

# SOLVING FOR 2019

NEUBERGER BERMAN

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## CONFERENCE SUMMARY

### DAVID LYON

MANAGING DIRECTOR,  
CO-HEAD OF THE PRIVATE CREDIT BUSINESS

### JULIAN MARKS

MANAGING DIRECTOR,  
INVESTMENT GRADE CREDIT

### PIM VAN SCHIE

MANAGING DIRECTOR,  
COLLATERALIZED LOAN OBLIGATIONS (CLO)

## CREDIT OPPORTUNITIES IN A MATURING CYCLE

*“We were very excited for about four days in December, and while everything bounced back very quickly, perhaps that indicated the opportunity that is still to come in this cycle.”*

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## KEY POINTS

- Themes of quality and opportunism define credit investing as the cycle matures
- Hybrid securities can boost yield by moving down the capital structures of quality issuers
- High volatility and low illiquidity can create value opportunities in leveraged loans
- CLO debt offers a wider spread than high yield bonds despite enhanced credit protection

Following on from the theme of the maturing business cycle that was addressed by Joe Amato and Erik Knutzen, three panelists active in alternative parts of the credit markets discussed opportunities for investors concerned about downside risk. While they did not report any immediate catalysts for a turn in the cycle—default rates are low, maturities are extended, earnings and interest coverage are robust—they did argue for strategies that exemplify the themes of quality and opportunism that are likely to provide an edge as conditions become trickier.

### Julian Marks

Julian spoke about the relatively new sub-sector of non-financial corporate hybrid securities. Hybrids are very long-dated but callable subordinated bonds, whose coupon payments can be deferred just like dividend payments. For that reason, credit rating agencies count them as half equity and half senior debt, which makes them advantageous for issuers. No hybrid coupon has ever been missed, however, and that reflects the high quality of issuers: 50% come from large telecom and utility companies based in high-rated countries. The fact that credit agencies rescind the half-equity categorization if a hybrid isn't called also acts as a very strong incentive for issuers to call these securities at their first-call date. The average rating on the issuers is A- and the average rating on their hybrids is mid-BBB, and hybrids typically offer four to five times the spread of the same issuer's senior bonds.

Picking up extra spread by moving down the capital structure of a high-quality issuer is an attractive prospect in the mature part of the cycle, Julian argued, relative to chasing yield from lesser-quality issuers. Corporate hybrids will be more volatile than senior bonds, he warned, but if you know the issuer well and value hybrids conservatively, that can create opportunity.

### David Lyon

David works in non-investment grade, syndicated bank loan markets, with paper that is generally issued by mid-market privately-owned companies. While his strategy does not seek out companies in or close to bankruptcy or insolvency, it is a distressed strategy in the sense that it looks for loans that trade at substantial discounts to par for reasons unrelated to underlying performance—whether that is because of risks that are magnified by the market or distress on the part of an investor looking for liquidity.

Over the last three or four years average spreads in first-lien loans in this space have narrowed by around 150 basis points and covenants have been diluted or removed. A focus on issuer quality is therefore very important, David told our audience. That means seeing a lot of paper, and David pointed to Neuberger Berman's varied private equity businesses as a source of visibility into deal flow. He also emphasized the importance of an investment vehicle structure that can absorb mark-to-market risk but also be opportunistic. David's strategies have investor capital on call for more than four years, enabling him to choose entry points and avoid chasing yield in junior capital or industries that cause him concern. In the right market conditions, when liquidity can dry up dramatically, his investors can provide liquidity unburdened by losses in their portfolios. He now sits on a lot of dry powder. "We were very excited for about four days in December, and while everything bounced back very quickly in January, perhaps that was an indicator of the opportunity that is still to come in this cycle," he said.

## Pim van Schie

Pim's team both structures collateralized loan obligations (CLOs) and manages a strategy investing in CLO debt. These are bonds backed by a diversified portfolio of widely-traded, non-investment grade syndicated bank loans. Pim argued that this asset class can be very useful as a cycle matures and risk is heightened as it offers a substantial premium over comparable high-yield bonds despite enhanced downside protection.

CLO BB bonds offer a spread premium of three to four percentage points over BB rated high yield bonds to compensate for complexity, illiquidity and higher mark-to-market volatility. Moreover, an investor in CLO debt can generally absorb as much as 20% credit loss in the underlying loan portfolio and still break even. Given the 75% recovery rates experienced over the past 30 years, that implies that 80% of the 200-plus companies in the CLO need to default before the CLO debt holder loses money. The historic default rate of CLO BB tranches, at just 0.06% annualized, has been 50 times lower than for BB high yield bonds.

Having made the case for the high quality of CLO debt, Pim went on to explain that, because it delivers a very high level of current yield, portfolios tend to generate a lot of cash that can be used to capitalize on bouts of volatility—facilitating the opportunistic stance that can come into its own as the credit cycle matures.

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