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Upholster your portfolio

Bond coupons have been shrinking for 3½ decades. Fortunately, they have not been shrinking in lockstep. Though most are low in absolute terms, some are higher than others. The highest of this low-hanging cohort protect the bond to which they are attached against rising interest rates. "Cushion bond" is the name of this genus, and *Grant's* is friendly toward it.

The proper cushion bond is not only endowed with a high coupon, but also with an early call date. In consequence, it's quoted near the call price, at a premium to par. The upside and downside are therefore each constrained (though, with respect to the downside—let us never forget—risk remains; to the inattentive investors in the Toys 'R' Us 7⅜s of Oct. 15, 2018, all seemed secure until the retailer filed for bankruptcy protection, as these pages noted in the issue dated Sept. 22, 2017).

The Oct. 19 Credit Suisse Credit Strategy Daily Comment lists 22 speculative-grade (or split-rated) cushion-bond investment candidates. The CS analysts observe that such securities delivered returns in the low single digits from January 2015 until February 2016 while, over the same span, the average junk bond suffered a mid-single-digit decline. The tendency of the price of a call-protected bond to home in on the call price—the "pull-to-call"—constitutes a kind of armor. And, if the bonds don't get called away, the holder gratefully clips those relatively plump coupons.

Dell Technologies, Inc. 7⅛s senior unsecured notes of 2024, rated double-B-plus, is the first illustrative specimen we've collected. "You'll recall," observes colleague Fabiano Santin, "that Michael Dell, in conjunction with Silver Lake Partners, took Dell, Inc. private in a $25 billion leveraged buyout 2013. A merger with EMC Corp. in 2016 created the current Dell Technologies, Inc. The tech giant sells PCs and tablets (under the Dell brand), digital storage devices (EMC), virtualization software (VMware), security identity products (RSA) and cloud solutions. It generated $73.4 billion in revenues and $7.8 billion in adjusted earnings before interest, tax, depreciation and amortization (EBITDA) for the 12 months ended Aug. 4. Cash flow is healthy, and the firm would like you to know that it aspires to achieve an investment-grade rating. As it is, Fitch Ratings judges the debt double-B-plus, i.e., the penthouse of junk."

Since the EMC merger, Dell has paid down $9.5 billion in debt. It is expected to end the fiscal year 2018 at a leverage ratio (debt to EBITDA) of 4:1, on its way to 3.5:1 in fiscal 2019, according to Fitch. Total debt stands at $40 billion and cash at $7.6 billion; a credit line of $3.15 billion is available under a bank revolver. Adjusted EBITDA covered interest expense by 3.3:1 over the past twelve months. Fitch, anticipating greater post-deal efficiency, expects that EBITDA will reach $10 billion in 2018 and $11 billion in 2019.

The 7⅛s trade at 109 cents on the dollar. They are callable on June 15, 2019, at 105.34, which produces a 4.5% yield to call or a 283 basis-point pickup in total return over the equivalent Treasury note. Absent the call, an investor could earn a 5.5% yield to maturity, for a projected 326 basis-point upgrade vs. Treasurys.

Specimen No. 2 are the Dollar Tree, Inc. 5¾% senior unsecured notes due 2023. They change hands at 105 to yield 3.2% to a 104.31 call next March 1 (a 193 basis-point pickup over the corresponding Treasury note). The issue, of which $2.5 billion is outstanding, is appraised Ba2 by Moody's, double-B-plus by S&P. Dol-

Yield on delay

Dell Technologies, Inc.'s 7⅛s Senior Unsecured Notes due June 15, 2024

Current Price: $109

Call Date	Call Price	Yield	Spread
June 15, 2019	$105.34	4.47%	286bps
June 15, 2020	103.56	4.69	296
June 15, 2021	101.78	4.82	295
June 15, 2022	100.00	4.90	291
June 15, 2024	100.00	5.47	325

source: The Bloomberg

lar Tree earned a single-notch upgrade from S&P in July. The company will "continue to deleverage and generate strong free cash flow in the coming year," the ratings agency judged.

Dollar Tree operates some 15,000 discount retail stores under the Dollar Tree brand (everything costs $1) and Family Dollar (nothing above $10). The stores sell candy and food, paper products, toys, durable housewares, gifts, stationery, party goods, greeting cards, pet supplies, diapers and the like. It's the low prices that keep Jeff Bezos at bay; Dollar Tree's shoppers are unlikely subscribers to Amazon Prime at $99 a year.

Revenue for the fiscal year 2016 jumped to $20.7 billion vs. $15.5 billion for 2015. The July 2015 merger with Family Dollar gets most of the credit for this acceleration. The tie-up crowned the new company as the largest operator of Dollar Stores in the United States. Gross and operating margins were 30.8% and 8.2%, respectively, in 2016, up from 30.1% and 6.8% in 2015. For the quarter ending on July 29, 2017, Dollar Tree sales grew by 5.7%, to $5.3 billion, from $5 billion in the same period last year, with operating income jumping to $419 million from $357 million. Same-store-sales rose by 2.4% in the last quarter vs. the same period a year ago. Free cash flow weighed in at $403 million in the first half of 2017 vs. $325 million the year before (the second half of the year, holiday-intensive, is the more lucrative). Total debt, including leases, stands at $11.2 billion, down from $12.9 billion a year earlier.

During last quarter's earnings call, CFO Kevin Wampler reiterated management's intention to return to the ranks of investment grade, from which it departed to consummate the Family Dollar acquisition. "Interest coverage," Santin notes, "as defined by operating income over interest expense, came in at a healthy 5.3 times for the first half of the year, up from 4.5 times 12 months earlier. Management says it expects to drive rent-adjusted leverage to below 3.5 times by early 2018, down from 4.5 times in 2015."

Our third specimens sit a little higher up on the credit scale. They are the triple-B-minus-rated Fortescue Metals Group Ltd.'s 9¾% secured notes due 2022, of which $2.2 billion are outstanding. Australia-based Fortescue sells iron ore to the hyper-encumbered People's Republic of China (the company is the world's fourth-largest iron-ore producer). These pages, long bearish on China, remain bearish (e.g., [*Grant's*, Jan. 13]). Though China is Fortescue's top customer at 95% of revenues, the Fortescue secured bonds seem contractually well-secured.

The securities came into the world in fiscal 2015 (ended June 30), a bad year for iron-ore prices, which fact you may infer from that outsize 9¾% coupon. Yet even in those unprosperous 12 months, net income registered positive $317 million in the face of a 27% drop in revenue, to $8.5 billion. Two years later, in fiscal 2017, revenue of $8.4 billion produced net income of $2.1 billion. Operating income covered cash interest by 7.5:1, compared to 1.6:1 in 2015 (interest expense was higher two years ago, let it be noted). Net leverage was 0.6 times EBITDA in 2017 vs. 3.0 times in 2015.

What a difference two years make: In May, Fortescue issued five-year, senior *unsecured* double-B-rated notes with a coupon of 4¾%. In case of default, S&P estimates, holders of that unsecured paper would achieve a 15% recovery, holders of the senior secured notes, a 95% recovery.

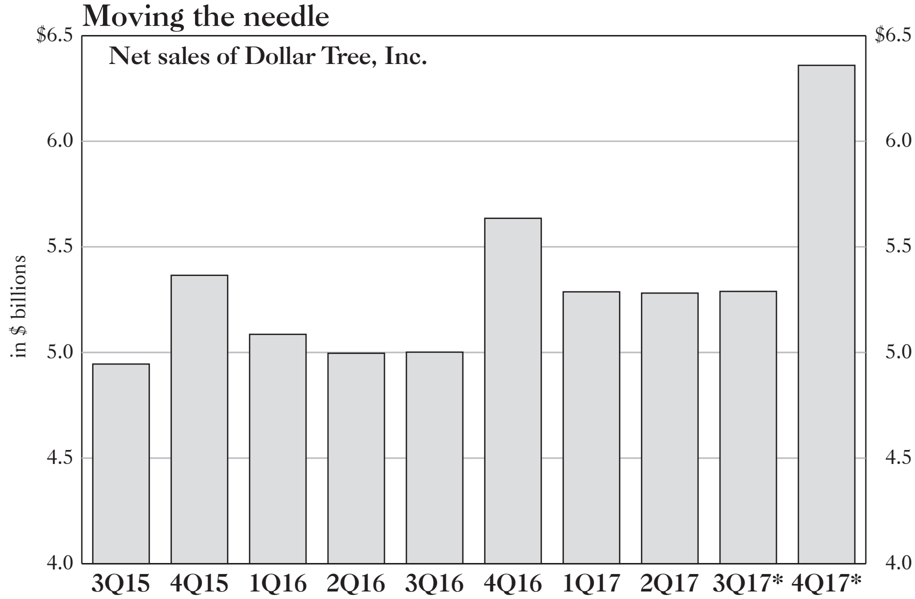
Fortescue's borrowings have been sawed in half since the end of 2015, to $4.4 billion. If the analysts polled by Bloomberg are on the beam, fiscal 2018 will show a decline in EBITDA to $3.5 billion from $4.7 billion in 2017. Free cash flow is likewise slated to fall, to $1.2 billion in 2018 from $3.4 billion last year.

It hasn't helped that iron-ore prices are quoted today at $63 per metric ton, which, while they are a far sight better than the $38 per ton logged in 2015, are a far sight worse than the $80 prices seen at the beginning of 2017. It's to the company's credit that it's joined BHP Billiton Ltd. and Rio Tinto Plc as members of the low-cost-producers club. Fortescue has reduced its cost per ton to $12.15 in the most recent quarter from $27 in 2015. Meantime, shipments show a steady rise, to 170 million tons in fiscal 2017 from 81 million tons in 2013. In its last conference call in August, management reiterated its intention to pay down debt.

"The Fortescue 9¾s trade at 111¾ cents on the dollar for a 2.5% yield to the call price of 109¾ on the first call date of March 1, 2018," Santin relates. "Not very beguiling, admittedly, but if Fortescue delays the call for one month, that 2.5% yield to call would jump to 3.9%. A one-year delay, till March 2019, would lift the yield to 5.7%, or 411 basis-points more than Treasurys. In effect, one is taking the risk to receive a current yield—coupon divided by price—of 8.7%."

No guarantee, of course, that you won't get that skimpy 2.5% return, but Fortescue may not find it so easy to re-

Moving the needle



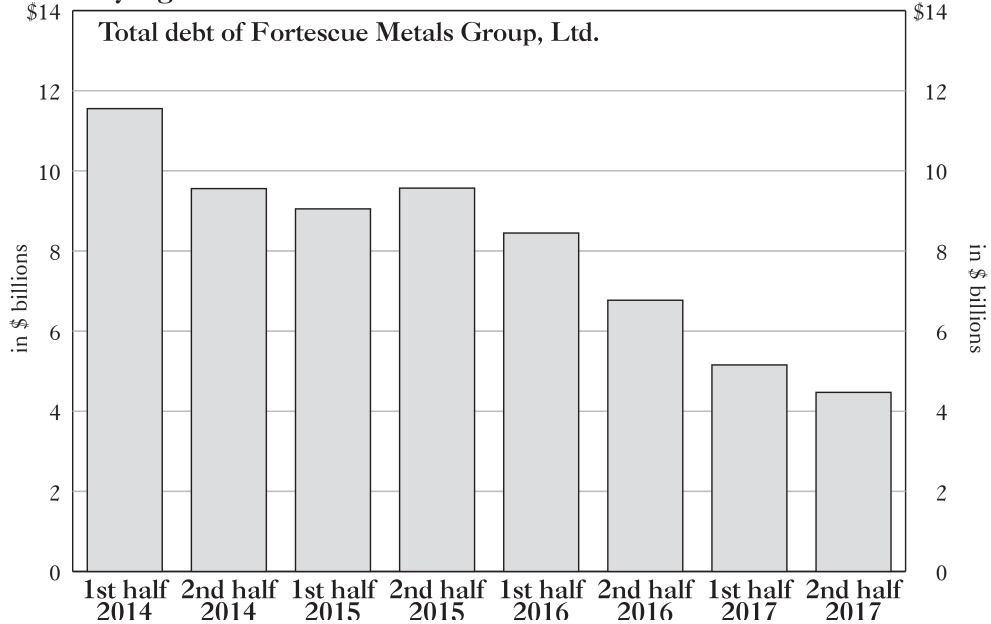
source: The Bloomberg *Bloomberg estimate finance a $2.2 billion bond issue all at one fell swoop. According to the aforementioned Credit Suisse report, nearly 20% of call-eligible bonds remain outstanding after their initial call date.

To understand why, a paid-up subscriber suggests, put yourself in the position of an ordinary American home owner. "Let's say somebody has a 5.5% mortgage with a 30-year term that today has ten years left," ruminates David Sherman, founder and portfolio manager of Cohanzick Management, LLC. "Why isn't he refinancing? His attitude might be, 'Look, my kids are off to college. Do I really want to go through all the paperwork and the headache on my $30,000 mortgage just to save a little bit of money?' He is going to save 200 basis points on $30,000. It's $600. And that's deductible for taxes. Does the guy care about saving a bit but having to spend on an appraisal and refinancing costs when he is going to sell the house?"

Like a distracted home owner, some corporations have more pressing things to do than refinance their debt. Intelsat was in such a position a few years ago (*Grant's*, March 25, 2016). The communications-satellite provider had done some high-cost borrowing after the financial crisis. The 11½% senior unsecured notes due Feb. 4, 2017, were callable at 105¾ starting on Feb. 15, 2013. Everyone knew that the company could refinance them. Everyone, too, was aware that an Intelsat IPO was in the works. In the event, the IPO had first claim on the attentions of the front office, and the bonds weren't called until two months after the first available date. On Jan. 25, one could have paid 106¼ for an evident yield-to-worst of minus 45 basis points. Who would have bothered? In the event, "the worst" was an April date rather than a February one. Any who ventured into the trade three months earlier earned an annualized return of 8.8%.

It helps, then, to read the mind of the relevant CFO. It is especially useful in the case of companies encased in the portfolios of private-equity sponsors. In certain cases, a little adversity is just what the bondholders

Paying it down



root for. Such troubles, provided they do not impair credit quality, work to prolong the lives of callable bonds.

Funds managed by Cohanzick own, for instance, the triple-C-plus-rated McGraw-Hill Education 8.5% senior unsecured notes due Aug. 1, 2019. The securities trade at 100¼ and become callable at par on Dec. 4. McGraw-Hill disappeared into the maw of Apollo Global Management, LLC, in 2013. Naturally, Apollo will try to monetize its investment. In September 2015, to that end, it filed an S-1 form for an IPO, though the transaction has been pushed off into the future. Though leverage is high, at 5.5 times EBITDA, comparable textbook publishers trade at enterprise values of between 10 to 12 times EBITDA. This means that, should McGraw-Hill stumble, there is a measure of equity protection for the creditors (by implication, an amount equivalent to 4.5 to 6.5 times EBITDA). The bondholder gets 8.3% in yield to maturity on Aug. 1, 2019, if the company doesn't call until that day.

A similar story surrounds the triple-C-plus-rated Dyncorp International, Inc.'s 11⅞% second-lien secured notes due in 2020. Dyncorp, now in the possession of Cerberus Capital Management, L.P., is a 70-year-old American defense contractor. Cerberus invested in 2010, catching its acquisition at its peak financial performance. After the peak came the disappointment (at least from the financial point of view): the winding down of the American presence in Iraq and Afghanistan and corresponding stringency in the U.S. defense budget. The accession of the Trump administration promises a more muscular defense posture and brighter times for military contractors. The second-lien bonds trade at 106.5 cents, near their Dec. 8 call price of 106, which would provide 17.9% yield to call. If the company waits until the next call date, in July 2018, the call price drops to 103, and the yield shrinks to 6.9%. In the opinion of Brendan Whittington, senior analyst at BulwarkBay Investment Group, LLC, cash interest coverage (2.5 times), liquidity (ample) and operational prospects (improving) should support the business as Cerberus readies its exit strategy. We concur.

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