XAIA INVESTMENT
Quarterly Letter
2024|01

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Higher rates bring credit raiders to Europe

After a multi-year break, XAIA is finally back with a quarterly letter.
XAIA portfolio managers Philipp Graxenberger and Josef Pschorn share their perspective on global credit markets. Both mainly focus on market neutral strategies, always looking for exploitable price asymmetries. The format and length of this letter will vary over time. We highly appreciate any form of feedback from our readers and we are more than happy to engage in personal discussions.
In our first quarterly letter, we elaborate on the status quo in the credit market. We also delve into the impact of higher interest rates on highly levered capital structures.
Finally, we look at where we currently see price anomalies and how dispersion in the credit market will continue to provide idiosyncratic investment opportunities.

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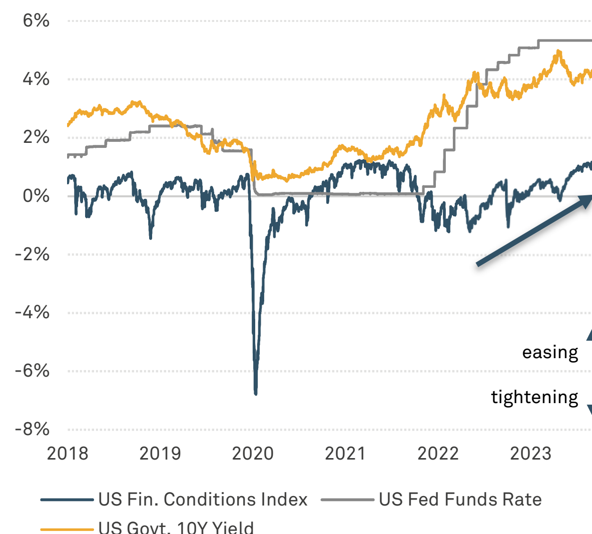
Higher for longer, but spreads keep grinding tighter

The global interest rate hiking cycle and the tightening of financial conditions over the course of 2022 led to a sharp repricing of risk assets as well as government bonds. As interest rate volatility increased, credit spreads widened sharply. Investor sentiment deteriorated, the secondary market turned sour and new bond issuance vanished temporarily.
The market turned a corner over the course of 2023. Since then, equities and credit have enjoyed a fantastic winning streak, with European and US equity indices hitting new highs, and credit spreads tightened significantly.
Surprisingly, even the Fed’s commitment to "higher for longer" did not stop the ongoing rally.
While interest rates have remained at historically elevated levels, financial conditions have eased materially since risk assets bottomed out in Q4 2022.
Financial conditions loosened, despite optically tight monetary policy. US equity market returns were largely driven by Big Tech, which explains the outperformance of market-cap-weighted indices over equal-weighted indices. Gold and bitcoin also hit new all-time highs and we have seen positive momentum in commodities recently.

CHART 1: FINANCIAL CONDITIONS EASY DESPITE HIGHER INTEREST RATES
Relationship between interest rates and financial conditions



Source: Bloomberg, XAIA Investment GmbH

In the credit market, we have seen spreads tighten, refinancing activity pick up and secondary trading volumes increase. Lower interest rate volatility and easing financial conditions supported the asset class as a whole, despite relatively high interest rate levels. In addition, corporate bonds were supported by strong inflows into the asset class.
While overall credit spread levels have tightened significantly, we are seeing increasing dispersion in the credit

market. Despite the low level of spread volatility, restructurings are picking up, especially in the European high yield market. Finally, the current interest rate environment seems to become problematic for a rising number of companies.

Interest rate induced corporate dichotomy

Contrary to the popular belief, companies have become more financially prudent since the GFC (global financial crisis). The average ratio of debt to total capital for the Russell 3000 is lower in the easy money era (2009-2021) than in the pre-GFC era[1]. It is important to note that Mauboussin's paper only looks at public stock market indices. These are increasingly dominated by large, debt-free companies. In addition, the ZIRP era has led to an increase in debt-financed, take-private transactions, increasing the overall share of leveraged finance in the system. The lower yields and hence return on assets fell, the more leverage was needed to generate meaningful returns on equity.
The rise in interest rates has had little impact on large companies due to their termed-out debt profile and large cash holdings. In contrast, the whole subset of leveraged assets is more exposed to the impact of higher interest rates. We have identified four adverse developments from higher interest rates, which we discuss in more detail in the next section:

>> Higher cost of capital reduces asset values
>> Margins are (partly) driven by interest rates
>> Overlevered capital structures need to be rightsized
>> Certain industries/companies struggle in a higher interest rate environment

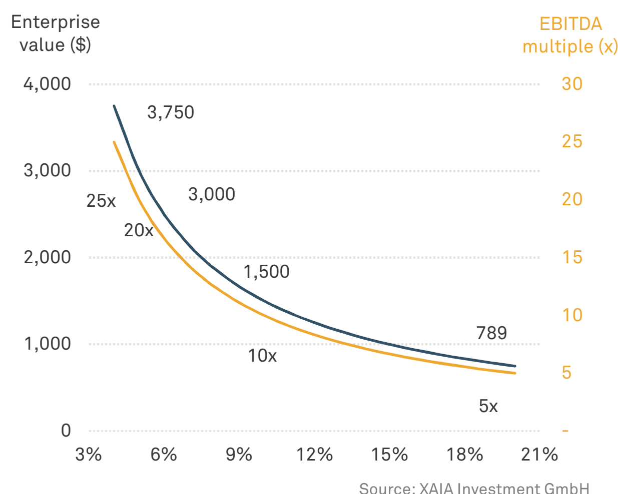
Our analysis in this paper applies to all companies, but is particularly relevant for leveraged companies.

HIGHER COST OF CAPITAL REDUCES ASSET VALUES

Higher yields and thus higher required returns should significantly reduce asset values. In a simple asset pricing model, higher borrowing rates increase the cost of capital and simultaneously require higher returns on equity (equity risk premium).
We provide a very simple example to illustrate the impact of interest rates and the cost of capital using the constant growth valuation model (EBITDA / (Cost of capital – growth rate)). For simplicity, we assume an EBITDA of €150 million and a growth rate of 0%. Using a cost of capital of 4% (a realistic assumption for a prime asset in a zero interest rate environment), we arrive at a valuation of €3,750 (€150 / (4%-0%)). If the cost of capital doubles, the value of the company halves, all other things being equal. The EBITDA multiple is also halved.

CHART 2: CONVEXITY AT PLAY

Relationship between CoC (x-axis) and valuations (y-axis)



Source: XAIA Investment GmbH

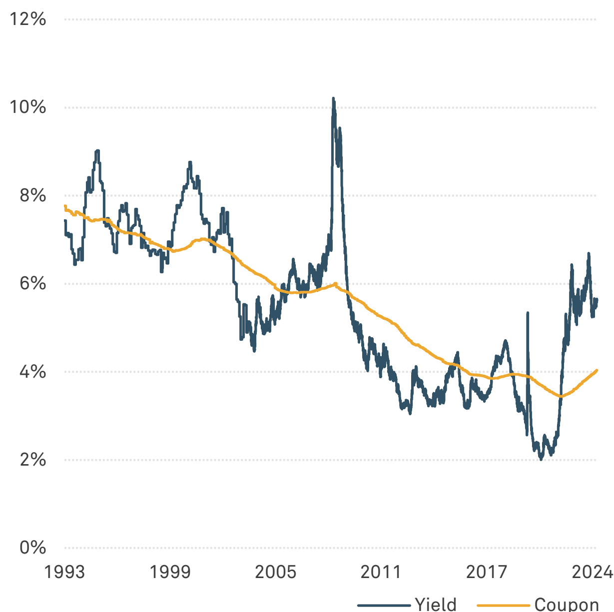
CHART 2 illustrates the inverse relationship between the cost of capital and valuations/multiples.
The decline in valuations is more pronounced when the starting cost of capital is low.

MARGINS ARE (PARTLY) DRIVEN BY INTEREST RATES

Over the past 40 years, refinancing costs have been an important driver of profit margins. This is particularly true for companies with higher levels of debt. One of the most important transmission channels for monetary policy is through the balance sheets of non-financial corporations. Lowering/increasing policy rates have an immediate impact on holders of floating-rate debt and, with a lag, on borrowers refinancing fixed-rate debt. An increase in the cost of borrowing reduces profitability and leads to a reduction in firms' willingness to borrow and invest. In addition, firms may try to offset higher costs by reducing hiring or even laying off workers.
Since the early 1980s, interest rates and hence borrowing costs have fallen. According to a 2023 paper by Bräuning, Joaquim, Stein[2], the aggregate interest expense ratio (interest expenses/sum of total debt) in the US has fallen steadily from 6.3% in 1996 to 3.7% in 2022.

1 https://www.morganstanley.com/im/publication/insights/articles/article_costofcapitalandcapitalallocation.pdf?1713259815667
2 https://www.bostonfed.org/publications/current-policy-perspectives/2023/interest-expenses-coverage-ratio-and-firm-distress.aspx

CHART 3: HIGHER COUPONS ON NEW ISSUES WILL INCREASE BORROWING COSTS
Average coupons and average yields for US BBBs



Source: Bloomberg, XAIA Investment GmbH

Historically, coupons, ~ cost of debt, lag the observed yield on their outstanding bonds. CHART 3 shows how the resetting of coupons going forward could reprice the cost of funding for companies.
We need to remember that when refinancing costs are falling, (i) the value of the asset is increasing and (ii) the cash flow profile is improving. Going forward, these two trends will reverse. This will have an impact on future capital allocation decisions. Historically, FCF has been used primarily for dividends, whereas now debt reduction will be a much higher priority for prudent companies going forward, which is a credit-positive and negative for equities.

CHALLENGED BUSINESS MODELS IN A HIGHER RATES ENVIRONMENT

The first popular victim of the rate-hike cycle, the Silicon Valley Bank (SVB), did exactly what you would expect a well-tamed bank to do: Borrow short, lend long, and when there's no one to lend to, invest in government and agency bonds. While SVB was very aggressive in its risk management, a 2023 paper finds that the market value of total assets for US banks declined by 10% during the hiking cycle. The 10% figure does not include credit losses. That is why banks in the US are not merging, despite all government efforts. If the book value of the target bank's equity is negative, why should the acquirer pay a positive market value for it? They would end up recapitalizing the acquired bank and be subject to additional capital requirements. The New York Community Bancorp case shows that even at low valuations, asset acquisitions can be a burden on a previously viable institution. After SVB, Signature bank and First Republic failed and were assumed by the FDIC, buyers of the assets emerged. The suburban New York-based institution acquired most of Signature bank's deposits and just over a third of its assets including nearly $13bn in loans, in a deal arranged by the Federal Deposit Insurance Corp.
The regional bank lost $260 million in the final three months of 2023, compared with a profit of $164 million in the same quarter a year earlier. The bank blamed in particular an increase in expected loan losses. Many of these were on loans tied to office buildings. In addition, the bank had to cut its dividend to comply with banking regulations as a result of the takeover, which pushed the bank's assets over $100bn and brought it under stricter capital requirements.
The higher funding rate environment hits all borrowers who have not matched their income stream with their funding cost stream. Financial companies with unhedged balance sheets suffer from rising borrowing costs, while not all of their asset base benefits from higher base rates. In particular, companies whose assets have fixed coupons, such as debt collectors, are suffering from higher funding costs. Similarly, companies that have relied on low-cost funding, such as healthcare providers or telecom companies, are seeing cash flows evaporate and balance sheets become more stretched.

OVERLEVERED CAPITAL STRUCTURES NEED TO BE RIGHT SIZED

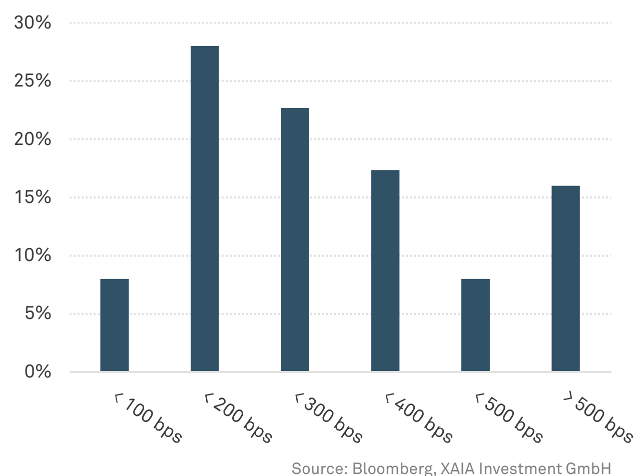
In the first two sections, we have shown, that leveraged companies with no growth should see (i) asset values fall and (ii) profit margins fall. This is particularly true for assets with low initial returns or, in other words, high valuations. The more certain the cash flows, the more important the discount rates are in valuing the asset. Put differently, the valuation of an office building, leased out for 20 years to a government agency relies more on interest rates / discount rates than a distressed turnaround or a biotech name.
Let's look at the impact of higher financing costs with a simple CRE example. A hypothetical CRE (commercial real estate) asset generates $100 million of net operating income (NOI) per year. Using a cap rate of 4%, the asset value is $2.5 billion. Increasing the cap rate from 4% to, say, 8%, which is still below the cost of debt (5.3% SOFR + 300bps credit spread = 8.3%), results in a 50% reduction in asset value. If the property was financed with 50% debt, which was and is conservative, the equity holders are wiped out and the losses for the debt holders start to bite.
From a risk-return perspective, providing debt financing at current valuations, low LTVs and 8.3% looks attractive. In contrast, equity investors enjoy lower returns than debt investors from a cash-on-cash yield perspective and must hope for lower policy rates and higher future valuations. Investors are facing negative leverage for the first time in their careers. Negative leverage is described as a situation where returns fall when leverage is added. This happens when the cost of debt exceeds the returns generated by cash flows. Refinancing transactions in 2024 tend to be these negative leverage events, where the mere act of rolling over debt pushes

up leverage. Buying at valuations that are lower but still too high may prove very costly in a higher-for-longer environment.
In light of the above, it does not seem far-fetched that Fortress CEO Pack has claimed to have bought performing loans at discounts of 31% - 60% to their face value[3]. The example above used a low starting cap rate, but also did not take into account the uncertainty around CRE (mainly office). The understandable reluctance to sell loans at a discount helps explain the wave of A&E (Amend and Extend) transactions in the US CRE space. Despite all the negativity surrounding the asset class, we recognize the tremendous opportunities, such as repositioning/remodeling assets or buying assets below replacement cost and/or at land value. However, unless interest rates fall again, this type of investment will require low purchase prices and/or a long-term time horizon. We have used a CRE example, but the principles apply to virtually any asset with high leverage and low growth. Assets whose cash flows do not match rising financing costs will need to reduce gross leverage in the new environment.

The current state of public credit markets

Despite the problems outlined above, credit indices such as the Itraxx Crossover are currently trading at historically tight levels. A closer look reveals that the majority of credits are trading at a spread of 300bp or less. Despite the dominance of tight credits, there is also a meaningful part of the market trading wider than 500bp. This highlights that there is underlying stress for some companies.

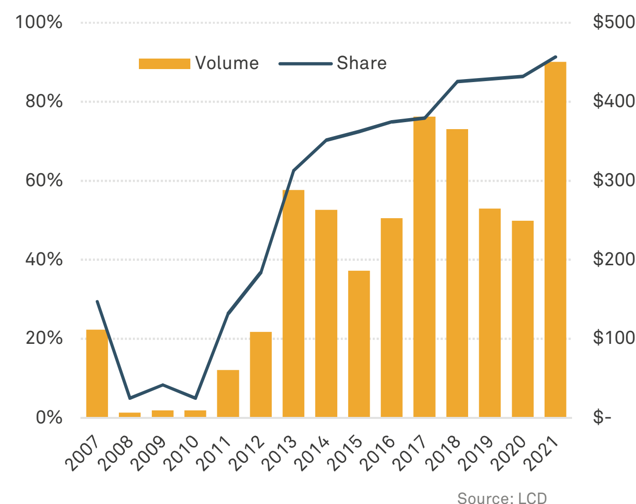
CHART 4: DISPERSION IN EUROP. CREDIT MARKET
Itraxx Crossover spread distribution



Source: Bloomberg, XAIA Investment GmbH

While we see a benign default environment in public high yield, anecdotal evidence tells a different story. Houlihan Lokey's Hardie points to an elevated level of out-of-court restructurings, particularly for private companies in the US[4]. As the name suggests, out-of-court restructurings take place largely outside the public eye, with debtors and creditors reaching an amicable agreement to modify their liabilities.
While out-of-court restructurings have been widely used in the US, the recent case of Ardagh Packaging brings creditor on creditor violence to Europe. Ardagh is overleveraged in the current interest rate environment and requires funds to repay/refinance its 2025 maturity. Apollo provides a new senior secured credit facility to its wholly-owned subsidiary, Ardagh Investments Holdings Sarl (AIHS). Apollo secures a lien on the previously unencumbered assets (equity interest in AMBP US) and even has the ability to swap further subordinated debt at Apollo's purchase levels. The deal, which effectively bypasses existing creditors, is the kind of aggressive liability management that has become common in the US but remains relatively rare in Europe. These so-called "drop-down" (moving assets into an "unrestricted subsidiary") and "up-tier" (raising one's position in the rank structure) deals are the most aggressive moves we have seen in Europe to date.
If interest rates remain high, investors and various creditor groups will struggle to recover their investments. Investors without the necessary resources seem to be ill-equipped to combat LMEs (liability management exercise). A main driver for the occurrence of creditor-on-creditor violence is the weakening of covenants, which protect creditors' interests.

CHART 5: COVENANTS HAVE WEAKENED SUBSTANTIALLY
US Covenant-lite new issue volume and share



Source: LCD

The proliferation of covenant-lite documentation allows aggressive market participants to improve their position in the capital structure. These credit raiders often position themselves ahead of other creditors in the first round of stress. In a distressed-debt exchange, some creditors exchange their existing debt for higher-ranking instruments, thereby improving their position in a potential future default. If the company does not turn

3 https://news.bloomberglaw.com/private-equity/fortress-co-ceo-sees-cre-stress-leading-to-more-bank-failures
4 https://www.bloomberg.com/news/audio/2024-03-09/houlihan-lokey-s-hardie-on-yet-to-crest-wave-of-distressed-debt

around and has to restructure, the existing creditors face lower recoveries on their positions. Primed creditors fare worse in this second restructuring than in a restructuring during the first wave of stress. The beneficiaries are financial institutions, such as Apollo, that can amass large enough positions to dominate creditor discussions and have the legal capacity to implement these deals. When defaults do occur, recoveries tend to be lower than in previous cycles.
This is particularly true for unsecured/junior parts of the capital structure. Even secured creditors face lower recoveries going forward. S&P Global expects recoveries for European secured debt to hover around 59%, 15 percentage points below the long-term average[5]. This is due to a higher prevalence of top-heavy capital structures (more secured debt relative to unsecured debt), covenant-lite documentation and the aforementioned higher number of distressed debt exchanges.

Investment opportunities in the current environment

The beauty of market neutral strategies is that they are independent of the direction of credit spreads. That's why we focus on identifying price anomalies and uncorrelated trades with attractive risk/return profiles. Building a portfolio of uncorrelated trades allows us to reduce overall drawdown risk.
The current environment offers an attractive set of opportunities despite overall tight spreads. Looking under the hood of the credit markets, we see three main opportunities:

NEGATIVE BASIS ON SENIOR BANK BONDS

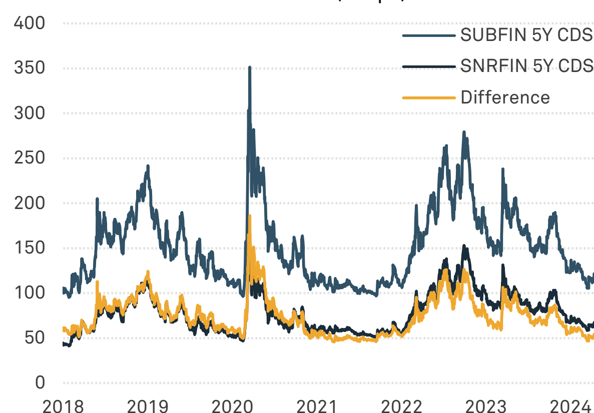
For many European banks, some USD senior unsecured bonds are still cheap on the bond curve, yielding significantly more than EUR issues. After hedging the FX risk, we end up with an attractive bond-CDS basis. Negative basis offers attractive carry income. While we have already seen some basis repricing in recent weeks, there are still mispricings and opportunities to be exploited.

SUBORDINATED BANK BONDS TRADE HISTORICALLY TIGHT COMPARED TO SENIOR BONDS

In the strong market environment of recent months, credit spreads for European banks have tightened significantly. The spread differential between senior and subordinated debt is trading at very compressed levels. Therefore, it is quite cheap to build decompression trades on European banks with single name CDS. In addition, we can hedge the cheap USD senior bonds (the same bonds as the negative basis trades) with CDS referencing subordinated debt. With minimal or no negative carry, these positions offer cheap optionality that pays off in the event of a market correction or repricing of the senior sub differential.

CHART 6: FINANCIALS SPREADS HISTORICALLY TIGHT

Difference Sr/Sub Financials CDS (in bps)



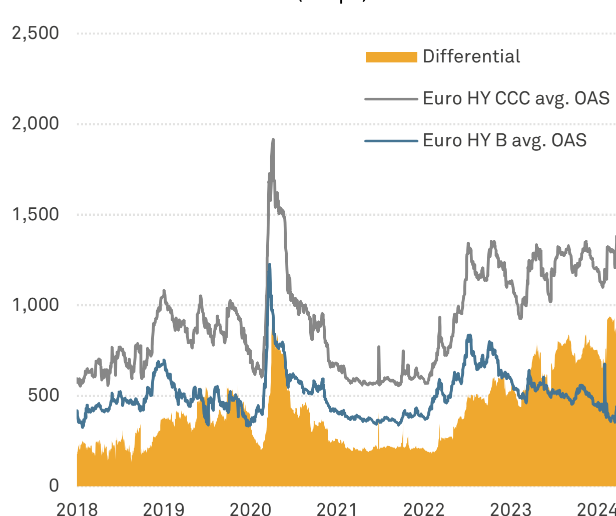
Source: Bloomberg, XAIA Investment GmbH

RESTRUCTURINGS IN EUROPEAN HIGH YIELD

Despite subdued growth, credit spreads have compressed significantly. The difference between BBBs vs. BBs in euro is close to the ~20 year tights. The only outliers are CCCs. Historically, CCCs have outperformed in the late cycle of the credit market. However, the negative factors induced by higher interest rates keep the differential elevated. In the absence of a significant change in the interest rate environment, we see little reason for this to reverse.

CHART 7: CCCS HISTORICALLY WIDE – FOR A REASON?

Difference Euro Bs und CCCs (in bps)



Source: Bloomberg, XAIA Investment GmbH

As a result, we have seen an increase in restructuring activity in the European HY market and greater volatility in the distressed credit space. Large price swings in single-name credits offer attractive opportunities. Despite rising restructuring risk, credit curves are often quite steep, understating near-term default risk. Front-end CDS protection on distressed issuers, offers high re-

5 https://www.spglobal.com/ratings/en/research/articles/231116-european-secured-debt-recovery-expectations-q3-2023-update-recovery-prospects-stable-as-issuance-slows-12911571

turns in the event of a credit event. Bond-CDS basis positions on distressed names, which benefit in the event of a default, were a focus over the last quarter.

Exciting times ahead

Given the fundamental backdrop, we expect a continued high level of idiosyncratic situations in the stressed credit markets. Creative but aggressive solutions for distressed credits appear to be becoming the norm rather than the exception in European credit markets.

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