Preferreds Market Weekly Review: Approaching Sell-Offs In Holdings

ADS Analytics

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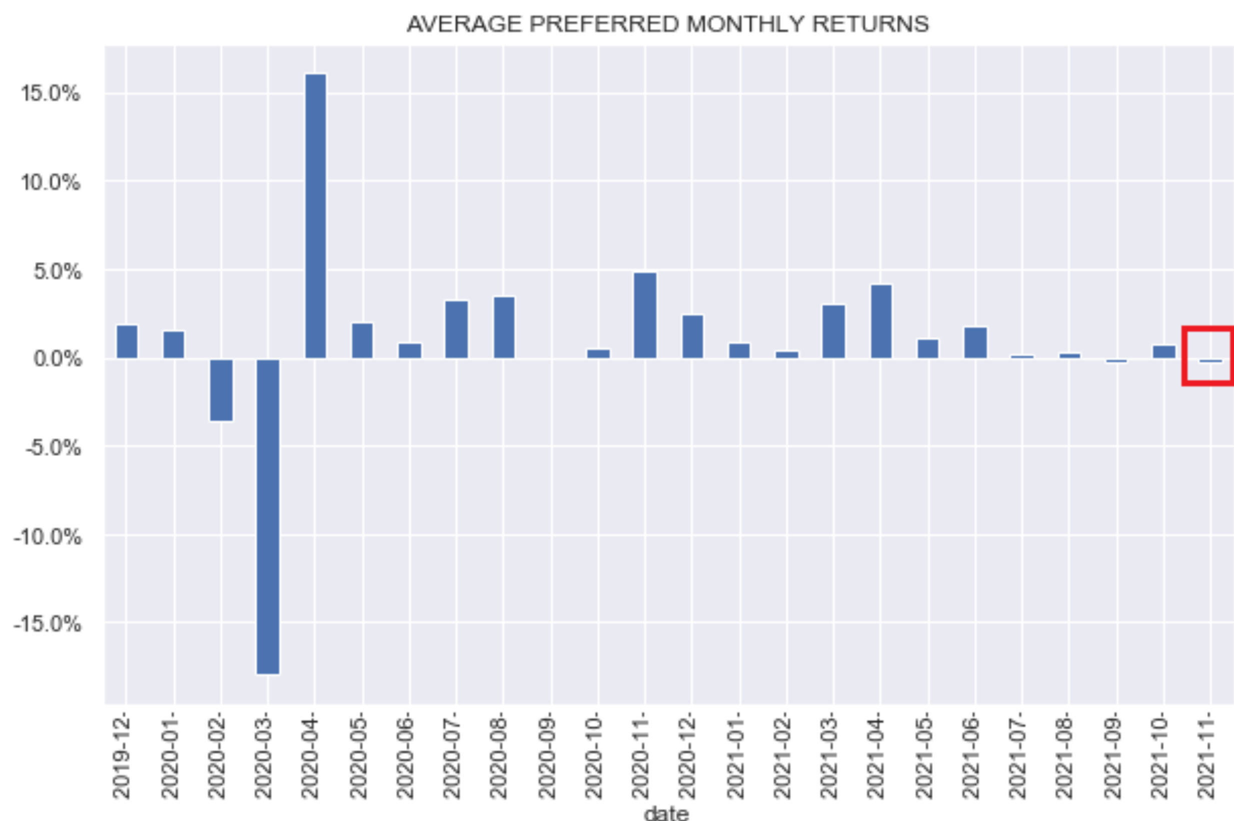
Welcome to another installment of our Preferreds Market Weekly Review where we discuss preferreds and baby bond market activity from both the bottom-up, highlighting individual news and events, as well as top-down, providing an overview of the broader market. We also try to add some historical context 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 second week of November. 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

The preferreds market struggled this week, unable to overcome the sharp rise in Treasury yields, with the 10Y yield rising 0.13% and the 5Y rising by 0.20%.



Source: Systematic Income

Only one sector - Utilities - finished in the green with Energy, CEF and mREIT sectors outperforming. Higher-quality sectors as well as a few idiosyncratic stories underperformed.

The key macro news this week was the big upside surprise in the CPI which came in at a 0.9% in October with the year-on-year figure

rising over 6% - the highest in 3 decades. Core CPI was up a more moderate 4.6% YoY

Among other drivers, house prices are feeding into the CPI (shelter is a third of the index) and because it's sticky it is unlikely that inflation will go down very quickly. At the same time, we should keep things in perspective despite the blaring headlines. Core YoY CPI you is barely above where it was in June - the last four months have delivered YoY core CPI readings between 4-4.5%. Maybe that's why even though the 10Y yield jumped 0.10% it remains below its level from a week ago and about 0.2% below its level earlier in the year.

Market Themes

An ongoing theme in markets, that will likely increase in frequency as the market cycle ages, is a sell-off in individual securities that investors may hold. Because these sell-offs are inevitable it's a good idea to have a plan for how to respond.

In order to respond appropriately, it's first important to understand what kind of sell-off a given security is experiencing. We can split these into two broad types: systemic vs. idiosyncratic and fundamental vs. technical.

A **systemic** sell-off in a security is one that also takes down the broader market while an **idiosyncratic** one is where a given security is the only one or one of the few that is affected. This distinction is not always binary but usually investors can gauge pretty well where along this spectrum a given sell-off resides.

Moving to the other pair - a **fundamental** sell-off is one where a given security falls for a good reason. That can be a drop in earnings, a worsening of its credit profile etc. A **technical** sell-off is one where the sell-off appears to happen outside of any clear fundamental

reason. Again, the distinction here is not always binary and a technical sell-off can foreshadow fundamental evidence that is not always immediately apparent but this is a reasonable distinction to have in mind because it is quite real in markets.

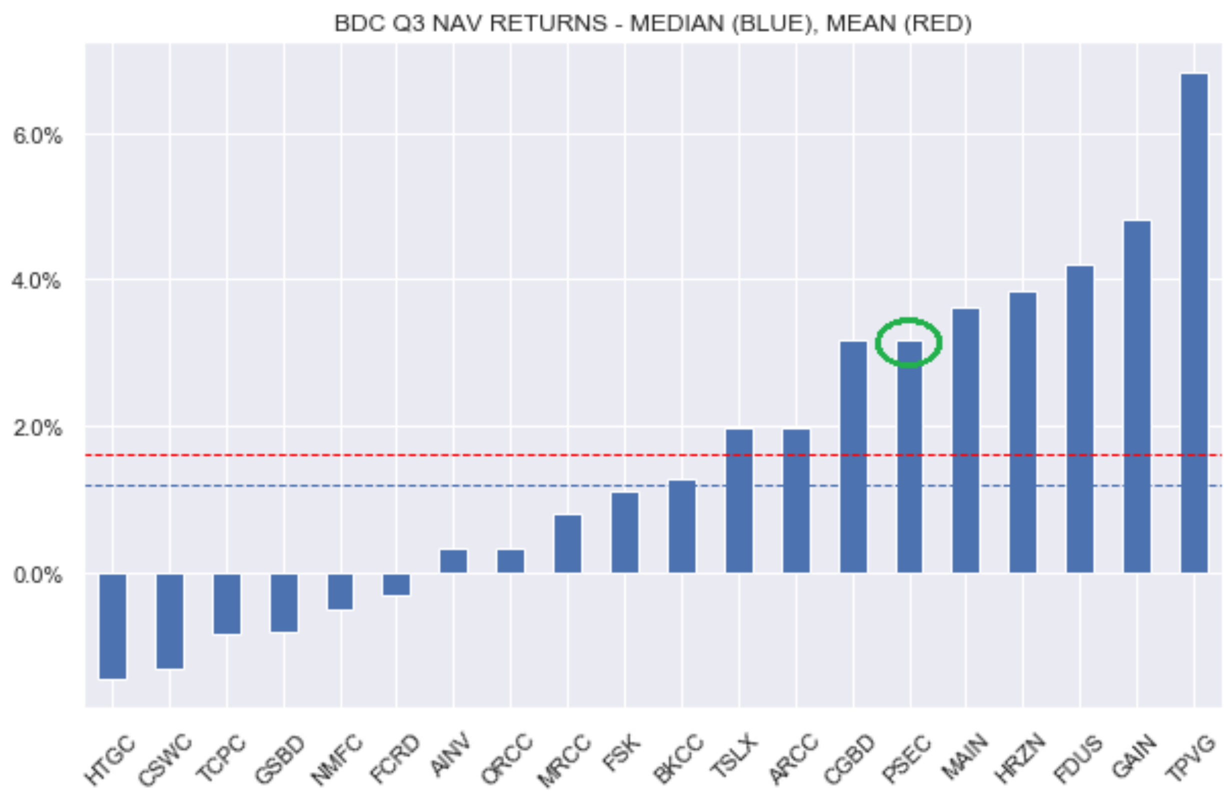
The reason these distinctions is important is it can organize the thought process around what to do - cut, do nothing or add.

Let's now use the Prospect Capital 5.35% Series A (NYSE:PSEC.PA) as an example. This preferred has been in our Core Portfolio for a few months and has delivered a -5% total return over the last three months versus a 0.2% total return for the broader preferreds market and a 0.8% return for the Core Portfolio.

Given the moves in the broader market as well as strength in the BDC space, it's clear this is very much an idiosyncratic move. Now let's see if it is fundamental or technical.

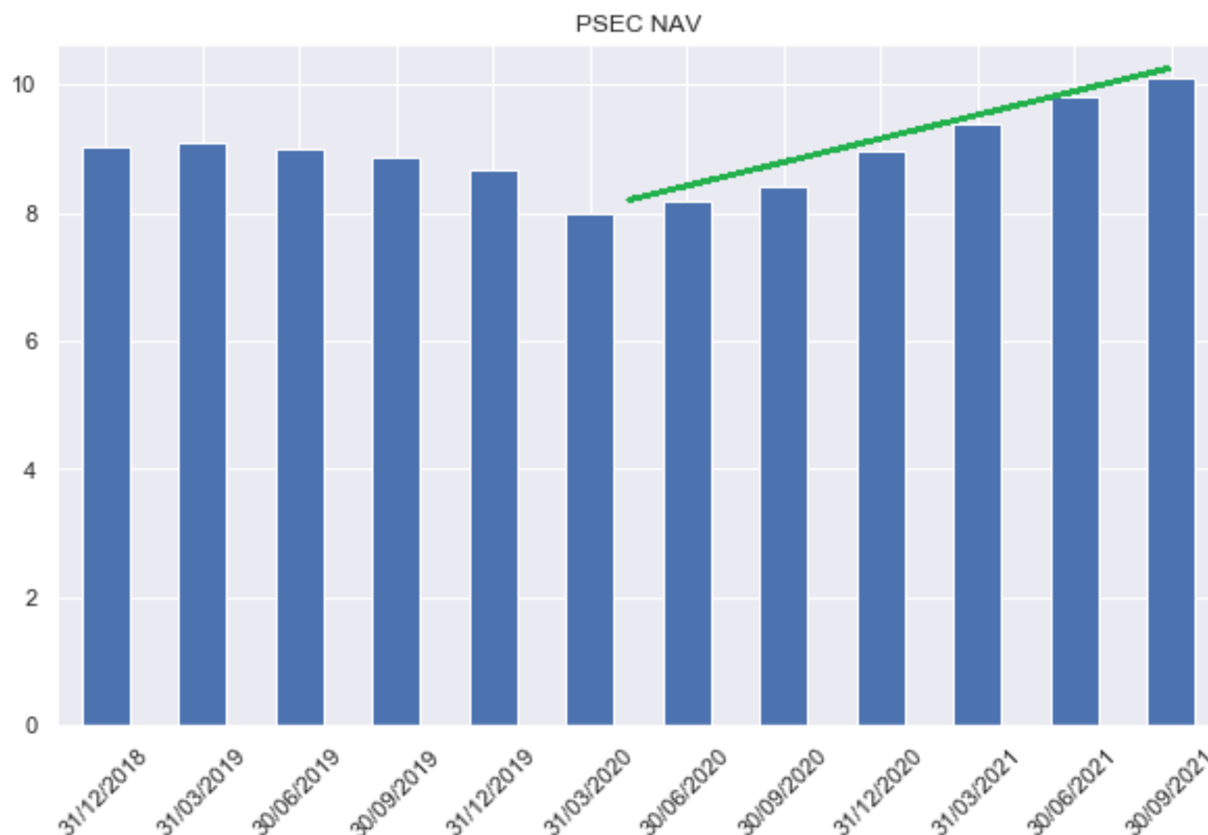
As it happens, PSEC recently released Q3 earnings which gives us a good peek into the internals of the portfolio.

PSEC delivered a 3% gain which is at the higher end of the BDC sector and a very healthy gain in net assets. Preferreds shareholders want to see net asset gains (whether it's from asset revaluation, common share issuance, etc.) because that increases equity / preferreds coverage or the amount of assets that can protect the preferred.



Source: Systematic Income

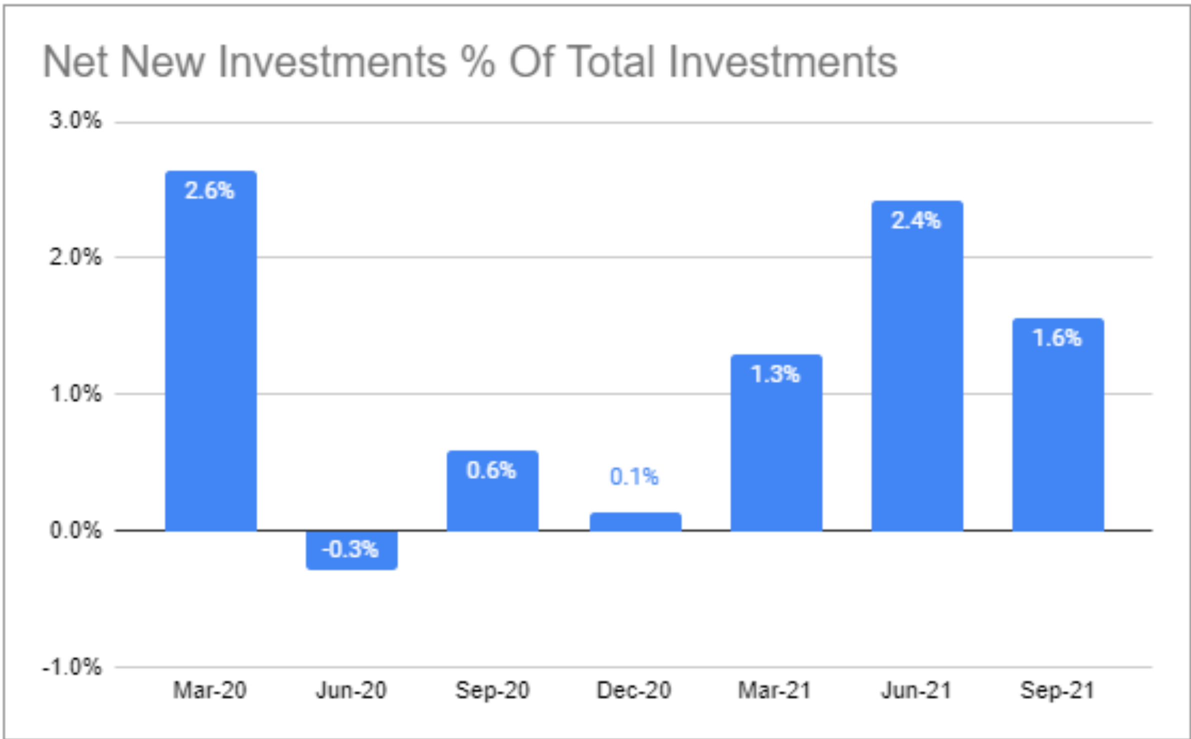
NAV has been increasing steadily and now stands well above the pre-COVID period.



Source: Systematic Income

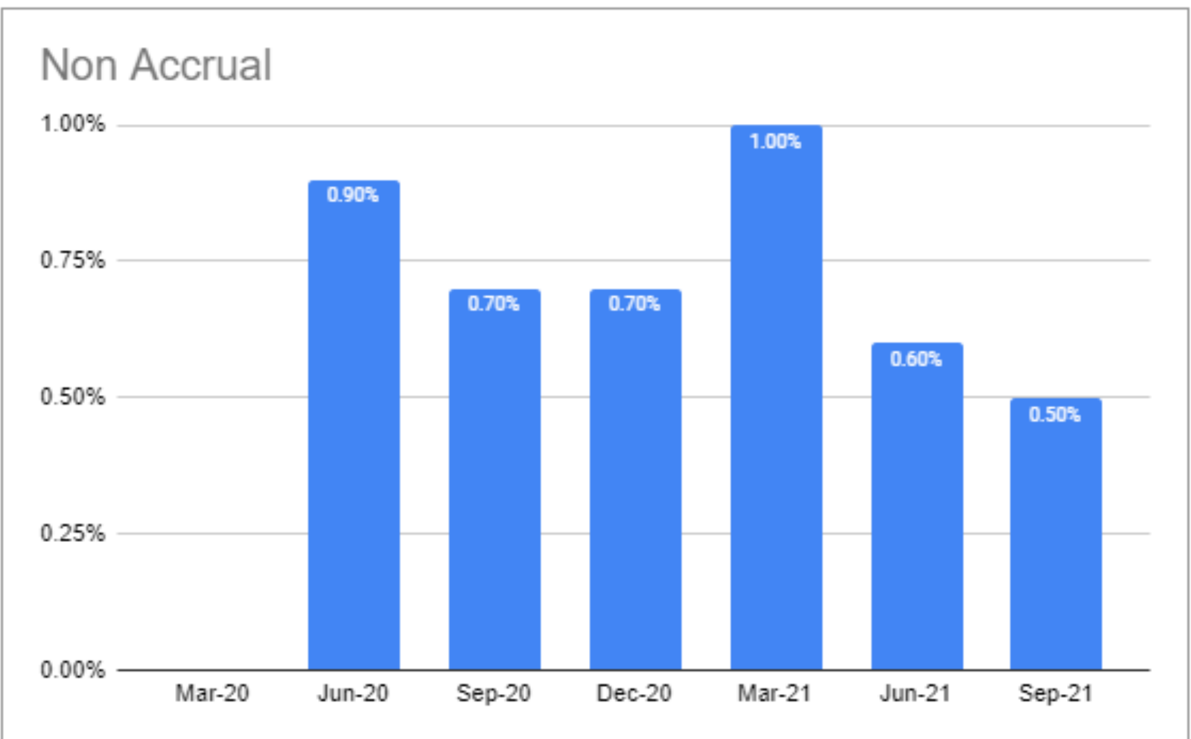
NAV is also valuable because it services as a kind of portfolio quality proxy, however imperfect. In other words, if the portfolio were going through serious difficulties, the NAV would not be rising, pretty much by definition.

Of course, NAVs are liable to rise in a strong market environment so we also want to see whether the portfolio is adding new assets. This is because the NAV could be rising from pure price gains which could evaporate as quickly as they came. On this front the news is good as well as the net new investment numbers have been positive.



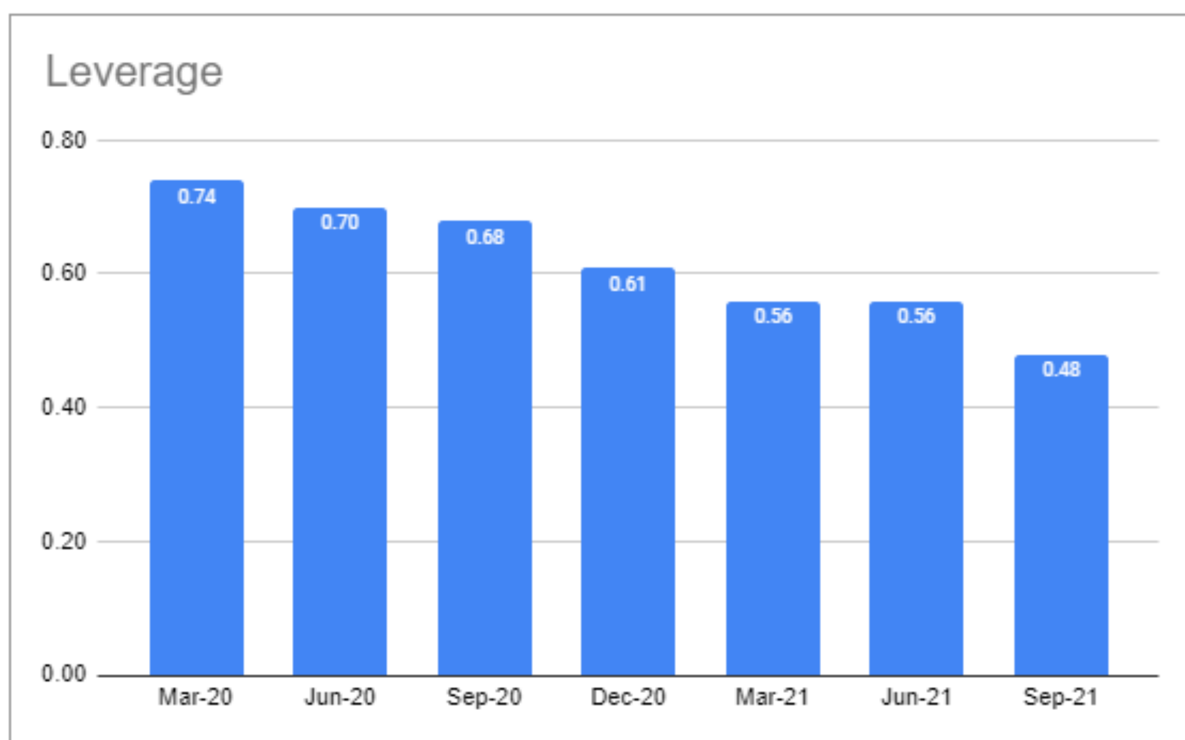
Source: Systematic Income BDC Tool

Non-accruals are falling as well which also highlights that portfolio quality is on a positive trend.



Source: Systematic Income BDC Tool

Leverage has fallen, meaning there is less debt to be paid off ahead of the preferred which is good.



Source: Systematic Income BDC Tool

The common stock price itself is sending a positive signal and is trading about 5% off its 5-year high, having risen 73% year-on-year.

This is not an exhaustive analysis but it's sufficient to give a sense that the preferred is not moving because of obvious credit issues. What this suggests is that the sell-off is more likely to be technical, rather than fundamental in nature. These technical drivers could include a reallocation from the PSEC.PA into the private PSEC preferred (which may be attractive to some investors because the price is fixed at $25 and does not fluctuate) as well as tax-loss selling.

PSEC recently indicated that they have continued to issue shares of the private preferred which has put pressure on the equity / preferred coverage, however, the full $1bn program has been clearly

stated from day-1 and so this is not exactly a new piece of information.

To get a clearer picture of where current and future coverage could be, we can look at the following table. The Q3 column is where things stand with current coverage as of Q3 at 9.9x. In more intuitive terms, the portfolio assets need to move to 36.4% (i.e. drop in price by 63.6%) before net assets fall below the liquidation preference of the preferreds.

(in thousands)	Q3	Pro-Forma Full $1bn preferred issuance
Net Assets	3,943,263	4,083,000
Pref A	150,000	150,000
Pref Private	250,000	1,000,000
Debt	2,118,000	3,164,000
Total Assets	6,497,000	7,247,000
Equit / Pref Covrg	9.9	3.6
Asset RR	39%	60%
Pref RR	100%	100%
Leverage	0.54	0.775

Source: Systematic Income

The second column shows a reasonable "worst-case" scenario where the private preferred is taken to the full $1bn and the portfolio leverage moves up to the company's longer-term range of 0.70-0.85x. At this point the coverage will drop from the current 9.9x to 3.6x.

Coverage of 3.6x is clearly worse than 9.9x however we need to keep two things in mind. First, this scenario is fairly unlikely as it requires both a full $1bn of preferred issuance and a significant increase in debt. The impact on NII of a $1bn preferred paying 5.5% while PSEC has a debt facility which only carries a rate of around 2% will be very detrimental. It is also not clear the market will digest this size.

The second point to keep in mind is that even under this scenario the company's asset valuations have to drop 40% before net assets move below the preferreds liquidation preference. In the context of a 2/3 secured loan (50% first-lien) portfolio that is a pretty crazy scenario - first-lien loan recoveries have historically been on the order of 70% i.e. a loss of 30% on average. Even during the GFC the company's NAV fell about 30% - and that's a leveraged figure with the right comparable figure would have been on the order of 20-25%. In short, we need a scenario of twice as bad as the GFC or about 8x as bad as the COVID shock before net assets fall below the liquidation preference.

What does this mean for investors? If our story that fundamentals have changed is correct it means that the preferred has only gotten more attractive - now at a 6% yield from its 5.35% issuance. However, it is also important to let whatever technical factors exist play out - possibly waiting towards the end of the year if that technical factor is indeed tax-loss selling and possibly longer if that technical factor is rotation to the private preferred. At some point the yield differential between PSEC.PA and the private preferred will be too attractive to pass up (currently, PSEC.PA yields 0.5% more than the private preferred). However, we will only know this once PSEC no longer has sufficient demand for the private preferred which we would learn from a press or earnings release.

The key takeaway here is that this playbook of checking whether any fundamentals have changed and, if not, waiting for the technical factors to play out should come in handy if we do see a few bumps on the road to a full macro recovery and interest rate normalization.

Market Commentary

REIT Public Storage is out with another 4% preferred PSA-R

(BBB+/A3), temporary ticker PBSTV. It is currently trading a bit below "par" and a 4.03% YTW which is on the higher end of PSA yields. However, the 4% Series P (PSA.PP) is still ahead with a 4.28% yield.

Overall, 4% is not bad for the rating / quality however, being low coupon, the stock is fairly vulnerable to higher rates. That said, it’s always a good idea to have securities with different features in the portfolio (unless, of course, you have a very very strong view about what’s going to happen).

High-quality / long duration assets are always valuable in case we get a macro shock and rates fall. It certainly feels like rates have nowhere to go but up but the long bond (30y Tsy) yield is pretty much where it was in the fall of 2019. Historically, it’s certainly on the lower end but at 1.95% it’s high enough that there is enough room for it to fall – it was sub-1% in March-2020.

The CLO Equity CEF OCCI Series A (OCCIP) will be redeemed. This one was outstanding for a while - puzzling since OCCI was able to issue OCCIO well below the OCCIP coupon. OCCIO is not super exciting at a 5.11% YTC and 5.76% YTM though, unusually for the sector, OCCI has no debt in the capital structure which makes its preferreds first in line to get repaid. The relatively short 2026 maturity is also a plus in this environment.

The SiriusPoint 8% Series B (SPNT.PB) fell about 4% over the previous month and is trading at a 5.62% yield which is at the high end of its historic range. The company reported a net underwriting loss of $266m due to losses from to Hurricane Ida and European floods. The common fell but did not react strongly, moving back to where it was trading at the end of 2020. Equity / preferred coverage is still in the double digits based on Q3 filings. It remains attractive both from a yield / quality perspective, being just one notch below

investment-grade as well as from a duration perspective.

Specifically, there are three elements which limit its duration. First, its very high coupon mathematically limits how much duration it has (the higher the coupon of a perpetual security the lower its duration, all else equal). Secondly, the fact that its high coupon is way above its yield means it is very likely to be redeemed in 2026 – making it a quasi-maturity security. And third, its CMT reset rate of 5Y Treasury yield + 7.298% (equivalent to a yield of 7.54% at the current price and 5Y Treasury yield) gives investors more than adequate protection in case of further rate rises.

We also covered the the new PFX bond in our BDC weekly but it's worth doing it here as well as not all senior security investors will be interested in our BDC commentary.

BDC PhenixFin (ex-Medley Capital) is issuing $50-57.5m of 5.25% 2028 Notes (PFXNZ) to refinance the $77m of 6.125% 2023 Notes (PFXNL). PFXNL are to be only partially redeemed and look attractive with a very short 2023 maturity. At par PFXNZ will be the highest-yielding BDC baby bond outside of the Great Elm Capital bonds.

As of Q2, asset coverage was north of 300% which was the highest number in the entire BDC space. Cash made up $52m or about 20% of total assets. Leverage was about 0.5x – very low in the sector. 73% of investments were first-lien. To give a more intuitive perspective here, the company's assets have to fall below 13% for the bonds not to pay off in full. The company, unusually, has no secured debt ahead of the unsecured bonds which is a good result for the bonds.

Obviously, this could all change but the bonds seem pretty attractive here for investors happy with the yield level. NAV has been rising the

last few quarters as the company is conserving cash by not paying dividends. Non-accruals were fairly high at 7.5% on a fair-value basis. A total of 8.7% of investments are in the bottom two grades i.e. where some loss is expected. All-in-all, however, you could do a lot worse at a 5.25% yield.

Elsewhere on the new issuance side new 2028 bonds TELZ from LNG producer Tellurian are now trading at a 8.36% yield – company's net income is negative (about half its expenses) though leverage looks to be low with lots of cash on the balance sheet (about half of total assets). EFSCP preferred trading at a 4.96% yield from the small Enterprise Bank with $12bn in assets. The 4.75% Series C (HPP.C) from Hudson Pacific Properties is now trading at a 4.81% yield.