Tiburon Capital Management

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Disarray in Credit Markets– Passive Investment Risks/Active Investor Opportunities

We have been in the midst of market behaviors and anecdotal data suggesting a pause in ready High Yield fixed income ("HY") capital markets availability. I use the word *pause* as its seems that HY investors are taking notice of the inadequate pricing and rights and remedies offered creditors for risks to be taken – not a wholesale dismissal of the HY markets. Financings have been pulled for lack of investor interest at pricing in line with the sponsors/companies/underwriters expectations – most recently the *Carlyle Group's* buyout of *Symantec Corp.*'s data-storage business *Veritas*. As we've discussed in the past, there is new volatility in HY and Leveraged Loan market pricing given the impact and importance of the daily liquid mutual fund and ETF products.[1] *Dodd-Frank*'s chilling impact on market making by dealers leads to gappy swings in market prices on news events – witness the recent trading dynamics of the bonds of *Valeant*. Finally there is the looming prospect of impending defaults in the energy sector – once the largest component of HY outstandings, now second to technology at approximately 17% (at current market value). Given our point of view that oil prices decline from here, it would seem likely that hastened bankruptcies and restructurings are on the horizon. Given the newfound pricing discipline among HY investors, it seems that exchanges pre-bankruptcy and restructurings and reorganizations will be more expensive and less coveted than might have been anticipated a year ago when oil prices first fell off a cliff. The ramifications of these HY market dynamics combined with a new pricing discipline and impending energy issuer tumult makes for – as always – both risks and opportunities. We'd argue that the risks inordinately impact passive managers and vehicles, and conversely, that the opportunities decidedly inure to the benefits of active managers.

Passive versus Active HY Investment

For the sake of this discussion, I use the expression, *passive managers*, to describe long only, index-centric mutual funds and ETFs. I use the expression, *active managers*, to describe investment firms, like *Tiburon*, making more-narrow, conscious, often idiosyncratic portfolio allocation decisions, regardless of an index.

Let's review some of these current HY market dynamics:

First, energy defaults should remain concentrated within high-cost producers. We expect lower for longer oil prices will continue to pressure defaults among high-cost producers. The concentration amongst high-cost producers is self-reinforcing, as multiple defaults by the same issuers result in even more concentrated ownership with each credit event becoming less relevant for the broader market. For recovery rates, we also think risks are skewed to the downside as long as defaults remain concentrated among over-leveraged and high-cost issuers. The key hazard to this view is a more persistent, steeper decline in oil prices that would put pressure on over-leveraged but low-cost producers. If large capital structures of low-cost producers were to default, the impact on risk appetite and market sentiment would be much more pronounced. Passive managers will own securities more or less in line with index holdings. An active manager can choose shorts, glean relative value within a company's capitalization and be long (better covenant, security, top of capital structure)/short (lesser covenants, no security etc), or avoid entirely if there is no attractive risk-adjusted trade to put on.

Second, oil, not rates, remains the key risk to credit. The Fed's signal of a December hike will likely redirect the market's attention to the risk from rising rates, especially in HY. We reiterate our longstanding view that HY spreads will resist higher rates. To the extent rising rates are a response to stronger growth, risk appetite should remain firm and thus drive spreads tighter. At the same time, excess capacity alleviates inflation concerns, allowing the normalization of policy rates to be gradual and predictable. And while an inflationary shock leading to higher rates could obviously push spreads wider, such a scenario remains unlikely, in our view. Against this benign view on the impact from rising rates, we continue to view downside risk from oil prices as a meaningful (tactical) risk to the HY market and HY E&Ps. Passive managers will own securities more or less in line with index holdings. Active managers can mitigate unwanted risks, isolating returns from the companies, via hedges that limit oil price exposure and/or rates, if prudent and desirable.

[1] *Assessment of Loan ETF (and Mutual Fund) Redemptions and Scenarios*, Lupoff, Shark Bites Volume 4 Article 5, June 2014 http://tiburonholdings.net/uploads/Shark_Bites__-_Liquid_Loan_Vehicles_-_Issues_and_Opportunities.pdf

Third, we can choose the instruments and prefer leveraged loans vs HY bonds on lower Energy exposure. In both the HY bond and leveraged loan markets, the Energy sector has performed abysmally year-to-date. But the impact of Energy has been dramatically lower in the leveraged loan market relative to HY. Key to this difference is the smaller weight of the Energy sector in the leveraged loan market, around 5% in market value versus 17% in HY.

We are constructive on value, cautious on credit quality. From a bottom-up perspective, the deterioration of corporate balance sheets is increasingly alarming to us. Given the growing downside risk for global growth, the outlook for earnings and revenue growth will likely remain challenging, *especially for globally exposed issuers and sectors*. As for active forms of re-leveraging, we continue to closely monitor share buyback programs. As a manager with equities allocations as well, this give us clues on equity longs with such shareholder-behaviors, a tailwind to target prices, as well as potential fixed income shorts, with borrowings and/or cash thrown after share repurchases. Passive managers, again, will own the "market" more or less. Active managers can emphasize or avoid regions and industries. As a manager that trades equities in other vehicles as well, Tiburon is well-suited to identify clues in company behaviors, suggesting shareholder or bondholder friendliness (one often at the expense of the other).

Rounding out the Picture – Broader HY Commentary

Credit quality continues to deteriorate. IG and HY net leverage ratios are oscillating around their third historical quartiles,[2] credit quality is at concerning levels, especially if revenue and earnings growth continue to struggle. Given increasing downside risk to global growth, the pressure on revenue and earnings growth may persist especially for globally exposed sectors. The only silver lining across credit metrics remains the historically high interest coverage ratios, which stand around the 70th percentile in IG and the 65th percentile HY.[3] These high levels provide an offset to the negative impact from rising net debt on balance sheets and mediocre earnings growth.

Buybacks and M&A have been positive themes – Can this Persist? This is an ancillary point, really, as it relates to HY uses to the benefit of equities. Companies in the S&P 500 have repurchased $2.6tn of stock in the last five years. This enormous sum is more than what the Federal Reserve spent on quantitative easing and equates to 15% of the market capitalization of the S&P 500. In addition, US companies are on pace to complete a record amount of mergers, with the average acquisition premium at 25%. Surely these two trends have been positive for equity prices. Could they now be at risk because of elevated financing costs in the high yield market?

The widening of HY spreads should not matter. Most of the companies in the S&P 500 are Investment Grade rated. In fact, only 57 of the index's constituents are rated High Yield. Furthermore, the companies that are HY tend to be small. When adjusted for market capitalization, the percentage of non-investment grade companies drops to just 4%. Therefore, we conclude that the 180bp widening of spreads in the HY market in the past year does not pose a fundamental risk for the S&P 500.

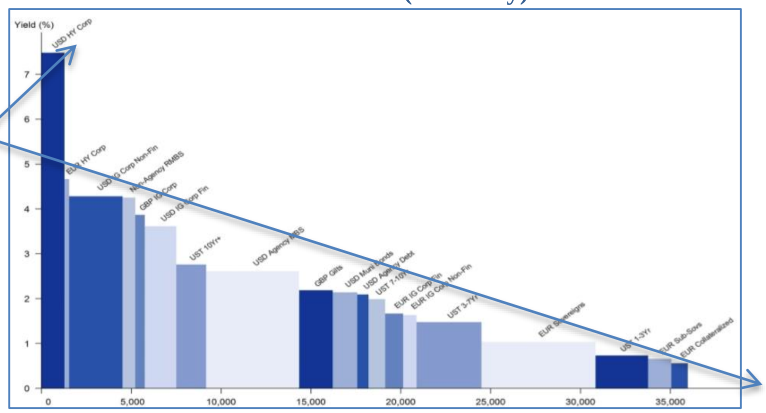
The cost of funds is a consideration in M&A, but we think the most significant driver is market volatility. When volatility rises, it becomes more difficult to find common ground between what buyers would like to pay and what sellers would like to receive, slowing deal flow. While current conditions are still supportive for M&A growth, albeit at a slower pace than in the past several years, if the higher volatility of July through September persists through the end of the year, we expect that M&A growth could flatten or even fall.

Returns from US HY ain't too shabby. At this writing, the average yield on the composite HY market bid (90.93%) is 10.05%, pushing the average bid and yield down to levels not seen since the recent low of October 4, 2011 (Euro-Contagion Fears, remember that?) [4] The Average price of leveraged loans has slid to 89.47%, for a yield to maturity of approximately 6.03%, also the lowest level in 4 years.[5] Mind you, loans enjoy collateral as security, and a LIBOR floor (albeit, low), affording holders interest increases are rates rise.

[2] *The Credit Trader*, Goldman Sachs Global Investment Research, October 30, 2015
[3] IBID
[4] S&P Capital IQ LCD
[5] IBID

Global Reach for Safe Yield (DM Only) Favors US HY

What the Energy component of HY and *Dodd-Frank* hath wrought.



Source: Goldman Sachs Global Investment Research

In short, the HY markets offer attractive yield relative to other fixed income markets. Its tiresome to call it a "pickers" market – isn't it always? But again, without a bias at the mandate level, managers like *Tiburon* can choose to be long credit "thrown out" due to technicals, where the company is fundamentally sound and has a plausible *Revaluation Catalyst*. Additionally, we can find attractive shorts where self-defined HY managers must own the bonds as a function of index and/or peers, despite weakening fundamentals, poor market conditions and the existence of a plausible catalyst to drive the securities price to a fair (and vastly lower) price.

The Current Disarray in HY is "Healthy"

In the middle of difficulty lies opportunity – Albert Einstein

Bloomberg reported this week that more than $15 billion in debt offerings of both loans and bonds made to HY companies have been rejected by investors or sold at steep discounts since October.[6] Unlike the abrupt shutdown of HY markets in August-October 2011, this, as mentioned, may be more about a more discerning buyer exercising prudence. Howard Marks of *Oaktree*, to this point said, "These are indications of a more sober market, which is saying there's such a thing as too much debt issued, there's such a thing as an over-leveraged company…this is all very healthy."

Out of these current dynamics, a prudent and *active* manager with a flexible mandate, can choose to be long or short among bonds and leveraged loans and among industries, harnessing events that can catalyze revaluation to fair price, disintermediating the liquidity needs of the *passive* daily liquid mutual funds and ETFs when they are sellers into the *Dodd-Frank* shackled dealer-free market, taking advantage of directional and/or passive holders who simply "own the index".

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[6] *Bloomberg*, November 20, 2015