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Prospect News High Yield Daily

Monday June 24, 2013

Junk market steadies but wary after Thursday slide; American Equity, Intralot deals postponed

rue21 to get $680 million facility, $250 million notes for buyout

Prospect News Distressed Debt Daily

Monday June 24, 2013

Distressed market 'somewhat stabilized' as equities hold in; PDVSA regains ground; OGX tumbles

Morgans noteholders demand prepayment, could trigger revolver default

Highland sees little gain for high yield, expects boom in distressed

By Paul Deckelman

New York, June 24 – **Highland Capital Management, LP** does not see much improvement for the recently battered high yield market in the remainder of the year, believing that fixed-income investors will do better in bank debt generally and especially, collateralized loan obligations, which it sees as "the best way to play loans."

And the Dallas-based investment company, which has over $18 billion under management, believes that distressed debt is an up-and-coming area for investors to consider, based on what its co-founder and chief investment officer, Mark Okada, calls "idiosyncratic" features built right into a lot of the bonds and leveraged loans now in the market.

"You've got to get ready for distressed now – because it's going to start coming," he told financial reporters at Highland's second-half outlook briefing on Monday.

"We've seen a lot of stuff on the calendar that we think is really silly, and at some point, the fundamental idiosyncratic risk will catch up to those players – and we'll be ready to buy that stuff."

Middle market a problem spot

For instance, Okada said that even now, Highland – which is the largest U.S. CLO manager in terms of CLO assets under management and which also runs a variety of hedge funds and other investment funds – is raising a fund that will specialize in buying bank loans made to middle-market companies that become distressed.

Such companies roll up annual revenues of anywhere from $10 million to $1 billion, depending on the definition used, although the vast majority of them only have revenues of $50 million or under – and Okada believes that such credits are particularly vulnerable to running into trouble because they don't have the same kind of cash flows that bigger players in their respective industries have.

"You have an issuer base that has more fundamental volatility," he said. "When you're a [relatively] small company and you have a problem, the cash flow doesn't just go from $100 million to $90 million – it goes from $100 million to $50 million. You have much more downside volatility in the cash flow of a small company versus a large company, where you tend to have more levers to pull."

For that reason, Highland assiduously avoids including loans of such companies in its structured finance vehicles such as its CLOs – in this regard, Okada said "I tend to be pretty contrarian versus the rest of our competitors" – but on the other hand, "we love it on the distressed side – we want to buy a lot of these credits."

The three-year jinx

Looking at the overall debt market, Okada explained that having recently seen several successive years of record or near-record issuance of new high yield bonds and leveraged loans, "there was too much paper from issuers that probably at some point won't be able to support that debt. That's coming."

It's certainly not a new phenomenon.

"Any time you have massive new issuance, you're going to have big problems down the road," Okada declared. "It's happened every cycle. You have a big new-issue calendar, and two years, or three years down the road, you have higher default rates – this is natural."

This coming flood of issuers running into trouble won't happen tomorrow, or in the current or even next quarter – but Okada predicted that "a lot of problems" will start showing up in the 2014 to 2015 timeframe.

One of the traditional root causes of a lot of credits becoming distressed and possibly even defaulting has been

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refinancing risk arising from their real or perceived inability to access the capital markets to refinance upcoming maturities. Over the past few years many companies have successfully refinanced debt and pushed out their maturities.

However, Okada said that "we've had the wind at our back this whole time. You're refinancing into a liquid market, cutting interest costs – but your cash flow is growing."

Now, though, Highland's economists are of the opinion that from a macroeconomic point of view, the global economy is slowing – although the U.S. economy still has "some engines working nicely," Okada said, mentioning sectors such as housing and the production of chemicals and energy.

The economists assert that corporate fundamentals like revenue and EBITDA are peaking, and are unlikely to show any kind of strong sustained growth. At the same time, companies' net profit margins – which rose by an aggregate of some 270 basis points in the past 15 years – also seem to have topped out.

Against that kind of a backdrop, Okada cautioned, "if your cash flow stops growing, and you have leverage back to 2007 levels, then you're not going to be in that [favorable refinancing] situation going forward. We think it takes time for that to happen – but that certainly means distressed is going to be the place to be."

Debt recently retreats

Okada made the distinction between credits which will likely run into trouble over the next several years because of such "fundamental and idiosyncratic" factors, and those which have recently moved onto distressed-debt investors' radar screens when they've been hammered down in the junk bond and loan markets due to the great volatility there lately arising from investor fears about possibly higher interest rates should the Federal Reserve make good on its announced intention to start winding down its expansive quantitative easing monetary stimulus program.

"I think volatility has to show up somewhere in the pricing of risk assets," he said of the latter category. "If you have higher risks, you're going to have pricings down."

While some credits have been marked down by a few points, so that "maybe the distressed player would be buying," those bonds and loans recently taking their lumps don't exhibit the same kind of potential problems as the credits that will likely run into trouble in the next several years because of their own fundamental weaknesses.

He said that the distressed-debt market has "gotten a little better from a pricing standpoint," in that more credits have come into that universe of late, versus the dearth of such paper that traders had lamented earlier this year, "but the overall default rate and the amount of idiosyncratic defaults that we're seeing right now haven't changed" and won't kick in till next year, at the earliest.

He did note that there are "a lot of things in the emerging markets that are trading at very distressed levels. That's really a liquidity call right now."

High yield treads water

Okada noted that the high-yield market has recently been hit especially hard, losing approximately 140 basis points off its year-to-date return in just one volatile session, last Thursday. That was the day after Federal Reserve chairman Ben Bernanke had confirmed financial market fears that the central bank in fact does plan to start winding "QE3" down later this year, expecting to move in stages so as to have its $85 billion a month bond-buying program completely over with by the middle of next year.

However, Highland Capital did not have terribly high expectations for Junkbondland to begin with.

When it released its projections for 2013 late last year, Highland's forecasters suggested that junk bonds – which returned anywhere from 14% to 15%-plus last year, depending on the index quoted – would likely only generate between 3% and 4% this year. In contrast, the investment firm expected the loan market to return between 6% and 7%, and said CLO investors would reap between 10% and 14%.

Okada said that "although the Street consensus was about 6% to 7%, or 8%, for high yield, we were about half that," explaining that "we thought high-yield bonds would have an issue – if volatility was going to start happening, we thought the higher-beta asset class would get hit."

Even though junk's year-to-date return has at this point been chopped down to about half of Highland's prediction, or even less, Okada opined that "if we have just a little bit of stability after some volatility, we could probably get back to 3% or 4%" for the full year. "But we obviously think loans outperform bonds in here."

Highland is holding to its previous projection of a 6% to 7% return for the year in bank loans, but it upped its anticipated return on CLOs to between 15% and 20%.

Okada said that Highland initially had been "pretty bearish" on U.S. stocks with its estimate that the Standard & Poor's 500 index would only return between 4% and 5% this year, acknowledging that it drastically underestimated the strength of the equity market. That market had returned more than 12% through mid-June, neck-and-neck with CLOs and well ahead of junk or

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bank loans. Even with the carnage seen on Wall Street over several sessions last week in the wake of Bernanke's statement, Okada noted that as of Monday morning stocks were still up about 10% on the year – the mid-point of Highland's revised forecast of a 2013 return between 8% and 12%.

Looking at the volatile flows of cash into and out of mutual funds investing in particular asset classes, Okada acknowledged that high-yield mutual and exchange-traded fund flows "have turned pretty negative" over the past few weeks, with over $9 billion having hemorrhaged from those funds in that time – an exodus which he said "made sense to us; if you're buying high-yield bonds below 5%, I don't know why you're doing that. It doesn't make any sense."

At the same time, he noted the heavy flow of cash into both equity and loan funds, each topping $26 billion on a year-to-date basis. Like the flow of cash out of the high-yield funds, he said that the flow of cash into the loan funds "makes a ton of sense to us."

That's also Highland's assessment of bank loans overall as a vehicle for investors – Okada pointed out that on the day when junk bonds slid by 140 bps, bank debt was only down 14 bps on the day, "so it's working." He added that CLOs are "the best way" for an investor to play loans.

As to when the high yield market might escape from its current doldrums, the Highland co-founder said that "at some point, there will be a time to buy high yield again" if the fundamentals steady and interest rates, as typified by yields on Treasury issues, come back down – "but it's probably not now. So what we think people should be thinking about is distressed." ■