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# Hidden value

Klaus Blaabjerg tells **Martin Steward** that hunting down the size and value effects in high-yield credit spreads can minimise downside risk and maximise acquisition risk

Klaus Blaabjerg has steered the Sparinvest High Yield Value Bonds SICAV well, through good times and bad: on year-to-date, 12-month and three-year horizons it sits consistently near the top of league tables. And the reasons he gives for why conditions are good for high yield credit in general and his strategy in particular sound, initially, quite familiar.

Credit usually outperforms equity after recessions, he observes, because sorting out debt becomes a priority for management. As an example, he picks out a refinancing by the Mexican cement firm Cemex that he bought earlier this year: "They promised to issue $1bn of new shares. That's going on all over US credit at the moment, creating a much better environment for creditors than shareholders." But, he adds, the beta story is largely over – "there is no more free money on the table" – and many high-yield names will struggle to make it through the next two years, which means that an aggressively active strategy like his is essential. To demonstrate this, he picks out German bathroom fittings manufacturer Grohe: "It's a typical LBO name owned by many high-yield managers whose credit story isn't improving. So why did it go up so much? Because of the index technology and managers staying too close to benchmarks. My central scenario is not for a big sell-off, but there are better opportunities for more selective management."

But when Blaabjerg offers more detail on his method of selection, he begins to sound a little different from many other credit managers – and more like an equity manager. This being credit, one might assume that the spread one buys is made up mostly from credit risk. But a 2001 paper by Edwin Elton, Martin Gruber et al suggests that "expected default accounts for a surprisingly small fraction of the premium in corporate rates over Treasuries" – once state taxes are added, it accounts for just over half the spread. Fama-French regressions show that almost 85% of the rest is "closely related to the factors that we commonly accept as explaining risk premiums for common stocks" – that is, the size and value effects.

"Size is linked to liquidity – so if you buy bonds from smaller companies you need to be paid for assuming liquidity risk," says Blaabjerg. He thinks this is a good time to be overweighting those risks, and Sparinvest has recently launched a new Luxembourg fund – "bought by a select few pension funds" – with a three-year maturity specifically to exploit that niche. More generally, the 2001 paper's findings inform Sparinvest's investment process, which starts with a value screen that looks beyond credit ratings to focus on market capitalisation, price-to-book ratios and net debt-to-equity ratios. This value screen is followed by more conventional company and bond analysis and portfolio construction that is 100% bottom-up and value-oriented. "Most credit managers are focused on sector, region, ratings, interest coverage – but not on how the cheapness of the equity relates to the cash position on the balance sheet," Blaabjerg observes.

He uses US golf clothing manufacturer Perry Ellis as an example of the opportunities that get missed by that kind of pure-credit analysis. Because it is a cyclical business and its interest-coverage ratio is about half that of the benchmark average, it is saddled with a B- rating. But even after making a number of acquisitions, the firm's net debt-to-equity remains stable at about one-fifth of the benchmark average level. "Regarding refinancing risk, they have not drawn from existing credit lines and have cash on the balance sheet," says Blaabjerg. "You can be low-rated because you have a bad balance sheet – or you can be low-rated just because you are small."

Perry Ellis is only 2% of the size of the average firm in the benchmark and, moreover, its equity is cheap – its P/B ratio is about one-seventh that of the benchmark. If you believe that value is a factor in credit spreads and pays during an economic recovery, that is an unequivocal buy. And even if you don't, the prospect of Perry Ellis itself becoming a target for acquisition is attractive, because a change-of-control covenant on its bonds make them puttable at 101 cents on the dollar. In mid- December its 2013 bond was ►

◄ yielding roughly 10% and trading at 98 cents.

But just as equity managers talk of the 'value trap', so too does Blaabjerg: "Don't invest with the lowest P/Bs unless they also have low net debt-to-equity," he warns, "because low P/B can be a distress indicator."

Norway's Sevan Marine is his textbook example of a low P/B (currently 0.45-times) backed up by assets with keen loan-to-value metrics. Considerable refinancing risk has been addressed somewhat by an equity issuance. But more importantly, the 2011 bonds Blaabjerg bought come with a first priority pledge on a successful North Sea oil rig in the event of default. This rig was constructed in 2004 at a cost of $140m (the value of the debt locked-in on the bonds), but is now conservatively valued at $250-300m. "It would be expensive if we did end up owning this rig," Blaabjerg concedes, "but even if it costs $20m to hire the lawyers to take care of it, that puts us well in excess of the $140m we'd need to get par on our bond."

So why is the average bond price 86 cents and the yield on the portfolio 13.5%? Because it is offbenchmark and non-rated. Going off-benchmark is not that unusual among high-yield managers, of course; but it might be argued that this equity-style size-and-value strategy is best suited to identifying the choicest of these peripheral opportunities – particularly as those factors begin to pay off as the economy recovers.

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