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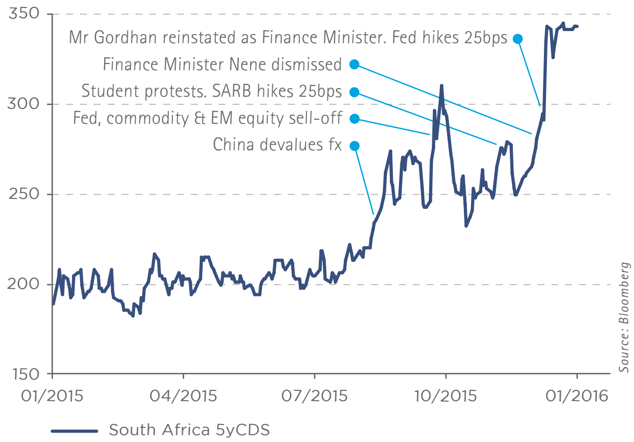
IS YOUR CREDIT LINE SECURE?

A cornerstone of functional markets is the principal of being rewarded for risk taken. The higher the risk is, the higher the reward needs to be to entice investors to invest their funds. In the credit markets, high-yield bonds are synonymous with risky assets, whereas investment-grade bonds are lower yielding, as investors are willing to receive a smaller return on their investment because of the low probability of a loss in the principal or non-payment of interest – known in credit as "default".

When the credit quality of an issuer deteriorates and investing in the entity becomes riskier, investors could reasonably be expected to require a higher return on their investment. In a relatively developed market, these expectations quickly filter through to the price of an instrument, so that bond yields (the return investors require) should go up following events that could worsen the credit quality of the borrower. This reaction function is easily observable in the sovereign bond market, which is deep and liquid. An example of this in December 2015 was the unexpected cabinet reshuffle and the replacement of a competent Minister of Finance with a little known, lesser qualified individual causing South African government bond yields to spike dramatically. We have illustrated this in graph 1 using the South African credit default spread, a pure credit quality measure.

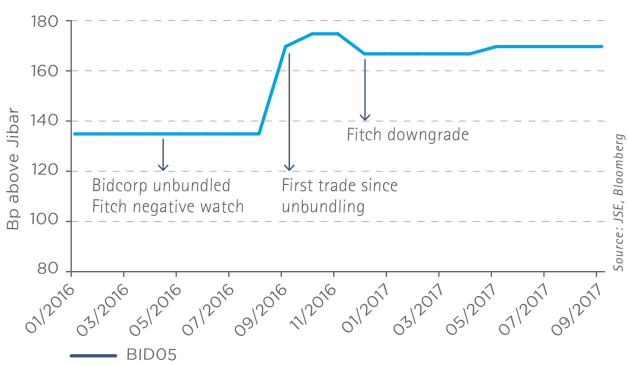
Graph 1



Unlike international credit markets, events affecting credit quality and risk don't always have an immediate impact on spreads in the domestic market. In a recent example, Bidvest unbundled its foodservices business, Bidcorp, in May 2016. The business was restructured so that only 34% of group debt was transferred to Bidcorp, which accounted for 66% of earnings. The Bidvest that remained was thus left with a weaker business risk profile, higher gearing levels and lower interest cover (a measure of how easily a company can pay interest on its outstanding debt). Consequently, rating agency Fitch placed Bidvest's credit rating on negative watch and proceeded to downgrade the issuer from AA to A+ in January 2017. Bidvest's bond programme did not protect bondholders against the sale or unbundling of a major part of the company's assets and bondholders had no recourse to these assets, nor were they entitled to increased compensation in the form of higher- or penalty interest.

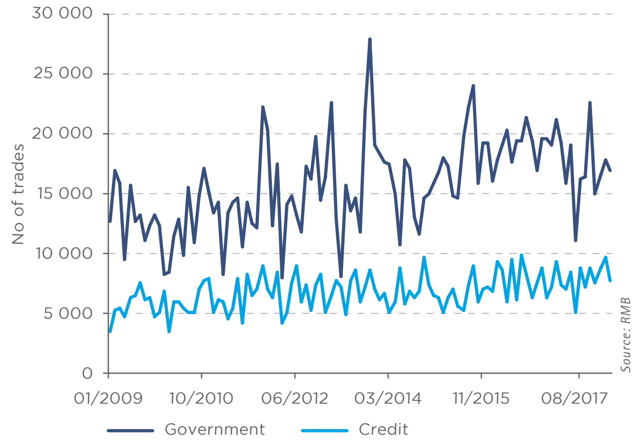
As can be seen in the graph below, the reaction to these events was slow and relatively muted in the corporate bond market, with the yield on a five year Bidvest bond only increasing by 0.40% following the unbundling (corporate yields are a function of interest spreads above a benchmark rate such as the money market rate used in South Africa, called Jibar).

Graph 2: BID05 (5 year Bidvest bond)



This delayed reaction can largely be explained by the relative illiquidity of the corporate bond market when compared to its government bond counterparts. Government bond trading volumes are vast with annual trading volumes often in excess of 1000% of the total value of government debt outstanding. By contrast, credit trading volumes are minute (graph 3).

Graph 3



Bond market liquidity

Following the Global Financial Crisis of 2007/2008, regulation has been put in place requiring banks to hold assets such as corporate bonds which they would be able to sell in times of stress. The regulation is being phased in locally, with full adoption required by January 2019. This has led to slightly better liquidity in domestic credit, as banks are now also buyers of these instruments. The enhanced liquidity is limited to bonds issued by highly rated non-financial institutions, but comes as a welcome development.

Contrary to the government bond market, South African credit investors cannot easily move in and out of positions to take advantage of changes in credit quality or to adjust their portfolios according to their risk appetite. In this regard there is a definite benefit to being a smaller player in the market. Tantalum Capital has been able to take advantage of pockets of liquidity which are unavailable to managers of a much larger size, by both buying in to positions where we've seen value and selling out of positions in order to de-risk. However, in general, risk for credit investors is biased to the downside as returns are limited to coupon payments and the return of capital. As bondholders are not compensated for credit deterioration, liquidity is not the only answer: it is imperative to seek protection against events that could increase the probability of default. Seeking out this protection, and unravelling the legal status of the bondholders' claim, is the key to our credit investment process at Tantalum.

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Bond holder protection

Investor protection is often expressed in the form of bond covenants that can provide explicit protection by prohibiting certain events unless bondholders provide consent or by giving bondholders the right to demand early repayment of their capital if specific credit events occur. Unlike bank covenants contained in loan agreements, bondholder covenants tend to be less restrictive, so as not to impede the borrower from conducting their business freely. Lighter lending terms also serve as an incentive for borrowers to issue bonds as an alternative source to bank funding. It is therefore not common to see strict requirements, such as maximum gearing levels, in bondholder documentation.

The most common covenant in domestic bond documentation is the negative pledge clause. This type of covenant aims to prevent the borrower from pledging assets as security if it would result in less security for senior bond holders. However, the majority of programmes render this clause largely ineffective by excluding any indebtedness incurred in the ordinary course of business from the negative pledge. "Ordinary course of business" is usually very loosely defined, allowing borrowers to gear against assets in a range of circumstances. Even if the negative pledge is upheld according to its intention, it may not provide unsecured senior bondholders with any protection. As an example, according to our calculations, based on Emira Property Fund's annual report for the year ending June 2017, 89.8% of their investment properties were encumbered as security to various lenders, leaving very little value for unsecured senior creditors in the event of default. While the level of unencumbered assets available is only a single factor in the investment decision making process, this example does illustrate how certain covenants can be deemed quite ineffective.

As bonds are not homogenous instruments, different bonds issued by the same entity could have different terms and covenants.

Cross default covenants prevent borrowers from selectively defaulting on certain obligations and can be useful to ensure equitable treatment amongst creditors of a similar class. As bonds are not homogenous instruments, different bonds issued by the same entity could have different terms and covenants. One class of bondholders may thus have the right to call for the early repayment of their principal based on a breach of a certain covenant such as receiving a qualified audit opinion. If the entity has issued bonds containing cross default covenants, the early repayment of principal would extend to all bonds that fall under the cross default protection – placing the borrower in an unenviable position. Complicating the matter is the fact that bondholders have to rely on the timely notification of borrowers that a covenant has been breached. The JSE's Debt Listing Requirements state that credit issuers have four months after their financial year-end to release their financial statements. State owned entities are afforded six months to publish their financial results (or seven months once the updated draft listing requirements are adopted). Although not confirmed, we believe it is possible that Eskom delayed the release of its annual report for March 2017, which contained a qualified audit opinion, in order to persuade certain bondholders not to call for early redemption, and thereby avoid triggering the default of multiple facilities protected by cross-default covenants.

Bondholders can only enforce their rights based on publically available information and several bond programmes require the majority of bondholders to vote in favour of early redemption even if covenants have been breached. Convening a meeting of bondholders can be quite an onerous task, as public records of bond ownership are often out of date. In most developed markets, a bond trustee (usually a commercial bank or trust) is appointed for every bond issued and is given the fiduciary power, by both bond issuers and bondholders, to enforce the terms of a bond programme. Bond trustees are not a feature of the South African listed credit market, but could assist in the monitoring of covenants in the future and would function as liaison between bondholders, reducing the administrative burden these investors currently face.

Other forms of investor protection

Due to some of the shortcomings of general bond covenants, when analysing an issuer we seek out alternative sources of protection. Property companies in particular tend to disclose their most onerous company-wide bank covenants, which usually limits the level of gearing they are allowed to undertake and ensures that there is a minimum level of earnings available to service debt. These limitations serve to keep the company's credit metrics healthy and will indirectly protect all senior creditors.

Guarantees can also be powerful sources of protection. One legal entity in a group of companies may own the bulk of that group's assets or earn the majority of its income and can guarantee the timely repayment of interest and debt principal due by a smaller subsidiary. Subsidiaries of multinational companies often benefit from guarantees extended by their parent companies. We favour guarantees that are easily and directly enforceable, such as the guarantee provided to Mercedes-Benz South Africa Limited by its German parent Daimler AG. Essentially Daimler AG will step in to service Mercedes-Benz SA's debt if the South African company fails to do so. On the other hand, bonds issued by Toyota Financial Services South Africa are three layers removed from the ultimate guarantor: Toyota SA bonds are guaranteed by Toyota Motor Finance (Netherlands) B.V., a finance company with no operating earnings. The Dutch company then has a credit support agreement with Toyota Financial Services, which in turn has a credit support agreement from its parent, Toyota Motor Corporation. An unconditional guarantee is legally stronger than a credit support agreement and direct enforceability is arguably superior to a multi-step process. As Mercedes and Toyota bonds offer local investors the same level of returns, we believe that our preference for Mercedes is an obvious choice.

While the level of protection provided by bond programmes often does not strengthen the investment case, the local market is slowly developing to better protect bondholders.

While the level of protection provided by bond programmes often does not strengthen the investment case, the local market is slowly developing to better protect bondholders. The Land Bank has made tremendous progress in this regard, adding covenants to its bond programme that protect investors against a breach of anti-corruption laws or the entity's corporate governance policies, the disposal of the greater part of the bank's assets or business, a change in the manner in which it conducts its business without bondholder consent and a breach of environmental law. At a time when risk aversion towards state owned entities is elevated, these enhancements have allowed the Land Bank to raise R2.6 billion in the local credit market since the update to its bond programme.

Where we are today

Unfortunately, we expect that the implementation of covenants that go beyond what is currently considered the market norm will be slow. The demand for corporate credit has exceeded the level of supply for some time. Investors continue to support issuers offering weak levels of bondholder protection as they seek out returns for their clients and have a limited investable universe through which to do this. This creates the false impression that investors are comfortable with the terms under which bonds are issued. Unless an issuer is faced with no alternative but to improve the level of bondholder protection, like the Land Bank was, a change in regulation may be the only path towards a lower-risk environment for bondholders.

As we have illustrated above, credit is not uniform and each name has its own nuances. We need to be fully informed of all of these before making an investment decision. As explicit protection against credit deterioration is rare, a sound investment process that seeks out the highest quality of risk-adjusted returns is vital. This ensures that an investment does not deteriorate to levels were investor compensation becomes wholly inadequate. As the media has made us aware, high-yield is just a sophisticated term for junk!