The barbarians are NOT at the gate

Credit quality in the high yield market is improving – leading to lower expected defaults.

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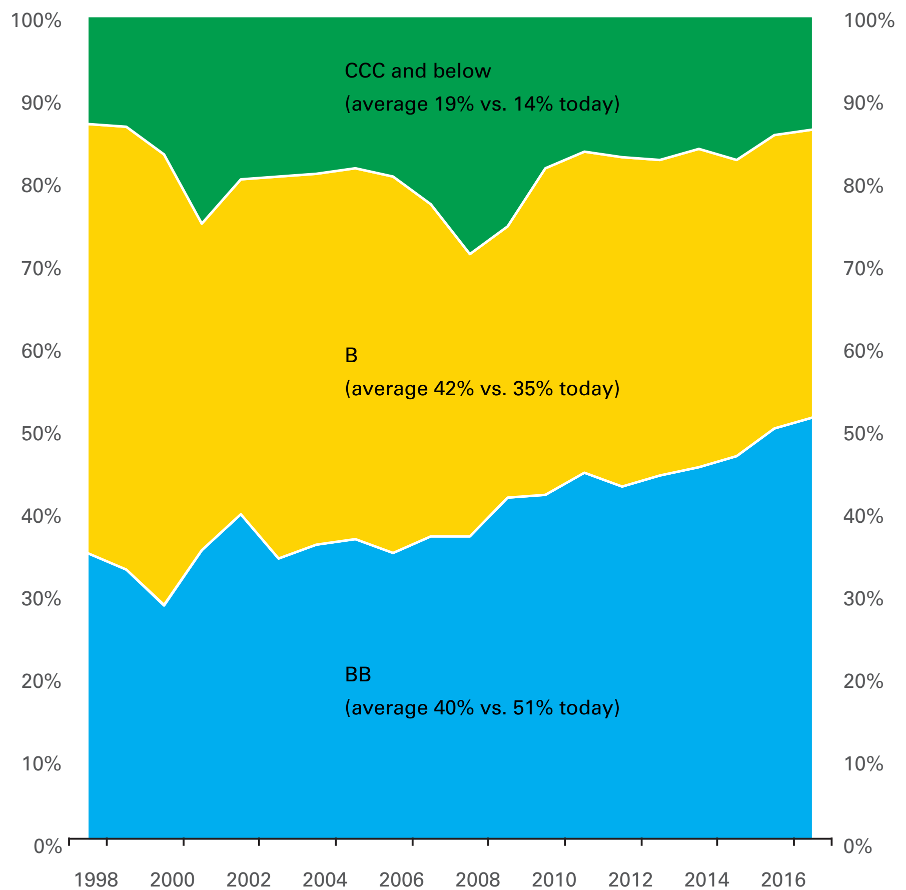
When journalists Bryan Burrough and John Helyar wrote Barbarians at the Gate in 1989, they described a world where the rise of the leveraged buyout was leading to a corresponding decline in the credit quality of high yield bonds.

Today however, the credit quality of the issuers in the global high yield index is rising. The percentage of the index with BB rated bonds has increased to 51% from an average of 40%, while CCC rated bonds are now only 14% of the index, having previously averaged 19% (Figure 1).

This change is a global phenomenon that we believe points to lower numbers of future defaults.

Financing costs for high yield companies have also been on a steadily downward trend. This has been directly helping to improve free cashflow for high yield companies, so we believe the quality of the index has clearly improved.

Figure 1: The changing credit quality of the high yield market



Rating	BB	B	CCC
Avg. 5 yr Default rate	7%	17%	33%

Source: Internal and Bank of America Merrill Lynch as at June 2017

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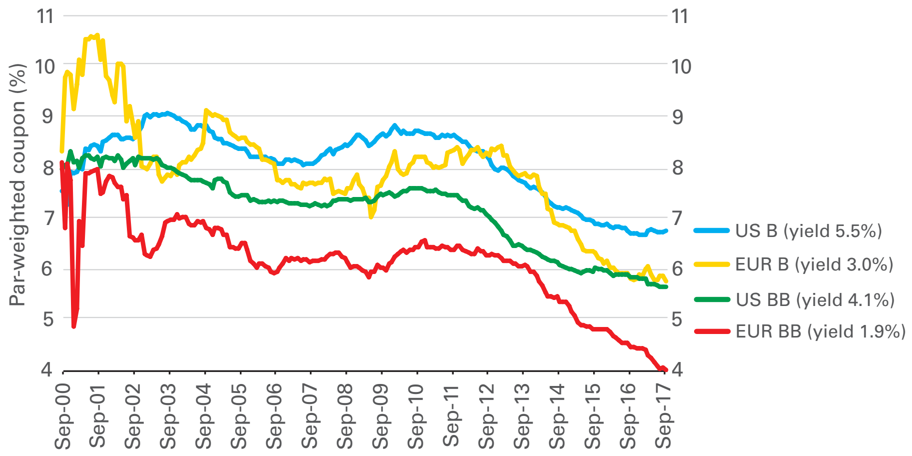
Current coupon rates are around 2% higher than today's yield on many high yield bonds – using European BB rated bonds as example, existing bonds are paying a 4% coupon but when these companies come to refinance the market yield is only 2% – further reducing their borrowing costs.

This also means there is room for higher global interest rates before financing costs start to cause a negative affect for companies' cashflows and financing needs (Figure 2).

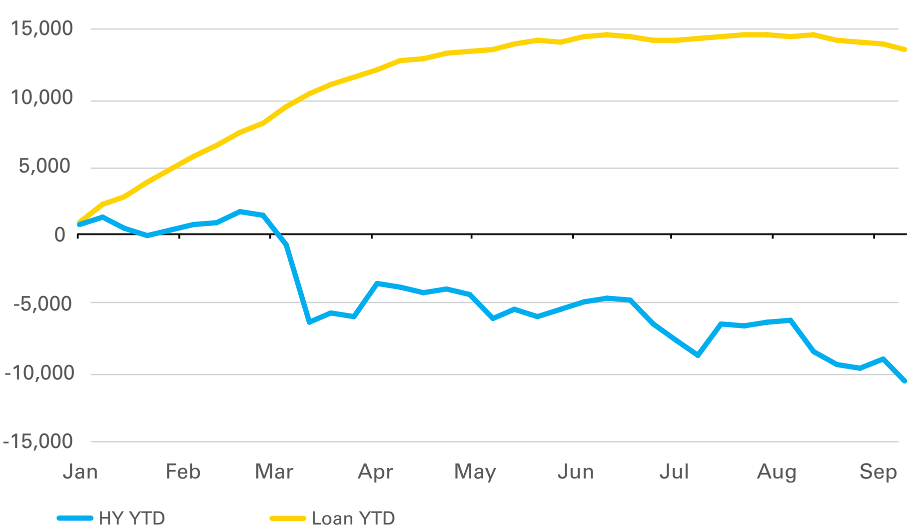
Figure 2: Coupons have fallen but remain well above interest costs



Source: Par-weighted coupon for BofAML indices US BB, US B , US CCC, EUR BB, EUR B as of 30 September 2017.

There is a more diverse range of financing sources today as leveraged companies are starting to prefer issuing loans and private credit over high yield bonds to finance themselves, reducing the amount of high yield bonds from their capital structure. This is supportive for the high yield market but needs to be recognised as leverage is not declining, just being transferred. So issuers are not turning as much to bonds as they once did and likely future credit concerns are being displaced from the high yield bond market to the covenant light loan and private credit arenas.

Figure 3: US High yield and loans year-to-date flows ($mn)



Source: Internal and Bank of America Merrill Lynch, LGIM internal as at September 2017.

Along with the increase in loan issuance, the demand for loans has been on the rise. While overall demand for higher-yielding assets has never been greater, this shift to loans has led to outflows from high yields bonds (Figure 3). Yet this has not hurt the performance of high yield bonds, and as Figure 4 shows there has in fact been a negative correlation so far this year.

We believe there is also a curious by-product of the persistently low rate environment that is disadvantageous to private equity. Indeed the price of investment grade debt is so low that trade buyers can outbid leveraged private equity. Kraft bidding for Unilever was a good example of this. When private equity does put capital to work, they can find the low price of loans compelling. Should there be an increase in LBOs, they are likely to be limited and buy outs of small divisions using the leveraged loan market to finance.

Figure 4: Correlation between flows and total high yield returns

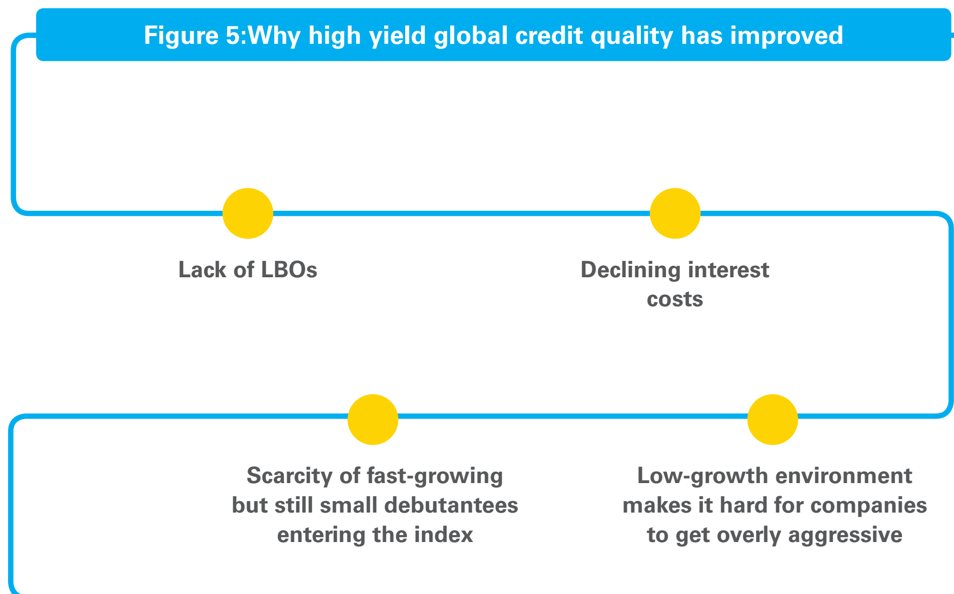
2015	**75%**
2016	**79%**
YTD	**-83%**

As the covenants are falling off these loans quickly, one could argue that they are becoming more risky than historically, as credit risk normally grows fastest in rapidly growing lending markets.

Perhaps investors should therefore also be aware of the risks of direct lending. Yet, for high yield investors, this is reducing some of the debt that would have found itself moving from bank balance sheets to the high yield bond market.

In the context of declining expected default rates, investors would naturally expect spread compression to continue. However, even though spreads have compressed during 2017, as we enter 2018, based on average experience in BB rated credits and also possibly in B rated credits, there is still sufficient compensation for default risk. In the CCC market this might not be the case.

Figure 5: Why high yield global credit quality has improved



Some have argued that the improvement in credit rating within the index could be a product of the rating agencies changing their methodology. There is little evidence to support this view and not our experience when we are reviewing the many issuers that pass our desk.

So on that basis, the next time we hit a major macro slow down, the high yield bond market could actually experience a lower level of defaults. This has not yet been talked about in the market and is therefore not likely to be fully priced in.

CONTACT US

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