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Invest
by Zürcher Kantonalbank

Secured High Yield

The hidden treasure in the search for yield?

The search for positive yields in the area of fixed-interest investments remains challenging for all investor groups. Risk premiums on investment grade bonds have decreased significantly. As of September 2016, more than 80% of EUR investment grade bonds reported a yield of less than 1.0%. The challenge is particularly significant in the current market environment, which is characterised by various uncertainties involving major market fluctuations. Fundamental factors are increasingly being dominated by overlapping political issues, or by decisions taken by central banks (e.g. the ECB's CSPP program), which have had far-reaching impacts on the development of yields. Since the end of June 2016, the ECB has bought between EUR 5-10 billion of corporate bonds from European issuers each month. The total volume of the corporate bonds purchased by the ECB represents approximately 30% of all net new issues in 2016. This has accentuated the distortions of the bond market and placed increasing pressure on yields causing investors to look for other investment alternatives. Most investors have been tempted to take either more duration risk or more credit risk by investing in lower quality issuers. Ultimately, the question is in which segment the best yield/risk ratio is to be found.

Basel III – Banking regulations as an investment opportunity
When seeking value creation within the leveraged financial market (loans and high interest bonds or high yield bonds) we have long been aware of a positive structural shift towards the issuance of senior secured high yield bonds. Following the last financial crisis, stricter bank regulations were introduced with the aim of making banks safer. The Basel III reform package imposes higher capital requirements on the banks. They are therefore forced to take corporate loans from the books to reduce their risks. Companies with a poorer credit rating have less easy access to bank loans, but are still dependent on the capital. The solution to this problem is to raise the money on the high yield bond capital market. The issuers must not only offer investors attractive coupons, but, as opposed to classic high yield bonds, also include additional or specific collateral. The stricter regulations governing banks inevitably lead to a larger range of securities with collateral being on offer in the form of secured high yield bonds.

Today, this sub-segment comprises in excess of 500 issues from more than 350 issuers diversified across 13 sectors with a market capitalisation of over USD 500 billion. Currently, this sub-segment accounts for 30% of the regular high yield market.

We removed CCC rated bonds from this sub-segment in order to take even fuller advantage of secured high yield bonds. The exclusion of debtors of this inferior quality is important because in the region of 80% of all losses are attributable to issuers in the CCC category. The risks can therefore be reduced without forgoing yields. On the one hand, relative to the regular high yield universe, the secured high yield bond segment has a higher proportion of bonds with a B rating which partly compensates for the lack of CCC bonds. And on the other hand, similar to the new issuance premium required by equity investors in an IPO, first issuers in the secured high yield market have to pay a new issue premium in order to place the bonds. It appears to us that there is a decisive argument for the exclusion of CCC bonds, as we are in a mature phase of the credit cycle and are confronted with a rising default rate; particularly in the metals, mining and energy sectors. In addition, these days CCC issuers are increasingly finding access to the capital market and as a result it is to be expected that CCC companies in particular will have problems with debt repayments in the medium term.

The collateral of secured high yield bonds consists of the company's assets, such as machinery, stock, patents or licences, which serve as a guarantee to meet investors' demands in the event of bankruptcy. A further possible form of collateral is the investor holding a pledge on the company's entire balance sheet. Accordingly, secured high yield bonds are high up in the borrower's capital structure. For this reason, they are often compared to senior secured loans, i.e. loans that are structured by banks and passed on to investors. Basically, every bond's collateral package is designed differently and each case requires thorough analysis. This must include the assessment of the company as well as the individual assessment and valuation of the collateral associated with the bond. In the beginning a rigorous issuer analysis is always necessary wherein the company-specific risks and the credit rating of the issuer should be carefully scrutinised.

The capital structure of a company is of crucial importance to credit investors in the event of bankruptcy. The demands of senior or secured creditors would be the first to be settled with the available money. Lower ranking creditors need to be aware that they might suffer a total loss, while secured creditors can expect payment. Secured high yield bonds are therefore safer than subordinated bonds.

Additional benefits of the secured high yield universe

Further positive aspects of secured high yield bonds firstly include lower exposure to Fallen Angels and the risk of rating migration. In the current year bonds worth more than USD 100 billion have been downgraded from investment grade to high yield. This resulted in the fact that various investors had to part with their bonds (so-called forced sellers) resulting in considerable price pressure on the bonds concerned. Secured high yield bonds are better protected from this price pressure as investment grade bonds are generally unsecured and do not fall into the category of secured high yield bonds. The second positive aspect is the much lower proportion of these bonds in sectors under stress, such as metals, mining and energy.

Attractive relative valuation

With the recovery of the financial market since the end of February 2016, a massive tightening of high yield credit risk premiums has also taken place. At the same time the risk premiums on unsecured high yield bonds have declined rather more than on secured ones. In February 2016, unsecured high yield bonds showed a premium of 100% as opposed to secured bonds; the premium today stands at 40%. This means that investors are currently significantly undercompensated for an investment in unsecured bonds as opposed to secured high yield bonds.

Conclusion

Secured high yield bonds are characterised by attractive risk-adjusted yields and, compared to regular high yield bonds, the default risk is considerably lower. In today's environment of low risk premiums, investors can benefit from the lower volatility of secured high yield bonds without missing out on potential returns while also moving up in the capital structure. In addition, under the new BVV2 regulations, these secured high yield bonds are treated as traditional fixed-income investments and are therefore not counted as alternative investments, as is the case with secured loans.

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