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Western Digital offer highlights junk bond concerns

Unexpected setback for bankers as investors shun riskiest part of debt sale

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The $1.3tn market of US junk-rated debt experienced a notable V-shaped recovery during the first quarter, but sentiment remains fragile with investors wary of riskier offerings from companies.

The Barclays US high yield index has recorded a total return of 4.2 per cent as of March 30, leaving the sector up 3.10 per cent for 2016, a notable reversal after a punishing start to the year. By mid-February, junk bonds had lost more than 5 per cent for the year.

Portfolio managers have debated the durability of the recent recovery in fixed income and equity markets. The market mood had shown signs of wavering ahead of the quarter ending, but earlier this week Janet Yellen indicated that the US Federal Reserve would proceed cautiously in tightening policy this year, boosting sentiment for equities and corporate debt.

"We rallied from weak levels and came really far really fast," said Jack Flaherty, investment director of GAM. "The markets are addicted to central bank liquidity.''

Optimism over the outlook had been tempered after one of the largest junk bond offerings on record delivered an unexpected setback to bankers on Wednesday after investors shied away from the riskiest piece of the transaction.

The sale of debt from computer storage maker Western Digital to fund an acquisition— a so-called crossover deal that included both investment-grade and junk-rated paper — revealed that investors remained reluctant to take on substantive risk, with order books heavily favouring the higher-rated portion of the deal.

Underwriters ultimately cut the size of the financing package to $5.225bn from $5.6bn and shifted more of the offering to the investment-grade market. That leaves the deal as the second-largest US junk bond offering on record, behind Frontier Communication's $6.6bn sale last year, according to Dealogic.

"For lack of a better term, high-yield investors are sheepish and we all tend to flock together," said Darren Hughes, co-head of high yield at investment manager Invesco. "If most of our peers don't want to own unsecured Western Digital paper, that makes any questionable deal easier for us to say we'll underweight it or not own it at all."

One banker in New York said there was still a sense that another downdraft could halt new junk debt issuance, leaving underwriters with as much as $15bn of so-called hung deals. Those deals, which banks struggle to sell and often must pull because of a lack of buyer interest, have resulted in losses that have spiralled into the hundreds of millions of dollars over the past six months.

Private equity groups also took an interest in the sale as they look to gauge demand for low-rated debt used to finance takeovers. Anaemic leveraged buyout activity has been blamed on the restless market tone as well as the rise in borrowing costs — which, despite slipping from a high touched in February, remain above year-ago levels.

Bankers are now shifting their focus to Dell, which later this year is expected to sell $8bn of junk bonds and $9bn of subinvestment grade loans to finance its takeover of EMC, according to a person familiar with the matter.