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Wrong number

The phone in your pocket is the receptacle of the wisdom of the ages. Just tap lightly. For instance, "Deflation and debt mix like orange juice and Listerine." Or, "Technology is creator and destroyer alike." Or, "Have you ever noticed that management incentives invariably take the form of stock options rather than bond options?"

Sprint Corp., America's fourth-largest mobile network, is in the foreground and background of this unfolding essay. We write not only to analyze its capital structure—to anticipate, we're bearish on it—but also to marvel at the volatility of perception of today's junk-bond investors. The metaphysics of accounting and the complacency of lenders are likewise on the editorial agenda.

As to junk bonds, let us say that Donald Trump's Nov. 8 victory was not the only upset of 2016. The BofA Merrill Lynch U.S. High-Yield Index effective yield began the year at 8.8%. By Feb. 11, it stood (on tiptoes) at 10.1%. It's quoted today at 6.3%. Particular examples help to illustrate the about-face. Thus, the 6½% notes of Transocean, Inc. and Atwood Oceanics, Inc., both maturing in 2020, have rallied to dollar prices in the 90s, from the 70 and 50, respectively, at which they were quoted when we said our bullish piece in the March 11 issue of *Grant's*. To infer from the action of the junk market, a latent recession has given way to an incipient boom. This implied economic transformation has occurred even as Moody's Investor Service's trailing 12-month default rate by U.S. junk-rated issuers ticked up to 5.6% in November, from 2.9% in November 2015. Go figure.

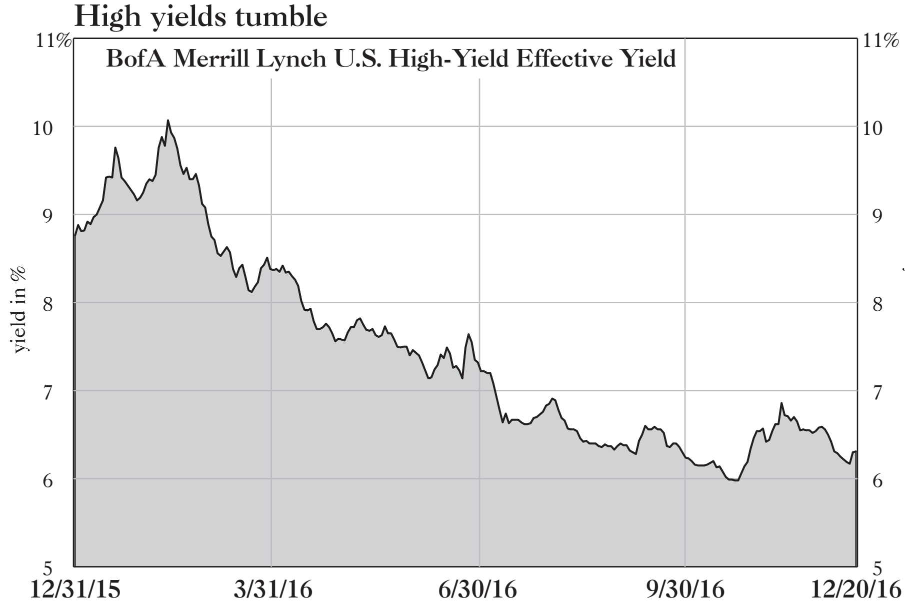
Apollo Global Management's Nov. 3 buyout of Rackspace Hosting, Inc. (*Grant's*, Jan. 25, 2013) highlights another aspect of the credit markets' journey to manic from depressive. To fund its acquisition, Apollo floated a $2 billion B-term loan at a 400 basis-point spread over Libor. That was on Oct. 25. Not even two months later, Mr. Market presented the borrower with an opportunity to refinance. On Dec. 15, Apollo procured a spread of 350 basis points over Libor.

What's a yield-grubber to do? Junk bonds tend to shine when real interest rates rise on account of better business; as bankruptcy risk recedes, investors settle for narrower yield spreads on sub-investment-grade debt. The trouble these days is that the option-adjusted spread on the BofA Merrill Lynch U.S. High-Yield Index is already quoted at 423 basis points while the five-year average is 525 basis points. So the good news is out—and in.

Nor would slumming in the bottom reaches of credit quality avail you much in this happy-clappy market. While triple-C-rated bonds supply an average of 11.9%, according to Bank of America Merrill Lynch, few such rated issues are actually priced to deliver the average yield. Some bonds produce 20%—functionally, they're equity in waiting—while others fetch 5% to 10%. The latter are the issues priced for earthly perfection.

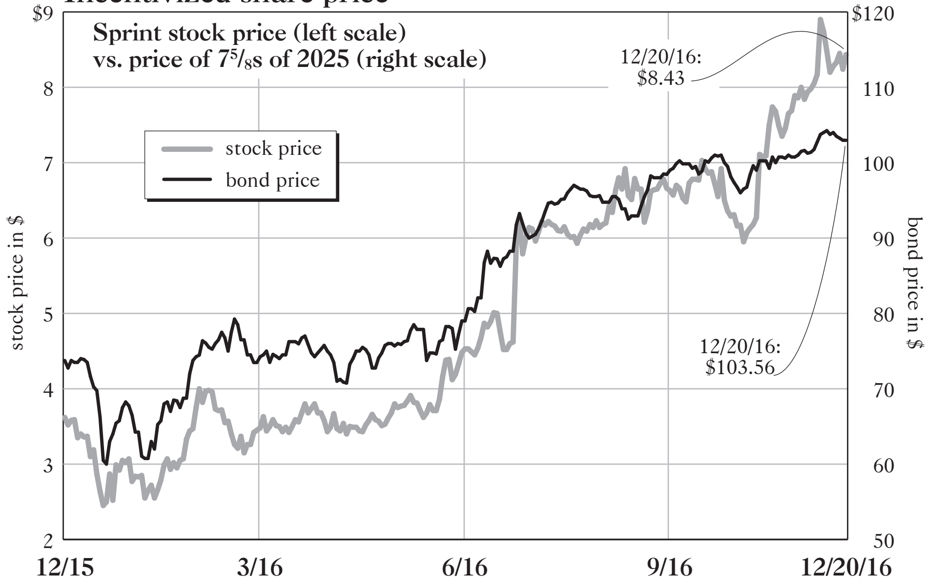
You may choose, for instance, be-

High yields tumble



source: Federal Reserve Bank of St. Louis

Incentivized share price



source: The Bloomberg

tween the triple-C-plus-rated Cablevision System Corp. senior unsecured 5⁷/₈s of 2022, which trade at 96.8 to yield 6.6%, or the banged-up senior unsecured payment-in-kind 14s of 2021 of iHeartCommunications, Inc., which are priced at 39.50 to yield 48.5%. You say you choose neither? So say we, too.

Back, now, to B/B3-rated Sprint (S on the New York Stock Exchange). The 2016 high-yield rally was the gods' gift to the wireless carrier. Only 11 months ago, the Sprint senior unsecured 7⁵/₈s of 2025 changed hands at 60 to yield 16.2%. The price was the fixed-income equivalent of a churchyard cough. Today, the same 7⁵/₈s trade at 103.56 to yield 7%.

Just how much help Mr. Market received from the Sprint front office is the question before the house. Raul Marcelo Claure, president and CEO since 2014, has recruited a team of highly capable, highly incentivized people to lead the company away from the precipice. We bears don't just imagine that there is a precipice. Fitch Ratings, in an analysis dated Oct. 12, saw one, too. Thus:

> Beyond fiscal year 2018, [debt] maturities total in excess of $10 billion during the next four years. A failure to execute on current strategic plans to improve the cash generation and position the company to reduce debt materially over the long term increases the risk that Sprint's capital structure becomes unsustainable.

Wireless is a deceptively simple business. You build and maintain a network. You outfit your customers with smartphones. You charge them for their use of your network. For your trouble, you earn EBITDA margins ranging between 20% and 25% and returns on stockholders' equity of between 10% and 20%.

Of course, things are not so simple. Competition is stiff and stiffening—and was even before the top two cable companies, Comcast Corp. and Charter Communications, Inc., announced their intention to enter the business. Retail prices are sliding relentlessly. Capital spending consumes (or should consume, according to Moody's) 15% to 18% of network revenue. Heavy leverage turns ordinary business molehills into existential mountains. Sprint is heavily leveraged, unprofitable and—in comparison to its peers—under-invested in its own network.

"If you go back to pre-2011, the industry competed on three dimensions: the basis of network quality, handset selection and price," Craig Moffett, the founder and one-half of the nameplate of MoffettNathanson Research, tells colleague Evan Lorenz. "Starting in 2011, the diversity of the handset ecosystem started to sharply decline—consolidating around two suppliers, Apple and Samsung—and the ability of carriers to differentiate on handsets sharply declined with it. Everyone eventually carried the iPhone and the Galaxy. As a result, the basis of competition collapsed from three dimensions to two.

"All you had left were network quality and price. Even the conversation around network quality became more subtle and nuanced. It was no longer a conversation about how Verizon was good and everyone else was bad. Now, in a world of data, rather than voice, there are conversations about speed, coverage, latency. It became harder to claim that one network was truly better than the other. Each had modest advantages in one area or another."

To convey a sense of the immensity of the cellphone market, none of the wireless companies contributes as much as 10% to Apple's top line, though even little Sprint, the smallest of the four, sold or financed $6.23 billion worth of phones and tablets in the 12 months through Sept. 30. Assume a $400 average price per digital device (phones both smart and dumb), and you would be talking about 15.6 million handsets.

Sprint wants more—it wants growth—and to get more, it's prepared to deal. To any who switch from AT&T, Verizon or T-Mobile, it's offering half-price monthly plans as well as free upgrades to the iPhone 7. To the investing public, it's delivering fatter reported EBITDA. Whereas an iPhone 7 is an iPhone 7, the new and ostensibly improved EBITDA is not really improved.

Just how a wireless company reports the sale or lease of a handset makes a world of ocular difference to its short-term financial results. Key is the timing of the recognition of customer revenue and corporate cost.

There are three such accounting methods. They deliver identical economic results over their respective lifetimes. Appearances are another matter. The first technique, the so-called subsidy plan, tends to flatten reported EBITDA. The second, the installment method, is more or less neutral with respect to reported EBITDA.

The third method—to which Sprint and the rest of the industry are migrating—is the one that shines the flattering light. Under this, the lease plan, the company recognizes the cost of the phone as a capital expense in the current reporting period. Only later does that sum register on the income statement, and only then as a depreciation expense. Revenues get different treatment. The company recognizes them on the income statement ratably over the life of the sales contract. You might call this the "having your cake and eating it, too" plan.

"Thus," Lorenz relates, "in the September quarter, lease and installment plans made up 73% of sales (to the postpaid customer cohort—of which more in a moment), up from 64% in the year-earlier period. In keeping with accounting convention, the shift mechanically lifted EBITDA. It grew, in fact, by 22% from the September quarter in 2015. Adjust for this change in the sales-plan mix, and Sprint's third-quarter EBITDA would have grown by just 1.4%."

Confusion comes with the wireless territory. "The accounting changes going on in the wireless industry are so profound that it is probably not an understatement to say that almost no one fully understands the financials being reported," says Moffett. "It makes comparison both between carriers and to history almost impossible."

The analyst describes a meeting at which he rose to explain Verizon's latest earnings release. He said that he'd resolved not to talk about accounting: "I was about 2.5 minutes into my allotted 90 seconds and realized I was going deep into the weeds of accounting when one of the portfolio managers stopped me and said, 'What I hear you saying is that none of us can trust any of the numbers from telephone companies right now. These companies are virtually uninvestable.'"

Mobile-phone contracts come in two varieties, prepaid and postpaid. The terms are self-explanatory. A prepaid customer sends money first. A postpaid customer remits funds following a month's usage and typically commits to a multiyear contract. Postpaid users are generally the bigger spenders, hence the more desirable clientele.

To build its postpaid segment, Sprint offers something called "Unlimited Freedom," a come-hither wireless plan with no data caps, as well as the aforementioned enticement to switch from a competing vendor. Such gimmicks have spurred the company's postpaid subscriber count (up by 347,000 in just the September quarter). But losses in prepaid subscribers (down by 427,000 in the same quarter) spell continuing net losses to the customer base.

If prices are falling, and if the client count is falling, cost must likewise tumble. Management says it aims to slice $2 billion of annual expense from the business by the end of this coming March. Not one single business segment is under the ax; the plan is rather one of a thousand cuts.

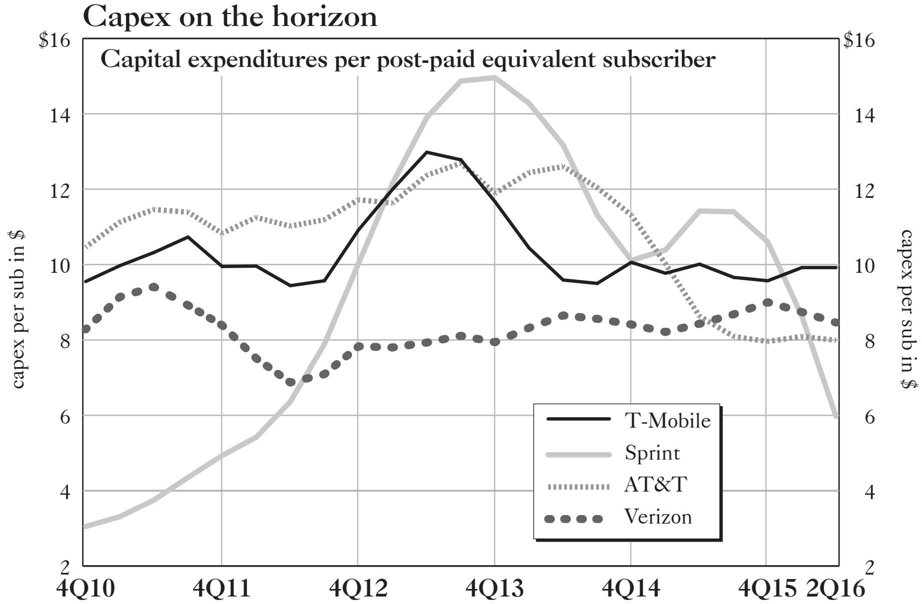
"We have had great savings in network operating expense," says Rose Kopecky, a finance manager at Sprint. "Some of that is shutting down the WiMAX network; continuing to renegotiate contracts as they come through; moving [from] outsourcing our networking agreement with Ericsson to [having those agreements moved] in-house. We've had savings on the cost of service. . . . Roaming rates both nationally and internally have all come down. Customer care has been a fabulous savings: average holding time, digital—ways people can self-serve online, better upfront things we've done in the process to help make sure customers understand their first bill, and actually show them a preview of their first bill before they see it so it doesn't generate additional calls to care. We've gotten a little bit tighter on some of our payment policies, which pulled forward churn about a year ago. Right now they get two chances to pay, and then they get cut off. We used to grant a lot more extensions, and that was causing increased calls to care. Lots of marketing expenses got cut back. We are doing a lot more in-house from a marketing standpoint. Several IT initiatives. We just got another email from [CFO] Tarek [Robbiati] today about how we are going to be reviewing TV expenses going forward. It is almost a culture change in how we spend money at Sprint."

Or perhaps there's little of consequence left to slash. "I remember conversations dating back at least seven, eight years now where they would talk about unscrewing every other light bulb in the hallways," says Moffett. "They got rid of printers. Limited the number of tire changes on repair vehicles. They've been managing costs pretty aggressively since 2006 to get out of the mess they found themselves in after the Nextel acquisition. That doesn't mean that every stone hasn't already been turned, but you would assume the low-hanging fruit has already been picked."

There are plenty of bonds left. As of Sept. 30, Sprint's debt, net of cash, summed to $30.9 billion, or 6.7 times adjusted EBITDA. While Sprint did generate positive free cash flow in the six months ending Sept. 30, that achievement—if achievement it be—is attributable to a 68% decline in capital expenditures. In relation to its history and its peers, Sprint would appear to be under-spending. Expressed as capex per subscriber per month, Sprint laid out $5.97 in the three months till Sept. 30, lowest of the four major wireless network providers. A rebound in capital outlays is expected to be in store for 2017.

Sprint is neither your ordinary junk-bond credit nor your garden-

Capex on the horizon



source: MoffettNathanson Research

variety Big Board-listed common stock. It's a majority-owned subsidiary of SoftBank Group Corp., the Japanese telecommunications and Internet conglomerate. As the parent holds 83.2% of its subsidiary's outstanding shares, only 642.7 million, or 16.1%, of Sprint's stock trades freely. And out of that compact float, no fewer than 22.9% is sold short.

The wireless subsidiary, according to Fitch, is a better credit on account of the support of its parent: "Fitch's rating of Sprint is primarily supported by the material benefit Sprint's [issuer-default rating] receives from SoftBank's tangible support, which essentially sets a floor to the rating at 'B-plus.'" So said the agency in October. Then, again, SoftBank itself, rated Ba1/double-B-plus, is only a junk-issuer. As of Sept. 30, SoftBank's debt, net of cash, amounted to 4.9 times trailing EBITDA and operating earnings covered interest expense by only 3.1 times.

You can't fault Sprint's management for lack of creativity. An October financing—$3.5 billion in five-year notes at a fixed 3.36% with an option to raise an additional $3.5 billion under the program—was secured against the value of the Sprint wireless spectrum.

"While the spectrum notes remove the threat of an immediate bankruptcy," Lorenz observes, "they do not fix Sprint's underlying problems. And, from a recovery standpoint, the spectrum notes subordinate senior unsecured noteholders' claims on Sprint's most valuable assets: its portfolio of electromagnetic wave frequencies. This follows Sprint's borrowing against the handsets it leases to customers and against some of the company's network equipment."

The notion of valuing spectrum separately from the business that uses it raises questions of law and regulation. Turning again to Moffett: "It would make sense if the spectrum could be reclaimed and subsequently sold in the event of a bankruptcy, as would be the case in a Chapter 7 liquidation, but as a practical matter, that's not particularly relevant, as the FCC wouldn't allow an operator with 50 million customers to liquidate but instead would require that it be recapitalized to emerge from Chapter 11 instead. In that sense, the loans aren't really secured in the traditional sense, even though they do notionally gain a measure of seniority."

The spectrum loan buys time, not deliverance. A loss-making speculative-grade credit still confronts a formidable maturity wall. In the next three years, some $9 billion falls due, including $3.6 billion, $1.9 billion and $3.1 billion in fiscal years 2016, 2017 and 2018, respectively. Another $10 billion, as mentioned, matures in the four years beyond fiscal 2018.

You wonder how much of the $40.5 billion in spectrum book value can be hypothecated. Perhaps a great deal. Because Sprint was once an investment-grade credit, "its bond indenture has a fairly weak set of protections against assets sales," observes Mark Stodden, who covers Sprint for Moody's. "So there aren't a lot of restrictions on their ability to sell assets and lease them back. I think that will probably change over time as they layer on more secured debt, but I don't think that there is a limit today as to how much of this they can do."

Of course, the market might set its own limits. Holders of Sprint's senior unsecured claims took no visible offense at the spectrum securitization. Maybe they reason it will postpone the evil day of insolvency. Or perhaps they agree with Stodden that the $40.5 billion of spectrum book value "probably understates the true value of the spectrum by quite a bit." Then, again, as Stodden also notes, the clever Sprint securitizations are really a zero-sum game: "They achieved a lower cost of borrowing, but it was really at the expense of the existing bondholders." Sprint's senior subordinated creditors earn yields of 6% and 7% on the claims of a company that generates no positive free cash flow, shows a ratio of EBIT to interest expense of 0.99 times and arguably has some catching up to do in capital expenditure. Maybe the Federal Reserve ought to impose a creditor's minimum wage.

Not that such an idea would gain much traction at Sprint, where equity—in particular, the price of the equity—seems the very point of the enterprise. The top six executives stand to take home 16,875,000 shares if the stock price remains above $8 for 150 calendar days between now and May 31, 2019. If the price flutters above $10, the C-suite's gift is boosted by 20%, to 20,250,000 shares. Conversely, the award is cut in half, to 8,437,500 shares, if the price dips to $7.50 for 150 days. Below the $7 barrier, the brass receives coal. Would the dangled enticement of serious wealth compromise the judgment of the corporate stewards? Might it tempt them, for instance, to stuff the subordinated bondholders with continued spectrum securitizations, thereby possibly risking some future debt complication? The stewards might ask themselves the questions while shaving.

"How to value a business that doesn't make any money?" Lorenz ponders. "On the hope of a transformative M&A deal, perhaps. Or by imputing value to some other embedded corporate option. The shares do have option value, but that value is partly dependent on the continued complacency, if not obliviousness, of the Sprint creditors. What if they wake up?"

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