Tiburon Capital Management

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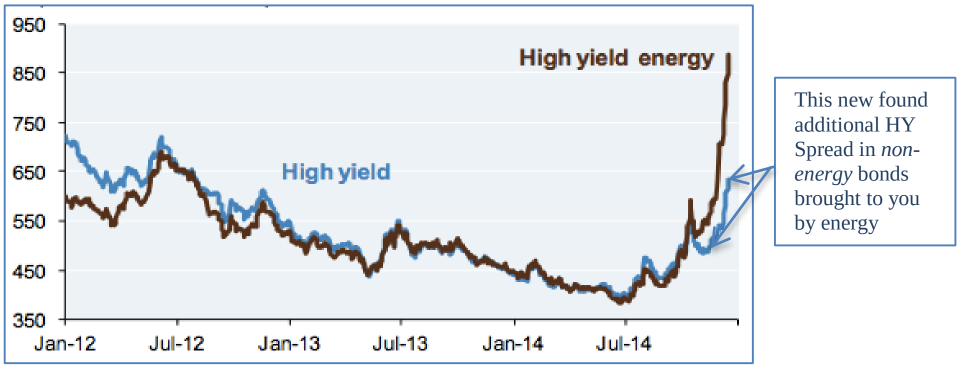
Oil's Price Decline and its Impact on the High Yield Market

Existing angst about deteriorating credit quality, low absolute yields and increasingly lax covenants has been reinforced by fresh worries about the proximity of Federal Reserve rate hikes and the impact of last year's dramatic decline in oil. The fact that energy and mining bonds represent about a fifth of the benchmark index today - nearly double their weight a decade ago—only exacerbates anxiety about commodity exposure.

While energy defaults are no doubt set to rise, we expect the increase to be less than what their bond spreads now indicate. Keep in mind that the market is currently implying annual energy defaults of more than 8%, well above the sector's 4.6% long-term average and current trailing default rate of just 1.6%.[1] The proverbial baby has, and will continue to be thrown out with the bathwater.

HY Index Spread to Worst, Ex-Energy



Source: JP Morgan

HY Interesting but with Mark-to-Market Risk due to Energy Sector Exposure, Dodd-Frank

The most important macro risk impacting HY is the sharp decline in oil price, which is down by 50% since June. Oil's price move has greater ramifications for HY than any coming, anticipated rate hike in the US. As we've written, our forensic work on the energy sector suggest that the weaker US shale producers could be entering a zone of deep distress at oil prices below $60/bbl, with the more recent data-points suggesting that we could have an additional $5 room before this happens. If prices were to stay sustainably below these levels for a few months/quarters, chances of a broad sector restructuring increase materially. This scenario would have repercussions for the timing of overall HY default cycle. At this writing, WTI crude oil is approximately $50/bbl.

Oil exporting sovereign's travails can weigh on HY. Credit markets broadly would be roiled further by a Venezuelan and/or Nigerian sovereign default, along with a concurrent and highly probable debt restructuring by Venezuela's national oil producer, *PDVSA*. Other focus developments include Russia's state-owned enterprises and Brazil's *Petrobras*, where sustainability of IG ratings could be put into question.

Winners and Losers as a Function of the Oil Price Move

In a prior *Shark Bites*, we discussed Tiburon's energy strategy as choosing between *Hard Bets* and *Easy Bets*.[2] The radical move in energy prices will have material impact on company performance in the quarters to come. For some fund managers, say with no exposure to the energy sector due to mandate or serendipity, they can easily miss the massive ramifications for their portfolio - which at worst, has a *second derivative effect*. Therefore, every position must be re-reviewed through a lens of current oil prices. From such a review, one can determine sector and company winners as a consequence of increased consumption due to the consumer "windfall" from lower gas prices and companies' reduced Cost of Goods Sold, a function of lower

[1] *US Preeminence* – Goldman Sachs Investment Management Division – January, 2015
[2] See *Where is the "Bottom" in Oil – Parsing the Risks and Opportunities*. Lupoff, Shark Bites Vol 4 Article 11 December, 2014
http://tiburonholdings.net/uploads/Shark_Bites_-_Where_is_the_Bottom_in_Oil_-_Parsing_Risks_and_Opportunities2.pdf

input costs and logistics/transport costs.

The *Easy Bets*, then, require a review of the impact on the existing portfolio for increased or reduced target prices. We at Tiburon will also screen for companies meeting the elements of our *BRACE* methodology, that assuming a plausible *Revaluation Catalyst*, now in addition, have the prospect of improved dynamics due to the precipitous fall in the price of oil.

The *Hard Bets* are those calling a bottom in oil. Many will be prone to call the direction of oil on nothing more than hunch or backward looking data. This is a *Hard Bet*. It is worth pursuing, but unless there is an *informed house view* regarding supply and price, as impacted by OPEC, the Saudis and those sovereigns facing economic devastation as a function of the oil price move; and a view on global demand and oil's price move's impact on substitutes, how can one possibly have sufficient confidence on valuation?

We will have, and will continue to dynamically alter the portfolio to affect the *Easy Bets*. We will continue to burnish an informed house view, in order to facilitate allocation to the *Hard Bets*.

Easy Bet Buys - Cheap Oil's Duel Favorable Drivers – Increased Consumption, Higher Margins

Sectors, companies and their securities can be beneficiaries of the drop in the price of oil in two ways, either increased consumer expenditures, a function of the "windfall" from reduced oil/travel costs and/or reduced Cost of Goods Sold ("COGS"), a consequence of a company's reduced input or travel/logistics costs. Here's the reprint of one of our tables that describes sectors and the drivers. HY issuers that fit the criteria below stand to be beneficiaries.

Sector	Oil's Driver	Comments
Apparel and Footware	Input Costs	Lower COGS for vendors
	Consumer Spending	Retailers, particularly skewing to lower end retail
Autos	Input Costs	Lower costs of fabric, rubber, other inputs
	Consumer Spending	Plausible increased sales volume, higher margin vehicles
Auto Parts	Consumer Spending	Reduced costs of oil derivative products
Beverages	Input Costs	Lower COGS
	Consumer Spending	Increased discretionary spending. Staples outperform when oil drops
Building Products	Input Costs	Reduced cost of carpets, flooring
Consumer Durables	Input Costs	Resin (oil based input) cost
	Consumer Spending	Increased discretionary spending, Durables, travel
Food	Input Costs	Reduced cost of plastic packaging, transport, logistics, cooking/processing
Food Retail	Consumer Spending	Travel costs particularly for those serving lower end food retail
Household Products	Input Costs	Lower cost of plastic packaging, fuel/logistics costs
Retail	Consumer Spending	Reduced travel costs

Source: Tiburon, Goldman Sachs Global Investment Research

Given the coming, inevitable defaults, bankruptcies and restructurings of energy-related HY issuers, the HY market is prone to shocks that can provide attractive entry points among bonds of issuers that are beneficiaries of oil's price decline.

Bond Market Liquidity

Dodd-Frank has pretty much killed the dealer community – rendering them all "flow-trading" boutiques. As larger money-center dealer desks trade with little to no capital or position-taking authority, any unanticipated market shock could really cause some great gaps down. If, for example, a massive hedge fund had some institutional specific issue concurrent with market draw down, and put multiple billions dollars of loans or bonds (even equities for that matter) into the market for bid, what would happen? Larger alternatives managers talk about *being the bid*, the market maker, and taking up attractive securities or obligations at bargain prices. Maybe things play out this way, in this very scripted scenario, maybe not. In any event, great price dislocation is the outcome and a broader market's indifferent calm can evaporate in an instant. This technical matter exists before or despite any coming wave of energy HY defaults.

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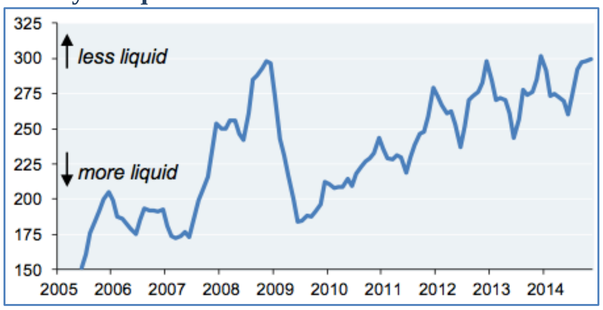
Liquidity has worsened at the same time that the global bond market has grown significantly and corporate broker-dealer bond positioning has at least halved. The consequence is extremely hampered liquidity as evidenced by the table below. *Average trading days required to turn over the outstandings in the US bond market is presently in line with October 2008 levels!*

Days Required to Trade Entire Bond Market



Source: FINRA, TRACE

Fasten your seatbelts, it's going to be a bumpy ride! - Bette Davis, *All About Eve*

We are in a moment in markets where there is increasing dislocation in HY, particularly energy-related HY. If we are correct in our *lower rates longer thesis* (little to no interest rate hikes in 2015), then *all* of HY is being hit based upon perceived default risk among energy-related companies *specifically*. Investors can buy HY of non-energy companies actually beneficiaries of the drop in the price of oil. Such companies are the Easy Bets and should show improved credit metrics a function of either lower COGs, heightened consumption or both. Liquidity and mark-to-market are the chief concerns.

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