Investing in Corporate Debt

Paul Gardner & Partners

Corporate bonds seem to be consigned to the position of "ugly sister" of investment classes. It appears that most investors have flocked to the income trust market for enhanced yield or they have appointed themselves to the risk-free zone of government bonds. The in-between area populated by the corporate bond market doesn't seem to offer the average investor enough extra "yield spread" in order to get excited about it.

Dynamics of the Corporate Bond Market

First of all, when we refer to corporate bonds, we are not referring to high yield or "junk" bonds. We consider corporate bonds as investment grade. The credit agencies, specifically DBRS, rate bonds on their credit worthiness. All bonds rated BBB (low) or higher to AAA are considered investment grade. This can range from credits such as Suncor and TransCanada Corp (A Low/A) and to Finning and Sobey's (BBB high). Obviously, the higher the risk, the more yield you will be paid to own it.

There are three main problems owning corporate bonds in today's market place: liquidity, pricing and spreads. Unfortunately, the Canadian corporate debt market is not "deep" in liquidity. Trying to find the corporate bond that you want can be very frustrating. Many times, the debt issue you're interested in has been purchased by insurance companies or large pension and mutual funds and "cannot be had".

Generally speaking, pricing or trading costs are high. There is no transparent market for the retail investor. It is almost impossible to find out what the bond is trading at in the wholesale market. Unlike stocks where commission is charged separately, bond commission is embedded in the price you buy or sell it for. At times, commissions can be as high as 5% of the value of the trade. Obviously, that can wipe out most of a year's return. One way to fight this is to check with other brokerage firms that you have a relationship with.

Finally, this is technically the best and worst time to own corporate bonds. Balance sheets have never been better. Credit worthiness for most companies has improved significantly over the past four years. And that is the problem—spreads (added yield over Government of Canada bonds) have never been more tight. It is very hard to find any value (as in most assets these days) or "cheap" credits.

Strategies and Recommendations

One rule you must apply is: Generally, never lend to companies for a period greater than five years. The simple reason is that as a lender you cannot forecast what the business will be like over a business cycle. At least we can forecast with some confidence how a company will do within a 3-5 year timeframe. (Remember our objective is to get our money back at maturity.) Another rule (which complements the first rule) is: The "juiciest" part of the credit curve is the 1-3 year maturity range. This is a relatively "orphaned" term because the bond manager does not care about two-year maturities (since the time is too short for them) and the money market traders don't care because the period is too long for their mandate. Last October, an investor could have bought GMAC bonds in the 2 ½ term at 300 basis points over Government of Canada (GOC) bonds. When these bonds reach a one-year piece of paper they should trade at 50 basis points over GOC bonds. This is what we call the "roll down" effect; it rolls down the credit yield curve. When you calculate total return over a 1 ½-year period (assuming you sell the bond) using this example, a 10% return will be obtained (8% interest income + 2% capital gain, assuming interest rates are constant). Unfortunately, as we mentioned before, it is prohibitively expensive to trade corporate debt.

Fundamentals of Credit Analysis

When we consider any company for investment we think of only one thing, "Will we get our money back?" How do we determine this? There is obviously a whole list of measurements we look at such as the competition and competency of its management, notwithstanding the overall business. When we strictly look at the financial statements, we

concentrate on several credit metrics.

The following are ratios that we find important but not exclusive.

Debt/Equity Ratio - Short and long-term interest-bearing debt (including capital lease obligations) divided by shareholders' equity. This ratio indicates the extent to which a company is financing its assets with debt and its degree of financial leverage. A high debt-to-equity ratio, which indicates very aggressive financing or a history of large losses, results in very volatile earnings. A low debt-to-equity ratio indicates conservative financing and low risk, with reduced possibilities of large losses or large gains in earnings.

Interest Coverage - Earnings before extraordinary items plus income taxes and interest expense. This shows how many timesover a company can cover its interest obligations from earnings. This ratio measures a firm's ability to pay interest.

Debt/Cash Flow - Total debt divided by cash from operations. This ratio measures the degree of certainty that the company can pay its debt charges from available cash flow. This is a key measure when looking at the credit worthiness of oil and gas companies.

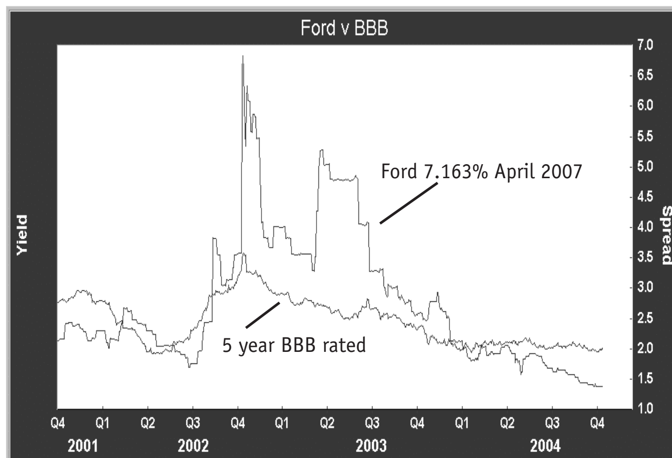
Free Cash Flow - Cash from operations less maintenance capital expenditures less dividends. FCF determines the degree of flexibility the company has in growing its business or paying down debt.

It is hard to recommend any corporate bonds due to their expensive nature. That being said, on a relative basis, here are two companies that still show "some" value.

Ford Motor Credit Canada (2 ½ Year)
Rated: BBB High (DBRS)
Spread : 150 basis points over GOC

Generally, the auto industry is dealing with large overcapacity and a product that is suffering from deflation. The overall fundamentals are challenging. Despite this, their financial arm makes a considerable amount of profit for the company. (You could almost say their vehicles are a loss leader to get finance business.) Last quarter, 58% of all earnings came from Ford Motor Credit. On the auto side, there is a constant challenge from domestic rivals and foreign competition. Recently their PAG (Premier Auto Group) has suffered as well. So, why do we like it?

Ford Motor Credit Canada (FMCC) has a reasonable balance sheet. Its leverage (which is always high for a finance company) is at the lower end of the range in recent years. Its credit losses have receded from recent highs (2.05% from 2.69%) and FMCC has good access to the asset-back



and debt markets. The ability to finance its portfolio should remain reasonable. Finally, FMCC has the full support of its parent company, Ford. Although the credit is vulnerable to a challenging industry that is highly cyclical, which has too many autos chasing too few customers, investing in Ford Motor Credit Canada in the short term is a reasonable bet.

TransAlta Corporation 6.60% October 2009
Rated : BBB (DBRS)
Spread: 120 basis points over GOC

The company is an electric generation and marketing company. TransAlta's growth is focused on developing coal and gas-fired generation in Canada, the U.S. and Mexico. It owns more then $8 billion in assets with ownership of 8500 MW of capacity.

TransAlta seems to be in the middle of a turnaround. Its credit quality (after it was downgraded every year from 1999 to 2002) seems to have stabilized. Management has indicated that it would like to get back to BBB (high) within the next three to four years. It will not be able to acquire and grow (which is a short-term positive for bondholders). It intends to pay down debt and improve its production base without spending beyond maintenance capital expenditures. Its stated goal is to maintain debt-to-capital between 45-50% (now 51%) and improve cash flow-to-interest levels to 5.5x (now 4x). If this fails it seems that the credit agencies will not tolerate anything other than the company focusing on getting leverage down and improving its credit metrics. Otherwise, this would mean a downgrade to "junk" status which TransAlta cannot allow.

TransAlta has offset pricing volatility (which hurt it in the past) by locking in an excess of 75% of its capacity under contract. This helps its stability. The negatives still exist. Not exiting the active energy marketing and trading business causes concern for bondholders. Historically, their operating earnings have been poor, and the unknown about the deregulated power market in Ontario is a risk.

Conclusion

Unless you do your homework and have relatively good access to the bond market, we recommend using professional managers who specialize in corporate debt portfolios or by using low-fee mutual funds that do the same thing.

Paul Gardner, CFA, Paul Harris , CFA , and Bill Harris, CFA, Portfolio Managers, Avenue Investment Management, 4950 Yonge Street, Suite 2200, Toronto, Ontario M2N 6K1 (416) 482-2004 pgardner@avenueinvestment.com, pharris@avenueinvestment.com, billharris@avenueinvestment.com