INVESTMENT

High-yield markets: Where are we in the cycle?

With high-yield spreads at their tightest in three years and not that far from all-time lows, there is now an obvious question in the market: Where are we in the cycle and is there still upside?


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The economy tends to move in cycles, and the high-yield market inherently moves with it. Here, one can broadly distinguish between four phases. In the 'stability' phase, companies are generating higher profits and cash flows, and leverage generally remains stable. During the second phase, the 'expansion' phase, corporate managers and entrepreneurs see opportunities to invest in new projects or acquire other companies. At this point the market seems to be moving from the stability phase to the initial stages of the expansionary phase. The macroeconomic backdrop continues to be relatively benign, with most economic indicators pointing towards a somewhat expanding economy. Earnings releases have in general been relatively strong, with the majority of companies reporting figures at least in line with consensus forecasts. Leverage came down slightly in Q4 2016, from 4.0x net debt/EBITDA at the end of September 2016 to 3.9x at year-end for the sample of high-yield companies that have released figures to date.

Moving on to the next phase, confidence grows and more shareholder-friendly measures are taken, such as dividend increases and/or share buybacks. Ratings agencies tend to not raise ratings anymore, given that leverage is increasing. This is not alarming in and of itself as new projects are undertaken to increase future profitability. What we are currently seeing is that balance sheets are being managed relatively conservatively. In general, companies are not aggressively leveraging up for M&A or to pay dividends to shareholders. There are some exceptions (Loxam, Verallia, etc.), but they remain limited to individual cases.

In some situations it may turn out that companies have overpaid for investments or acquisitions, or that the profitability of projects is far below expectations. This can have several causes: a slower economic environment, a more difficult competitive environment or overoptimistic forecasts of future cash flows. This is how we end up in the third phase, the 'slowdown' phase. Here, leverage increases and ratings agencies tend to cut ratings rather than raise them. The fourth phase in the cycle is then when companies start to restructure and deal with the excesses of the previous phase. At this point in the cycle measures are taken to decrease leverage, for example selling loss-making divisions, cutting costs, etc.

Our assessment of the current market situation is that we are in the stability phase and are moving slowly towards the expansion phase. Defaults remain limited and most market participants do not expect them to rise in the foreseeable future. Moreover, only 3 per cent of the benchmark is trading at prices below 80 per cent (or at levels that can be referred to as distressed). The asset class can hardly be called cheap, of course, with spread levels hovering around 325 bps. However, current spread levels are compensating for a five-year cumulative default rate of approximately 26 per cent, sufficient to cover an average five-year default cycle.

One final point: the supply/demand balance for high yield also continues to work in favour of high yield. Most new issuances are currently for refinancing purposes, meaning net new supply is for the time being relatively limited. Nevertheless, on the demand side, investors looking for positive carry are still investing in the category. European high yield can hardly be called inexpensive, but the environment is expected to remain favourable for the category in the near future. ■

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