	85	304	N/A	N/A	N/A
Claire's Stores	1,571	297	-64	8.0x	8.0x	21	76	1,584	294	-41

Note: LTM data as of 3Q13; 2014 estimates represent the fiscal year ended approximately December 31, 2014, for VISANT and AOI and the fiscal year ended approximately January 31, 2015, for TOY, JCP, SHLD, GYMB, and CLE. Visant 2014 estimates are stand-alone and do not include any contribution from the announced acquisition of American Achievement expect to close in 2Q14. Source: Company filings, Barclays Research

Good Liquidity, Bad Results

Toys 'R' Us (TOY)

We are Underweight Toys Delaware and holdco bonds and Market Weight the propco II notes. We do not believe Toys' capital structure is sustainable at current EBITDA rates and think the company faces structural market issues that may prevent EBITDA improvement through FYE14. Our outlook suggests that the 2016 Delaware maturity wall could be a contentious refinancing.

TOY reported holiday (five-week) sales up 1.8% y/y domestically, with international sales down 1.1%. However, for the nine-week period ending January 4, domestic comparable sales declined 4.7%, while international was off 3.0%. Both were marginally worse than we expected, given the combination of an expected lift from gaming consoles (which does not appear to have materialized) and a calendar shift to a later release of the Big Book (Toys' holiday catalogue).

We are concerned that recent margin pressure is structural and related to free shipping, online matching, and a highly promotional category, which may make it difficult for TOY to return to historical operating levels. For the third quarter domestically, TOY noted declines in educational, juvenile (specifically infant), and core toys (i.e., dolls). We are most concerned about the reversal in juvenile this year. We believe that TOY's side-by-side juvenile strategy has run out of runway domestically and is facing increasing competitive pressure from Bed Bath & Beyond's Buy Buy Baby expansion (both on and offline), increased price competition from Amazon and mass retailers (Target), and increased show-rooming of higher end infant products.

The company has indicated that the new management will (eventually) outline potential changes in strategy. Our initial read is that TOY is likely to become more like Best Buy and focused on price matching. While price matching may take some pressure off sales, it can result in permanently reduced margins. Best Buy has been able to offset this pressure largely through expansive expense cuts, which is a lever we do not believe TOY has (or at least not nearly to the same degree). Best Buy is also implementing these changes when its balance sheet is in a much better position than TOY. Finally, we think the greater use of online marketplaces (Amazon, eBay, Google, etc.) has increased transparency in the toy market, pressuring margins.

JC Penney (JCP)

After providing same-store sales growth of 10% in November, for the December holiday period, JCP noted only that it was "pleased with its performance" and reaffirmed its outlook for 4Q13 guidance. 4Q guidance is for margin and same-store sales improvement sequentially and y/y, with SG&A expenses expected to be lower (both comp against very low bars), and to end the year with more than $2bn in liquidity.

Consensus 4Q targets were for 4-6% sales growth (against a -32% comp in 4Q12). The lack of details provided for the holiday comp, combined with the difficult results reported by the peer set, suggests that JCP may fall short of the target.

Under even a best-case scenario, we expect JCP to burn a significant amount of cash in 2014 and to explore additional liquidity options this spring, which could include some combination of 1) monetizing non-core land surrounding its headquarters, 2) selling its tire and battery locations, 3) monetizing under-market leases, 4) divesting the remaining mall interest, and 5) exercising the $400mn ABL accordion. Other options include second-lien, unsecureds, or convertible notes (convertible notes could be more difficult in near term, given the disclosed SEC inquiry into the October secondary equity offering).

We continue to believe that holiday 2015 will be the fulcrum point for JC Penney. We had previously though that fair value for CDS was 18-24pts. However, given the move out in the comp set (TOYS and SRAC), we now think the range could shift to the mid-to-high 20's.

Sears Holding (SHLD)

We downgraded Sears Holding second-lien 2018 notes to Underweight from Market Weight in December. While we believe the ultimate recovery on the SHLD 2018s could be higher than the retail peer group (close to par), if the company migrates from a stressed to a distressed credit, our concern is that more pressure on levels is likely before the market assigns recovery valuations, and we do not believe holders will be able to realize recovery in 2014.

We expect the core company to continue to consume cash in 2014 and do not see how it will be able to reduce the double promotions associated with Shop Your Way and/or improve margins. Our thesis for 2013 was that bonds were locked in a $92-100 range. However, we think the cash burn, accelerated comp declines at core Sears, and continued asset monetizations (to support the cash needs of the core) are likely to put Sears in an increasingly weak position. We think bonds can trade down to the mid-$80s before the market refocuses on recovery.

Sears posted extremely weak holiday sales, with 4Q quarter-to-date sales down 7.4%, including 9.2% at Sears Domestic and 5.7% at Kmart. SHLD provided 4Q EBITDA guidance of ($65mn) to $65mn, compared with $429mn y/y, with domestic EBITDA of ($80mn) to $20mn, versus $365mn y/y. The company affirmed plans to spin off Lands End, divest its Auto Services unit, and realize value from Sears Canada. In addition, most of Sears's real estate is unencumbered.

Gymboree (GYMB)

We maintain an Underweight rating on GYMB and continue to believe that bonds may have to drop into the mid-$80s before finding a clearing level. We found 3Q results (released mid-December) highly disappointing and have increasing concerns about execution. In mid-December, the company revised full fiscal year same-store sales guidance to a mid-single-digit decline, compared with previous guidance of a low single-digit decline, and indicated that full-year F2013 adjusted EBITDA is expected to be $125-130mn.

While GYMB should have had enough visibility to provide achievable quarterly guidance, we remain concerned that the promotional environment for children's apparel remains competitive and note that Children's Place (PLCE), presenting at ICR while reaffirming forecasts, mentioned that the operating environment remains difficult. In addition, GYMB appears to have stopped shipping web orders from January 15 to 19 to do warehouse inventory (highly unusual).

Visant (VISANT)

Visant 10% senior notes due 2017 are among our top trades in 2014 and one of the few for which we believe there are 10pts of upside between carry and price appreciation, driven by a defined time line catalyst. Specifically, we think the probability that the American Achievement transaction will gain regulatory approval by June is high.

If the American Achievement transaction is approved, we think it will eliminate market concerns about the company's ability to refinance the 2017s. We estimate pro forma leverage at 6.2x through the senior notes (not including synergies) and free cash flow in excess of $100mn, which should allow Visant to reduce pro forma leverage by 0.3x per quarter. If the deal is approved, we would expect the bonds to trade to an implied YE15 call, given the likelihood for a global refinance when the seller PIK notes mature at YE15. If the transaction is not approved, we think the 4-5pts in carry between now and May will largely offset the price reset back to the 92 level.

Sun Products (SUNPRD)

We expect the low point for levels on the Sun Products 7.75% senior notes due 2021 to be the February launch of Tide Simply Clean & Fresh. While we think that 2014 will be a difficult year for Sun and the company is going to have to continue trading price to maintain volume share in the first half of the year, laundry price wars do not last indefinitely. We highlight the rebound in levels at Armored Auto, a company that moved higher after posting just one quarter of more positive results following missing for the better part of year. What gives us confidence in Sun is that when stressing our model for a Tide launch worst-case scenario, we continue to show the company generating positive free cash flow. We expect improvement in Sun levels to be back-half weighted.

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