NEWPERSPECTIVES

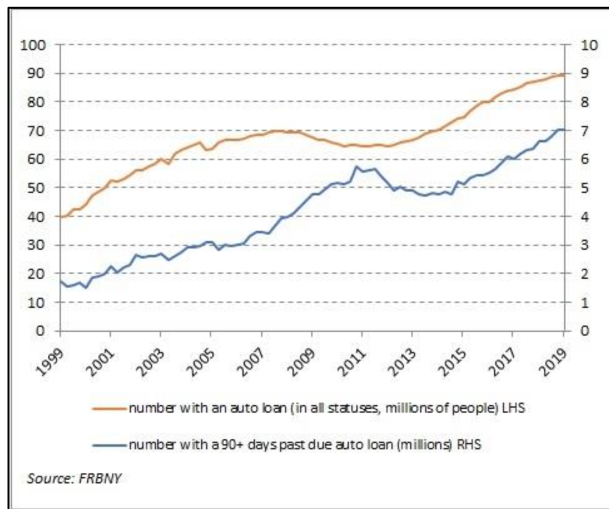
Commentary from New Century Advisors - March 2019

NCA Market Notes

- **Debunking The Auto Delinquency Myth**
- **Index Deep Dive – How Changing Sector Composition is Driving Sector Performance**
- **Goodwill Hunting – M&A Chickens Coming Home to Roost**

Rising Delinquencies in Auto Loans Are Not a Precursor to the Next Financial Crisis

Subprime auto loans and securitizations have been under the microscope recently after several misleading stories in the financial press stated that rising auto delinquencies pose a risk to ABS investors and could turn the credit cycle, and maybe even threaten the stability of the US financial system, just like subprime mortgages did in the run up to the financial crisis.



This comes after the 4Q 2018 Household Debt and Credit report by The Federal Reserve Bank of New York (FRBNY) showed that nearly 7 million borrowers were 90 or more days delinquent on their car payments, approximately 1 million more than when delinquency rates were the highest during the financial crisis.

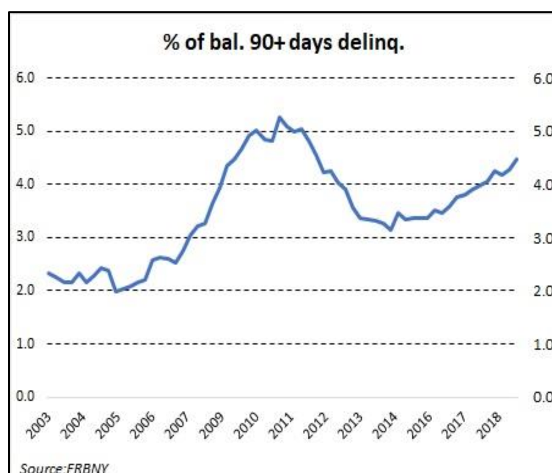
Although we agree it is important to monitor the trend level of auto delinquencies, we disagree with the narrative that this is a red flag for a turn in the credit cycle, or that delinquent auto loans in securitizations could pose a risk to financial system stability. We attempt to debunk some of these narratives in this piece.

First, there is substantial seasonality in auto credit data

Auto credit data is seasonal; delinquencies and net losses generally tick up in Q4 as back to school, Thanksgiving and Christmas related expenses crowd out the auto loan payment for the average American. Delinquencies trend down through the first quarter of the following year, especially around the time of tax refunds. As a result, highlighting a Q4 data point can be misleading and creates a sense that credit conditions are worse that they really are.

Second, the amount of auto debt outstanding is less than subprime mortgage debt pre-crisis, and only a fraction is ABS-funded

In 3Q 2018, auto loans outstanding were $1.25 trillion and only 13% of this amount was financed in the ABS market (securitizations). Subprime auto loans were $285 billion (13% of total), and only 18% ($51.5 billion) of that was funded in the ABS market. In comparison, at its peak in 2007, the amount of total subprime mortgage debt outstanding was $1.3 trillion, with most of it funded in the securitized market.



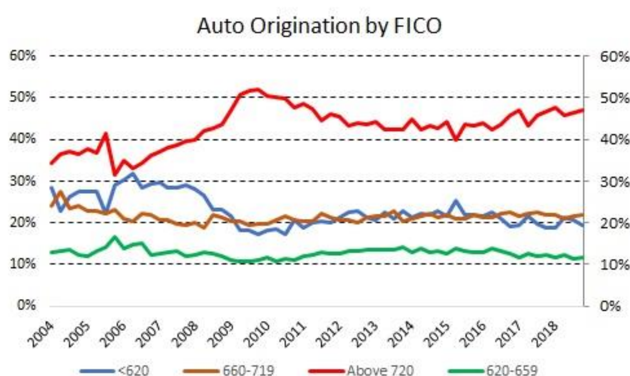
Source:FRBNY

Third, based on percentage of balance, 90+ days delinquent auto loans are lower than they were at the peak of the financial crisis

As of 4Q 2018, the percentage of 90+ days delinquent loans was 4.47%. This is lower than 5.3%, the peak level in late 2010. The 90+ days delinquency rate and the roll rate into the 90+ days delinquent bucket have been rising moderately, but both are in line with the expansion in credit availability.

Finally, the average quality of auto loans outstanding has been improving and is even better than it was pre-crisis

In recent years, the percentage of originations to borrowers with high credit scores has been increasing, causing a positive quality shift in the outstanding pool of auto loans. As of 4Q 2018, 47% of auto loans originated were to borrowers with FICO scores above 720. In contrast, originations to the same category were only 40% in 4Q 2007. Meanwhile, the percentage of total auto loans outstanding originated to borrowers with FICO scores below 620 has fallen to 19% versus 29% in 4Q 2007. It looks like originators and securitizers may have learned something from past experience



Source: New York Fed Consumer Credit Panel/Equifax

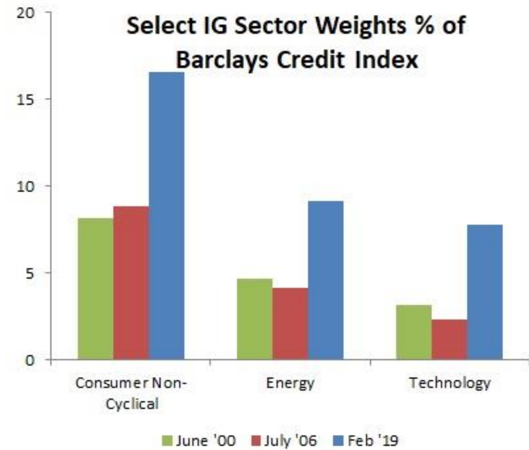
Auto Credit Outstanding by Holder as of 3Q-2018

Lender/Holder	Total ($, bn)	% of total	Est. % in subprime
Auto Finance Cos.	150	12%	50%
Mfg Captives	281	23%	19%
Credit Unions	340	27%	14%
Banks	474	38%	39%
Total Loan Amount	1,245	100%	23%
ABS Market Funded		13%	18%

Source: FRBNY, Wells Fargo Securities

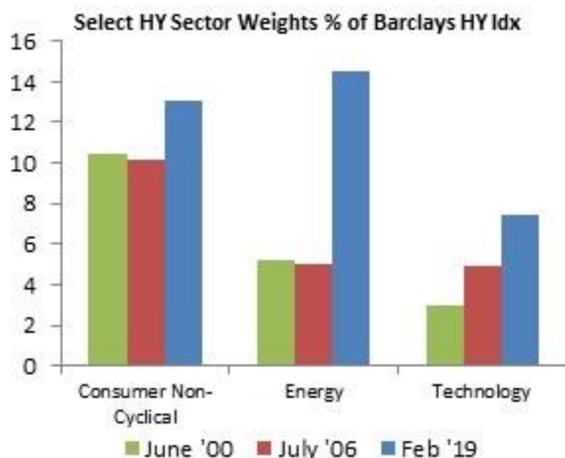
US Corporate Credit Indices Display Different Risk Factor Bias than Previous Late Cycles Due to Sector Composition

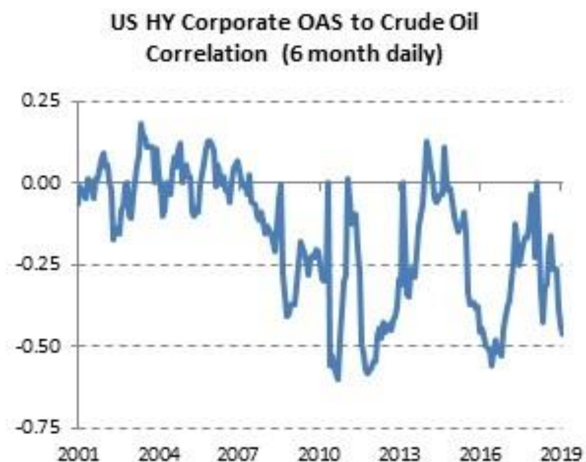
The US corporate credit sector composition looks fairly different than previous Fed hiking cycles ending July 2006 and June 2000. Market share in consumer non-cyclical (specifically healthcare and pharmaceuticals), energy, and technology sectors has increased significantly since the financial crisis as they fill the void of investment grade financials (-10% market share since 2006), communications (IG wirelines -5% and HY wirelines -18.5% market share since 2000), and high yield automotive (-12% market share since 2006). Changes in the index risk profile favor energy prices, healthcare policy, and the technology sector due to the increase in contribution to duration and market weight of these sectors, in our view.



1) The US energy revolution imposes a volatile presence on credit index performance

Corporate credit index spreads have demonstrated a greater inverse correlation to energy prices compared to the previous two cycles (HY OAS average correlation -0.28 vs -0.04 from 2000-2008) as the energy sector increased index market share. Energy comprises ~9% of the investment grade index vs. ~4% prior to the financial crisis and ~14.5% of the high yield index vs. ~5% prior to the financial crisis. The debt-financed US shale boom has contributed to a high yield energy market share of almost triple historical levels which will need to be continually refinanced. Although credit metrics look healthier following the 2016 commodity crisis, the current energy sector debt level translates to an elevated risk exposure to energy prices in corporate credit indices. Late cycle commodity dynamics will prove to be a more prominent factor in corporate credit index performance going forward.





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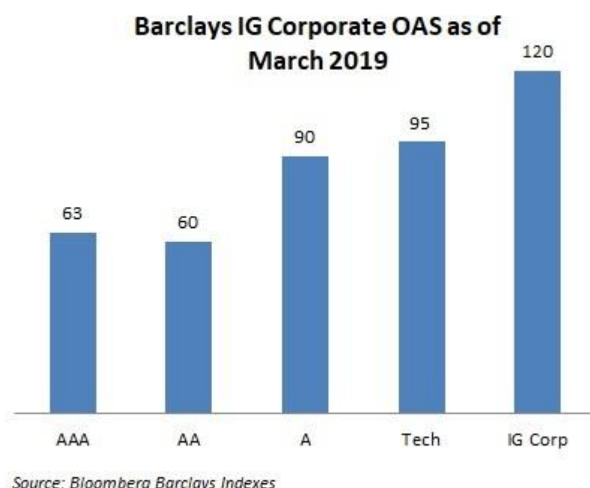
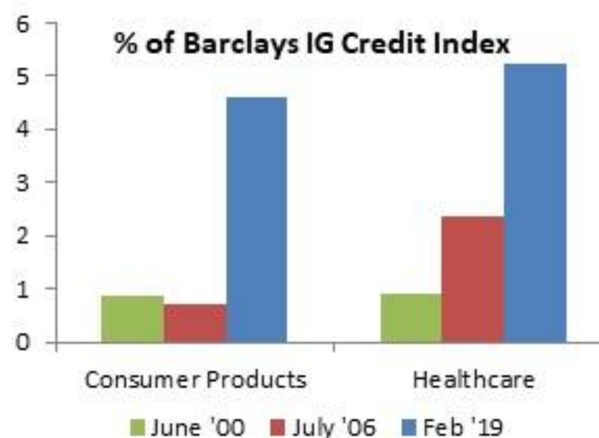


Source: Bloomberg Barclays Indexes

2) Healthcare M&A debt issuance is supported by less cyclical revenues but sector is threatened by policy disruptions

Healthcare policy could have a larger impact on corporate credit indices than in past cycles as healthcare and pharmaceutical sector debt constitutes almost 10% of US investment grade corporate credit compared to just over 3% in 2006 and ~9% of the high yield index vs. ~5% in 2006. These sectors have recently found themselves in the policy cross hairs due to the Republican Party's negative stance on the affordable care act and bipartisan disapproval of elevated drug prices. This is concerning given the elevated debt levels. Sector leverage appears to have peaked in the near term but the upward trend remains intact as healthcare companies increasingly attempt to find synergy by consolidation (CVS/Aetna & Cigna/Express Scripts ~$70bn debt funded deals) and pharmaceuticals fill the fundamental need to strengthen drug pipelines (Bristol-Myers/Celgene ~74bn debt funded deal). Growth has come at a steep price given recent market multiples and frequency of M&A in these sectors. If changes are not materially negative or do not materialize, however, in a late cycle environment, the insurance and tax dollar-funded debt burdens in healthcare/pharmaceuticals tend to fare better than lower margin and cyclical sectors as they enjoy stable revenue streams in lower economic growth environments.



Source: Bloomberg Barclays Indexes

3) Clean balance sheets outweigh late cycle growth fluctuations in the technology sector

The rise in technology sector debt share poses a limited increase in credit risk as this cash-rich sector maintains solid debt metrics (~-21% net debt/EBITDA as of 4Q18) despite a high exposure to economic growth rates. Spread levels may limit further outperformance but the sector should outperform in a risk-off environment, as seen in the 2018 flight to quality (Technology -2.33% ER vs. Corporate -3.15% ER). Like healthcare, M&A has been the main source of issuance. Tech sector debt represents almost 8% of the investment grade index compared to just over 2% in 2006.

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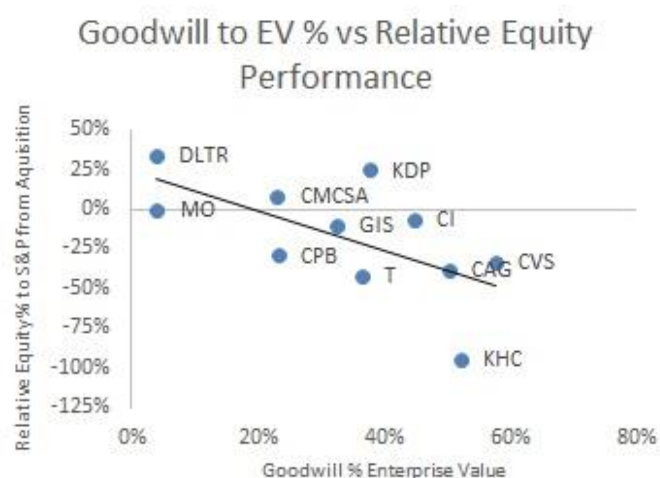
Goodwill Hunting

The recent admission by Warren Buffet that he overpaid for Kraft should give investors pause and provide a window to the longer-term impact of overpaying for acquisitions, especially when financed with too much debt. In 2015, Warren Buffet's Berkshire Hathaway and private equity firm 3G Capital partnered to acquire a majority stake in Kraft through a debt-funded merger with H.J Heinz, making it one of the world's largest consumer branded food companies.

Almost 4 years later, it seems the full price of the transaction, then valued at approximately 24x EBITDA, still reverberates. In its most recent quarterly earnings, Kraft announced a disappointing $15.4 billion dollar write-down of intangible assets including part of the goodwill premium that Buffett paid above book value. This news pushed the stock price down 30% and widened Kraft's credit spreads 10-15 basis points on approximately $31 billion in Baa3 rated debt. S&P and Moody's responded by revising their outlook down, despite a 36% dividend cut and the acknowledgment by Buffett that Kraft now needs to focus on reducing debt through asset sales.



Source: Bloomberg

Kraft now joins a growing list companies having to appease rating agencies with promises to pay down debt and a 'commitment' to maintain their IG ratings. This is typically a siren song for yield-hungry credit investors, especially when it comes from deep-pocketed equity investors such as Warren Buffet. However, the increasing number of large, over-levered companies now singing a de-leveraging tune is notable and a systemic risk worth monitoring.

A simple screen of recent M&A transactions shows the lofty multiples that companies have paid for acquisitions, the subsequent equity (often under-) performance versus the S&P 500 and the now elevated levels of goodwill as a percentage of enterprise values.

Ticker	Company	Target	Acquistion Multiple*	Date Completed	Goodwill to Enterprise Value	Equity Return	S&P Return	Relative Return
DLTR	Dollar Tree	Family Dollar Stores Inc	11x	7/28/2014	8%	87%	53%	34%
KHC	Kraft Heinz	Kraft Food Group	24x	3/25/2015	52%	-50%	45%	-95%
T	AT&T	Time Warner Inc	14x	10/24/2016	37%	-8%	34%	-42%
CVS	CVS	Aetna	16x	12/3/2017	58%	-27%	7%	-34%
CPB	Campbell Soup	Snyder's-Lance Inc	44x	12/18/2017	23%	-25%	5%	-29%
GIS	General Mills	Blue Buffalo Pet Products Inc	25x	2/23/2018	33%	-8%	2%	-11%
CI	Cigna	Express Scripts Holding Co	9x	3/8/2018	45%	-5%	2%	-7%
CMCSA	Comcast	Sky Ltd	19x	4/25/2018	23%	14%	6%	8%
KDP	Kuerig Dr Pepper	Keurig Green Mountain Inc	12x	6/26/2018	38%	27%	2%	25%
CAG	Conagra Brands	Pinnacle Foods Inc	18x	6/27/2018	51%	-36%	3%	-39%
MO	Atria Group	JUUL Labs Inc	8x	12/20/2018	4%	10%	12%	-2%

Source: Bloomberg

**Ebitda to Transaction Value*

For more information on any of the data, trends, or trading strategies in this piece, or to discuss how New Century Advisors might help your fixed income allocation, please contact Leigh Talbot, CFA, Director of Client Relations at 240-395-0012 and ltalbot@ncallc.com

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