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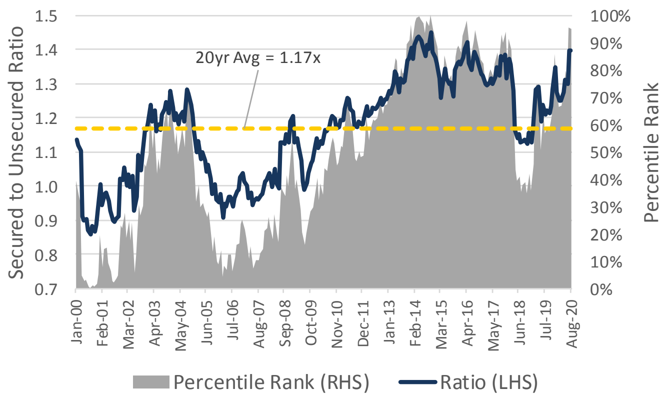
Weekly Briefing

SKYView: Secured Bond Premiums

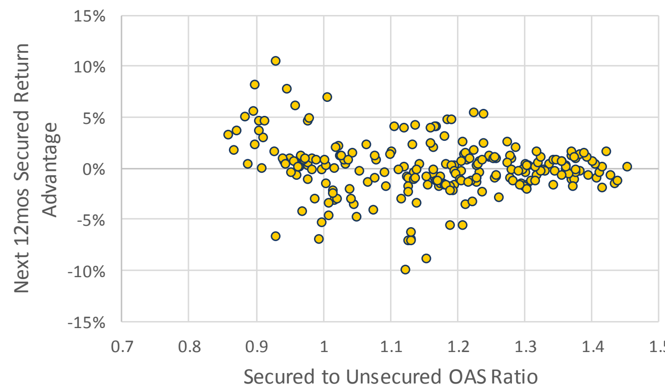
US high yield markets continue to grind tighter, with index-wide indicators of stress now approaching more conventional levels. Spreads, distress ratios, and measures of index dispersion are now more reflective of a recovery phase in the market, prompting CCCs to close the performance gap with higher-rated issuance over the last several weeks. Amidst the continued search for alpha generation, an overweight to secured bonds has emerged as a consensus-long thesis among industry participants. In this *Weekly Briefing* we analyze the rationale for this positioning, and draw upon an internal valuation model to identify potential mis-pricings of risk in the current market environment.

Taking a look at the ratio of secured to unsecured bond spreads among constituents within the ICE BofA US High Yield Index (H0A0) over the last two decades, the former screen attractively, all else being equal. In fact, the secured to unsecured OAS ratio at August 31, 2020 was 1.40x, well above the 20yr average of 1.17x, ranking 95th percentile over the same time period (left chart below). Elevated secured to unsecured OAS ratios, however, have shown no correlation to subsequent outperformance over time (right chart below). This lack of follow-through – even in prior periods of severe dislocation – leads us to believe a more nuanced approach to the valuation of secured premiums is merited.

Secured to Unsecured OAS Ratio
monthly data, since 2000



Sec. to Unsec. Ratio vs. Next 12 Months Return Differential
monthly data, since 2000

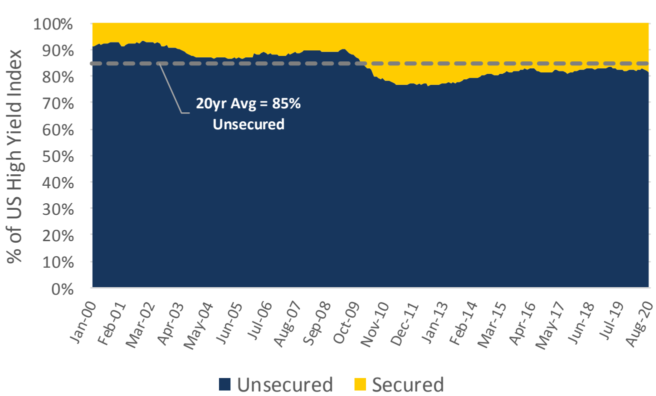


Source: SKY Harbor, ICE BofA Indices

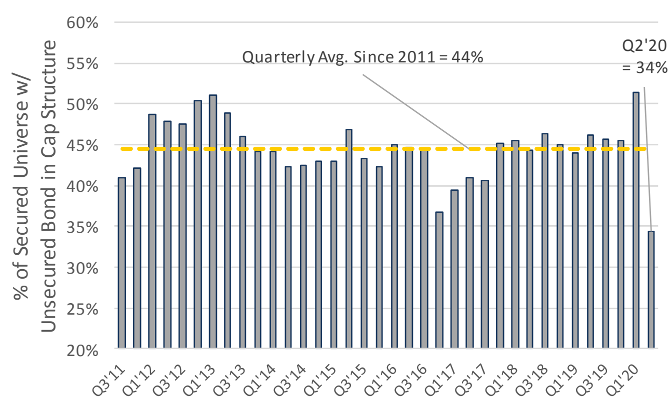
The penetration of secured bond issuance within H0A0 has been relatively consistent over time. From January '00 to August '20, secured bonds made up ~ 15% of the ICE BofA US High Yield Index by face value, with a modestly larger share (~ 17.5%) over the last decade (left chart below). From a credit rating perspective, however, the unsecured bond universe has achieved a one notch improvement relative to secured bonds over the last several quarters. Additionally, relative duration and issue size (secured vs. unsecured) metrics have fluctuated by ~ 20% over the last five years, further clouding the comparison.

In our view, an even more important driver of differentiation - beyond variances in credit rating, duration, and bond size – is the non-uniform secured issuer set over time. Since 2011, on average only 44% of secured bonds were part of capital structures that also contained at least one unsecured bond (right chart below), a metric that has diminished further as of the most recent quarter (34%), and now represents a data set low. The unadjusted secured to unsecured OAS ratio for the index as a whole (1.40x, as demonstrated in the first chart) fails to distinguish single-bond capital structures from those with multiple subordination types, making the metric less useful for comparison purposes given the higher importance yet limited penetration of the latter cohort.

Secured Penetration of US High Yield Index
monthly data, since 2000



% of Secured Universe w/ Unsecured Bond in Cap Structure
quarterly data, since 2011

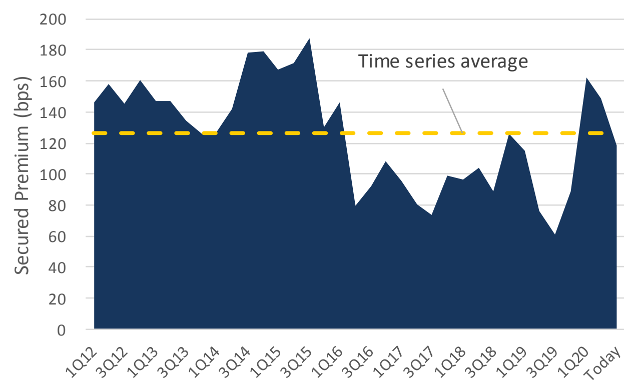


Source: SKY Harbor, ICE BofA Indices

A more relevant measure of the secured premium, in our view, would be to limit the universe to include only capital structures that contained at least one secured and one unsecured bond, at which point a premium could more reliably be measured on a "matched sample" basis. We limited the ICE BofA US High Yield Index by this methodology, and calculated quarterly secured bond premiums since 2012, after controlling for differences in credit rating, duration, issue size, sector (a dummy indicator for Energy given meaningfully weaker performance than the index in this time period), and price points above par. Our results (left chart below) imply that the secured premium at present is modestly <u>below</u> average. Furthermore, the unadjusted secured to unsecured OAS ratio and the matched sample secured premium (again, after controlling for differences in credit rating, duration, issue size, sector, and price points above par) have moved disparately on a YTD basis.

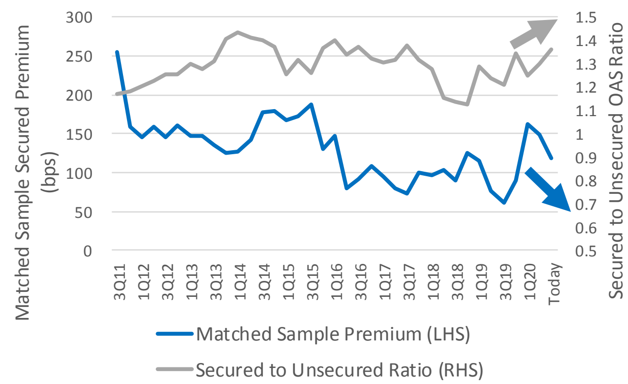
Secured OAS Premium

quarterly data, based on cap structures with secured & unsecured bonds



Matched Sample Secured Premium vs. All Index Secured Differential

quarterly data



Source: SKY Harbor, ICE BofA Indices

While our matched sample analysis refuted the notion that secured bonds were generically cheap, our resulting fair value model ($R^2 > 0.9$) identified several theoretical mis-pricings among secured and unsecured pairs. Using the resulting coefficients from our matched sample bond regression (risk factors listed above), we isolated tickers in which the secured to unsecured valuation gap (actual vs. model-implied fair value) was greatest. The table below lists the most significant outliers, with potential secured opportunities on the left, and unsecured opportunities on the right.

Model-Implied Secured / Unsecured Pair Mis-Pricings

data as of August 31, 2020

Secured Bond Looks Cheap

Ranking	Ticker	Coupon	Maturity	OAS	Model FV	Δ
Secured	NAV	9.500	05/01/25	445	322	123
Unsecured	NAV	6.625	11/01/25	511	552	(40)
Secured	CLF	9.875	10/17/25	652	363	290
Unsecured	CLF	5.875	06/01/27	681	747	(66)
Secured	TDG	8.000	12/15/25	402	328	74
Unsecured	TDG	5.500	11/15/27	540	628	(87)
Secured	RAD	7.500	07/01/25	716	587	130
Unsecured	RAD	7.700	02/15/27	999	1,151	(152)
Secured	CAR	10.500	05/15/25	432	269	163
Unsecured	CAR	5.750	07/15/27	587	659	(72)
Secured	ADNT	7.000	05/15/26	368	339	29
Unsecured	ADNT	4.875	08/15/26	556	618	(62)

Unsecured Bond Looks Cheap

Ranking	Ticker	Coupon	Maturity	OAS	Model FV	Δ
Secured	CTL	4.000	02/15/27	309	374	(66)
Unsecured	CTL	6.875	01/15/28	460	394	65
Secured	WSPKHD	6.750	07/15/26	384	386	(3)
Unsecured	WSPKHD	10.500	07/15/27	707	494	213
Secured	RGCARE	4.375	02/15/27	386	486	(100)
Unsecured	RGCARE	9.750	12/01/26	589	484	105
Secured	CCO	5.125	08/15/27	434	454	(20)
Unsecured	CCO	9.250	02/15/24	951	600	352
Secured	IHRT	5.250	08/15/27	477	552	(74)
Unsecured	IHRT	8.375	05/01/27	732	611	121
Secured	MDP	6.500	07/01/25	489	486	3
Unsecured	MDP	6.875	02/01/26	957	706	251

Source: SKY Harbor, ICE BofA Indices

Despite an elevated (95th percentile) secured to unsecured OAS ratio, we reject the notion that secured bonds are generically cheap at present. Upon further investigation, we find disparate trends in issue attributes (credit rating, duration, issue size, etc.) and varying degrees of secured and unsecured ticker overlap limit the efficacy of this unadjusted ratio in measuring relative value. Instead, we calculate secured premiums based on a matched sample universe of bonds, and only after controlling for differences in credit rating, duration, issue size, sector, and dollar price. On an adjusted basis, we find secured premiums to be in-line to modestly below longer-term averages. Despite our estimation of approximately median compensation in aggregate, we have identified a select group of secured vs. unsecured pairs that appear to deviate materially from our model fair value output, and have implemented this screening method to more efficiently utilize the time of our bottom-up credit analyst team.

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