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'Really, just IOUs'

On the authority of Leon Black himself, the credit markets have achieved a state of bubbliness, the next-to-last stop in the expansion phase of the credit cycle. "The amount of covenant-less debt is more than in 2007," the co-founder of Apollo Global Management told the Goldman Sachs Financial Services Conference last week. "You have a thirst for yield that exists on a global basis. So there is true excess."

Amen to that, we say. Suppressed interest rates and their crowd-pleasing corollaries, low default rates and high bond prices, have set the stage for panic, the final cyclical stop (after which, following an interlude of penitence, begins a new expansion). If the free-and-easy portion of the credit cycle is behind us, better days—at least, for the intrepid, value-seeking readers of *Grant's*—may be at hand.

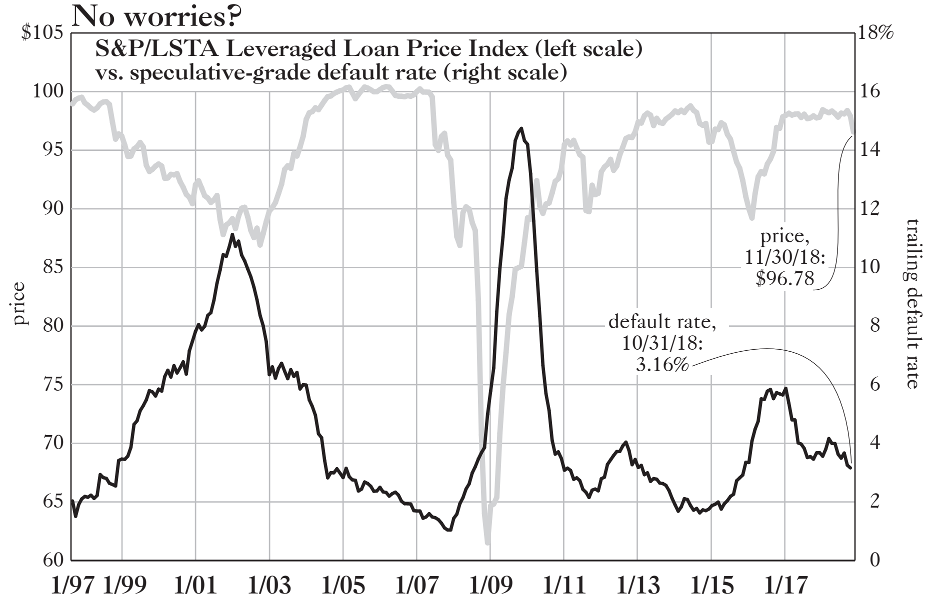
Credit is broadly at risk, we think, from investment-grade debentures to junk bonds to emerging-market debt to leveraged loans—perhaps especially loans, and still more particularly the exchange-traded funds that house those illiquid claims. Collateralized loan obligations, a.k.a. CLOs, are likewise in the cyclical cross hairs. Facts, figures and stratagems to follow.

Not the least of the troubles with floating-rate, senior, secured bank-like loans (the tradable kind incurred by speculative-grade business borrowers) is their appealing record. They shone in 2008 and led the credit pack in 2018. In a year when nothing seems to go up, leveraged loans have returned 2.5% to date, compared with -0.3% for junk bonds, -3.1% for emerging-market corporate bonds and -3.2% for U.S. investment-grade corporates.

Yet even that meager edge appears to be slipping away. On Dec. 11, the S&P/LSTA Leveraged Loan Index hit 95¾, a two-year low. The downtick may look inconsequential—the decline from the October reading of 98.7 is hardly a crash. Then, again, the well-informed leveraged-loan market usually doesn't move without reason. Public companies report quarterly. Leveraged-loan borrowers report monthly—and those monthly reports, addressed to the creditors alone, are rich in detail, including internal financial projections. It's to gain access to such fancy information that leveraged-loan asset managers have become sought-after acquisition targets for non-specialist money managers, Bloomberg reports; the acquirers want a peek at what the loan insiders are seeing. More likely, then, we judge, the recent softness in loan prices is an augury of something not bullish.

It's nobody's secret that the evisceration of covenant protection is among the loan market's top risks (*Grant's*, July 13). In the absence of the customary legal language forbidding the borrower from slathering on more debt, or from running up its fixed charges in relation to its earnings, creditors face a heightened likelihood of disappointment. Gone, in the cases of "covenant-lite" or—as Black put it—"covenant-less" loans, are the opportunities for mid-course corrections that covenant violations provided the creditors of yesteryear (and still provide the holders of fully armored loans today). You can hardly trip a covenant if none exists; and without the tripping, creditors are

No worries?



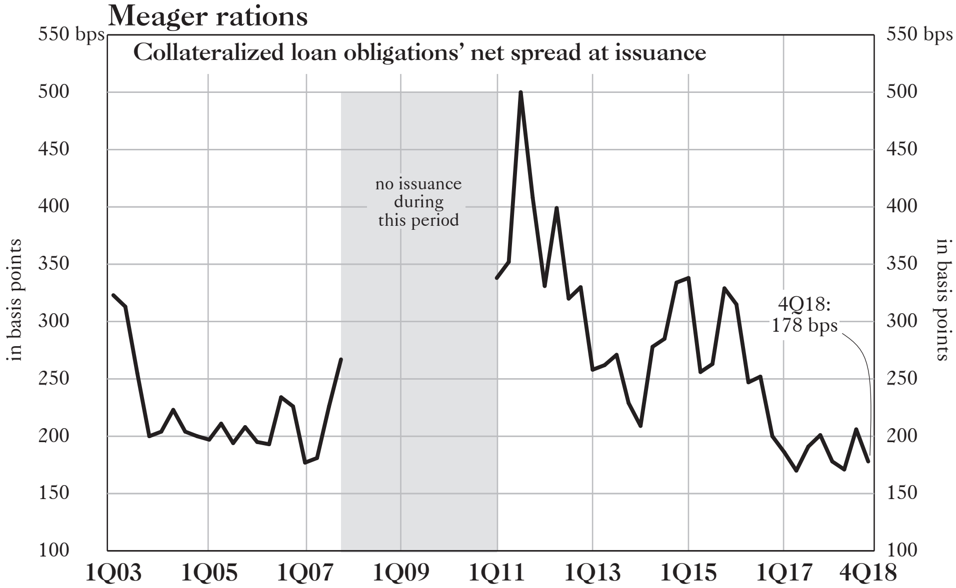
source: The Bloomberg

powerless to demand concessions from a borrower who's running afoul of the interests of the senior claimants. "I'd like to say," Peter Washkowitz, covenant analyst at Reorg Research, Inc., tells colleague Fabiano Santin, "that these debt documents are really kind of turning into IOUs at this point."

In November, the percentage of credits showing a bare minimum of covenant protection, taken as a percentage of all leveraged loans issued by American borrowers, reached the unprecedented level of 79%. However, in view of persistently good credit experience, investors let the fact roll off their backs. In November, the loan-default rate reached a 13-month low of 1.61% on the afore-cited S&P/LSTA index. Including bonds, Moody's calculates, the speculative-grade default rate for the 12 months ended Oct. 30 stood at 3.2% vs. a long-term average of 4.7% and a projected forward rate for the 12 months ending Oct. 30, 2019 of 2.3%. Then why worry?

We know a few reasons, including an interesting interest-rate wrinkle. CLOs, which hold 52% of broadly syndicated loans, are coming under margin pressure (*Grant's*, Sept. 7). As you know, a CLO is a business on a balance sheet. To generate income, it holds leveraged loans. To finance those loans, it issues debt. Such debt rests on a thin wedge of equity. Both the interest it earns and the interest it pays reference the London interbank offered rate, though not identical maturities of that rate. A typical CLO earns interest based on one-month Libor; it pays interest based on three-month Libor. The difference is of no importance when the two rates align. But they don't align today, as the three-month rate is quoted 35 basis points over the one-month rate. Hence the pressure on the margins of the CLO managers: Instead of a 178 basis-point net interest margin, the average CLO is looking at a 140 basis-point margin, near a post-2008 low, according to Wells Fargo Securities, LLC. Things have come to such a pass that, in October, the Loan Syndication and Trading Association (LSTA) prayed for relief from the Volcker Rule to allow a CLO to diversify away from loans to bonds. All of which intensifies the frictions surrounding the regulatory push to drop Libor in place of a new rate (which is another story for another time). Suffice it to say that, because CLOs are not so prosperous as they used to be, they are not such eager bidders for loans as they formerly were.

Meager rations



sources: Intex, LCD, Wells Fargo Securities

Late credit-cycle sightings abound. Thus, October brought a $540 million three-year-note issue from HC2 Holdings, Inc., a conglomerate with interests in undersea-cable servicing, structural steel, broadcasting, telecom, life sciences, insurance, energy and—to complete the corporate theme of miscellany—"other." Led by Philip A. Falcone, HC2 is chronically unprofitable, with a share price ($3) and debt ratings (Caa1/single-B-minus) to match that record. "Only 1% of HC2's assets are available to support the notes," Santin observes. "As to the ratio of debt to earnings before interest, tax, depreciation and amortization, it stands at 15.5 times as conventionally calculated, and at half that much for any who would play the game of 'EBITDA add-backs'—inflating that already dubious, non-GAAP metric with so-called pro forma cost savings, projected synergies, etc."

Give HC2 this much: Its notes scored the highest in covenant protection on the Moody's scale of any leveraged loan in the past five years. Mr. Market, however, weighing weak business fundamentals against strong legal language, has rendered his verdict: The 2021 notes, which came to market only two months ago with an 11½% coupon at 98¾, now change hands at 94¾.

The truth of it is that corporate creditors constitute an abused class of persons. The Federal Reserve debases them, and corporate managements outsmart them. Perhaps an enterprising politician could adopt them as a new grievance community.

To illustrate, consider the $2.26 billion, first-lien, senior secured loan of engineering and construction firm McDermott International, Inc., due May 2025. It debuted in May to finance McDermott's acquisition of Chicago Bridge & Iron Co. The McDermott credit boasts maintenance covenants requiring minimum liquidity of $200 million, a minimum interest coverage ratio of 1.5 times and a maximum leverage ratio of 4.25 times debt to EBITDA. So far, so good.

However, in 2017, before its McDermott tie-up, CB&I incurred charges of $870 million related to immense cost overruns on a pair of gas-turbine projects and on another pair of LNG-terminal projects. How to account for these financial and operational bruises? Here the narrative takes a slightly technical turn (readers impatient for the how-to-short-credit discussion will find it at the bottom of this article).

Before the McDermott purchase, CB&I would have expensed the charges, lowering adjusted EBITDA. But after the purchase, in the quarter ended Oct. 30, McDermott announced extra costs of $744 million related to the projects. Dan Nicolich and Stephen Opper, covenant analyst and distressed debt analyst, respectively, at Reorg Research, Inc., describe what happened:

> Following the acquisition of CB&I, Mc-

Dermott has accounted for the increased costs by adjusting its CB&I purchase price allocation. Changes in purchase price allocation driven by the increased cost estimates only affect the company's balance sheet and do not flow through the income statement. Since the increased costs do not flow through the company's income statement, they potentially inflate the company's covenant EBITDA—which builds off of GAAP net income—while also allowing the company to avoid credit agreement caps on addbacks for charges on the [relevant] projects. In addition to influencing the company's covenant compliance, the use of purchase price accounting distorts the ability to use McDermott's reported EBITDA as a proxy for its cash flow.

Had that mammoth $744 million charge coursed through the income statement, rather than being redirected to the balance sheet, Reorg estimates, McDermott's leverage ratio would have spiked to 6.28 times adjusted EBITDA, easily crossing the 4.25 times threshold and technically signaling default under the credit agreement. Whatever the accounting niceties, the loan price has tumbled to 96 from more than par. So much for apparently strong covenant protection.

To be sure, the book is not closed on McDermott—observe, the Reorg analysts remind Santin, that 18 months passed before aggrieved lenders to closely held Neiman Marcus Group Ltd. put up their dukes. The department-store controversy started in March 2017 when Neiman redesignated its prized online business MyTheresa and other properties as unrestricted subsidiaries, meaning they were out of the creditors' reach. On Sept. 18, management presented them to the equity owners, Ares Management L.P. and Canadian Pension Plan Investment Board. Such slick dealing has become commonplace in the private-equity world—see the unedifying sagas of retailers J. Crew Group, Inc. and PetSmart, Inc. (*Grant's*, July 13 and Sept. 21).

On Sept. 18, Marble Ridge Capital, the creditor with the boxing gloves, wrote to Neiman's board of directors alleging that the distributions may have constituted "intentional and constructive fraudulent transfers," triggering a default under the indentures of senior notes due 2021. Marble Ridge further contended that, prior to the transfers, the borrower was nearly 10 times leveraged, which is to say, insolvent.

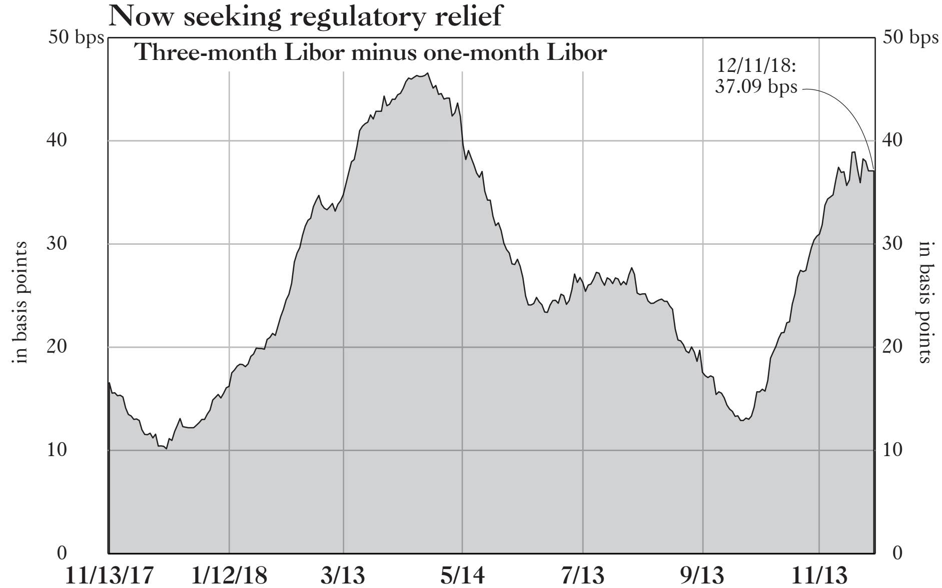
Neiman Marcus, snubbing Marble Ridge, has started to restructure negotiations with a select group of lenders owning a "material portion" of the senior notes due 2021 and the secured credit facility. To the secured lenders, in return for their assent, management is offering additional liens, seniority on unencumbered ground leases, a 25 basis-point boost in their interest rate. To the unsecured lenders, management is dangling the offer to repurchase, at par, $250 million of senior notes (trading at 50 cents on the dollar), in exchange for which the creditors would allow a three-year extension on the maturity of the debt they continue to hold. They would, in addition, be expected to affirm the legality of the dubious payout. As for more truculent and less privileged lenders—Marble Ridge, for instance—they would get nothing, not even the recourse to which they were entitled under the (for now) functionally dead-letter debt agreements.

"Perhaps," Santin speculates, "Marble Ridge—as well as other less 'material' creditors of Neiman Marcus—will finally be shut out of the clubby restructuring group. If so, they will surely not be the last to be so marginalized. Passive investors, too, may one day find themselves on the outside looking in. And if disaster ever did strike the passive investing vehicles, the less liquid kind would not be the last to feel it. Retail funds and ETFs make up 16% of the leveraged-loan investor base, while they represent close to 40% of the high-yield bond market, according to Bank of America Merrill Lynch. The Invesco Senior Loan ETF (BKLN on NYSE Arca), with $6 billion of assets, and the iShares iBoxx High Yield Corporate Bond ETF (HYG on NYSE Arca), holding $13.8 billion, constitute Exhibits A and B."

Adam Schwartz, paid-up subscriber and founder and chief investment officer of Black Bear Value Partners, L.P., a two-year-old fund managing mainly his own money, is using long-dated put options to short ETFs holding speculative-grade debt. "The primary thing," Schwartz tells Santin, "is that you have a lot more debt, a lot lower expectations for defaults because that has been the case for the last five years with rates being low. You have spreads near all-time tights, and you have covenants that are nonexistent. Lenders don't really totally understand that they have very little in the way of protection."

The work of redeeming and creating shares in ETFs is performed by so-called authorized participants—the APs exchange ETF shares for the underlying securities, and securities for shares; it is their arbitrage that's intended to keep share price and asset value aligned. What puzzles Schwartz is the contradiction between the liquidity of the ETF shares, on the one hand, and the substantive illiquidity of the ETF assets, on the other. Junk bonds do trade, even if by appointment. Loans, too, trade by appointment, though even less frequently than bonds, and settlement routinely takes a week or more.

Now seeking regulatory relief



source: The Bloomberg

Bond ETFs, at least, can count on APs to try to keep asset values and share prices in sync. No such mechanism exists for loans—the market isn't deep enough to allow it.

"I can't understand for the life of me, and no one has explained to me, where [the APs] are going to sell those cash bonds and what happens if the liquidity in the cash bond market gets strained," says Schwartz. "What I can see happening is this: People think that they have a very liquid instrument that is backed by very illiquid assets, and for the time being it is fine and works okay and the markets usually work. But if there is a large amount of selling at the ETF level which requires a large amount of unit redemptions at the issuer AP level, the APs are going to require a larger and larger discount to NAV and that in turn is going to create more panic and selling by the investors. Which, in turn, leads to more selling and the need for liquidity by the AP." Schwartz is saying that he's short across the spectrum from high yield to leveraged loans, emerging markets and investment grade.

A bearish bet against emerging-market bonds may also be worth consideration. You can implement it against the iShares J.P. Morgan USD Emerging Markets Bond ETF (EMB on the Nasdaq), which holds $14.9 billion of the kind of assets you wouldn't choose for your mother's portfolio. "If you look at the holdings list for EMB, in the top 11 you have 1MDB, which is caught up in the middle of all this fraud stuff; you have Iraq, which is a war-torn nation; you have Ecuador, which in 2015 paid a bond on time for the first time in its 180-year history," Zach Truesdell, co-founder and portfolio manager of Matador Global, tells Santin. "And the yield on the EMB is 4.8%, and its spread to Treasurys is at its narrowest ever." Like Schwartz, Truesdell says he prefers to operate with long-dated puts rather than shorting the stock outright.

At-the-money puts dated Jan. 21, 2021 against BKLN (quoted at $22.37) at the strike price of $22.00 are offered at $2.45. Out-of-the-money puts against the HYG at a strike price of $80 (quoted at $83.04) ending on Jan. 17, 2020 are offered at $4.30. Puts on EMB (trading at $104.14), with a strike price of $96.00 and an expiration of Dec. 20, 2019, can be had at $2.25.

"I don't know if this happens," says Schwartz. "This is a bet where if I think I'm right, then I want to make a lot and if I'm wrong, then I lose a little. It is very hard to predict what has been virtually a 25-year cycle of easy money. What that means when the government stops buying bonds, when the ECB stops buying bonds, when China stops buying our bonds, I don't know. Anyone who says they know, please give them my phone number, because I don't know. It is very uncertain."

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