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How Can Understanding Corporate Credit Improve Small to Mid Cap Equity Investing?

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Introduction: Credit Market Analysis vs Equity Market Analysis

Over 95% of publicly traded companies in the Russell 2500 Index access the credit market as well as the equity market. Equity investors study the price movements of stocks but often ignore credit market signals. We believe watching the credit market can help mitigate risk in an equity portfolio. The key difference between credit and equity investors is incentives. We feel credit investors have limited upside with unlimited downside in their investment. Equity investors have both unlimited upside and unlimited downside. The credit investor is heavily incentivized to sniff out trouble to avoid losses.

Penn Capital's Integrated Analysis

Credit Market Analysis	Equity Market Analysis
Evaluate the ability to pay back obligations	Evaluate the ability to grow business
Focus on total availability – cash and credit	Seek revenue/margin opportunities
Watch maturity wall and ability to refinance	Long term view of industry dynamics
Debt/EBITDA is key metric	Multiple metrics: P/E, P/S, EV/EBITDA
Consider obligations senior to investment	Only consider seniority in times of stress
Monitor covenants on capex, share buybacks	Evaluate management ability to reinvest
Walk EBITDA to FCF generation	Utilize favored metrics to determine growth

We believe using credit market analysis can provide downside protection for an equity investor. If the credit view of a company is deteriorating – the equity will follow. The credit market can also dictate to a company that credit market obligations have priority before shareholders. If the credit analysis provides a negative view of a company – the equity should not be considered for investment. In 2008, short term lending markets seized up causing a crisis for companies that were reliant on these markets to fund their daily operations. Lehman Brothers and other financial institutions failed primarily due to an inability to borrow in the short term – a liquidity crisis – which made the equity worthless.

Focus on Cash Flow Metrics over Accounting Profit

Credit investors focus on cash flow metrics over EPS to analyze a company. The key financial metric is ("EBITDA") earnings before interest, taxes, depreciation, and amortization, which is roughly equivalent to cash flow from operations. The credit investor's favorite metric is Debt/EBITDA which is how many years of cash flow it requires to pay off the company's debt. Penn Capital extends this metric to the Enterprise Value or "EV"/EBITDA which is how many years of cash flow is required to payoff the full value of the company. The EV/EBITDA metric is easy to calculate but requires industry knowledge to consider the proper multiple to apply to a company. Companies that have large barriers to entry, strong margins, and low cyclicality command high EV/EBITDA multiples.

A monopoly like Ticketmaster, the ticket processing company, is a great example of a high multiple business. Ticketmaster commands 80% market share, long term contracts with venues, and all concert attendees are required to pay processing fees to attend shows. The classic example of a low multiple business is the corner ice cream stand where a competitor could open across the street in a business with low margins and highly seasonal demand driven by weather.

Moving beyond the EV/EBITDA metric of a business, the investor needs to walk through the Cash Flow Statement to understand the underlying cash flow generation of a business. The key cash flow metric is Free Cash Flow ("FCF") which is the Cash Flow from Operations less Capital Expenditures. FCF is the residual cash the company generates for the shareholder after paying all bills including capital investments. Companies will prioritize the use of FCF to initially pay down debt, reinvest in their business, and finally return capital to shareholders.

Seek Companies with Strong or Growing Free Cash Flow

High quality companies trade at high EV/EBITDA multiples as a high percentage of EBITDA coverts to FCF. They enjoy high barriers to entry requiring low capital investment, consistent high margins, and modest debt service. These companies are defensive in nature and perform well during periods of economic stress. Burger King sells the rights to own a Burger King franchise, earns a fee on all products sold, and is a high FCF conversion businesses.

Low quality companies trade at low EV/EBITDA multiples as a small percentage of EBITDA converts to FCF. They are typically a capital-intensive business that has EBITDA which will be heavily offset by recurring significant capital expenditures, debt servicing costs, and cash

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income tax payments resulting in little or negative FCF. These companies can get stuck on a treadmill where reinvestment requirements more than offset cash flow generation resulting in a declining business to be avoided. Newspaper companies experienced declining sales as circulation declined, and many closed when they were unable to fund the high fixed cost of printing press plant reinvestment.

Some companies transition from a perception of low quality to high quality due to FCF improvement over time. A company can have a period of high capital investment and debt service costs that is followed by a period where those investments payoff and the company pays down their debt levels. These FCF growers are dynamic opportunities where fundamentals improve and the markets reward the company with a higher multiple over time. Penn Capital seeks to identify these opportunities through our equity process. These companies have invested in a new product line, built the new facility or identified and integrated the perfect acquisition to trigger a virtuous cycle for investors. For example, MGM Resorts invested heavily in their latest Macau and Las Vegas projects and generated strong FCFs as those projects opened and they reduced their debt load in 2013.

Today, there are many companies that have no plan to generate FCF which is challenging for an investor that utilizes a credit view. These companies will have ongoing cash requirements in the future and will need to access to debt or equity markets. The business model does not anticipate a period when capital markets could be closed. If these companies fail to prioritize FCF generation in the near future, they could face bankruptcy during tough times.

Track Credit Security Price Movements

When a company has publicly traded debt – track price movements. Stocks can swing widely based on earnings prospects, rumors and market sentiment. Debt usually trades in a much smaller range based on fundamental factors that are tied to cash generation to service the debt. Occasionally, debt will have large price movements based on the underlying prospects of a company – this is a strong signal to the equity investor. Debtholders are seeking interest payments and ultimately repayment of principal – they do not have the same upside potential as equity investors. Credit investors generally follow the rule, “sell first, ask questions later” when problems mount. Declining credit prices are a strong signal that a company’s prospects have deteriorated. Often a company’s bonds will deteriorate well before the underlying stock. Tesla Motors corporate debt, issued in August 2017, has steadily weakened since issuance due to deteriorating credit fundamentals. Tesla Motors stock traded near all time highs as late as December 2018 despite these concerns emanating from the credit market.

Corporate Credit Ratings Provide Valuable Information

Corporate credit ratings are a good indicator of bankruptcy risk. Outside the highly regulated industries like financial services and utilities, small to mid cap companies typically are not rated investment grade. S&P corporate ratings are assigned using an intermediate term risk of default.

"What are the odds this bond defaults over the next 5 years?"					
Credit Rating	A	BBB	BB	B	CCC
Default Odds	0.5%	1%	6%	17%	46%

Source: S&P Global Market Intelligence

Companies that are receiving downgrades from credit agencies have a higher propensity for bankruptcy. The company will witness their credit rating decline over time as the bankruptcy risk rises. The credit market is signaling to avoid these stocks because prospects are diminishing. While credit ratings provide valuable information, the rating agencies can be backward looking and slow to adapt to change. Penn Capital utilizes our proprietary Penn Risk Rating ("PRR") which focuses on forward cash flows over the next three years to evaluate credit risk. This forward-looking tool helps forecast credit trends to identify companies with improving and deteriorating outlooks.

Credit Quality Is Important During Recessions

Credit losses follow a cyclical pattern and losses are concentrated in recessions						
Year	2007	2008	2009	2010	2011	2012
Overall Default %	0.4%	1.8%	4.2%	1.2%	0.8%	1.1%
Speculative %	0.9%	3.7%	9.9%	3.0%	1.8%	2.6%

Source: S&P Global Market Intelligence

Lower rated companies will underperform as the equity market sells off. Due to rising default risk, companies with speculative-rated debt find it difficult, and in some cases impossible, to refinance their debt, resulting in bankruptcies. Monitoring the overall cost of credit is a very strong indicator regarding recession risk. We believe the best metric is the "credit spread" – the difference in yield between a credit instrument and US Treasuries (which are considered risk free). The credit spread is the market price for taking the additional risk that the company could default. In good times, the credit spread is low because the risk of not being repaid appears low. In bad times, the credit spread is high because it appears much more likely repayment will not occur. Tracking the absolute level and recent direction of credit spreads is important to evaluating credit risk.

Conclusion

The credit market is a good forward indicator for the equity market. The credit market typically sells off before the equity market during periods of economic stress. Companies with lower credit ratings typically underperform during a period of economic weakness. Defensive companies with strong balance sheets will outperform in this environment. Importantly, the credit market historically bottoms before the equity market providing a strong signal that the equity market will improve. Cyclical equities will outperform during the recovery.

The credit market provides strong signals regarding individual companies and the overall market that can improve equity returns. Identifying drivers of cash flows for individual companies can aid security selection. Understanding the credit cycle can help position an equity portfolio to perform through time.

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Mr. Maguire began his career with Penn Capital in January 2005. He currently serves as a co-portfolio manager for Penn Capital's Convertible strategy and is the portfolio manager for Penn Capital's Small to Mid Cap Equity strategy. Prior to joining Penn Capital, he served as a senior audit associate for PricewaterhouseCoopers LLP, and conducted private equity research for AMS Inc. During graduate school, Mr. Maguire interned with Penn Capital's investment team. Mr. Maguire received a BBA in Accounting from The College of William & Mary and a MBA from the Kenan-Flagler Business School at the University of North Carolina at Chapel Hill.

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Specialists in capital structure investing

At Penn Capital, we believe that understanding a company's entire capital structure is the best way to identify investment opportunities with the most value. In fact, we've found that managing bond portfolios makes us better equity managers, and vice versa. Employing a fully integrated credit and equity research process, we focus on non-investment grade companies in the micro to mid-capitalization range, where we can take advantage of inefficient security pricing. We are an independent, employee-owned boutique investment management firm based in Philadelphia. We forge our own ideas, we respect hard work, and we are committed to our clients, our staff, and our community.

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