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Finding Value Across the Capital Structure

Independent research identifies opportunity along the quality spectrum.

The current state of the credit market requires an eagle's eye to identify selective opportunities. They aren't easy to find, which is why Bryan Krug, founding Portfolio Manager of Artisan Partners Credit Team, underpins his high-conviction investment process with deep fundamental — and independent — credit research. II recently spoke with Krug about the work behind the process that invests across the capital structure, and why it's a difference maker.

How would you sum up your investment philosophy?

We are value-based investors. We invest across the capital structure and the risk spectrum, and we look for opportunities of dislocation and mispricing. Where we get our edge is through our fundamental credit research process. We do independent work. We talk to not only the management of a company, but also suppliers, competitors, former employees, and so on, and through those conversations we're able to triangulate independently what's happening with a company. Based on our views that emerge from that research, we identify the part of the debt portion of the capital structure that we believe offers the best risk-adjusted return. And, we have a concentrated portfolio where our best ideas meaningfully impact performance through the cycle.

Can you give us an example of that in action?

We have a full-time data scientist to try to get a greater depth of understanding through public and private sources of data, which in turn allows us to confirm or reject investment theses. In one example, there was a restaurant company that was in the process of being bought out, the same store sales look to be relatively stable, and their margins looked to be improving. On the surface that sounds reasonable and stable. However, when we dug deeper into the underlying data through alternative data methods, we found that traffic was down double digits, and that was being offset by double-digit price increases. In that case, the core health of businesses is clearly deteriorating. That strategy is just not sustainable for the long term. That's the kind of incremental insight we gain from using independent data.

What do you focus on to determine where you should be positioned across a company's capital structure?

We form a fundamental view on the trajectory of the business, based on our independent research. With that view, we anticipate how financial leverage will work through different parts of the capital structure. With each capital structure, we assess the maturity profile and the opportunities for the company to enhance its capital structure by performing a capital market transaction — and then we identify a piece of debt with the best risk-adjusted return. In general, if we're more constructive on material credit improvement, we're likely going to be more junior in the capital structure or in the part of the capital structure that's most likely to experience spread the most compression.

Does a more complex capital structure mean there is more opportunity?

Capital structures evolve, and as covenants have become looser, debtors have opportunities and flexibility that they wouldn't have had 10 or 15 years ago. That flexibility sometimes will allow junior capital to potentially become more senior than the bond indicates. So, there are times when a junior piece of paper can actually be refinanced into a more senior piece of debt because documents generally are more issuer-friendly. While we're doing our deep dive on companies, we also do a deep dive on the documents to understand what flexibility the issuers have. This is important and worthwhile, because the market often does not anticipate those potential transactions, which creates opportunity for us.

What are some of the other key differentiators in your investment process?

We invest across the full quality spectrum, and we are very selective when we're going into the lower grades. There are a number of businesses that have strong business models with higher-leveraged balance sheets that are justified. We view that as an opportunity that many of our peers would avoid. You could have a CCC rating and this can be CCC bonds that have equity subordination of 50% of the capital structure. So, we think the risk of impairment is low. We think that a lot of our peers gravitate toward higher quality, which is the most efficient part of the market where there's very little ability to differentiate.

Another is that investing across the capital structure has clear benefits to mitigate risk. We tend to think on a risk-adjusted basis, by investing across the capital structure you can have different outcomes among securities of the same company. For example, if a company were to test a financial covenant, that would be a negative event for a bond, but it could actually be a positive event for the term loan. So, our ability to flex between bonds and loans gives us the advantage of a broader opportunity set to express our views.

Another differentiator is that we're cash-flow lenders as opposed to asset-based lenders. The reason is because cash flow is what will ultimately pay back our invested capital – it's much more real. Asset value is great theoretically, but it is also tied to cash flow. In the event of a deterioration, the asset value collapses. A good example is in energy, when higher oil prices became lower, asset value fell apart pretty quickly, and investors who thought they were protected by asset value were actually impaired.

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You have significant loan exposure, which means you likely keep a close eye on underwriting. What trends are you noticing in that regard?

We're seeing a couple of trends in the below investment grade market. The high yield bond market has shifted more to a high-grade, higher quality market. Most of the underwriting has been higher quality issuance over the last few years. For example, the amount of CCC new issuance has been below historical averages. On the loan side, it has been incrementally more aggressive than it was in the past, and documents have gotten looser. Additionally, there's been a massive trend of junior debt capital moving to the private credit solutions, because it's become a more robust source of financing and, in certain cases, the private market is cheaper than public market alternatives.

How do you size up the current investment environment overall?

It's an odd environment for investing, in my opinion. There's a lot of focus globally on central bank activity. If you look at bond yields globally — the pricing on a valuation basis, they're pricing-in recessionary environments. And equity markets are not pricing-in recession at all. It's a very odd dynamic, fueled by liquidity-induced drought, and rallied by central banks broadly. Central bank policies are blunt instruments. As we look at valuations, particularly higher quality bonds in the marketplace, they're extremely expensive on both a spread and a yield basis. As a result, we are flexing our ability to invest across the ratings spectrum. In our view, BB bonds are expensive and have tightened to relatively unattractive levels. We think we can pick-up spread by buying B loans that on a loan-to-value basis are reasonably close to some of the BB bonds. That's an opportunity we're seeing in today's market.

Because the lower grades of the credit market have lagged dramatically, we think there are selective opportunities that could achieve equity like returns. Rising dispersion across credit quality has led to increased alpha generation potential through credit selection. These tend to be more idiosyncratic names that's often overlooked by the market.

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Disclosure

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Alpha is a quantitative measure of the volatility of the portfolio relative to a designated index. **Below-Investment Grade** refers to fixed income securities with lower credit quality. **Credit Quality Ratings** are from S&P and/or Moody's. Ratings typically range from AAA (highest) to D (lowest) and are subject to change. **Spread** is the difference in yield between two bonds of similar maturity but different credit quality.

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