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Why COVID-Sector Credit Opportunities Remain Attractive Today

Jeff Friedman and Jon Roiter | December 2020

EXECUTIVE SUMMARY

Fantastic vaccine news and a post-election relief rally has left many credit investors asking, "Is there any opportunity left from here?" We believe the answer is yes. The ink spilled in the marketplace about record low yields due to record low rates overlooks the significant dislocation that remains in COVID-impacted sectors.[1] The broader credit market opportunity we referenced in papers earlier this year[2] has largely played out, but many COVID-impacted businesses are still trading at levels offering attractive total return to normalization and face cyclical, rather than secular, challenges. These sectors account for only 25% of the high yield market but account for most of the spread widening on the year, despite maintaining meaningful equity market caps. For some of these businesses, enterprise values have recovered fully from pre-COVID levels, despite optically large equity share price declines. Meanwhile, the credit spreads of many of these businesses are still wider on the year, and we believe continues to present a good opportunity to capture excess return in credit.

What COVID Sector Defaults?

While default rates in the market have continued to increase overall, COVID sectors have contributed only 0.4% of the current high yield market's 6.2% default rate, while accounting for ~25% of the market. In fact, Energy, Retail, and Telecom account for more than half of the high yield market's defaults this year alone while comprising only 23% of the high yield market.[3] However, spread underperformance has created an opportunity to build exposure to many of these COVID-impacted names that boast double-digit total return absent the secular risk of distressed sectors. While many of these businesses will emerge from COVID slightly more levered than pre-COVID due to cash burn and debt issuance (along with equity issuance), there is still substantial equity cushion support before the debt can be impaired. Further, the importance of running a sound balance sheet is likely to be reinforced by management as a priority going forward after flirting with the disaster of this past year.

COVID Sector Credits Are Still too Wide and Attractive

With the meaningful rally in the markets since the spring, we are now only 73 bps off pre-COVID levels.[4] High yield spreads are now trading at ~500 bps versus their long-term median of ~550 bps and year-end 2019 levels of 424 bps. Similarly, leveraged loan spreads are now just 60 bps wide of year-end 2019 levels and 20 bps wide of the long-term median for loan spreads.[5] While high yield and loans are at least relatively in-line to average historical levels, investment grade bonds are now at a spread of ~110 bps versus the long-term median of ~172 bps, offering very little compensation for investment grade credit risk over Treasuries, comparatively.[6]

So, where is the dislocation? Despite the significant tightening in credit spreads from the wides this spring, hard-hit COVID-impacted businesses with (and without) public equity market caps continue to trade at meaningful discounts that offer double-digit returns. Many of these COVID-impacted sectors remain substantially wider from year-end 2019 levels and have contributed 61% of high yield's overall spread widening on the year. As a result, remaining high yield sectors are relatively less attractive because they have seen either spread tightening or minimal widening during this period. As we can see in Exhibit 1, when we strip COVID-sectors out of the high yield market, the remaining 75% of the market has widened out only 39 bps in aggregate versus COVID-impacted sectors still being wider by anywhere from 126-405 bps on the year.

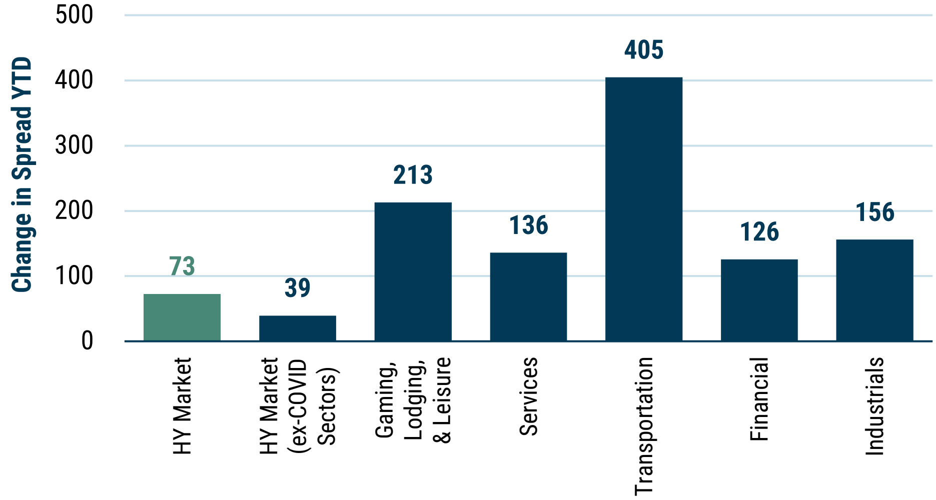
1
We define COVID-impacted sectors as Gaming, Lodging & Leisure; Services; Transportation; Financials; and Industrials. These sectors account for ~25% of the high yield market.

2
Jon Roiter, "Shelter In Credit," March 2020 and Jeff Friedman, "Introducing Stressed Performing Credit," May 2020.

3
J.P. Morgan High Yield Default Monitor, November 30, 2020

4-6
Op. cit.

EXHIBIT 1: HIGH YIELD VS. COVID-IMPACTED SECTOR SPREAD CHANGES YTD



As of 11/30/2020 | Source: J.P. Morgan High Yield Default Monitor

"We are relatively confident that people will continue to want to enjoy vacations, drink beer, and order margaritas by the pool or beach long into the distant future!

While many of these COVID-impacted sectors are undergoing significant near-term disruption, we believe many of these affected individual businesses offer better downside protection than typical junk-rated companies, which often face more structural challenges. The vast majority of the high yield issuers in these sectors have significant equity market caps, despite debt prices still being down 10+ points in many cases. We are particularly constructive on consumer leisure as our work suggests that consumers are in relatively strong shape financially, with surveys and advance bookings indicating that consumers are eager to travel. Notably, we do not see a technological substitute for this consumption. We are relatively confident that people will continue to want to enjoy vacations, drink beer, and order margaritas by the pool or beach long into the distant future!

The Dilution Solution: Strong Credit Support

With a recent rebound in "reopen equities," many investors are looking at certain equities down 35-55%, wondering whether opportunities remain. However, despite these share price declines, the enterprise values have in many cases recovered to, or even exceed, pre-COVID levels. How can this be? Equity holders have been heavily diluted and share counts have increased dramatically as companies raised money through equity offerings. While dilution is bad for the equities, it's great for credit investors as the cash raised supports liquidity and lowers credit risk by deleveraging balance sheets. So, while many of these individual share prices are down meaningfully, this is not necessarily a signal of cheapness for the stocks or risk for the credits – quite the contrary.

As we can see in Exhibit 2, in the cruise and airline sectors there has been dilution of 20% to as much as 100%+ depending on the company, after adjusting for both equity and convertible notes issued in order to raise liquidity. Overall, this substantial equity support remains supportive for COVID-sector credit, and we expect further credit-positive equity issuances from these companies to fund ongoing cash burn as share prices have rallied.

EXHIBIT 2: SHARE COUNT DILUTION AND ENTERPRISE VALUE (EV) CHANGE OF COVID-IMPACTED COMPANIES

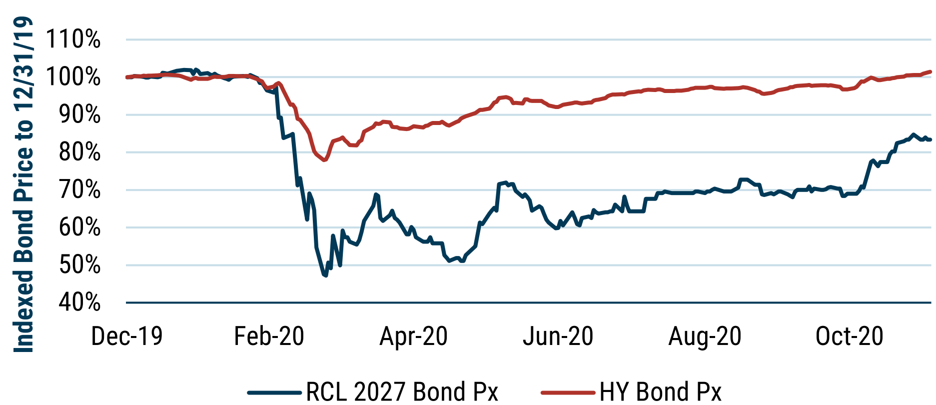
Company	*Ticker*	*Share Price Gain (Loss)*	*Share Count Dilution (incl. Converts)*	*Market Cap Gain (Loss)*	*EV Change Gain (Loss)*
Royal Caribbean	RCL	-38%	24%	-23%	-13%
Carnival Cruise Lines	CCL	-54%	66%	-24%	-9%
Norwegian Cruise Lines	NCLH	-55%	105%	-8%	-2%
American Airlines	AAL	-43%	45%	-17%	4%
United Airlines	UAL	-44%	20%	-33%	-17%

As of 12/4/2020 | Source: Company filings
Note: Enterprise value calculation excludes future burn assumption.

Cruising After a Bruising

Cruise lines in particular have been a topical area of the market given that their revenue has gone to virtually $0 and uncertainty remains over when they will sail again and what demand will look like. As we have evaluated cruise lines, we continue to find attractive mis-pricings. For example, Exhibits 3 and 4 show one particular cruise line, Royal Caribbean (RCL), has debt trading at prices ~20 points below pre-COVID levels and spread levels of ~400 bps wide of pre-COVID levels, while maintaining a market cap equal to roughly 50% of its outstanding debt.[7]

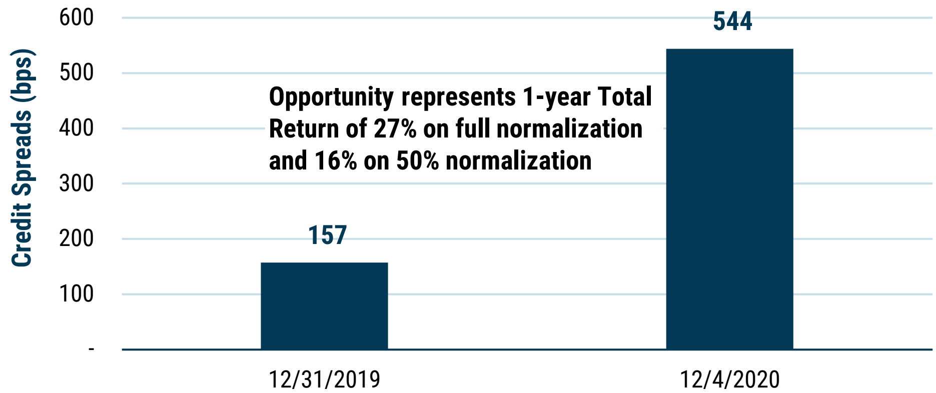
EXHIBIT 3: RCL 7.5% 2027 VS. HY BOND PRICE INDEXED TO 12/31/19



As of 12/4/2020 | Source: Bloomberg, J.P. Morgan High Yield Default Monitor

7 Bloomberg.

EXHIBIT 4: RCL BOND SPREADS: PRE-COVID TO TODAY



As of 12/4/2020 | Source: Bloomberg

While some investors may look at RCL's debt price and think, "Hey, it has $0 revenue currently, what's the value there?" We argue that the current credit spread of ~544 bps offers an attractive return relative to the underlying default risk, especially as the company has shown a willingness to fund cash burn through equity issuance. The substantial asset value of the ships, brand, and customer loyalty serve to limit fundamental risk for creditors despite such an enormous disruption. Even with the lack of current sailings, data points to a healthy return to operations once pent-up demand is unlocked: second half 2021 cruise bookings are already tracking at the high end of historical ranges[8] and over 100,000 people signed up within days of calls for volunteers for RCL's test cruises.[9] Creditors are often backwards-looking given they do not get paid for growth, but ultimately the credit spread is compensation for impairment risk and we believe that as mark-to-market fundamentals continue to normalize, so will spread levels. Realizing even half the tightening back to pre-COVID levels would result in a mid-teens total return, including a year of coupon payments, and full tightening back to pre-COVID levels would offer a 25%+ return potential.

Meanwhile, the equity market is less generous in offering a discount for dislocation. As we see in Exhibit 5, the enterprise value (EV) of RCL implied by the equity market is down only 5% this year with a roughly $21 billion equity market cap sitting behind our debt on an as-converted basis! While RCL is still burning cash, there remains a massive 58% equity layer for the company to need to chew through before the debt becomes impaired, offering a substantial margin of safety to the debt.

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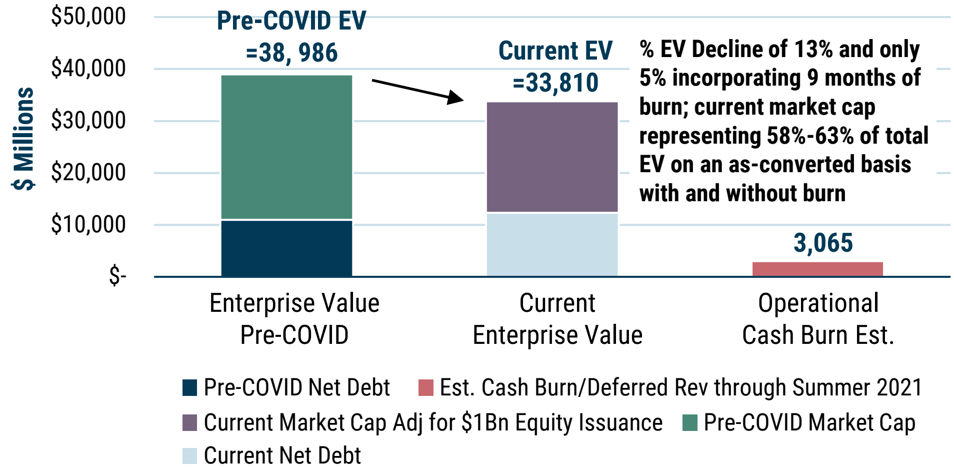
8 RCL earnings call transcript, October 29, 2020.

9 https://www.thestreet.com/investing/royal-caribbean-says-100000-volunteer-for-sailing-tests

EXHIBIT 5: RCL PRE-COVID ENTERPRISE VALUE VS. CURRENT ENTERPRISE VALUE



As of 12/4/2020 | Source: Company filings, GMO estimates, Bloomberg

RCL is just one of many leisure opportunities present in the market: hard-hit companies that may be burning cash today yet have durable cash-generative business models with solid long-term demand prospects and significant equity market support. We have found similarly attractive credit set-ups in various hotel resort, theme park, live entertainment, and aerospace[10] credits, where in some cases the EVs today are now above pre-COVID levels.

Conclusion

We continue to find a number of opportunities in the debt of cyclically disrupted leisure-oriented business at large price discounts to pre-COVID levels, with large equity layers providing market support and currency to raise liquidity and deleverage the balance sheet as needed. Notwithstanding near-term challenges, we believe medium-term demand will remain strong in consumer leisure sub-sectors such as hotel resorts/timeshares, theme parks, aerospace, cruise lines, and live entertainment. We are still finding attractive return opportunities with low permanent impairment risk in many of these businesses and, as a result, these COVID-impacted sectors remain a large overweight exposure in our portfolio. While there are pockets of defaulted debt becoming more compelling as the default rate has risen from earlier this year, we continue to believe the majority of these defaults are in businesses facing secular challenges, while many COVID-impacted credits remain at meaningful debt discounts with minimal secular or default risk. This landscape presents a unique opportunity for us to generate attractive returns with superior fundamental downside protection.

In our GMO Credit Opportunity Strategy, we believe we are unique in that we have a nimble and selective process that allows us to take advantage of broad dislocations, such as the large COVID sector opportunity that we still see, without being tied to a yield or hurdle bogey. In a world in which government bonds offer very little return and negative yielding debt abounds, it's important to be able to earn excess spread in the marketplace without taking excess risk. While many other managers in the market are either simply focused on tracking error to an index or investing in illiquid

10 Aerospace includes aircraft and aeroparts suppliers, airlines, and other aircraft-backed instruments.

defaulted debt opportunities of secularly challenged businesses that have been around for years, we are able to capitalize on dislocation through a total return all-weather approach from dislocated investment grade through distressed. Accordingly, despite low rates and lower all-in yield opportunities, attractive spread levels allow us to generate strong total returns through trading price and coupon upside, with less risk and better liquidity than other distressed opportunities we've seen in recent years. This approach has allowed us to outperform without being constrained by dollar price, yield hurdle, or poor liquidity. With low-risk benchmark fixed income not providing much benefit to portfolios in an environment of record low rates, we believe having a consistent credit alternatives allocation to take advantage of dislocations and excess spread opportunities is particularly important today and going forward.

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