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Grand tour of junk

The lowest interest rates, the most accommodating Fed, the shortest junk-bond durations, the highest corporate leverage and the longest business expansion frame the value proposition for junk bonds and the speculative-grade, tradable bank debt styled "leveraged loans." "Hold on to your hats!" is the investment conclusion of the analysis to follow.

We write to connect fact with perception, perception with valuation and valuation with risk. The conclusion, a truism, is foregone: Bubbles end with televised congressional hearings. What turns a truism into capital gains for the alert speculator is the correct answer to the question beginning "When?"

We don't know when. Nor does history shine a bright light on the future in this particular cycle, given that so much is new, even unprecedented, in today's markets. Here's what the past does teach:

1. Ultra-low interest rates distort investment judgment, prolong the lives of profitless companies and inflate the present value of future cash flows.
2. Desperately searching for yield, investors often find trouble.
3. Technological innovation threatens established businesses, heavily leveraged established businesses most of all.

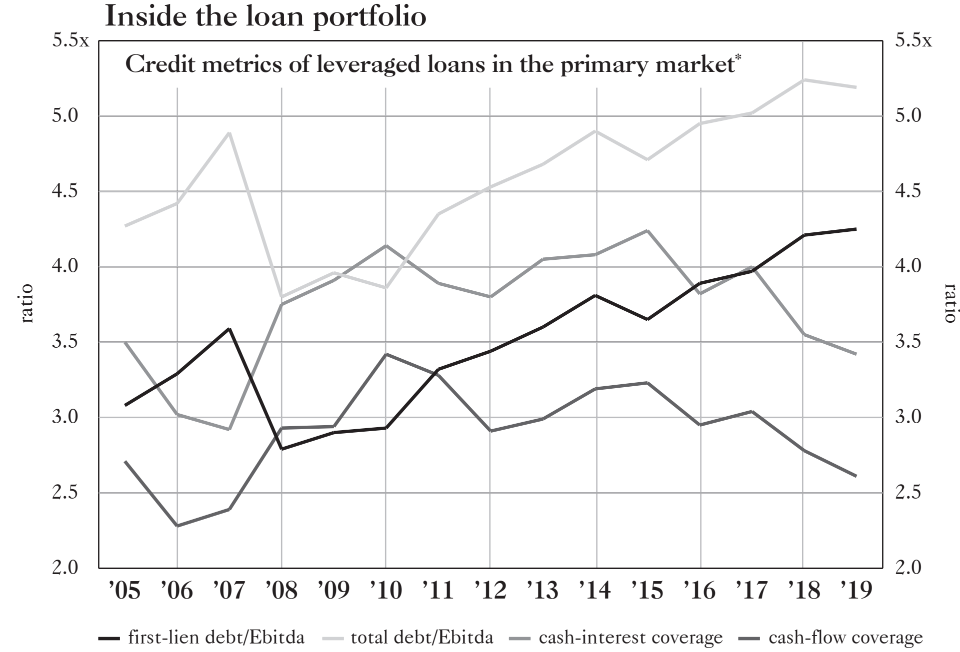
Community Health Systems, Inc., one of America's largest hospital operators, "overleveraged and stressed for a long time," as Brian Horey, paid-up subscriber and president of Aurelian Management, reminds colleague Fabiano Santin, could be the avatar of those three lessons.

Rated Caa/B-minus, the company owes $13.4 billion (its securities constitute the fifth-largest holding of HYG, the iShares iBoxx High Yield Corporate Bond exchange-traded fund). It generates, or over the past three years has generated, no free cash flow, rather a net cash loss. Since 2015, it has cut capital spending in half. Since 2014, to finance an aggressive acquisitions strategy, it has increased its indebtedness by 50%. Fewer patients are seeking admission to its mostly smaller, mostly rural hospitals, at which operating costs are rising faster than Medicare and Medicaid reimbursement rates and thus pressuring margins.

Even so, on Jan. 23, Community Health was able to issue $1.46 billion of five-year, first-lien notes bearing a coupon of 6⅝%. The issue refinanced $1 billion of 5⅛%, first-lien notes of 2021 as well as $426 million of 6¼% first-lien securities of 2023.

Time will tell if Caa2/B-minus are reasonable ratings, if 6%-plus is adequate compensation for the creditors and if management can juggle the new, higher interest costs it's just contracted. Income-seeking investors are perhaps less concerned about those ques-

Inside the loan portfolio



* Analysis based on pro forma adjusted Ebitda.

source: LCD, an offering of S&P Global Market Intelligence tions than they are captivated by the figure 6%. Then, too, the refinancing has bought Community Health three more years of corporate life.

It can't be said that Mr. Market is oblivious to such businesses and the risks they pose. Anomalously last year, triple-C-rated bonds, situated near the bottom of the junk pile, underperformed double-Bs, which rank near the top of that stack. The record of the past 30 years is that, in a strong market for high-yield debt, the more speculative stuff outshines the better stuff. Not this time.

In the second half of 2019, Standard & Poor's three-month trailing ratio of loan downgrades to upgrades topped 3:1. It was the most elevated reading since the dark second quarter of 2009.

If bubbles are their own worst enemies, it's because investors and promoters reasonably act on the incentives that the cyclical gods dangle before them. Thus leverage builds, valuations stretch and loan covenants disappear as borrowers and lenders internalize the message (especially persistent since 2008) that the after-tax cost of borrowing will remain low indefinitely, if not for longer. In Davos last month, boldface Wall Street names claimed that boom-and-bust is history.

The junk-bond eminence Ed Altman, emeritus professor of finance at the Stern School of Business at New York University, writing last year on the CFA Institute's website, called the 10-year-old credit expansion a "bubble." Unburst, it continues to exhibit the characteristics that promote growth in lending and borrowing, he noted, e.g., low default rates, OK recovery rates on actual defaults, small yields, liquid markets.

Since the dawn of the modern junk market in the late 1970s, such "benign" cycles, he calculates, have lasted for six years on average. If you classify the downside rip in 2016 as a localized energy crisis, not as a full-fledged contraction, today's debt expansion is closing in on its 11th birthday. "[O]nce such a cycle ends," Altman writes, "the subsequent spike in high-yield bond default rates and decline in recovery rates have been dramatic, with default rates reaching at least 10% for one or two years and recovery rates dropping below 40% and sometimes even below 30%."

Altman hazards no guess about when this granddaddy of benign cycles will turn malicious: "When both macro and micro market forces point to an unmistakably negative outlook, I expect the next stressed credit cycle to produce default amounts that will be higher than any in the past due to the enormous bond, bank and nonbank buildup, and the crisis may last longer than the previous one."

Or it just might be, as Santin suggests, that this time around, the credit tail wags the macroeconomic dog. The Jan. 23 bankruptcy filing of McDermott International, Inc. highlights the possibilities for microeconomic, credit-led trouble.

The former J. Ray McDermott & Co., founded in 1923, survived many an oil-and-gas slump but came a cropper following its particularly leveraged, especially ill-founded merger with CB&I, the old Chicago Bridge & Iron, in December 2017. A year later, McDermott featured in these pages in an analysis of the games that managements can play when accounting for merger-related business difficulties (see "Really, it's just IOUs" in the Dec. 14, 2018 issue of *Grant's*).

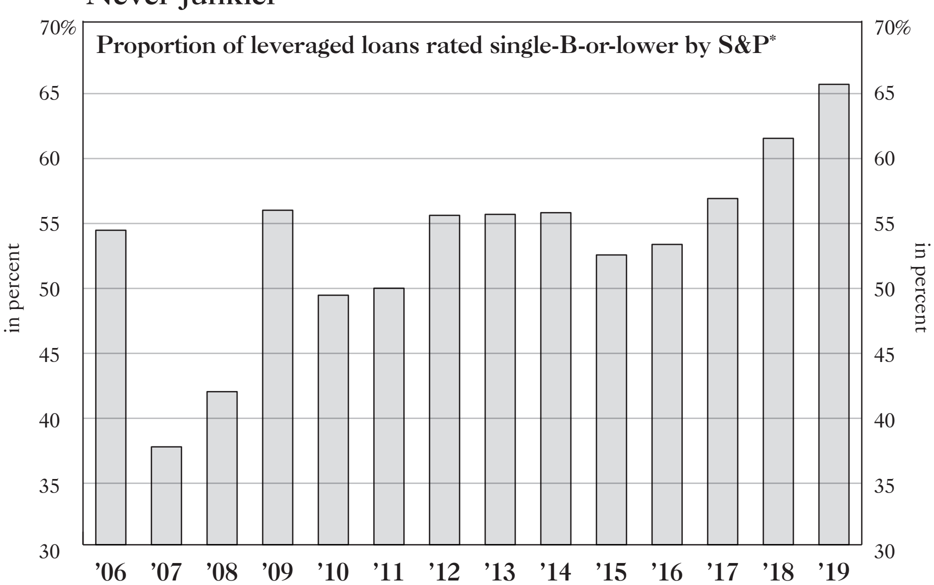
So it was no state secret that something was amiss at McDermott. Yet as recently as the end of July 2019, the then-B3/CCC-plus-rated McDermott 10$\frac{5}{8}$s of 2024 traded at 96. Two months later, the bonds, suffering a two-notch downgrade, dropped to 68 before plunging to 16.5 (it took just two days) at the end of September.

"The price of McDermott's first-lien loan largely followed the price movement of the bonds," Santin observes, "perhaps because CLO managers were slow to realize that the loans were indeed in danger of losing their B-ish rating, which would jeopardize CLOs' typical 7.5% exposure limit to CCC debt." Post-bankruptcy, the bonds change hands at 13 cents on the dollar, the loans at 65.

Certainly to the readers of *Grant's*, the generalized deterioration in corporate-credit quality is old news. Thus, issuers of leveraged loans last year carried leverage of 5.2 times adjusted Ebitda, matching the all-time record set in 2018 and up from 3.8 times in 2008 and 4.9 times in 2007, according to S&P's LCD unit, though it was very likely that even the "all-time record" was greatly understated.

With respect to Ebitda—earnings before interest, taxes, depreciation and amortization—it's the promoters who make the adjustments, and the "adjusted" Ebitda level at which they borrow is seldom the Ebitda level that they subsequently earn. From 2016 to 2018, S&P has found, most loan issuers missed their published Ebitda targets by 25%, suggesting that actual leverage is meaningfully higher than that to which the deal-doers admit. "The implication is that the loan market is riskier than that implied by credit ratings," the analyst team led by Matthew

Never junkier



* Based on S&P Facility Ratings only.

sources: LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index

Mish, head of credit strategy at UBS, justly concludes.

The ratings agencies, not customarily the market's thought leaders, have themselves noticed the signs of termites in the house of credit. "Thus," Santin relates, "at the end of 2019, 65.1% of U.S. leveraged loans rated by S&P received a single-B or lower rating versus 37.4% at the end of 2007. It's the worst ratings distribution for the S&P historical series going back to 2006. Given that leveraged loans were much safer and better-rated until the last economic cycle, it's likely that this is the highest proportion of lower-rated loans ever.

"A broader data set from Moody's Investors Service's annual default study, dated Jan. 30," Santin continues, "showed that issuers rated triple-C and lower represented 43.6% of the global speculative-grade issuers rated by the agency in the beginning of 2019, compared with 19.7% in 2007. Here, at least, no new dubious record was set: The all-time high of 44.5% is from the beginning of 2016."

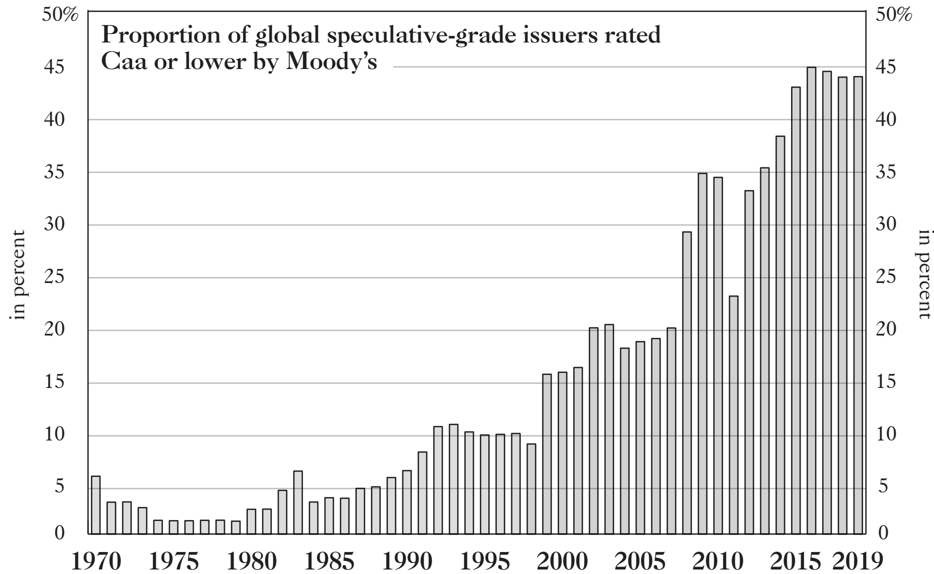
What might truly define this cycle in lending and borrowing, a veteran credit investor remarks, is the systematic removal of the covenant language that prevented borrowers from spiriting away the assets that the lenders had assumed would protect them in bankruptcy.

"That to me is the existential threat in the [leveraged loan and high-yield bond markets]," our source says. "There are issuers who on day one have tremendous financial flexibility to pay out dividends or dividend out assets, which goes right against the efficacy of a creditor's fundamental protection of assets and cash flow."

Far from resisting these insults to financial safety and soundness, the creditors appear to have succumbed to a kind of Stockholm syndrome. It's fallen to S&P, for instance, not the Society for the Defense of American Savings (which organization happens not to exist) to observe that the growing frequency of loan-only capital structures is jeopardizing the safety of first-lien lenders. It stands to reason: Without a loss-absorbing layer of subordinated debt, senior creditors bear greater risk. And yet, S&P reports (via LCD News, on Feb. 3) that the market has been pricing "loan-only" obligations at just a slight discount to the better-protected ones.

In line with recent history, but contrary to the accumulating evidence that this cycle is, in fact, something new and different, Moody's projects smooth sailing in 2020. It forecasts that the speculative-grade default rate will shrink to 3.5% by the end of the year, down from 4.2% in December 2019. For context, since the beginning of 1970, the trailing 12-month default rate has averaged 3.9%.

Leverage goes global



source: Moody's Investors Service

Maybe Moody's is correct, and perhaps the simplicity of its three-factor default-rate forecasting model is a source of analytical strength, not shortsightedness. Anyway, to arrive at the near-term default rate, Moody's weighs the spread of junk yields to Treasury yields, the national unemployment rate and the history of ratings migrations (of which more in a moment).

Forecasting simplicity may have reached its apogee last year in a model devised by a former Fed economist. The Claudia Sahm Recession Indicator holds that when the three-month average rate of unemployment increases at least one-half a percentage point above its low from the previous year, the economy is effectively in a recession. Back-testing since 1970 rings up a perfect score with no false positives.

Although the consensus of prognosticators anticipates that joblessness will more or less hold steady at 3.7% over the next year, Moody's projects a bump up in the three-month average rate to 4.1% by June 2021, exactly half a percentage point above the 3.6% rate one year earlier. This would indicate a 97% probability of a recession by the middle of next year, according to Sahm's indicator.

Santin asked Moody's whether a 4.1% jobless rate wouldn't imply a surge in defaults just beyond the temporal horizon of its own default forecast. The agency declined to say more than that 12 months is the outer limit of its default-prediction range. At that, it's further than ours. All we think we know about the next default cycle, in bonds and, especially, in leveraged loans, is that it's going to be a doozy.

Although ratings are backward-looking, Moody's incorporates the history of ratings changes—the so-called ratings-transition matrix—into its default prediction model.

Thus, for instance, based on the record between 1987 and 2017, a previously downgraded double-B-rated U.S. issuer has a 30% probability of being moved down another notch within the next six quarters. In contrast, a new issuer has only a 7% chance of being downgraded in the same time frame. It makes no difference whether the particular borrower drills for oil, sells sheets and towels at shopping malls or manages a water utility.

"What Moody's and S&P want to show people is a smooth transition," Christopher Whalen, publisher of *The Institutional Risk Analyst*, tells Santin. "They want people to believe that you can predict the future in terms of defaults. I would tell you that if you look at their own historical numbers, defaults are a little more idiosyncratic than they would have you believe."

. . .

With the understanding that we will stick to journalism and let Moody's assign its ratings, we wonder what will become of the vintage businesses, encumbered by cheap debt to finance private-equity-sponsored buyouts and dividend distributions, come the next credit comeuppance. Testament to the instability of business models in this time of ultra-low bond yields and up-tempo technological change is that even some of the top disrupters—Uber Technologies, Inc., The We Co., Inc.—have wound up on the back foot.

Consumer taste is perhaps no more fickle than it ever was, and government regulation no more capricious, but the restaurant business is struggling more than you'd expect in the current economy. "It shouldn't be in this shape because the consumer is supposed to be in pretty good shape—still spending, still wanting to eat out," says John Hamburger, founder and CEO of *Franchise Times*. But, Hamburger adds, consumers are picky, wage costs are rising, "and then this movement towards digital and mobile ordering, it is starting to accelerate right now."

According to the Moody's one-year ratings migration table (1983 to 2018), there was a more than 70% probability that the leveraged loan of restaurant chain Steak 'n Shake, Inc. would retain its B3-rating, or even be upgraded, through October 2018—only consider the chain's "strong brand awareness" and "relentless focus on value." Instead came an April 2018 demotion to Caa1—only consider the "challenging operating environment with higher costs, including commodities and labor, alongside reductions in traffic...and weakened credit protection measures."

Now, according to the agency's protocols, there was a 70% probability that the loan would retain the Caa1 rating for at least another year. But April 2019 brought another downgrade, to Caa2, along with a shift in the ratings outlook to "negative." As for the loan itself, it changes hands today at less than 71, down from par in October 2017.

It will be said that migration-table probabilities apply not to any single issuer but to a statistically significant cohort of issuers. Granted. Yet the "Industry Sector Outlook" report of Jan. 30 from Moody's underscores how broad-based is the deterioration in credit fundamentals (there's been nothing like it since 2008–09, Moody's says). And the investors? Income is the prize, and they hunger for it, as they seem not to hunger, for instance, for conservative leverage ratios.

"Another potential overhang to leveraged loans and high-yield credit in general is if CLO equity returns continue to deteriorate," Santin observes. "This could make it more difficult for new CLOs to raise equity and consequently throw a spanner in Wall Street's structured-financing machine. On Jan. 27, S&P's LCD reported that CLO managers are 'struggling to convince past LPs...to stick around because of equity underperformance.' An unnamed lawyer explained to LCD that equity returns have just not 'turned out as well as envisioned.'

"An interruption in the issuance of leveraged loans could increase debt costs as borrowers turn to the bond market instead," Santin continues. "Given that high-yield bonds and loans are outstanding in roughly equal measure—$1.2 trillion—and given that CLOs hold 70% of leveraged loans, a 30% shrinkage in the CLO market could require a meaningful jump in bond financing. By the numbers, it could, in fact, call forth a jump of 21%, or $252 billion, in new issuance.

"It would be rash to attempt to predict the denouement of these various trends and forces, both macro and micro, as they bear on leveraged finance," Santin winds up, "but on the face of it, it doesn't sound bullish."

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