JOHCM Global Income Builder Fund

GLOBAL VALUE AND INCOME DISPATCH

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The things that make you go hmm

We have written extensively about the changes in the high yield market that investors should be aware of. These include looser covenants, watered down metrics such as adjusted EBITDA and finally limiting access to information via private markets. (Please refer to the links to access previous notes on the subjects at the end of the document.) In this report, we wanted to provide an update on recent developments that have caught our eye.

Adjusted EBITDA has now morphed into adj. EBITDAC in the age of Coronavirus

We have now seen at least one company add back losses due to the pandemic to its adjusted EBITDA calculation. It is feasible that we will see others follow suit due to the broad discretion allowed under the definitions. To remind our readers, EBITDA is a non-GAAP figure that is subject to many "subjective" adjustments. It forms the key metric in many loan and bond covenant calculations that determine how much debt a company can incur. This matters because relying on adjusted EBITDA alone can lead one to misjudge the true health of a company, thereby increasing the possibility of capital loss.

The problem with EBITDAC is that it allows companies to add back a cash flow stream that may be permanently impaired at a time when the future cash flow stream is also uncertain. It will increase the risk of capital impairment to the investors.

Keeping up with the Joneses: "Are you on the black or the white list?"

If you thought that the password-protected investors sites were bad, you will be certainly disappointed to learn about the black and white lists in the leveraged loan markets. A white list includes lenders that an investor can sell their paper to without requiring borrower consent; the Black list includes lenders that a lender cannot transact with. The white list seems to be more common in the European market while the black list is mostly prevalent in the US markets.

In essence, these lists are created to block vulture funds, industry competitors or distressed investors from investing in the loan with an intention to take an equity stake in the company without the borrower's consent. Since you already need to have access to a lender site to get the financials, these additional onerous terms under the loan documents further act to restrict the free flow of information and can hinder efficient pricing of securities.

Too much focus on the "J-Crew style" trap doors but not enough on the overall documentation

J-crew style trapdoor was coined after J-Crew took advantage of looser covenant documentation to transfer its intellectual property (IP) assets away from its lenders in the winter of 2016. Since then we have seen numerous high yield deals that have afforded the borrower this flexibility. Naturally, the lender community has been very focused on this aspect, as it allows for value leakage from the collateral pool. However, the entire covenant package matters to properly judge a company's financial health. Looser terms will allow companies to operate longer and restructure later, but, in the meantime, perhaps destroy value for the lenders.

High yield and leveraged loan markets have evolved and more pricing volatility is to be expected

The most obvious consequences of looser documentations and restrictions to financial information imply that:

1) At the first sign of fundamental credit deterioration, the downward price movement will be outsized as investors will opt to "shoot first and ask questions later".
2) Price discovery in the secondary markets will take much longer as interested parties will need to seek borrower consent to access financials and/or to purchase the debt.
3) Smaller firms or retail investors will be put at a significant disadvantage due to their lack of resources to analyze these complex legal issues.

As a result of the above factors, investors should be prepared to experience more secondary pricing volatility and wider bid-ask spreads as the credit cycle begins. While credit cycles cannot be prevented, capital impairment can be avoided. As we enter the credit cycle, investors should not rely on reported leverage metrics and do their own work to assess the true financial health of the company.

Unlike stocks, as Benjamin Graham noted, "bond selection is primarily a negative art. It is a process of exclusion and rejection, rather than of search and acceptance." An investor who can actively avoid weaker business models and covenant structures with understated high levels of leverage may come out ahead.

Links to previous reports:

What do Swiss cheese and high yield covenants have in common? A lot of holes!

The "smoke and mirrors" of financial analysis: adjusted EBITDA

Growth of the 144A Private issuer: For your eyes only!

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Past performance is no guarantee of future results.

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