Global Letter

A tale of toggle PIKs

A low interest rate search for yield can end in tears; but seemingly the US is not there quite yet

Credit market excesses typically occur in times of low interest rates, when investor demand for higher-yielding instruments leads to the creation of asset classes with returns that, in hindsight, were out of line with the risk involved. So it is of at least *prima face* concern[1] that yields on fixed income asset classes are now even lower than they were in the run-up to the great financial crisis.[2]

Reaching for yield – the case of toggle PIKs

A common way for corporate bond investors to pick up yield is by accepting more credit risk and less favourable repayment terms. The recent sale of several toggle PIK (payment in kind) issues in the US high yield market – aggressive structures that give issuers the option to substitute additional debt for interest payments – exhibit both these features.

Companies that issue PIKs are often described as being in 'fly or die' situations. They are typically under stress, such that 'dying', in the form of defaulting, is a real possibility. But they also have a lot of potential: if they can make it through the coming few years, the alternative scenario – 'flying' – kicks in: sales grow, they generate cash; pay down debt; or maybe get bought by a stronger entity.

Thus, toggle PIKs can help an issuer stay aloft for a while: but because the company becomes more leveraged as a result, it increases the risk of crashing later on.

An important consideration is the purpose to which the proceeds of the bond sales are put. The risk for bondholders is reduced when the borrower uses any available cash to repay its creditors.[3] Unproductive uses[4] however signal that bondholders are accepting even more risk in their pursuit of yield, and so are a bad sign. Recent trends in this regard are not encouraging.

According to media reports,[5] some recent toggle PIK deals are "dividend recaps", meaning that the companies have taken on additional debt in order to pay their owners, usually private equity firms, a 'special' (i.e. very large) dividend. A dividend recap is therefore nothing more than a transfer of funds from a company's bondholders to its shareholders.

On the face of things, therefore, the risks related to toggle PIKs could be taken to indicate that a market peak is fast approaching. There are however counter arguments.

Counter arguments

Since March, when the Federal Reserve Bank unveiled support packages for the markets and Congress passed the CARES Act and other measures, yields on bonds rated CCC (the highest risk) have fallen by less than those on bonds rated BB (the lowest risk in the high-yield bucket), as well as for the market as a whole.[6] Thus bondholders are still being paid a premium for buying riskier debt – although of course that does not prove that they are being paid sufficiently.

A second consideration is that market collapses, particularly in high yield, are often triggered by a loss of liquidity, which typically occurs when a sharp rise in risk levels sets off a flight to safe assets, making it prohibitively expensive for issuers to sell bonds. The current stability of spread levels suggests however that such is currently not the case.

A third consideration is the comparison with the behaviour of equity markets. Until the Covid crisis, the high-yield bond spread and the VIX Index of equity option volatility moved quite closely together – albeit the VIX was more volatile. In March of this year the VIX rose above its level at the time of the Great Financial Crisis. It has since remained much more elevated than the high yield spread, a significant departure from the past: this likely reflects the Fed's support programs for the credit markets, for which there is nothing comparable for equities.

A fourth factor is that the US Q3 GDP figures suggest that, after the extraordinary COVID-19-induced soaring of the saving rate and associated collapse in consumer spending, the economy may be starting to stabilise. With the pandemic still coursing through the population it is too soon to be sure: but the economy is performing impressively under the circumstances.

Conclusion

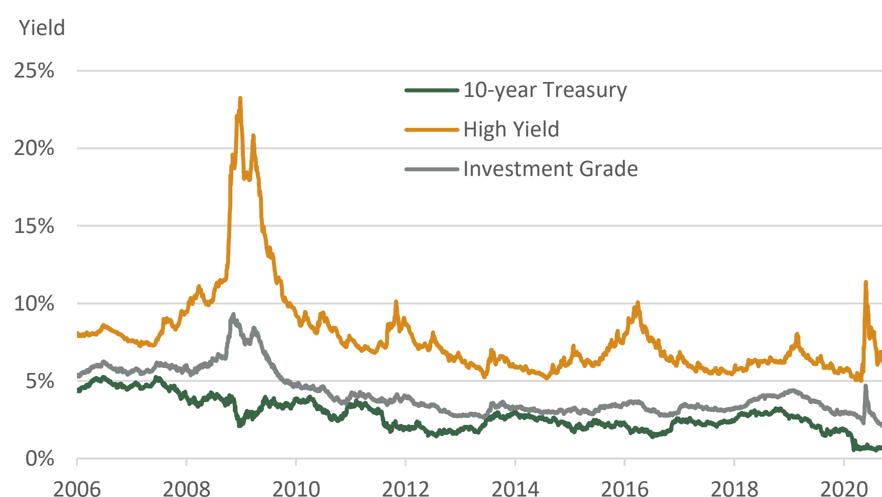
Notwithstanding a general fall in bond yields, investors in high-risk bonds continue to be paid more than those invested in safe assets – indeed the spread has widened slightly. Whether this fully compensates them for the risk is unknowable: but provided that the US economy continues to recover, and the Fed remains supportive, a major credit event may still be some way off.■

David Munves, an Associate of Llewellyn Consulting, is President of DWM Consulting Services, New York. link Earlier, he held leadership positions at Moody's Analytics, Lehman Brothers, and S&P Global Ratings.

[1] Concern can only be heightened by the rising demand for income-producing bonds from retirees.

[2] Indeed, yields are at record lows even over a much longer period for which the data go back – to the mid-1990s for credit indices and to 1962 for 10-year Treasuries.

Figure 1: Yields on US fixed income asset classes



Source: FRED, ICE BofA Indices

[3] Thus productive uses include retiring higher interest rate borrowings, investing to boost sales or efficiency, and financing a strategic acquisition.

[4] Examples of unproductive use include building a new company headquarters building – which does happen – or using the liberated money in a pay-out to shareholders.

[5] See for example Rennison J., 2020. *Risky PIK deals pitched by private equity to yield-hungry investors.* Financial Times, 23 October. Available at https://www.ft.com/content/83954fe0-2e81-451c-b94d-688d92270e87 [Accessed 15 November 2020]

[6] In other words, CCC spreads have recovered by less, on a percentage basis, than those for higher rated entities (Figure 2), meaning that holders of these CCC bonds are still being paid relatively well.

Figure 2: Yields on below-investment-grade bonds

	Mar. 23 (bp)	Nov (bp)	Diff (bp)	Pct Diff
HY	1,087	529	-558	-51%
BB	837	389	-448	-54%
CCC	1,962	1,136	-826	-42%

Source: FRED, ICE BofA Indices

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