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Alice in Junkland

Evan Lorenz writes:

Little by little, life returns to normal. Just last week, five speculative-grade companies borrowed money only to hand it back to their respective private-equity promoters. Yet there was nothing conventional about the macroeconomic setting in which those "dividend recapitalizations" took place. They happened during a recession.

A survey of the junk-bond branch of speculative-grade finance is the work in progress, and here, too, unemployment, bankruptcy, insecurity—recession—is the discordant element in the story line. Defaults are increasing, yet junk-bond yields trade relatively tight to Treasurys, and the percentage of the low-rated market deemed "distressed" is smaller than the long-term average of that troubled cohort. Leverage is on the rise, and junk-bond issuance is booming.

On tap is an overview of the market and of the central bank that enables it, followed by a close analysis of a trio of speculative-grade corporate credits. In preview, we have no use for the lot of them—the three speculative-grade borrowers, the broad junk market itself or the punchbowl-spiking monetary enabler.

Even so, we tread humbly, having more than once underestimated the market's prescience while overvaluing our own. Yet, it's passing strange, is it not—we put it to the readers of *Grant's*—that the quality of corporate credit is deteriorating as the prices of low-rated corporate securities are appreciating.

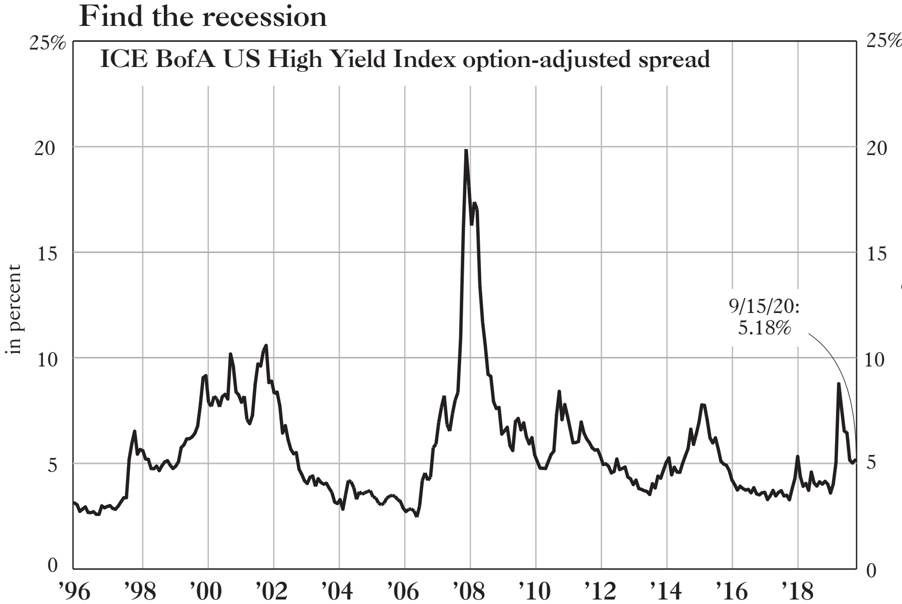
High-yield default cycles tend to be multiyear affairs. In the bust that followed the dot-com boom, defaults picked up in 2000 and did not fall below their long-term average of 4.1% until 2004. The Great Recession stood out for both its severity (trailing 12-month defaults hit a record high of 15.5% in November 2009) and its brevity (in 2010, the default rate sank to 2.8%). For that foreshortened timeline to recovery, one may credit (or blame, as partisans of price discovery are inclined to do) the Fed.

Investors are betting that the Covid-19-cum-lockdown slump ended almost as soon as it began. The ICE BofA U.S. High Yield Index put in its low price, 78.61, on March 23, the day the Federal Reserve took charge of American solvency (in addition to American liquidity); in August, the index reading climbed above par.

Between Jan. 20 and March 23, the spread on high-yield bonds to Treasurys soared to 1,087 basis points from 338 basis points. It rests today at 518 basis points, below the 24-year average of 556 basis points.

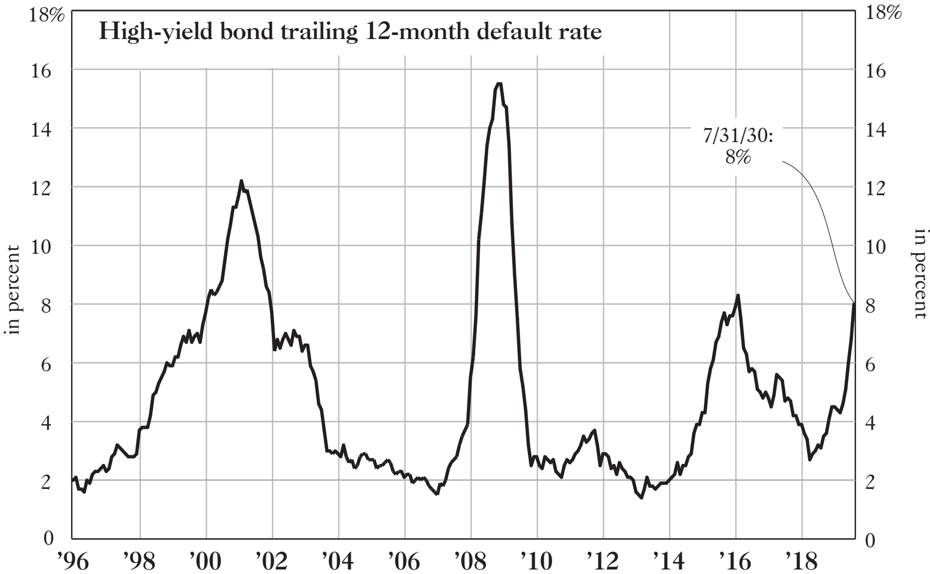
Improving fundamentals do not explain much of this miracle cure. The trailing 12-month high-yield bond default rate leapt to 8% in July from 4.3% in February, says Moody's Investors Service. According to CreditSights, Inc., the ratio of median net debt to earnings before interest, taxes, depreciation and amortization for nonfinancial borrowers rose to 4.4 times in

Find the recession



source: Federal Reserve Bank of St. Louis

***There's* the recession**



source: Moody's Investors Service

second-quarter 2020 from 3.9 times the year before. However, that gentle increase obscures a widening disparity between the most and least encumbered speculative-grade borrowers.

Take the median issuer among the 25% most indebted firms. Its leverage has almost doubled, to 11 times Ebitda from 6.3 times last year. Now compare the median borrower in the 25% least indebted companies. Its leverage ratio has declined, to 2.0 times from 2.2 times.

"An 11x net leverage number pretty much undermines a viable equity value for many HY companies or reflects an anomaly to be explained away," CreditSights notes. "Covid is the anomaly, and the pushback on panic is that the expected forward Ebitda run rates will improve as Covid eases, the effects get mitigated by top-line recoveries, the expense structures get adjusted, and other actions are taken to stabilize financial metrics. That's the part where the 'V shaped vs. W vs. Swoosh recovery' debates weigh in."

Yet, the market bears few signs of this dispersion in performance. By convention, a bond is considered distressed when its yield has risen to 1,000 basis points or more over the relevant point of comparison on the Treasury yield curve. "On Aug. 31, the distress ratio was just 11.58%, down from 14.33% one month earlier," writes Marty Fridson, chief investment officer of Lehmann Livian Fridson Advisors, LLC. "The latest ratio is below the 1997–2019 monthly mean of 13.82%, despite the U.S. being in a recession." On form, Fridson goes on, 32% of such distressed debt will run into trouble, which leads to an implied "market-forecast" default rate of just 3.7%, below the aforementioned long-term average of 4.1%.

Abnormally tight spreads and raging yield hunger have sparked resurgent issuance. In August, sub-investment-grade companies sold $52.9 billion of bonds, a 445% year-over-year jump and "the second-highest total for any month on record, bested only by the $59.9 billion in June 2020," according to LCD. In the year through August, high-yield bond sales reached $291.9 billion, a 71% year-over-year rise. According to BofA Global Research, this puts the market on the path for full-year volume of $375 billion, which would shatter the record of $344.8 billion set in 2012.

Bank lenders must see a very different economy. Since May 6, commercial and industrial loans have shrunk by 10.6% to $2.8 trillion. In the Fed's July Senior Loan Officer Opinion Survey, 71.3% of respondents said they were tightening terms for large- and medium-sized companies; none was relaxing them.

We hereby invoke the afore-quoted Fridson, dean of high-yield analysts, to improve upon a point we were about to make: "By intervening on an unprecedented scale, the Federal Reserve is supporting high-yield bond prices at a level that otherwise would be unimaginable in a recession, with commercial bankers wary of extending credit to all but the safest business borrowers."

Such intervention was more rhetorical than tangible. Thus, as of Aug. 31, the central bank had purchased $50.3 billion of corporate bonds at par value, including $8.7 billion's worth of ETFs. However, only $1.1 billion's worth of those funds were rated subprime and only 3% of the individual bonds in the Fed's shopping basket were tagged below investment-grade.

Waning fiscal stimulus may yet summon a stronger monetary effort. The $600 in weekly Cares Act supplemental unemployment benefits ended on July 31. While President Trump has authorized new payments of $400 from the Federal Emergency Management Agency, states must reconfigure their computer systems and stump up $100 a week of their own funds to participate. BofA Global Research, informed about its own customers' spending habits, reported that those who earned less than $50,000 a year, and had received the now-lapsed $600 checks, used their credit cards 18% less last month. According to the National Multifamily Housing Council, just 76.4% of renters made full or partial payments by Sept. 6, a 4.8 percentage-point decline from the same point last month.

By no means are high-yield bonds without their high-profile fans. Ben Inker, head of GMO LLC's asset-allocation team, likes them as a partial substitute for today's nearly barren government securities in the standard 60:40 retirement portfolio.

Assume, Inker proposes, that the downside for junk bonds is only half as bad as that for equities in a truly bad economy. Junk would thereby provide some yield as well as, so he contends, a measure of risk reduction.

Just the other day, BlackRock, Inc. chimed in, upgrading junk bonds to overweight and demoting investment-grade corporates, which deliver a mere 2%, to neutral. "High-yield spreads have also narrowed sharply from March," counsels a team led by the company's global chief investment strategist, Mike Pyle, "yet there may still be room for further tightening, in our view, particularly as the economic restart gains steam."

Be that as it may, returns to junk

bonds will depend on the incidence of default and on the losses in the wake of those nonpayments. Moody's estimates that the U.S. sub-investment-grade default rate will soar, to between 10.9% and 14.5% by February 2021, up from the current reading of 8%. One week ago, Doubleline Capital CEO Jeffrey Gundlach predicted that that 8% rate could double.

Of course, default isn't the same as wipeout. Between September 2010 and March 2020, defaulted junk bonds delivered a salvage, or recovery, value equivalent to 39% of par, according to Moody's, though recession-era recoveries are naturally lower than the average. But even a 39% recovery rate suggests that today's 518 basis-point premium to Treasurys provides no real protection against adversity.

"I've seen in the past that bonds just turn on a dime," Fridson tells me. "They are trading at a steady level, and all of a sudden the price plummets and the analysts say it doesn't look much different from last quarter. Why did the price fall out of bed? The change is that the credit environment changed and the banks that had been willing to keep funding the companies stopped doing that."

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Which leaves us with a number of evidently distressed issues that trade as if they were prime. First up are the Aramark single-B-plus-rated, senior unsecured 6⅜s of May 1, 2025. At a price of 105.25, the notes change hands at a price to yield 4.8% to a 2024 call (that being the "yield to worst"), for a 451 basis-point pickup to Treasurys.

If you've dined at a ballpark, college dining hall, company cafeteria or even a jail, chances are that Aramark was the chef. The company is a giant in the food, stadium-maintenance and uniform-services industry. Domestic food and support services accounted for 61% of fiscal 2019 revenues, international food and support services generated 23% and uniforms chipped in 16%. The U.S. food unit counts the education sector (33% of 2019 sales) as its biggest customer, followed by sports, leisure and jails (26%), stadium management and miscellany (16%), business and industry (16%) and healthcare (9%).

In the quarter ended June 26, Aramark's balance sheet showed $9.3 billion in debt and $2.4 billion in cash for net debt of $6.8 billion. (Like much of corporate America, Aramark tapped its revolver in March.) The Street pencils in $1 billion of Ebitda in the fiscal year ending Sept. 30, 2021, which implies a leverage ratio of 6.6 times next year's estimate.

Revenues showed a year-over-year collapse of 46% in the June quarter, leading to an operating loss of $327.6 million versus a quarterly $94.2 million interest bill. On the Aug. 4 earnings call, management indicated that business had picked up after the spring lockdowns with July showing declines of 36% year-over-year. Nevertheless, Aramark faces the surge in working from home, virtual learning (news site Axios reports that 62% of school kids are starting the year electronically) and a depleted schedule of socially distanced sport and entertainment events.

"With respect to the dividend," CEO John J. Zillmer told the earnings-call audience, "given the strong cash flow generation, the improved significant cash flow results in the quarter, we've deemed it appropriate to go ahead and pay the dividend going forward." In the June quarter, Aramark earned $16.8 million in cash from operations, not quite enough to fund the $27.8 million dividend expense, especially after the $85.1 million in capital expenditures.

"We remain at underperform on Aramark," judged CreditSights in the wake of the dividend news. "Material headwinds and uncertainty due to Covid-19 disruptions continue to impact Aramark's core customer base and the unclear path of recovery will continue to pressure revenues, profitability and cash flow. Even in a post-Covid environment, Aramark will have a long road of deleveraging ahead and the company's decision to leave its dividend intact while cash flow is under pressure does not reassure us on the alignment of bondholder and shareholder interests." Just so.

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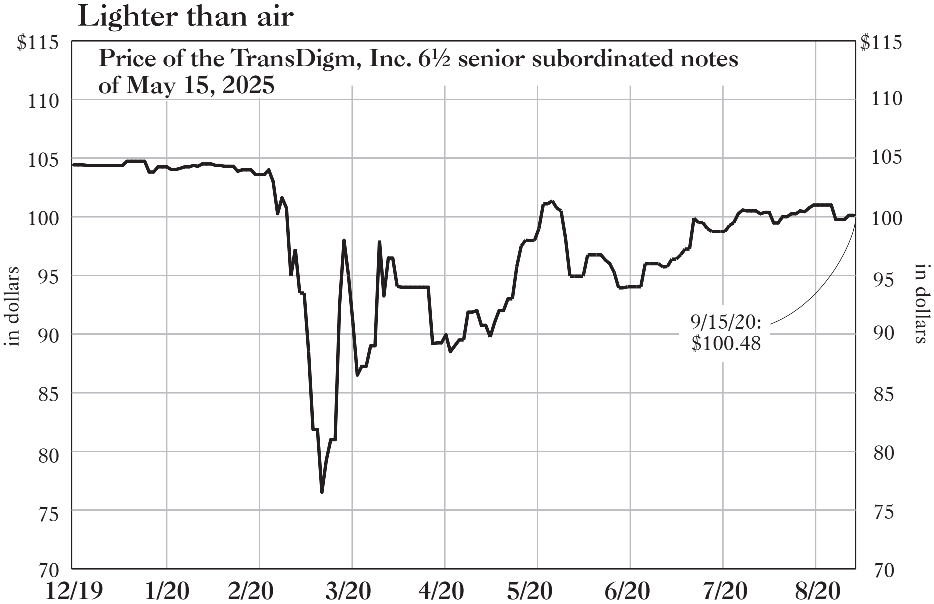
Next up in our trio of distressed securities impersonating nondistressed securities are the TransDigm, Inc. single-B-minus-rated, senior subordinated 6½s of May 15, 2025. The notes change hands at 100.48 for a yield to worst (i.e., to a 2022 call) of 6.2%, a 592 basis-point premium to Treasurys.

A leading supplier of aircraft components and systems, TransDigm serves both the Department of Defense (37% of fiscal 2019 sales, giving effect to acquisitions) and commercial interests (with 32% of sales to OEMs and 31% to the aftermarket trade). *Grant's* had its bearish say on TransDigm in the May 1 issue, when we described the essential managerial M.O. along these lines: To acquire sole suppliers of key avionic equipment, slash the R&D budget and raise prices. It's a strategy that en-

Lighter than air



source: The Bloomberg

cumbered the balance sheet and left the business ill-prepared to cope with the lockdown-induced collapse in air travel. Debt amounts to 6.7 times trailing Ebitda of $2.3 billion and to 7.2 times the consensus estimate for next year's Ebitda of $2.2 billion.

Revenue plunged by 32.8% in the June quarter, leading to a net loss of $6 million versus a net profit of $145 million in the year-ago period. Operating income of $286 million barely covered the $262 million in interest expense. As of June 27, the balance sheet showed $20 billion in debt and $4.5 billion in cash for net debt of $15.5 billion.

Even so, TransDigm has outperformed its commercial customers. According to the International Air Transport Association, revenue passenger kilometers fell by 79.8% year-over-year in July. Nor does IATA see a quick rebound. The association predicts that commercial airline revenues will halve in 2020, to $419 billion, and will recover only to $598 million in 2021, compared with the 2019 aggregate top line of $838 billion.

As for TransDigm's U.S. customers, the outlook is no cheerier. "Carriers are set to shrink massively when restrictions on laying off or furloughing workers expire with the aid package on Oct. 1," *The Wall Street Journal* reported last Friday. "American Airlines and United Airlines have announced job losses amounting to 19,000 and roughly 16,000 employees, respectively, in addition to the thousands of staff who have already quit or taken leave voluntarily."

To give the devil his due, adjusted Ebitda margins in the June quarter weighed in just 1.8 percentage points below the year-earlier level, at 41.5%, despite cratering commercial sales—down by 43% and 52%, in the OEM and aftermarket segments, respectively—and a 12% decline in defense sales. The disproportionate weakness in the commercial business lifted government sales to 49% of the total, from 38% in the same quarter last year. If defense sales are much more profitable than the company average, we should expect margins to benefit as defense becomes a larger part of the overall business.

Then, again, TransDigm faces a pair of government investigations, one from the Department of Defense Office of Inspector General and one from the House Committee on Oversight and Reform. On this score, it's notable that Defense asked Congress for new powers to review contracts in this year's National Defense Authorization Act and specifically cited TransDigm in its request. While Congress declined the appeal, it's clear that the Pentagon has the company in its crosshairs.

Then, too, TransDigm's results are notable for what they omit. Peer Heico Corp. charged $7.5 million in the quarter ended July 31 for bad debt expenses. "We probably had 20 airlines during the quarter [that] declared reorganizations or Chapter 11," said CFO Carlos Macau, on the Aug. 26 earnings call. "So that, our policy is to just basically write that stuff up, put a reserve up against it when we see that occurring. And if we get paid, great—and we hope to get paid—but, nonetheless, be conservative about it."

On TransDigm's Aug. 4 earnings call, CFO Michael Lisman pegged the company's bad debt expense from aviation customers at around $1 million. Analysts did not press the point.

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And then there are the Carvana Co. triple-C-plus-rated, senior unsecured 8⅞s of Oct. 1, 2023, priced at $104.56 for a yield to a 2021 call of 6.4%. Until last week, the Carvanas were actually trading above their Oct. 1, 2020 call price, which circumstance created the rarity of a negative-yielding triple-C-rated junk security.

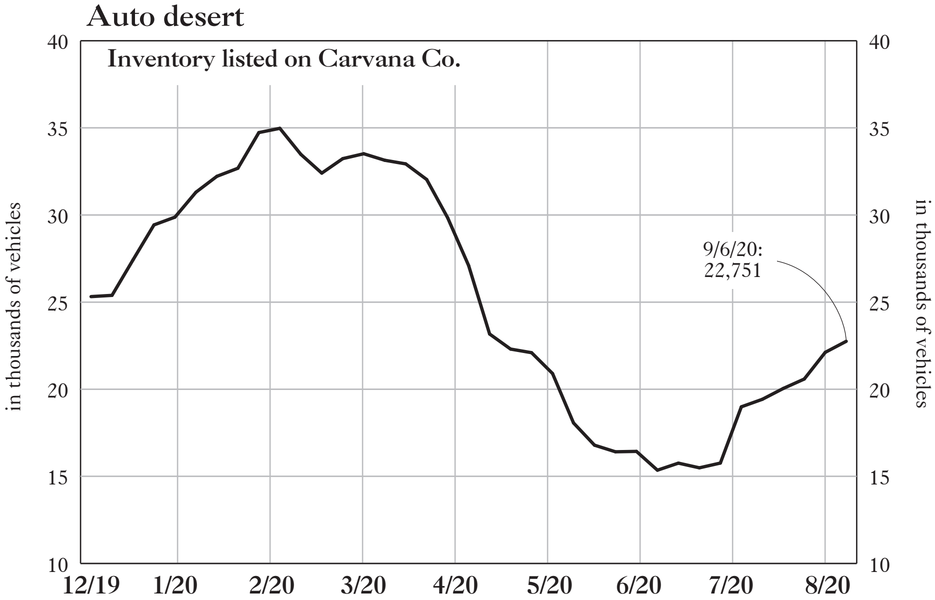
Carvana, as constant readers recall, is the online-only retailer of used cars perched in multistory vending machines. The company subjects the autos on its digital storefront to a 150-point inspection and offers customers a 100-day limited warranty on purchases. Among the sizeable population of bears (short interest in Carvana common foots to 26.6% of the float), the used-car company is also esteemed for its losses ($1,930 per vehicle sold in the second quarter).

Grant's sent a Carvana item to press on Aug. 4, one day before the company reported second-quarter earnings. We identified Covid-19-induced supply shortages of used vehicles as a major headwind to Carvana's future growth. In its Aug. 5 release, the company confirmed our suspicions: "We are inventory-constrained and over the immediate term we expect our sales volumes to largely be dictated by our production capacity."

Based on web sleuthing by YipitData, a boutique research firm, the number of vehicles listed on Carvana's website dwindled to 22,751 on Sept. 6 from 34,974 on March 1. In a perhaps more alarming find, the number of cars available for sale from that inventory has plummeted to 9,186 from 20,339 over the same period.

As a result, Carvana's year-over-year revenue growth slowed to 13% in the second quarter, from 45% in the first quarter and from 101% in full-

Auto desert



source: YipitData

year 2019. In the second quarter, the company generated an operating loss of $89.7 million before $19.9 million in interest expense. As of June 30, Carvana carried $1 billion in debt and $246.3 million in cash, for net debt of $802.8 million. The Street estimates that the company will generate negative $316.2 million in Ebitda this year and negative $103 million in Ebitda next year.

While Carvana remains a darling of growth investors, bondholders can, at most, receive interest payments and the return of their principal. This is something Carvana bondholders seem to forget at times.

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