FULCRA
ASSET MANAGEMENT INC.

September 2022

The End is Near… to the Year

September was an awful month for risk markets as the full realization of the Federal Reserve's determination to break the back of inflation destroyed investor sentiment. While the price of both oil (WTI down over 11%) and natural gas (Henry Hub down almost 26%) fell dramatically in September, the High Yield energy sector outperformed in the month. Despite the drop in commodity prices, producers are benefiting from prices that are well above what they averaged in 2021.

In September, the Fulcra Credit Opportunities Fund's position in the Rockpoint Gas Storage 7% bond due March 2023 was called at par. The private natural gas storage and infrastructure company benefited from the increase in natural gas prices and with the help of its equity owner, Brookfield, decided to refinance the bonds internally.

Oil and gas equity valuation multiples have recently hit multi-year lows, despite these companies benefiting from increased cash flows due to higher commodity prices. These lower valuations may be driven by public announcements of some institutions divesting from the sector. However, it has created an interesting opportunity for credit investors who can benefit from buying shorter duration bonds as these companies are now more capable to refinance, partially or completely, these obligations internally. The added flexibility of not having to rely on capital markets to refinance is, currently, a very attractive investment trait.

Elsewhere in the Fund, the two largest negative contributors to September's performance came from Rite Aid's 7.5% bond due 2025 and the Telesat 5.625% bond due 2026. Both companies generate free cash flow, despite their storied pasts. Rite Aid, its multiple attempts to sell but now committed to a turnaround, and Telesat issuing bonds previously to fund its new satellite network at an unrestricted subsidiary while experiencing launch delays due to supply constraints from satellite manufacturers.

September was the Fund's worst performing month of the year and moved the Fund into negative territory for the year. While never pleased with a negative result, the Fund's relative outperformance thus far in 2022 has been helped by an allocation to a handful of term loans. The coupons of term loans float, so as interest rates rise so do the coupon payments to investors. While increased coupon payments to investors mitigate duration risk, it does increase the cost of debt for the issuer - a credit negative. However, not all companies and balance sheets are the same. Interestingly, many issuers in a position of financial strength may look to reduce or redeem a loan sooner given the rise in interest rates. The Fund's position in the US Silica term loan is a great example.

We purchased the US Silica term loan two years ago as we were drawn to the strong asset coverage of its industrial materials business that was acquired in 2018 with the proceeds of the term loan. Prior to this acquisition, the company's business was much more cyclical given its then singular focus as a service company to the oil & gas industry. In the middle of 2020 economic uncertainty from the pandemic created many difficult to analyze/predict outcomes. The term loan of US Silica traded at a significant discount, suggesting the market still considered the company to be an oil & gas-focused company, despite the cash flow valuation from the much steadier industrial business capable of supporting the debt on its own. As both lines of business have seen increased cash flows this year, management has used this opportunity to reduce debt by $150 million over two separate tender offers in the last six months.

For investors, 2022 has been marked by losses in most liquid asset classes. As a result, Q4 will likely be marked by continued volatility (and opportunities) given the added influence of tax loss selling, rebalancing, and broad shifts in asset allocations. Flexibility and execution into the first half of 2023 will likely be the hallmarks of outsized investment returns as we look to the horizon over the next two years.