A big Fish in a Small Pond as the Nordic Corporate Bond Market Matures

Stockholm (HedgeNordic) – The Nordic corporate bond market is coming of age. More issuers are getting credit ratings, including from a relatively new agency, ESMA-registered Nordic Credit Rating ASA, though plenty remain unrated. The great majority of large-cap global companies based in the Nordics have a credit rating, usually from S&P or Moodys, but it can be too onerous and costly for mid-cap companies to pay for a rating.

Though Pareto Asset Management do their own credit analysis and do not actually pay much attention to credit ratings, which have been too lax in some cases, in broad brush terms Pareto Asset Management Portfolio Manager, Stefan Ericson, estimates that: "the Nordic high yield market would have a rating of BB minus now. This might drop to B Plus in a severe downturn, mainly because the market still has a relatively high weighting in energy and shipping. As such, the sectoral composition of Nordic high yield is closer to the US high yield market – where I have worked – than the continental European market".

Credit spreads are also nearer US than European levels – at around 500 measured in Pareto's base currency of Norwegian Krona (average yields of 630 versus interbank interest rates – NIBOR – of 130). Of course, after hedging into SEK, DKK or EUR the total yield is about 200 lower, but the spread is similar. This extra spread partly reflects the premium that investors demand for the cyclical, "boom and bust", nature of the energy and shipping industries.

Default cycles

Indeed, there have been bankruptcies and restructurings in Nordic high yield, with one wave around the global financial crisis in 2008, and the next around the oil price crash and oil service market crisis in 2014-2015, which has been described as a deeper crisis than the 2008 one for that particular industry. These cycles of corporate failure – and usually rebirth – highlight one way in which the Nordic market is rather different from the US: events and disputes are handled and resolved by out-of-court voluntary negotiations facilitated by the trustees, as opposed to courts. "Nordic Trustee ASA is by far the largest trustee, and the trustee function has been enacted into the legal framework of each of the four Nordic nations" says Ericson.

Defaults are healthy for the market, because investors can now see examples of what happens when a company defaults and restructures. "Some bonds simply swapped into equity while others adjusted maturities, changed amortisation schedules and introduced step-up coupons. The process was more complicated and took longer for firms with bonds issued both under local law and under New York law, such as Seadrill. The Nordic process is not better or worse than the US process – it is just different" argues Ericson.

Overall, the 2014-2015 bond market rout was less severe than in 2008, partly because the energy and shipping percentage of the market was down from 70-80% when Norway accounted for most of the high yield market. "Since 2010, Sweden has started to develop its own corporate bond market, as has Denmark to a smaller degree. Finland in fact has a long established corporate debt market that has been a good source of opportunities for us" Ericson illustrates. The Nordic growth is continuing, enabling a more diversified market resulting in energy and shipping continuously constituting a smaller part of the overall market, currently estimated to around 30%. During the2014-2015 correction, some of Pareto's strategies saw peak to trough drawdowns of around 18%, pretty close to the 15% swoon in US high yield. Since early 2016, their performance has been steadily climbing.

Floating rate coupons

Ericson, who also runs a global high yield strategy, points out another difference between Nordic, and US or European high yield markets: lower interest rate sensitivity. Most bonds in the Nordics are FRNs (floating rate notes) and the average duration of Pareto Nordic Corporate Bond fund is about 1.3 years, compared with a typical estimate of around 4 years for US high yield. (Of course, these estimates are subject to some margin of error due to different assumptions around call and refinancing dates). For investors who anticipate interest rates will eventually rise and even normalise, the yield on most Nordic high yield bonds should follow suit.

In the early years of the Nordic markets, Ericson recalls how "investing in high yield was more or less a buy and hold game akin to investing in syndicated loans in bond format. That has now changed, as there are more opportunities for subscribing to primary issues, reinvesting redemption proceeds, and switching between bonds" he points out. One technique used to enhance running yields is capturing capital appreciation from credit "roll down", and Ericson finds the sweet spot here involves holding a five-year bond for three years, until it has two years remaining to maturity.

Growing new issuance

Primary issuance gives Pareto the chance to help shape the pricing and terms of new deals. "As we are a big fish in a small pond, the majority of pre-sale processes in the Nordics involve us. We find it is important to meet companies face to face, read the materials, assess security packages and subordination, give feedback, and provide indicative pricing through a syndicate of banks and brokers. Our seasoned and senior teams based in Oslo and Stockholm have done this for over 800 companies – a large portion of the market the past 10 plus years. There are some differences between Norway and Sweden, in particular some bonds in Sweden have a much broader investment base. At any one time, we are likely to own 70-80 bonds, diversified by sector" he explains.

Overall portfolio turnover is around 25-30% per year, implying average holding periods of 3-4 years. The fund does not use leverage, but sometimes has some cash because it takes time to deploy. Active trading decisions recently have included selling out of some bonds issued by property builders, for fear of a property downturn.

The Nordic high yield market is now worth about EUR 50 billion, and as such ranks as the sixth biggest in Europe. With assets in Nordic high yield of close to 5.8 billion NOK (EUR 600 million), Pareto makes up just over 1% of the market. Ericson is confident that the strategy could manage at least EUR 1 billion (at Carnegie, Ericson ran peak assets of around EUR 2 billion in 2014, including some investment grade, when the market was about 40% smaller).

This indication of capacity should rise as the market grows. Ericson expects that "the market will continue to grow because regulators, policymakers and central bankers are keen to foster the growth of capital markets and reduce dependence on bank finance. We may not reach US levels, but could see capital market funding of companies rise from 25% to 35%".

Ericson is "not sure when the next distressed cycle will occur, but does not anticipate owning many distressed bonds, because the fund is not a specialist distressed fund, and getting involved in workouts and restructurings can be too time-consuming relative to the upside. Staggered maturities are intended to reduce exposure to companies that hit a wall when trying to refinance during a credit bear market".

When the next credit market downturn comes, Ericson hopes that “the fund’s good relationships with 17 counterparties will be helpful in sourcing liquidity – to sell out of distressed names, ideally before they become distressed. Currently, the strategy owns tiny scraps of two C-rated bonds, one being distressed claim and the other a remnant of a restructuring that has deferred coupons”.

For the time being, Ericson finds that Nordic corporate bonds offer relatively attractive yields and spreads versus the default risk, and the continued market growth is constantly expanding the potential to enhance portfolio diversification by country, industry and company risk.