

May 2, 2017

Unrated bonds are an expert's domain

Some years ago, 'bond king' Jeffrey Gundlach, the founder of DoubleLine Capital said: "Fear and loathing" best describes market sentiment toward risky assets. Today, the era of ultra-low-yields has somewhat reversed this sentiment.

In times of negative yields, the hunt for yield has led some investors into the uncharted territory of unrated bonds; this is a risky business. Bond ratings provide an assessment of the issuer's ability to pay coupons and return the principal in a timely manner. These are normally issued by one or more of the three independent rating agencies: Standard & Poor's, Moody's or Fitch. Ratings also provide a point of comparison across the 'graded bond' universe, allowing investors to assess whether a bond is over or undervalued relative to others.

Lately, more investors have been happy to venture into unrated bonds, taking fundamental analysis into their own hands, or ignoring the need for this entirely; in some cases at their peril. It is not to say that unrated bonds are, by default, a bad investment: this is a space that savvy, professional investors can navigate, scoping out good opportunities which offer a premium to compensate investors for the lack of rating or for having less liquidity, which is often the case in this market.

Issuers which are considered 'household names' have been able to take advantage of their status amongst retail investors and tap into the unrated bond market. Renowned companies do so to avoid the cost, in terms of money and time, involved with obtaining a rating. Adidas, Ferrari and Air France-KLM, have all issued unrated bonds.

However, this is a space where amateur investors can get burnt. An example of this is when in 2014/15, a series of defaults and insolvencies hit Germany's Mittelstand bond market, which was predominantly made up of unrated bonds issued by small and medium-sized enterprises (SME). According to the Financial Times, of 192 Mittelstand bonds issued between 2010 and 2014, there were 26 corporate defaults. Retail investors - enticed by 7% coupons and the 'famously reliable German SME sector' - suffered great losses and complain they were let down by a lack of transparency about the risk of their investments. Unfortunately, another wave of defaults could be likely when €1.6bn of Mittelstand debt matures this year.

Unrated bonds can allow companies to raise capital whilst masking ailing financials. Going unrated can also avoid the negative image associated with a low public rating, or sell-offs that could occur if their rating was to be downgraded. Unrated bonds have lighter covenant packages, meaning the issuer enjoys more flexibility than it would from bank loans. However, this means less protection for investors.

A 'red hot bond' market

In Europe where the European Central Bank (ECB) has been buying €80bn worth of assets per month (slowed to €60bn in April) under their Quantitative Easing program, prices were kept high and yields, artificially low. Yield-starved investors became more willing to move out of quality or graded bonds in pursuit of returns.

"If the market is really hot, and at the moment it's red hot, you don't always need a rating", said Roman Schmidt, head of corporate finance at Commerzbank speaking in the Financial Times.

As an example, in March, Fromageries Bel, the French cheese-maker who owns Babybel and La Vache Qui Rit (the laughing cow), issued its first Eurobond, absent of a rating. The issue was substantially over-subscribed; more than €2.3bn of orders were received for a €500m seven-year bond yielding 1.59% (coupon 3%).

In January, Louis Dreyfus, a Dutch commodity trader, issued an unrated 5-year Eurobond with a 4% coupon. There was strong demand with orders in excess of €1.7 billion. The transaction was upsized from €300 million to €400 million to accommodate investor interest.

We cite these examples, not to opine on whether these were good investments or not, but to highlight the extreme levels of demand that an unrated bonds can command in the current climate if the returns are right. The Federal Reserve (Fed) published a research paper in October 2016, concerned with herding in bond markets (this can cause large unsubstantiated rallies or sell-offs based on seemingly little fundamental evidence to justify either). It found that herding in unrated bonds is considerably higher than in investment grade bonds and even high-yield.

Fundamentals are key

Nonetheless, not all unrated bonds are low quality and can offer a slight premium. According to the rating agency Fitch, quite a few of the larger issues of unrated bonds display credit profiles that could be classified as investment, or near-investment grade. Unicredit, the investment bank, presents Prada as an example of this. In 2013, they issued a 5-year unrated bond with a nominal amount of €130m and a 2.75% coupon. They note that at this time, Prada's strong credit metrics compared well to large competitors, such as LVMH (Rating: A+).

In this opaque market, the challenge for investors lies in separating out the few high quality,

unrated bonds from those which may not even be worth the paper they are printed on. To do so, in-depth fundamental analysis is required and inexperienced investors should beware of relying on false queues such as brand name or image. We also note that if 'fear and loathing' returns to riskier assets, it is likely that unrated and junk bonds will suffer the most, given their vulnerability to herding and often fragile fundamentals. In brief: Unrated bonds are an expert's domain!

At BIL we have a dedicated team of fixed-income experts who can guide you in your investment decisions...

Disclaimer

All financial data and/or economic information released by this Publication (the "Publication"); (the "Data" or the "Financial data and/or economic information"), are provided for information purposes only, without warranty of any kind, including without limitation the warranties of merchantability, fitness for a particular purpose or warranties and non-infringement of any patent, intellectual property or proprietary rights of any party, and are not intended for trading purposes. Banque Internationale à Luxembourg SA (the "Bank") does not guarantee expressly or impliedly, the sequence, accuracy, adequacy, legality, completeness, reliability, usefulness or timelessness of any Data. All Financial data and/or economic information provided may be delayed or may contain errors or be incomplete. This disclaimer applies to both isolated and aggregate uses of the Data. All Data is provided on an "as is" basis. None of the Financial data and/or economic information contained on this Publication constitutes a solicitation, offer, opinion, or recommendation, a guarantee of results, nor a solicitation by the Bank of an offer to buy or sell any security, products and services mentioned into it or to make investments. Moreover, none of the Financial data and/or economic information contained on this Publication provides legal, tax accounting, financial or investment advice or services regarding the profitability or suitability of any security or investment. This Publication has not been prepared with the aim to take an investor's particular investment objectives, financial position or needs into account. It is up to the investor himself to consider whether the Data contained herein this Publication is appropriate to his needs, financial position and objectives or to seek professional independent advice before making an investment decision based upon the Data. No investment decision whatsoever may result from solely reading this document. In order to read and understand the Financial data and/or economic information included in this document, you will need to have knowledge and experience of financial markets. If this is not the case, please contact your relationship manager. This Publication is prepared by the Bank and is based on data available to the public and upon information from sources believed to be reliable and accurate, taken from stock exchanges and third parties. The Bank, including its parent,- subsidiary or affiliate entities, agents, directors, officers, employees, representatives or suppliers, shall not, directly or indirectly, be liable, in any way, for any: inaccuracies or errors in or omissions from the Financial data and/or economic information, including but not limited to financial data regardless of the cause of such or for any investment decision made, action taken, or action not taken of whatever nature in reliance upon any Data provided herein, nor for any loss or damage, direct or indirect, special or consequential, arising from any use of this Publication or of its content. This Publication is only valid at the moment of its editing, unless otherwise specified. All Financial data and/or economic information contained herein can also quickly become out-of- date. All Data is subject to change without notice and may not be incorporated in any new version of this Publication. The Bank has no obligation to update this Publication upon the availability of new data, the occurrence of new events and/or other evolutions. Before making an investment decision, the investor must read carefully the terms and conditions of the documentation relating to the specific products or services. Past performance is no guarantee of future performance. Products or services described in this Publication may not be available in all countries and may be subject to restrictions in some persons or in some countries. No part of this Publication may be reproduced, distributed, modified, linked to or used for any public or commercial purpose without the prior written consent of the Bank. In any case, all Financial data and/or economic information provided on this Publication are not intended for use by, or distribution to, any person or entity in any jurisdiction or country where such use or distribution would be contrary to law and/or regulation. If you have obtained this Publication from a source other than the Bank website, be aware that electronic documentation can be altered subsequent to original distribution.

As economic conditions are subject to change, the information and opinions presented in this outlook are current only as of the date indicated in the matrix or the publication date. This publication is based on data available to the public and upon information that is considered as reliable. Even if particular attention has been paid to its content, no guarantee, warranty or representation is given to the accuracy or completeness thereof. Banque Internationale à Luxembourg cannot be held liable or responsible with respect to the information expressed herein. This document has been prepared only for information purposes and does not constitute an offer or invitation to make investments. It is up to investors themselves to consider whether the information contained herein is appropriate to their needs and objectives or to seek advice before making an investment decision based upon this information. Banque Internationale à Luxembourg accepts no liability whatsoever for any investment decisions of whatever nature by the user of this publication, which are in any way based on this publication, nor for any loss or damage arising from any use of this publication or its content. This publication, prepared by Banque Internationale à Luxembourg (BIL), may not be copied or duplicated in any form whatsoever or redistributed without the prior written consent of BIL 69, route d'Esch | L-2953 Luxembourg | RCS Luxembourg B-6307 | Tel. +352 4590 6699 | www.bil.com.