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Overcoming Unsecured Insecurities

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With the current high yield market trading back near post-crisis tights following a rather choppy start to the year (with a yield to worst around 6%), investors have continued to search for opportunities in a compressed environment. In *Deconstructing Spreads*, August 4, 2017, we were generally constructive on credit risk and were comfortable selectively adding exposure to CCCs. After a significant rally last year, we no longer believe that investors should move down in quality solely in search of yield (see this week's focus section).

In concert with the decline in credit risk premiums, the incremental compensation for moving to less-liquid bonds has essentially evaporated, as 144A securities – which have historically been less liquid than registered peers – represent about half of the market. Meanwhile, term premiums have also compressed meaningfully, and investors do not appear to be getting paid for extending duration. For investors navigating the current yield-starved environment, we believe opportunities further down the capital structure can still provide yield pickup. Specifically, we favor selectively switching from secureds to unsecureds to take advantage of superior risk-adjusted value and a benign default backdrop in the near term.

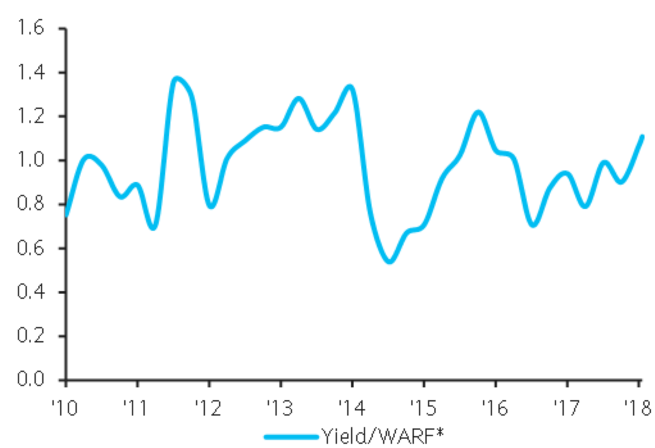
One pushback to our more sanguine near-term view on defaults has been concern of a potential turn in the cycle driven by a tightening in financial conditions and historically flat rate curves (with Treasury 2s10s near decade lows of 44bp). That said, we are not too worried about a spike in defaults and find that flattening in the rates curves is a relatively weak predictor of default rates over a one-year horizon (see *The Less You Give, The More You Get*). The relationship is much stronger using a three-year look-back, which supports our benign near-term default outlook given our position in the cycle.

But several caveats make the current cycle stand out. As outlined last week in *Credit Market Activism through Covenants*, lenders have in recent years pushed for covenants that allow room for more options if the company struggles. This should cut both ways for bondholders. On the one hand, looser protections pose headwinds for recoveries, as investors may find collateral impaired in a bankruptcy scenario. On the other hand, more

FIGURE 1
The Yield Differential between Secured and Unsecured Pairs Is in Line with the Historical Range…

Source: Bloomberg, Barclays Research

FIGURE 2
…But Unsecureds Appear Cheap When Risk Adjusted



* WARF is scaled down by a factor of 1000.
Source: Bloomberg, Barclays Research

creative utilization of covenant loopholes affords issuers greater flexibility and may actually delay (or even prevent) potential bankruptcies; and this second factor, in our view, should buffer a meaningful rise higher in defaults compared with prior cycles.

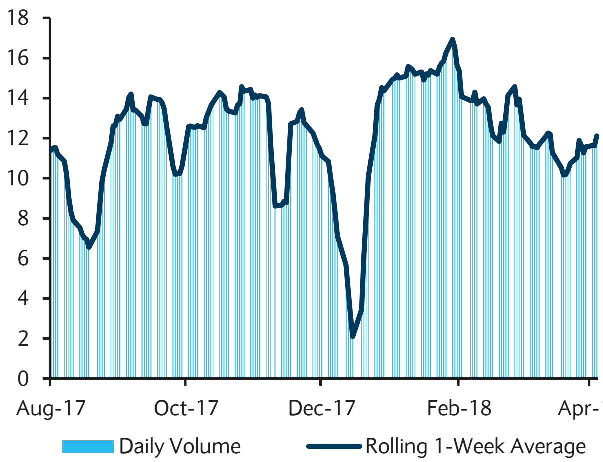
Considering our expectations of low near-term default rates, we are comfortable in principle with going down the capital structure in exchange for appropriate compensation. Screening for maturity- and issuer-matched secured/unsecured bond pairs, Figure 1 shows that the pair-wise yield differential is roughly in line with the historical quarterly range. In fact, the differential between the two is currently roughly 184bp, at the 30th percentile relative to the minimum of 115bp and maximum of 313bp since 2010. On a risk-adjusted basis, however, unsecured debt appears particularly compelling. Figure 2 shows the ratio of the yield pickup between secured/unsecured pairs for moving down in the capital structure normalized by incremental WARF (weighted average rating factor, used as an estimate for credit risk based on rating). This ratio ranks at the 73th percentile relative to the historical range since 2010 and has widened considerably since 2016. Roughly 30% of the unsecured debt in our matched pair universe is rated CCC, below the historical average of 51%. After controlling for the change in quality composition, Figure 2 shows that unsecured bonds screen as particularly attractive on a risk-adjusted basis.

We thus highlight select opportunities to swap out of first-lien debt into equivalent-maturity unsecured debt in the ARS and HCA capital structures, where we believe investors are well compensated for incurring incremental credit risk.

- **Swap out of ARS 9.5s of 2021 and into 7.875s of 2020**: As discussed in *Driving Downstream: Initiating on HY Aluminum Credits*, fundamental analyst Brian Lalli expects improvement in ARS's credit fundamentals, driven by EBITDA growth and a pickup in aerospace demand. The company has ample liquidity to fund its growth plan, and we would be comfortable dipping into the unsecureds to pick up roughly 1.4% in yield and take out 5.4pts.

- **Swap out of HCA 5s of 2024 and into 5.875s of 2026:** HCA first-lien 5s of 2024 trade 70bp tight of HCA unsecured 5.875s of 2026 on a yield-to-worst basis. As discussed in *Focus Credits: Securing the Top Spot*, healthcare analyst Rishi Parekh has Market Weight ratings on both bonds but believes HCA's credit metrics suggest ample cushion against most downside scenarios.

High Yield Average Institutional Trade Volume ($bn)

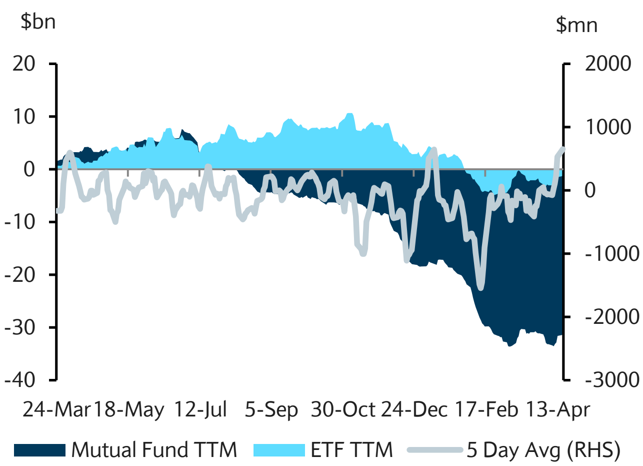


Note: Includes both registered and 144A volumes. Source: FINRA TRACE

On-the-Run HYCDX versus US High Yield Index (bp)

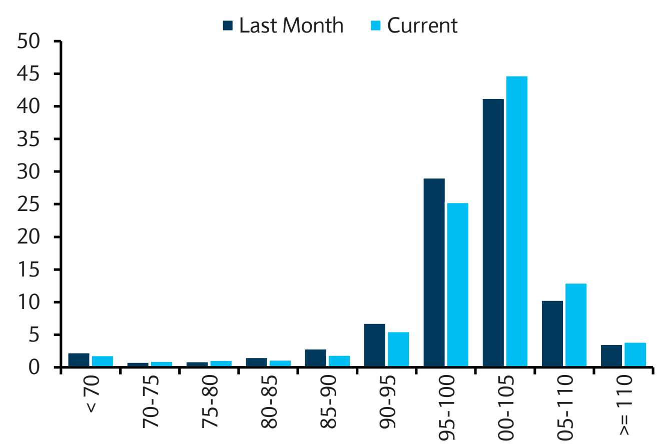
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



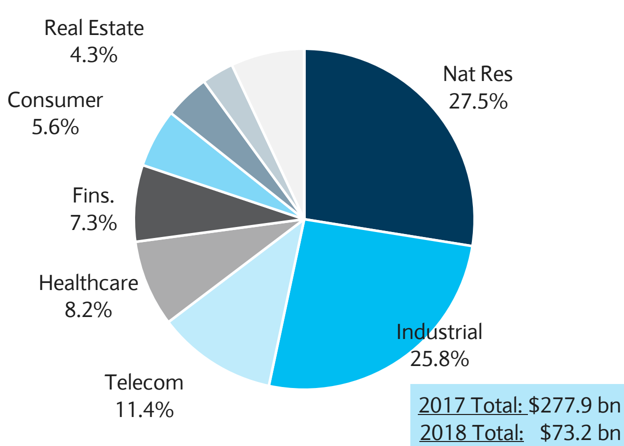
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



Source: Barclays Research

High Yield Supply by Sector



Source: Barclays Research

High Yield Spreads by Credit Quality

Source: Bloomberg Barclays Indices

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ALERIS INTERNATIONAL INC, CD/D/J/K/L/M/N

ARS 7 7/8 11/01/20, Overweight (USD 99.25, 18-Apr-2018)

ARS 9 1/2 04/01/21, Overweight (USD 104.63, 18-Apr-2018)

Valuation Methodology: At current levels, we rate both the 9.5% secured notes due 2021 and the 7.875% notes due 2020 at Overweight, as the yield/spread pickup on both notes is relatively attractive ahead of any capital market / refinancing activity. We see both notes providing solid returns as they remain outstanding over the coming months, particularly as credit fundamentals improve in 2018.

Risks that May Impede Achievement of the Rating: Weaker-than-expected operational environment in automotive and aerospace end markets and execution risk associated with ramping up new facilities leading to reduced financial flexibility.

HCA INC, A/CD/D/J/K/L/M/N

HCA 5 03/15/24, Market Weight (USD 103.00, 18-Apr-2018)

HCA 5 7/8 02/15/26, Market Weight (USD 104.13, 18-Apr-2018)

Valuation Methodology: Of the providers in our coverage universe, HCA has the credit profile (low leverage, strong FCF, market position) to weather any unfavorable regulatory outcomes or shifts within the industry. We also believe there is a strong likelihood that HCA will achieve IG status in 2018.

Risks that May Impede Achievement of the Rating: HCA is downgraded, the company spins off assets or creates a REIT, weak covenants, index trades wider and consistently weaker volumes.

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Market Weight (MW):
For sectors rated against the Bloomberg Barclays U.S. Credit Index, the Bloomberg Barclays Pan-European Credit Index, the Bloomberg Barclays EM Asia USD High Grade Credit Index or the Bloomberg Barclays EM USD Corporate and Quasi-Sovereign Index, the analyst expects the six-month excess return of the sector to be in line with the six-month excess return of the relevant index.
For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to be in line with the six-month total return of the relevant index.

Underweight (UW):
For sectors rated against the Bloomberg Barclays U.S. Credit Index, the Bloomberg Barclays Pan-European Credit Index, the Bloomberg Barclays EM Asia USD High Grade Credit Index or the Bloomberg Barclays EM USD Corporate and Quasi-Sovereign Index, the analyst expects the six-month excess return of the sector to be less than the six-month excess return of the relevant index.
For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to be less than the six-month total return of the relevant index.

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Yield 3% Issuer Capped Credit Index excluding Financials and are rated against the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials.
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