Three credit ideas in a low-yield world

Floyd Tyler, president and CIO of credit FoHF firm **PreserverPartners**, highlights attractive investment opportunities

For yield-focused investors, European CLO debt/equity remains one of the more enduring opportunities providing access to European corporate credit with geographic, sector and company-level diversification. CLOs work well through cycles, and they perform best when spreads are wide and default rates are low. We continue to find attractive opportunities in both new issue and secondary markets.

The eurozone macroeconomic data remains supportive of corporate credit conditions. CLO investing can leverage fundamental research to understand the underlying credits and supply and demand data. Loan yields are low by historical standards, but spreads are still wide enough to generate double-digit total returns with structural leverage. Mezzanine debt yields can be 7-8%, while the CLO equity yields are north of 20% annualised.

Discounted, short-duration, non-financial preferred securities

After the US election, US rates spiked and crimped returns of many interest-rate sensitive securities including preferred securities, which tend to have fixed rate coupons and long maturities. Investors' rate hike fears and overreaction to short-term business setbacks have created opportunities in preferred securities. If purchased at a meaningful discount, high coupon preferred securities with a substantial interest spread cushion over investment grade securities should perform reasonably well during a gradual rate normalization process. We have purchased short-duration, non-financial preferred securities with cumulative dividend structures.

Our focus is securities where the company is navigating a short-term setback that has depressed investor sentiment. These preferred securities often decline in sympathy with the common shares after earnings disappointments.

We are finding preferred securities with sizable discounts and current yields over 8%. Attractive candidates include Arconic Series B (yields 10%), Frontier Communications Series A (yields 11%) and Stericycle Series A (yields 8%). Mandatory redemption or voluntary call provisions create potential catalysts to narrow the discount to liquidation preference and significantly boost yields. Preferred securities with call dates or maturity dates within 1-2 years may have a yield to call or a yield to maturity over 20% (as of 20 February).

CDS on CMBS with low-quality mall exposure

While the economic backdrop continues to support commercial real estate, there are fissures emerging suggesting that future appreciation returns will be muted for US core and core plus properties.

Appreciation returns have declined in each of the last three years. Unlevered returns will likely approximate capitalisation rates plus or minus 1%. However, certain sectors such as low quality US malls may face much stronger headwinds. Department stores and apparel makers such as Macy's, Sears, and JC Penney have announced hundreds of store closings.

The Limited and Wet Seal have announced liquidation bankruptcies. E-commerce sales trends and millennials' shopping habits have weakened sales and foot traffic at many malls and brick-and-mortar retailers.

In 2016, e-commerce sales and non-store sales represent 16% and 14% of retail sales, respectively. Some mall owners have been slow to adapt to how customers now interact with malls and omni-channel sales efforts of retail tenants. Those mall owners that want to address these trends can be limited in their ability to reposition and reconfigure square footage due to long-held reciprocal easement agreements with anchor tenants.

Research firm Green Street Advisors estimates a range of 10-43% closures for major anchors. Anchor store closures are more problematic as they can set off a mall death spiral. Also, co-tenancy clauses in lease agreements may allow other tenants to break or renegotiate their leases after a loss of an anchor tenant. Class B/C malls with limited entertainment options and 1-2 anchor tenants are most vulnerable.

These challenges may be exacerbated by the wall of near-term CMBS maturities. Some underlying loans may not qualify for refinancing under current underwriting standards. CMBS have been a critical source of financing for retail properties. Trepp estimates $109bn in CMBS will mature in 2017, with retail the largest segment.

If the aforementioned headwinds were not enough, the Congressional border-adjusted tax (BAT) proposal that would tax imports and exempt exports could cause more difficulties.

The investment opportunity is to establish a bearish position against commercial mortgage bonds with significant exposure to class B/C malls. CMBS does not offer a pure play to be short retail commercial real estate risk. This investment can be expressed using selected CMBX contracts rather than shorting individual cash bonds due to illiquidity. CMBX contracts are essentially baskets of 25 single-name credit default swaps (CDS) bundled into one trade. The most advantageous positioning may be to bet against seasoned tranches with the greatest exposure to low quality mall properties underwritten by sponsors with less than stellar underwriting records. Given the cost of carry and inability to perfectly isolate the exposure, the trade is that the prices of these selected tranches will show markdowns, not go to zero. Yield spreads in selected tranches have already started to widen 50-100 basis points in recent weeks.