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Frontiers of junk

The junk-bond market, long overvalued, has lately been hammered into something resembling fair value, Marty Fridson, high-yield analyst par excellence, reports. Bondholders will vouchsafe two cheers, at the most, for this welcome intelligence. If a market can become overvalued—and can remain so (as this one has) for the better part of nine months—it can surely become undervalued.

Now under way is an update on the speculative-grade wing of the corporate debt market, with telecom in the foreground and credit—writ large—in the background. In preview, *Grant's* is bearish on the over-encumbered wireline operators that availed themselves of the hospitality of yield-deprived investors as recently as six weeks ago. Frontier Communications Corp. (FTR on the Nasdaq) is the index case. We would likely be bearish, as well, on Altice N.V., the debt-gulping, Dutch-domiciled cable and mobile-telephony roll-up. Since 2012, Altice has rolled up its own net indebtedness to an imminent €48.5 billion from just €1.7 billion. We say we *would* be bearish; Altice's baffling pro forma financials allow for no definitive judgment. A provisional judgment: Bearish.

Since June 2014, average junk bond yields have spiked to almost 8% from less than 5 ¼%, according to Bank of America Merrill Lynch. Proverbially, high prices ration demand; in the case of suddenly elevated corporate bond yields, the rationing effect has so far been muted. Following its $17.7 billion purchase of Cablevision Systems Corp. a couple of weeks ago—a transaction financed, in part, by $4.8 billion of low-rated debt—Altice, through its CEO, Dexter Goei, commented to Bloomberg: "There are enough examples in the history of the high-yield market where it shuts down. You're not going to risk that capital because you're trying to be, at the margin, thoughtful about 50 basis points or 25 basis points here or there. You may actually shoot yourself completely in the foot if you're too smart about it." And a good call it was. Since the Altice-Cablevision Systems news broke on Sept. 16, the Cablevision 5¼s of 2024 have plunged to 77, for a yield 9.15%, from 93.5, a price to yield 6.23%.

By the looks of things, Frontier Communications, too, slipped in just under the bear-market wire. Ten-year notes that the copper-wire-themed telecom roll-up issued only three weeks ago have declined by more than 5 cents on the dollar. The Frontier borrowing narrative takes some telling.

Stamford (Conn.)-based Frontier—it was born Citizens Utilities Co. in 1935, following the collapse of a preceding leveraged utilities roll-up—offers broadband, voice, video, wireless Internet data access, and bundled offerings for residential customers and businesses in 28 states. Growth through acquisition is the corporate métier. In 2010, the company purchased wireline operations in 14 states from Verizon Communications; payment took the form of $5.2 billion of common equity (Verizon shareholders received 678.5 million shares of Frontier stock) plus the assumption of

Yields rally

source: Federal Reserve Bank of St. Louis

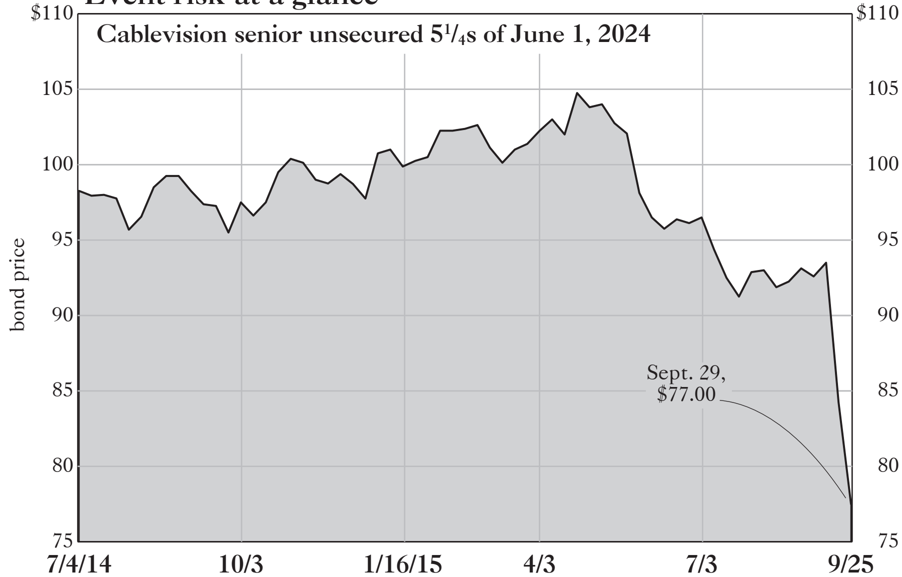
$3.5 billion of debt. In 2014 came the purchase of AT&T's wireline business and fiber network, each in Connecticut, for $2 billion; financing featured $775 million of 6.25% senior unsecured notes due 2021 and $775 million of 6.875% senior unsecured notes due 2025, each rated in the vicinity of double-B. Quoted at par as recently as April 2015, the 6.25s today trade at 84.75, to yield 9.67%; the 6.875s change hands at 78.75, to yield 10.5%.

Next came Big Bertha, the February 2015 purchase of Verizon's wireline operations in California, Florida and Texas, for a cool $10.54 billion. When signed, sealed and delivered, the transaction will double the size of Frontier, i.e., to $11 billion of revenue and $4.4 billion of EBITDA. To quote from the Frontier press release: "These Verizon properties include 3.7 million voice connections, 2.2 million broadband connections, and 1.2 million FiOS video connections. The network being acquired is the product of substantial capital investments by Verizon and is 54 percent FiOS enabled." The announcement found Frontier common trading at $8 per share.

How to finance this ten-and-a-half billion dollar extravaganza? Equity and debt: $2.75 billion of the former, $8.1 billion of the latter, including $1.5 billion of bank debt and BB-minus rated junk bonds, in the sum of $6.6 billion. There are three issues of senior notes: $1 billion of 8⅞s of 2020, $2 billion of 10½s of 2022 and $3.6 billion of 11s of 2025. Weighted average cost of the debt portion of the financing came to 9.1%. It was just what the planners had budgeted, Frontier management chimed in to say. Still and all, one may compare and contrast: Having paid 6.875% for 10-year funds in September 2014, the company is now paying 11%.

Not only paying 11%, but also committed to paying 11% virtually till maturity; so-called make-whole clauses warrant that bond buyers will not be the losers if management refinances today's bonds at tomorrow's possibly lower interest rates. The new Frontier debt, issued at par, has lately joined innumerable other speculative-grade securities in ticking lower in price, higher in yield. The deterioration reflects not only the weakness in junk as an asset class—more broadly, we believe, in credit as an asset class—but also the specific difficulties of the wireline industry.

Event risk at a glance



source: The Bloomberg

Wireline means wire, i.e., copper wire, through which is transmitted voice (via that phone that's curiously still connected to the wall), data (think: "DSL") and television (think: "cable"). Frontier, CenturyLink and Windstream Holdings are the three top pure-play wireline vendors. Each is a high-yield borrower, and each—to judge by the falling prices and the rising yields of the debt that bears their respective names—has run afoul of Mr. Market.

"These firms," observes a friend of this publication who asks to go nameless, "have tried to straddle a line of providing high current income to shareholders while trying to hold on to their subscribers and keep their revenue streams from declining. Increasingly, they are trading high-margin legacy voice and circuit-switched revenue for much lower margin Internet Protocol (IP)-based revenue, and they are having to maintain fairly high levels of capex in order to provide services that are competitive with cable providers and other combatants, or else risk watching their customers defect. That's a combo that doesn't bode well for shareholder payouts generally. So I think the bond market is saying that the expectations that shareholders have for return of capital are driving up credit risk and are inherently unsustainable."

This, too, is a "deflation" story, as our reader observes, more the kind associated with Joseph Schumpeter, coiner of the phrase "creative destruction," than with, for instance, Ben S. Bernanke or Janet Yellen, co-authors of the yield famine that the junk market has done its all to relieve. Striving to satisfy, on the one hand, shareholders with high dividends and share buybacks and, on the other, customers with costly capex, the telecom industry has seemingly underpaid its creditors. Now they want—nay, demand—a raise. "While it ain't the energy patch yet," says our friendly reader, "it seems like telecom firms may be living in their own version of interesting times."

In a September 9th press release, Moody's Investors Service expressed no such opinion. In the next few years, the agency ventured, Frontier's leverage will moderate "before falling further in 2018 due to expected debt repayment and synergy realization. . . . Moody's expects Frontier's consolidated revenue over the next several years to remain approximately flat as the growth within the acquired Verizon wireline properties offsets the low single digit percentage decline at the legacy Frontier business. The Verizon acquisition is positive to Frontier's cash flow profile given the high margins of the acquired wireline business and the high penetration of FiOS within the footprint. . . ."

Quick as a flash, the Frontier 11s have slipped from the Sept. 11 issue price of par to 95.5, a price to yield 11.8%. Perhaps the market, preoccupied with mutual fund redemptions and near-term supply, is not so much dissenting from the Moody's call as finding it (for the moment) irrelevant. Or maybe the market is paying closer attention to another Moody's judgment, that of Sept. 15, in which the agency rendered a new, disapproving view of Sprint. Said Moody's: "The brutal competition now playing out in the U.S. wireless industry will pressure the financial performance of even the strongest operators." The rating of the Sprint senior unsecured notes was slashed to Caa1 from B2.

It was amidst these disturbances that Altice clinched its $17.7 billion acquisition of Cablevision. Centerpiece of the financing was to have been $6.3 billion of junk debt. A look at the market forced a reconsideration; the aforementioned $4.8 billion rather came to market at yields ranging from 6⁵/₈% for 10-year, BB-minus rated, senior "guaranteed" paper to 10⁷/₈% for 10-year, single-B-minus-rated senior paper of the Altice-Neptune financing subsidiary.

"John Malone is my role model," the Franco-Israeli chairman of Altice, Patrick Drahi, told reporters in Paris in May, according to a Sept. 18 Bloomberg bulletin. "He's an engineer who started with nothing and got to where he is today. He's not afraid to take risks."

Neither is Drahi afraid to take risks. The question is, Are the creditors quite sure they are willing to bear the risks that the intrepid management is willing to take? Altice bought SFR, France's second-biggest mobile operator by subscribers, for €17 billion in April 2014. It bought Portugal Telecom for €7.4 billion in November 2014. It bought a 70% stake in Suddenlink Communications, the seventh-largest U.S. cable company, for $9.1 billion, last May. "Altice's debt binge for growth raises eyebrows" the *Financial Times* reported on Sept. 17. "[F]rom a modest €1.7 billion in 2012, analysts estimate it will have risen to €48.5 billion by the end of 2016 assuming that Mr. Drahi completes his latest purchase. 'I don't know any company of its size that has levered up that much that fast,' says Simon Weeden of Citi Research. Most of the debt is in the form of bonds, whereby Altice has tapped into a huge appetite for yield. 'They have been a main source of new borrowing in the high-yield markets in Europe,' says Mr. Weeden."

"Telecom businesses are often viewed as relatively safe investments," colleague David Peligal observes. "Safe—perhaps, until the dividends are cut. Which brings us back to Frontier, with its equity market cap of $5.5 billion and share price of $4.68, down from $8 in February and down from $5 in June, the price at which the company raised equity. In the context of telecom short-sale candidates, you think first, probably, of Windstream (WIN on the Nasdaq). Here the market cap is small, the short interest is high, and the borrow is tight. In the case of Frontier, the short interest is 14.9% and the borrow is not a problem. Consider that a $5.5 billion market cap would sit below an estimated $17 billion of pro-forma net debt in 2016. A Barclays credit research report lays out various 2016 pro-forma metrics. Thus, we see that Frontier's ratio of EBITDA to interest expense would stand at around 2.9 times, EBITDA less capex/interest at around 2.0 times; interest expense would amount to $1.5 billion, free cash flow at just under $1.1 billion.

"I'd argue," Peligal concludes—he speaks for the boss—"that EBITDA less capex/interest is quite relevant since Frontier needs to invest in the business to keep the customers happy. Then, too, management will always be in a kind of arms race with the cable guys or the wireless guys to create the fastest network. Frontier already spends about 12.5% of its annual revenue on capex. Bullish investors keep hoping that, at some point, you can stop the spending, at which point the cash flows will just come rolling in as the customers remain happily in place. Somehow, it never works out like that. Meanwhile, the dividend is going to have to compete with management's ambitions to delever the balance sheet. Altogether, the company will have its hands full. I think the dividend eventually gets cut—admittedly, I'm not sure when—and that the credit, which for so long was easy to get, will presently become a great deal harder to get. Come to that, credit has already become harder to get."

Frontier, as mentioned, is descended from Citizens Utilities Co., founded in 1935; Citizens was the second coming, through reorganization, of Public Utilities Consolidated Corp., a leveraged, 1920s-era utility roll-up led by Wilbur Foshay (1881-1957), a kind of junior Samuel Insull, the great utilities magnate whose bankruptcy shocked the world in 1932. Late in the 1920s, Foshay got it into his head to build the tallest building in Minneapolis, and he did, a 32-story Art Deco tower modeled after the Washington Monument (it still stands today, as the W Minneapolis). The grand opening of Foshay Tower took place over Labor Day weekend 1929.

"Foshay," according to the Foshay Tower Wikipedia entry, "invited 25,000 guests to the dedication ceremony and provided all expenses paid trips to many who attended, including cabinet members, senators and congressmen. Half-nude dancers entertained. Each guest received a gold pocket watch. The military gave 19-gun salutes. John Philip Sousa conducted music, including 'Foshay Tower-Washington Memorial March,' a march he wrote for the occasion. Foshay presented Sousa with a check for $20,000."

The stock market crashed, the check bounced, and Foshay's holding company went into bankruptcy. Foshay died broke. There must be a moral in all of this.

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