Tortoise QuickTake Credit Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, senior members of Tortoise provide a timely update on trending topics in the market.

Welcome to the weekly Tortoise credit podcast. I'm Greg Haendel, Senior Portfolio Manager at Tortoise. Living in Southern California for more than a decade I can't tell you how many times I've heard the weatherman say, "The forecast today calls for sunshine and 70 degrees." Albert Hammond even wrote a song entitled "It Never Rains in Southern California." If you listen to the lyrics of Hammond's song long enough or listen to the weatherman for long enough we can hear that it eventually pours in Southern California. For investment grade corporate bond market fundamentals, while it is still sunny and 70 degrees, there are clouds on the horizon and the forecast calls for a storm of fallen angels over the coming years.

For those not familiar with some of the slick bond market lingo, a fallen angel is a bond that had an investment grade credit rating, defined as BBB- or better, and has since been downgraded to high yield, defined as BB+ or lower, due to weakening financial conditions or overleverage of the issuer's balance sheet. In today's podcast we will discuss this increase in leverage within investment grade corporate credit, identify some of the industries that could be most at risk of having fallen angels, and explore some companies that are pushing the leverage envelope.

Post the financial crisis, corporate America has been on a borrowing binge increasing debt from a little over $2 trillion pre-crisis to roughly $6.5 trillion today with almost $5 trillion of that corporate debt rated investment grade and 50% of that or roughly $2.5 trillion rated BBB. To further put these numbers into historical context, in February 2007, 38% of investment grade debt was rated BBB, in February 1997 only 28% was rated BBB, while today roughly 50% is rated BBB. A number of factors have caused this borrowing binge over the last decade including easing borrowing conditions, lower borrowing costs as a result of declining interest rates, as well as aggressive corporate share buyback activity and increasing M&A. As a result, non-financial investment grade gross leverage is near a post-crisis high of almost 3 times (meaning total debt is 3 times as much as annual EBITDA, or essentially operating income) while excluding commodity-related companies, gross leverage is at a post-crisis high. In fact, there are few time periods when non-financial investment grade leverage has been higher, notably the 2001 and 2002 time period around the telecom and utility debacle. However, leverage must be examined in the context of a company's ability to pay their interest payments on their debt and as such declining interest rates and borrowing costs over the past decade should allow for higher amounts of debt all else equal. Unfortunately, debt and interest expense has grown at a faster pace than the decline in borrowing costs and as such, interest coverage in investment grade credit remains near its lowest level post-crisis at nearly 11 times. In fairness, this interest coverage is still much better than that experienced in the 1980's and 1990's given interest rates were much higher at that time.

While this increase in leverage and increase in the percentage of BBB rated companies can be alarming, not all BBB rated bonds are created or rated equally. The increase in leverage over the last several years has been driven primarily by M&A activity, has been hiding primarily within non-cyclical industries and has been most pervasive in healthcare, food and beverage, telecom, media, cable, and technology. While some of this increased leverage is less worrisome, such as the leverage increase in technology companies moving from less than 2 times to slightly higher than 2 times leverage on average, there are other industries where 4 to 5 times leverage or even more has become the norm as a result of M&A. In fact, roughly 14% of non-financial investment grade debt is leveraged more than 5 times and 9% is leveraged between 4 and 5 times, a combined increase of almost 10% over the last several years. A large amount of the increase in 4+ times leveraged companies is occurring within the food and beverage, cable and media industries.

When I was a credit analyst more than a decade ago, there were very few companies I looked at that had leverage over 4 times, let alone 5 times, that were not classified as high yield and rated BB or lower. Today, several companies are engaged in M&A whereby they are pushing the envelope of leverage and receiving an investment grade rating by either promising

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significant leverage reductions in the years ahead, significant expense or revenue synergies as a result of M&A, or securing a portion of their debt ahead of other unsecured debt holders.

A couple of noteworthy examples within the food & beverage industry include General Mills, Bacardi and Keurig. General Mills recently increased its leverage to roughly 4.5 times due to their acquisition of Blue Buffalo pet food. Bacardi recently increased its leverage to roughly 5 times in order to buy the remaining portion of Patron tequila it didn't already own. Taking the cake within food & beverage, no pun intended, is Keurig Green Mountain and its pending purchase of the majority of Dr. Pepper Snapple Group which in turn will bring leverage to almost 5.9 times before accounting for synergies. While all of these companies have anticipated significant synergies and have promised rapid deleveraging, any corporate misstep, unforeseen competition, or macro-economic downturn or shock could derail their lofty deleveraging plans which in most cases have virtually zero margin for error. For example, a lack of innovation by General Mills or Amazon's planned move into pet food could create problems for General Mills. For Bacardi, the fickle tastes by consumers and rising popularity of alternative tequila brands, such as Casamigos, may make rapid deleveraging challenging.

Other noteworthy examples within cable and media include Charter Communications, Discovery Communications, and Comcast. Charter, which was already a high yield company, purchased Time Warner Cable in 2016 resulting in total leverage of 4.5 times although to achieve an investment grade rating on some debt, portions of the new debt financing as well as legacy Time Warner Cable debt was secured, thereby resulting in 3.5 times secured leverage and 4.5 times total leverage. Discovery Communications recently closed on their acquisition of Scripps Networks resulting in leverage of roughly 4.5 times with an aggressive yet achievable target of 3.5 times leverage in the near term. Last but not least, Comcast is allegedly preparing a $60 billion all cash bid for Fox, which if the deal is accepted and approved would increase Comcast leverage from roughly 2 times to almost 4 times.

While a recession is not in our forecast in the near term, the credit cycle is in its final innings as is evidenced by both the length of this cycle as well as corporate leveraging activity. Further, we continue to forecast increasing borrowing costs as a result of rising interest rates and foresee continued fierce competition in several industries due to disruptors such as Amazon. Adding fuel to the fire, approximately 2/3rds of outstanding corporate debt must be refinanced in the next five years with the lions share rated investment grade and a significant portion concentrated within bonds rated BBB. Some of the companies pushing the BBB rated leverage threshold will be successful in their efforts to deleverage although many will not thereby creating a storm of fallen angels in the future. At Tortoise we believe that active fixed income management, strong fundamental analysis, and sound industry and issuer selection can help weather the coming storm as not all BBB's are created equal.

Thank you for listening, we'll talk to you again next week.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseadvisors.com.

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