NARROW ROAD
CAPITAL

# Credit Snapshots – October 2019

## Shenanigans in Leveraged Loans

There's something of an ongoing battle between journalists looking to write a sensational article about US high yield debt and fund managers saying that their investments in the sector are fine. For instance, journalists have been (mostly correctly) pointing out that covenant lite loans present a substantial risk whilst some fund managers (mostly incorrectly) respond that covenants are overstated as a form of protection with other avenues used to contain the risk in the loans they are making. This month there's been a few more articles warning of increasing risk which should have gotten a lot more attention than they did.

Like covenant lite, earnings add-backs are a toxic development that will make the next downturn far worse than it would otherwise be. Add-backs occur when company management and private equity sponsors make claims that earnings are understated due to one off events, therefore earnings (typically measured by EBITDA) should be adjusted higher with losses from the negative incidents added back to the EBITDA line. This could be restructuring costs or acquisition costs, or in more egregious cases expectations of future earnings growth from opening new stores or acquiring new customers. Sometimes this is for a short window such as one year, other cases have given the company substantial leeway to inflate earnings over several years.

The impact is that earnings for covenant testing purposes are far higher than they actually were, resulting in a covenant breach being avoided when it would have otherwise occurred. What used to be small, one-off adjustments are now nearly doubling EBITDA for B rated companies for testing purposes. This means that by the time a covenant breach actually occurs, the equity value is likely to be gone and the shareholders are far less likely to inject additional equity. It also means that the publicly reported leverage multiples (e.g. debt is six times EBITDA) can be massively understated, making historical comparisons an apples and oranges situation. Those who argue that leverage levels today are far lower than in 2006/7 are on very shaky ground.

Another article highlighted that leverage buyout (LBO) companies have a terrible track record of delivering the EBITDA growth and leverage reduction targets they put forward at the time of borrowing. Given many LBOs are starting with very high levels of leverage, the failure to grow earnings and deleverage leaves these business skating on thin ice for long periods. With miserly global economic growth and a rising risk of recession, these highly leveraged businesses are unlikely to make much headway in reducing their debt burden before they are tested by economic headwinds. One final article noted that the growing pool of B- rated companies will provide a rich vein of defaults in the next downturn. The combination of add-back shenanigans, under delivery on growth targets and economic headwinds makes this sector one to be highly sceptical of.

## Beware of Greeks Bearing Securitisations

For several years, people with more dollars than sense have been tossing around ideas about securitising non-performing loans (NPLs) as some sort of magic solution to fix banks weighed down with bad debts. This is particularly applicable for Greek and Italian banks. There are three main issues: what price is the debt sold at, how the government guarantees work and who will buy the debt. This week Greece released its plan for an NPL securitisation, with hardly any of the key questions answered. The proposed structure has a senior tranche to be rated BB- with a government guarantee attached. Then there's a mezzanine tranche, followed by a junior/equity tranche, which the banks may hold up to half of.

First – the debt price issue. The theory of selling NPLs is easy, the practice often falls apart when two parties try to agree a price. If the price is less than where the bank has marked the loan the bank records an instant hit to its profit

line for the difference. It's likely that banks in Greece have these loans marked at higher levels than the market will pay and are likely to need to take more hits to their limited capital bases to move the loans to the securitisation structure. The alternative is that the securitisation vehicle overpays for the loan, in which case potential buyers will probably see the charade and will refuse to buy any part of the structure.

Second – the government guarantee. Here again there are two sides to the coin with both presenting problems. For buyers of the senior tranche, the Greek government is one of the most indebted (on a debt/GDP ratio basis) and least credit worthy sovereign borrowers in the world. For a structure that is likely to have at least a seven year life, the time needed to deal with the problem loans, there's a high likelihood that the Greek government will be insolvent before the structure has reached its conclusion. A sceptical potential buyer of the senior tranche would view the government guarantee as worth not much more than toilet paper.

The flipside issue is that in the unlikely event that the Greek government is still solvent in seven years, there's a good chance that the guarantee will be called upon and that could send the Greek government broke. Taking a cynical political view of this exercise, the managers of the structure will be under pressure to overpay for the loans at the beginning (to minimise near term insolvency risks for Greek banks) and to go easy on the non-performing borrowers over time to preserve jobs for local workers. This could be one giant can-kicking exercise similar to what the Greek government and European lenders have already been engaging in for a decade.

Third – who will buy the debt? Given all the above issues, who would be crazy enough to buy the notes in this structure? If there are buyers for the senior tranche, will they demand an interest rate so high that it guarantees that there won't be enough of a return to attract buyers for the mezzanine and junior tranches? Will Greek banks be pressured to buy the senior notes, effectively repackaging toxic waste but leaving it with the same owners? Will there be an independent, trusted third party manager to make this exercise look credible to potential buyers from other countries? I'm struggling to see this getting away, other than if there's some form of gun to the head ultimatum for parties linked to the Greek government/economy.

**India's Bad Debts Fuelled by Western Central Banks**

India's banks and bond markets continue to take pain, mostly away from the gaze of first world investors. The problems have been building for years, with non-performing loan ratios at levels that cast substantial doubt on the solvency of a decent portion of their banks. Recently, depositors in PMC Bank (US$1.6 billion in assets) were blocked from withdrawing funds with allegations of fake accounts being created to hide bad loans. There's been an ongoing liquidity crunch with property developers the worst impacted leaving buildings half built. Investors are not surprisingly being conservative after a string of highly rated companies defaulted, trashing the reputation of local rating agencies. It's easy to say that this is typical emerging market behaviour (it is) but that misses the wider issue for all investors.

The ongoing manipulation of interest rates by developed market central banks in setting rates too low encourages this sort of irrational lending. When prospective returns in developed markets are so low, there will always be spill over into emerging markets as some chase yield. An interesting paper released this month looked at the series of cycles in the US that has seen interest rates ratchet down and the amount of debt outstanding rise as each business/credit cycle plays out. The author referred to this practice as making the US a "bubble or nothing" economy, vulnerable to a long and deep recession when the stimulus is eventually removed and debt levels are left to reset. Central bankers of course don't see this at all, this month they released a paper arguing that unconventional monetary policy tools have worked really well and with only minimal side effects! Australia's own Philip Lowe is the Chair of this committee, many have taken his role in this paper as a sign that quantitative easing will be arriving here soon.

Written by Jonathan Rochford for Narrow Road Capital on October 29, 2019. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

**Disclosure**

This article has been prepared for educational purposes and is in no way meant to be a substitute for professional and tailored financial advice. It contains information derived and sourced from a broad list of third parties, and has been prepared on the basis that this third party information is accurate. This article expresses the views of the author at a point in time, and such views may change in the future with no obligation on Narrow Road Capital or the author to publicly update these views. Narrow Road Capital advises on and invests in a wide range of securities, including securities linked to the performance of various companies and financial institutions.