Managing Corporate Bond Event Risk
U.S. Investment Grade Corporate Bonds

In the wake of the financial crisis of 2008 and the ensuing weak economic environment, most U.S. corporations adopted more conservative fiscal practices and took aggressive measures to reduce debt and improve liquidity. The results of those actions are evident today as the credit quality of the U.S. corporate universe is currently at fairly solid levels. Given recent signs of improving U.S. economic conditions, China’s continuing economic growth above 7%, and a healthier stock market, many U.S. companies are now taking steps to return value to shareholders, often at the expense of bondholders. Examples include:

► Re-leveraging share buybacks (and/or dividends)
► Leveraged buyouts (LBOs)
► Debt-financed mergers and acquisitions (M&A)

In this paper, we will take a look at the economic and market factors driving the recent rise in adverse event risk in the U.S. industrial corporate bond sector and review the steps that fixed income investors can take to manage the potential negative impact to their bond portfolios.

Solid Quality and Low Rates Support Shareholder-Friendly Actions

After nearly five years of cost cutting and shoring up balance sheets, many U.S. companies in the industrial sector are in solid financial shape. Companies are now sitting on record levels of cash—up more than 50% since the 2008 financial crisis—and the low interest rate environment is helping to keep interest coverage metrics at sound levels. While balance sheet debt has risen in recent quarters as companies rushed to lock in historically low borrowing rates, leverage metrics are still at acceptable levels, corporate earnings are still healthy, and the U.S. default rate remains historically low.
Given this improved environment, a number of U.S. industrial companies have begun to relax their recent defensive postures and initiate more shareholder-friendly actions. In their search for yield and incremental return, shareholder activists, hedge funds, private equity investors, and other investor groups are calling for increased dividends and corporate or financial restructurings designed to extract more value from company coffers. These shareholder-friendly activities are leading to increased event risk in the industrial corporate sector. Event risk is an often unpredictable financial event that can result in an unexpected change in credit quality, often benefiting shareholders and other constituencies at the expense of creditors.

**Share Buybacks and Dividend Payments on the Rise**

A key focus for many shareholder activists is the sizeable amount of cash sitting on corporate balance sheets. Activists are asking company management to ‘relax the purse strings’ and think about their balance sheets in a more aggressive manner.

The re-leveraging of U.S. industrial company balance sheets in an effort to reward shareholders gained momentum in 2012, as evidenced by a growing number of special dividend announcements and/or debt-funded share buybacks. In 2013, companies in the S&P 500 Index are projected to pay at least $300 billion in dividends—a record level. Similarly, announced share buybacks set a pace in Q1 not seen since 1985.\(^1\)

While good news for shareholders, the impact to bondholders can vary widely, from a mild reduction in balance sheet liquidity with no immediate impact to a company’s credit ratings, to increased leverage that pressures a company’s credit rating or even results in a rating downgrade. Costco, for example, paid a $3 billion special dividend last fall that had no effect on its ratings, while Rockwell Collins received negative rating actions from Moody’s and Standard & Poor’s in January, 2013 in response to the company’s higher leverage from financing shareholder returns with debt.

However, not all share buyback and dividend activities are being spurred by shareholders. In some instances, the company itself may decide to issue debt to repurchase stock because the economics are exceedingly favorable.

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\(^1\) Source: Standard & Poor’s, as reported in Wall Street Journal, March 7, 2013.
Corporate chief financial officers are operating in an unusual environment where the yields of industrial corporate bonds are often lower than the earnings yield on their stock (as calculated by the inverse of the P/E ratio). As is illustrated below, this development took hold in 2009 as interest rates dropped to historic lows and may be encouraging some companies to borrow money to pay for stock buybacks.

In addition to dividends and buybacks, some shareholder activists are pressing companies for other financial changes to help boost stock prices. For example, as has been widely reported in the press, Jana Partners, a hedge fund, is pushing Agrium, an agricultural chemical company, to separate into two new companies. Shareholders of Commonwealth REIT, a real estate investment trust that manages mostly commercial office properties, are attempting to block its plans to reduce debt via a tender offer, and Transocean has Carl Icahn looking for higher dividends and proposing new board members. In each case, the stock of the company had lagged in recent years and the companies’ high cash balances attracted the attention of activists with decidedly negative results for bondholders.

**Leveraged Buyouts (LBOs)**

By far the biggest event risk to investment grade corporate bondholders is a leveraged buyout. LBOs occur when an entity or investor group borrows money, primarily by issuing debt, to buy out existing shareholders and take a publicly-listed company private. LBOs generally result in a credit rating downgrade for the company and leave existing bondholders in a subordinated position to the newly-issued debt.

LBO activity tends to ebb and flow with economic and market trends, as well as corporate quality levels in general. Today's low absolute borrowing costs, high corporate cash balances, and slowly improving economic backdrop have all contributed to a recent acceleration in LBO activity. In the first quarter of 2013, more than 90 LBOs were announced or closed with the two largest, Dell and H.J. Heinz, totaling more than $50 billion. At this pace, LBO activity could reach its highest annual level since its peak in 2007.

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1. Source: Bloomberg.

U.S. LBOs: READY FOR A COMEBACK?

In addition to overall market trends, two corporate-specific valuation measures may be encouraging activists or external investor groups to initiate shareholder-friendly actions or take the LBO plunge. First, the differential in borrowing costs for investment grade issuers versus high yield issuers is considerably lower than the long-term average. Additionally, overall corporate borrowing costs are historically low. As a result, corporate financial officers may be willing to operate a company with a lower credit rating since the incremental increase in borrowing costs in today’s low rate climate is less punitive relative to the economics of the company.

SPREAD BETWEEN INVESTMENT GRADE AND HIGH YIELD QUALITY IS BELOW LONG-TERM AVERAGE

YIELDS HOVER NEAR HISTORIC LOWS

Source: U.S. investment grade corporate bond yields, Barclays Capital; U.S. high yield bond yields, J.P. Morgan; U.S. bank loan data, Credit Suisse. Loan data represents the senior loan discount margin based on loans with a four-year average life.
Second, price/earnings (P/E) multiples for U.S. industrial companies are relatively low, which can encourage private equity investors to target a company in an effort to boost its valuation. To gain a more complete picture, however, asset managers should also view corporate valuation trends from an insider, or corporate management, perspective. When a company’s equity valuation is considered low, corporate management and/or the board of directors may be less willing to ‘sell at the bottom.’ Conversely, when company valuations are either high or on the rise, management may actually be more willing to entertain outside offers. It is important to view each company’s situation as unique and to consider the perspectives of both external groups and internal stakeholders when assessing whether a company is vulnerable to an adverse financial event.

**P/E RATIOS ARE BELOW AVERAGE BUT IMPROVING**

Represents the average P/E ratio of industrial companies in the S&P 500 Stock Index.
Excludes financial companies, utility companies, and REITs.

Given the recent rise in LBO activity, some market participants are questioning whether debt-financed M&A activity will rise as well. Unlike LBOs, M&A activity is an ever-present risk, regardless of market conditions. However, given current favorable market conditions and excess cash levels, companies may well start looking for new ways to expand and grow their businesses, including through M&A transactions. Recent M&A examples include ConAgra’s November, 2012 purchase of Ralcorp, and Freeport McMoRan’s pending acquisition of Plains Exploration. In both cases, the acquirer’s credit quality initially weakened, reflecting the extra debt burden, with a corresponding negative response by the credit rating agencies.

**Technical Drivers Supporting LBOs**
Another factor driving recent LBO sentiment, in our opinion, is the renewed willingness of banks to back LBO transactions. Without support from the major banks to help finance the deal, most LBOs would likely not get done. Today, the combination of slowly improving U.S. economic growth and sustained low yields has revived investor demand for leveraged loans, including strong demand from U.S. collateralized loan obligations (CLOs). In turn, stronger investor demand for loans may be helping banks feel more confident in backing LBOs as they are more likely to sell those loans to investors.

It’s been reported, for example, that Berkshire Hathaway and 3G Capital solicited only two banks, JP Morgan and Wells Fargo, when putting together the financing package for H.J. Heinz in February, 2013. In years past, more sources of funding would likely have been contacted and the deals would have taken longer to put together.

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Managing Event Risk

Managing event risk is an ongoing, integral part of the corporate bond investment management process. Asset managers can seek to limit adverse event risk through in-depth, bottom-up research that carefully evaluates each company using both quantitative screening and qualitative research to assess management quality, industry trends, individual bond structures, and covenant protection.

Quantitative Screens

Quantitative screens can serve to highlight companies with characteristics that make an LBO attractive. While LBO and other adverse event risk screens are regularly published by the major broker/dealers, asset managers should also apply internal screens to help identify companies that may be at risk for an adverse event. These include:

- **Relative equity performance**: Lagging performance might suggest that the management team is not running the company as efficiently as its peers.
- **High cash balances**: Can indicate a risk that an LBO group could use the company’s cash as part of the funding for a go-private transaction.
- **Strong and steady free cash flow**: Implies a company may be able to operate profitably with much higher leverage.
- **Low leverage or low debt levels**: Another key metric to assess leverage capacity.
- **Relative size of the company**: Smaller companies are easier to take private as the total funding required is more easily accommodated from conventional sources.

Though helpful, quantitative screens do have limitations. For one, they do not take into consideration the idiosyncratic nature of the industry or specific company. Further, quantitative measures may not accurately depict the trends in the metrics. Companies that may screen attractively may also be on an improving credit trend, which could limit the momentum behind a possible LBO since the fundamental improvement may remove some of the efficiencies an LBO sponsor may look to achieve.

Other factors not necessarily uncovered by pure quantitative analysis include significant insider ownership (like Dell), which can put a company at risk for an LBO. Insiders typically have better information and can roll their holdings into new equity, which helps limit the amount of outside equity sponsorship needed for a go-private transaction.

To more effectively manage event risk, a deep qualitative analysis should also be conducted on each issuer to identify positive and negative company-specific trends that are not readily measurable through a quantitative screen.
Management Screens
It is our experience that companies led by successful management teams with clearly articulated, transparent operating strategies and financial policies are less likely to catch the attention of a buyout firm or shareholder activists.

Detailed bottom-up research is necessary to fully understand a company’s financial trends and whether management’s goals and objectives are reflected in the firm’s financial profile. We place a high value on management’s track record. If a firm follows through and delivers on its commitments, we are usually more comfortable with exposure to those companies. Management credibility as it relates to its lenders is a key area of focus.

Industry Screens
Historically, certain industries have been largely immune to both LBOs and significant re-leveraging risk due primarily to the nature of the industry or U.S. government regulation. Utilities are heavily regulated and therefore do not make for good LBO candidates. Bank and finance companies are under regulatory pressure to increase equity capital and therefore are not generally at risk for leveraging. Also, finance companies generally need a low cost of financing, which is inconsistent with an LBO structure. Mining companies are also less likely candidates due to high ongoing capital expenditure requirements and volatile metal prices. Tobacco companies carry significant legal risks, which likely make leveraging too risky.

Industrial segments that tend to make for better leveraging potential including food and beverage, consumer products, packaging, and certain retail segments. Companies in these sectors require careful monitoring and select exposure, especially in today's environment.

Further, U.S. companies that are ‘asset rich’ (including some retailers that own a major portion of their real estate, for example), may have large, unencumbered assets that could be securitized, which helps facilitate the financing of an LBO. Separately, if an ‘asset rich’ company’s stock is underperforming, the assets could attract private equity firms or activist shareholders who could call for the liquidation of some of those assets and steer the proceeds to shareholders.

Change of Control Provisions
Another way to limit the negative effects of an LBO is to concentrate holdings in bonds that carry a Change of Control provision. Bonds with an effective change of control covenant provide investors with the ability to put the bonds back to the issuer, usually at par or 101%, once the ownership of the company changes. Currently, about 28% of the bonds in the investment grade corporate bond universe carry a Change of Control provision. Not surprisingly, the provision is more likely to be included in bond indentures when LBO activity is on the rise.

It is important to note, however, that even with a Change of Control provision investors may experience a loss depending on the price the bonds were trading at pre-LBO. Change of Control provisions should be read and analyzed carefully to ensure the language will actually provide protection in the event of an LBO. Not all indenture language is created equal! Some bonds have weaker protection than others, and a careful understanding of the language and wording is critical.

Maturity Selection
Generally, shorter-dated bonds of LBO-targeted companies fare better than longer-term debt. This is because debt maturities inside of three to four years are typically provided for in the initial financing plan of an LBO. By design, these companies are likely to survive in the short run as equity sponsors usually plan for a longer-time horizon to execute their exit strategy. If near-term maturities are not honored, the equity sponsors risk their investment to the machinations of a bankruptcy court—a risk many equity sponsors are not willing to take.

\(^1\) Bloomberg. Represents holdings with Change of Control provisions in the Barclays Capital U.S. Corporate Bond Index as of March 31, 2013.
In Summary
Managing adverse event risk is an integral part of fixed income portfolio management. The degree of event risk present at any one time is often related to overall market and liquidity conditions, investors’ risk appetite, and corporate valuations and quality. Today’s environment of historically low interest rates, high corporate cash balances, and solid operating fundamentals, combined with low P/Es and low projected revenue and profit growth, is contributing to increased event risk in the industrial sector.

Identifying specific financial events, such as LBOs, is challenging, but bottom-up research using both quantitative and qualitative screens can surface potential candidates. Developing relationships with corporate management and closely following their track record, initiatives, corporate governance, and organizational developments is also important.

From a strategy perspective, asset managers can take several steps to help manage event risk: 1) Limit exposure to event risk candidates; 2) Concentrate on industries with less vulnerable prospects, such as the financial sector; 3) Focus on issues with Change of Control covenant protection; and 4) Buy shorter-maturity bonds, which are more likely to be paid off in the early years of an LBO. Managers may also consider buying shorter-dated bonds of companies rumored to be an LBO target and trading cheap, as these issues could deliver attractive returns whether or not an LBO occurs.

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