Preferreds Market Weekly Review: Opportunities Remain In The Pre-IPO Market

ADS Analytics

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Welcome to another installment of our Preferreds Market Weekly Review where we discuss preferreds and baby bond market activity from both the bottom-up - highlighting individual news and events - as well as top-down - providing an overview of the broader market. We also try to add some historical context as well as relevant themes that look to be driving markets or that investors ought to be mindful of.

This update covers the period through the third full week of October. Be sure to check out our other weekly updates covering the BDC as well as the CEF markets for perspectives across the broader income space.

Market Overview

It was a mixed week for the preferreds sector which is actually better than it sounds given the headwind of a 0.07% rise in 10-year Treasury yields. October, so far, is shaping up to be a good month for the space with only mREITs underperforming - a partial reversal of their previous outperformance. Cyclical sectors like Energy and the convertible-heavy Tech sector have benefited from strength in energy and equity markets.

Source: Systematic Income

The spread-to-worst (yield-to-worst less maturity-matched Treasury yield) of the sector has range-traded close to its 5-year lows and just above the pre-COVID level. This metric is worth checking up on because it controls for the volatility in Treasury yields and can provide a better sense of valuation in the sector. The takeaway from the chart is that the preferreds space is richly valued and we are unlikely to see a broad rally in the absence of lower Treasury yields.

Source: Systematic Income

Market Themes

With a number of attractively-priced issues coming to the market recently, it makes sense to revisit the listing framework for exchange-traded preferreds. Unlike baby bonds - the other exchange-traded "senior security" - preferreds start trading before they are officially listed on an exchange.

For all of the advances over the last decade in electronic trading, transparency of pricing and ease of market access, the retail preferreds market remains weirdly archaic in some ways. The way many retail preferreds come to market is first via the so-called "Grey" or "Other OTC" Market. However, because it takes a few days to get the shares listed on the exchange, the underwriters, who have already priced the shares, aren't particularly keen to warehouse them and take the price risk. Instead, they acquire a new temporary ticker for the shares, and start selling the shares to investors prior to their listing.

In order to be able to trade shares in the OTC market, investors need to know two main things. First, they obviously need to be aware that there is a new issue out there. Normally, companies make an announcement via a press release which investors can track directly on a platform like Business Wire or on a news aggregator like Yahoo.

There are already a number of challenges here. First, preferreds trade on the pre-IPO / OTC market with a different ticker than their permanent ticker. For instance, the Eagle Point Income Co. 5% Series A (NYSE:EICA) - we will use as a kind of case study - is currently trading with a different ticker than its permanent ticker.

The second challenge is that there are two distinct pre-IPO "modes" of trading. The first is when the stock doesn't even exist yet and trades as a kind of "IOU". Investors familiar with the Treasury market know that new on-the-run Treasuries trade on a "when-issued" basis, that is, before they are actually issued but when all the relevant economic terms are established which give traders the ability to fully value the security.

Something similar happens in preferreds which also trade on a "when-issued" basis. When this happens, the ticker typically ends in the letter "V" e.g. EICVP in the case of EICA. This "mode" typically doesn't last more than a couple of days and was only one day, if that, for EICA. It appears that EICA started trading on 19-Oct under the EICPV ticker, though it's not clear how many shares changed hands. One source shows 11k traded at $24.78 while another shows 448k traded at $24.60.

After the security is issued (but before it moves to the exchange), it trades on the Grey market for a few days to a couple of weeks. For EICA this ticker was EICPP. Not all brokerages will (easily) support Grey market trading, particularly, on the when-issued “V”, i.e. EICVP, ticker. And even if you are able to put in an order with a when-issued ticker, the brokerage will typically cancel your order once the ticker changes to the “usual” temporary ticker, i.e. EICPP, rather than simply reassign the ticker and keep the order outstanding which is, to say the least, annoying. It appears that on the morning of 20-Oct, a day after EICA started trading as EICPV, the ticker switched to EICPP with $135k shares trading between $24.83 and $25.20.

Even if having two OTC tickers was not complicated enough, it is not always clear what those tickers are going to be. Investors who followed the press releases from Eagle Point Income Co. would not have seen any mention of the temporary tickers.

Another potential issue is that the switch from one ticker to the next is not always very clean. Some brokers will quote on both tickers and price providers will also often show pricing across different tickers as well. For instance, prices for both EICA and EICPP are available via various pricing sources even though EICA has not yet officially listed as of this writing.

Furthermore, not all brokers will even offer an ability to easily transact in securities in the Grey market. This has to do with both broker peculiarities as well as the recent SEC Rule 15c2-11 which can complicate dealing in the Grey market. For instance, even if EICPP is technically a Pink / Current Info stock, some brokers will not allow trading in the security (presumably due to a delay in updating their database) and even though the Rule only has to do with quoting rather than trading.

All of this would not be a big deal, however, preferreds tend to be priced attractively relative to existing issues as well as the broader market - something we discussed in an earlier article. This means that new issues tend to rally out of the gates on average, providing early investors with higher returns and another source of alpha.

The key takeaway here is that it can be a good idea to get in as early as possible on securities investors find attractive. However, as this section hopefully makes clear, the current listing model makes it very difficult for investors who don't want to babysit each and every new allocation, to acquire an allocation as soon as possible.

Market Commentary

The primarily CLO Debt-focused CEF Eagle Point Income Co. (EIC) issued their first preferreds - the 5% Series A (EICA) highlighted above. It looks like the timing coincided with the maturity of its SocGen credit facility (on which it was paying a 1.86% fixed-rate equivalent). Interestingly, the pro forma (projected) balance sheet has them indeed repaying the SocGen facility but replacing it with a $25m BNP facility as well as issuing $30m of the new preferreds. The net result is that leverage rises from 21% to about 35% - which is certainly higher, though in the context of the CLO equity sector it’s not unusual, especially that only a quarter of the portfolio is in the higher-beta CLO Equity which is on the low side in the sector.For the preferred there are a couple of issues to consider: 1) there is a credit facility ahead of it in repayment and 2) leverage has gone up. Ultimately, the way to think about the risk / reward here is to line up the preferreds against the rest of the sector and see what happens when you stress test the underlying assets.

The results are largely a function of 1) what the capital structure looks like i.e. how much debt vs preferreds there is and 2) what you choose as far as relative recoveries of CLO Equity and CLO Debt. Recall that EIC is around 24% in CLO Equity (the mandate caps this at 35%) while the rest of the market (with the exception of XFLT which is around 40% in CLO Equity) is around 90%+ in CLO Equity e.g. PRIF, ECC, OXLC, OCCI.

A key related point here is what you don't want to do is simply go with asset coverage as the sole or even main indicator of risk. Asset coverage obviously not only ignores the level of leverage and portfolio composition but, less obviously, the more senior claim of secured and unsecured debt in the capital structure. In other words, the same level of preferred asset coverage can result in a very different outcome for two stocks with different capital structures.

The reason why portfolio composition is important is because there is no real valuation floor on CLO Equity in a truly cataclysmic scenario. CLO Equity tranches typically take the first 10% of losses in the portfolio and, while the repayment option can be very valuable when spreads are wide (as it allows managers to generate higher underlying cash flows from loan repayments), the difficulty here is that 1) repayments are generally very low when spreads are wide – which makes sense in an environment where it is very difficult / expensive to refinance debt and 2) in a distressed scenario excess cash is diverted away from equity tranches to debt tranches anyway so equity tranches may not benefit from this dynamic. All of this is to say that relative to loans or even CLO Debt tranches, the worst case scenario for CLO Equity is a lot worse. For example, if you let CLO Equity recover at 10% and CLO Debt recover 40%, then the ECC preferreds go to zero while the EIC preferred EICA goes to 92%. The market clearly distinguishes between lower-risk and higher-risk securities - it is no coincidence that XFLT.PA and EICA are trading at the lower-yield range, however, securities like OXLCL and OXSQG still look too cheap in our view - though this could be a function of their non-QDI profile versus the sector preferreds - not an issue for investors in tax-sheltered accounts.

At its current pricing, EICA is fairly close to fair-value at a 4.3% yield.

The lower yield barrier for the stock is XFLT.PA at a 3.63% yield which has a similar 2026 maturity and a stronger risk profile given its allocation to loans. The upper yield range if EICA is marked by the preferreds in primarily CLO Equity funds such as OXLC, ECC, Priority Income Fund and others which tend to trade in the 5.5-6% yield range, with a few exceptions to the downside.

Elsewhere, Morgan Stanley is out with a new 4.25% series (MNSLL) - split IG rated (Moody's and Fitch peg it as IG and S&P as the highest below-IG rating) currently trading right around "par" where it is the highest yielding MS series – the others trade between 0.50% and 4.12% yield. The 4.12% yield series is Series A (MS.PA) which pays $3mL + 0.70%, with the all-in coupon floored at 4%.

For investors worried that Fed policy rates could zoom up it could make sense to forego 0.13% of yield (i.e. own MS.PA at a 4.12% yield vs MNSLL at a 4.25% yield) while retaining the potential upside in Libor moving above 3.3% (at which point the MS.PA coupon will rise above 4%). There is some chance that MS.PA will also be redeemed at that point but that's not obvious – if MS.PA is redeemed MS would have to refinance it at an even higher fixed-rate possibly (and obviously a similar floating-rate plus pay some issuance fees).

Bank of America is out with a new preferred – 4.25% Series QQ (BOAPV when-issued ticker, BAC.PQ permanent ticker) trading at $25.02 and a 4.23% yield. It has the highest yield of all the other series save for the convertible BAC.PL which can be converted into $1300 of BAC stock (from current price of $1433) if BAC common reaches $65 (from today's $47), i.e. if the common rallies 40% you lose 9% on the preferred. Is that worth the additional 0.83% of yield? Hard to say – we peg it at only around a 0.32% additional yield premium for the conversion risk (there was an article on this way back). If you happen to hold BAC stock you are somewhat hedged since you'll make more on the common than lose on the preferred – the hedge ratio is the 9 / 40 ratio mentioned above.

The Pitney Bowes 6.7% 2043 Notes (PBI.PB) fell through $25 in clean price terms and bounced back somewhat.

Source: Systematic Income

It is currently callable but is still trading with no call price risk at a $24.83 clean price and a 6.76% YTW. This looks to be B1 rated (B+ in S&P terms) and BB by S&P. This is an odd two notch differential between the two rating agencies – they are usually more aligned. The company recently took out a loan to repay its notes which have lower coupons so there is some chance it will redeem PBI.PB as well. The 2027 and 2029 bonds are trading at 5.63% and 6.18% yield respectively so a 6.74% yield for a 2043 maturity is not amazing but it's not nothing either. Moody's had some positive comments in its recent review – they expect revenue and income to grow over the next year, and comments about the company's leading market presence, long standing customer relationships and some growth opportunities in ecommerce. The bonds remain attractive at the current price.

Stance And Takeaways

As highlighted above, we continue to take advantage of two key sources of returns available for investors in preferreds and baby bonds. First is the pre-exchange listing market which can offer very attractive pricing relative to a given issuer's other traded securities as well as the broader market, though it does take a bit more effort. This also allows investors to generate additional alpha in their portfolios on top of what is a pretty low yield market environment.

And secondly, we are taking advantage of mispricings in a number of niche sectors, particularly the CEF preferred sector discussed above where investors can improve their risk profile without having to move lower in yield. This is the kind of "time to repair the roof is when the sun is shining" task that is worth doing in order to maintain portfolio resilience through the investment cycle.