EDGEPOINT

Good loans aren't made in good times

By Frank Mullen, portfolio manager

A mere 12 months ago, the world according to the capital markets was a different place. With $25/barrel oil fresh in our memories, many investors were still concerned that a China-led slowdown would send North America into a recession. Despite the fact that oil recently retracted from recent highs, the fears that used to exist subsided and were replaced by rather complacent markets.

We'll always focus on long-term fundamental values when making a credit investment, but we understand that in the short term asset prices are driven by investor sentiment that isn't always aligned with fundamentals. Investor sentiment is often a contraindicator to us as it drives asset prices too high when everyone is optimistic and too low when fear is top-of-mind. The underlying fundamentals of businesses we lend to generally don't change as dramatically as sentiment, so we must focus on the price we pay to ensure that we aren't getting sucked into the emotions of the day.

Today we find ourselves operating in a market that is devoid of fear and full of optimism. Asset prices rose materially in the last 12 months, driving yields lower and credit spreads tighter on corporate bonds. From an investor's perspective, good loans aren't made in good times like today. Good times generally mean rising asset prices and looser lending conditions. The memory of the past fades quickly and investors turn from protecting their downside to trying to ensure that they participate in a rising market. Worst-case scenarios are forgotten as a means of risk management, and investors start thinking about how hard it will be to explain why they didn't own the latest new issue that rose in price. Career risk and a fear of losing clients prevents most from taking a step back and asking if the fundamentals align with the price.

Signs of the times

Covenant packages loosen, prices rise, yields shrink and suddenly dealers begin to tout how lucky an investor should feel simply for getting bonds in the latest offering. These are the times when bad loans are made. Companies that were once considered un-investable are suddenly raising money. Investors want to own them because they're now the only bonds that provide any yield, but with that yield comes risk. Consider the below signs that we're operating in good times:

> **Covenant package:**
> A collection of covenants outlined in a bond's legal documents. They're designed to protect bond holders by defining the borrower's requirements and limitations.

- YTD high-yield spreads across different sectors are at or close to the tightest levels since 2014 (the previous narrowest point). The only exceptions are industries that experienced material negative operating results like retail and utilities[i]. Since February 1989, the U.S. high-yield sector has provided higher yields 96% of the time[ii]
- A U.S. telecom company with a market cap of ~US$1.4 billion and debt of ~US$18 billion just issued a seven-year loan with a yield of ~5%. The stock is down almost 80% in the last year
- A large energy producer spent the last two years proposing debt exchanges that pitted bond investors against one another by trying to reduce indebtedness and transfer value from creditors to equity holders. These actions were quickly forgotten when investors lined up to lend them US$750 million at 8%. That seems pretty skinny for a CCC rated bond and $45/barrel oil

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[i] Morgan Stanley Research, "2017 Mid Year Recap – Safe is Sound", June 30, 2017, pg. 8.
[ii] Morgan Stanley Research, "Corporate Credit Chartbook", July 3, 2017, pg. 5.

- A large U.S. grocer just priced a term loan at ~5%. People need to eat, but the business operates with razor-thin margins, has almost five turns of leverage and has brand new competition from market entrants that have historically stolen tremendous market share. The stock is down almost 40% in the last year. Oh, and Amazon just decided they wanted to compete in their sector

Turn of leverage:
A company's debt relative to its earnings before costs. Five turns of leverage means the debt is five times its EBITDA (earnings before interest, taxes, depreciation amortization).

These events aren't indicative of a period of high future returns, and we ensure that we base all of our investment decisions on the long-term fundamentals of the business and are being properly compensated for the risks that we'd take.

These signs do provide a glimmer of hope for those willing to think long term. When the tide turns, and it always does, we'll have an ample opportunity set of bonds to buy. Optimistic buyers of skinny yields will wake up one day and be driven to sell. We don't know what will change sentiment from greed to fear, but we do know that the odds of bad news coming out from companies that took on too much debt are in our favour. An earnings miss, negative press release, aggressive actions by a competitor or a simple shift in investor emotions can each contribute to driving the price of today's market darlings to interesting levels.

Times change, but we won't

Our job will always be understanding the underlying value of companies and making sure that we only invest when we think that the yield pays us to do so. It's during these bad times that we hope to make our best credit investments. The power will shift from issuer to investors, and we'll be able to push for higher coupons and tighter investor protections.

At the risk of sounding like a broken record in my commentaries, I'll repeat the fact that sometimes the best offence is a good defence. We're positioned defensively with low duration and a relatively small weight in high yield. As bonds mature, we'll have plenty of dry powder to invest in new opportunities when they arise and can shift our predominantly investment-grade weight to more interesting high-yield opportunities. Rest assured that your Investment team continues to uncover unique situations to invest in, but they're currently harder to find. A wholesale shift in sentiment will come and will provide a fertile hunting ground for us to invest in.

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