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Basis points aloft

Evan Lorenz writes:

Fewer than one-sixth of U.S. speculative-grade bonds are priced to deliver a positive real yield, observes Jim Reid, head of global fundamental credit strategy for Deutsche Bank A.G. No surprise, perhaps, given that the average junk yield stoops at 3.97%, compared with the 5.3% year-over-year reading for the August consumer-price index. Even the European high-yield market, with its minus 0.7% average real yield, looks (somewhat) fetching among such options. Is there nowhere to turn for a little income?

Well, yes—for the risk-tolerant. In preview, *Grant's* is bullish on the bonds of Gol Linhas Aereas Inteligentes S.A. (GOL on the New York Stock Exchange). In addition, we propose a Gol Linhas-themed pair trade with another U.S.-listed Brazilian airline. Widows and orphans will avert their eyes from the second agenda item.

Skinny yields notwithstanding, the junk market is getting fatter and fatter. Through July, $748 billion's worth of high-yield bonds and leveraged loans came to market, easily overtaking issuance in the first seven months of both 2019 and 2020, according to S&P Global Ratings.

And the more debt, the more deals. Through August, announced merger and acquisition activity in the United States summed to $1.8 trillion, most for the first eight months since at least 1995, according to Dealogic. Worldwide, some $3.9 trillion's worth of transactions have hit the tape, notes Refinitiv, putting 2021 on pace to overtake the $4.3 trillion record made in 2007.

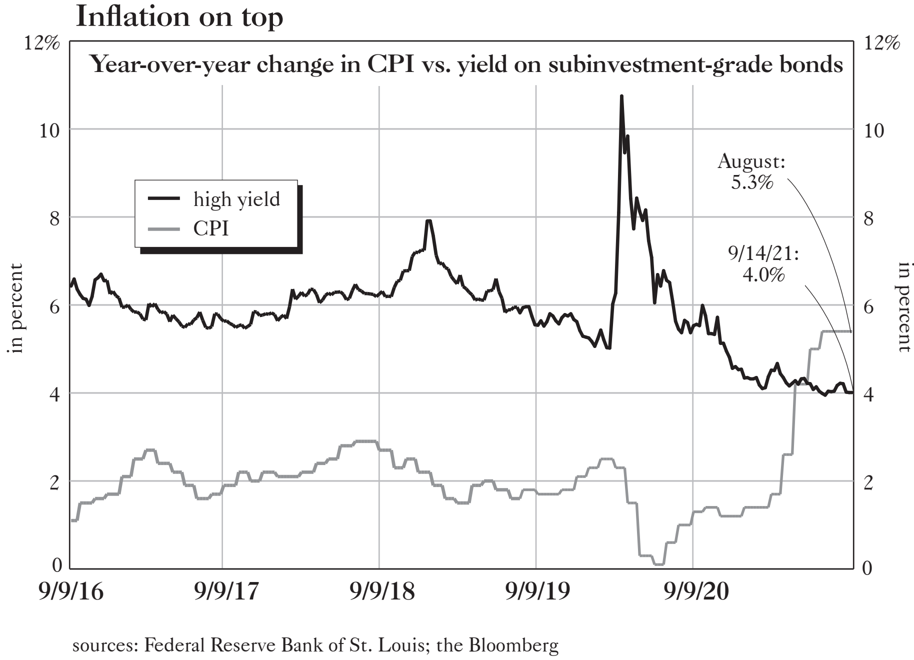
The regulators can't keep up. On Aug. 3, the Federal Trade Commission, overwhelmed to the extent that it can no longer hope to process the pre-M&A paperwork in the customary 30 days, started sending form letters to would-be deal-doers saying that "the agency may subsequently determine that the deal was unlawful. Companies that choose to proceed with transactions that have not been fully investigated are doing so at their own risk."

Creditors, too, must proceed at their own risk. Covenant Review, the gimlet-eyed analyst of the creditor protections afforded (or denied) in the fine print of bond and loan indentures, is warning of the wholesale breakdown of legal defenses since the Great Recession.

You can see it, CR advises its readers, by comparing bellwether transactions from the eve of the Great Recession to those of today—for instance, the First Data Corp. 9⅞% senior notes of 2015, issued in 2007, versus the Ancestry.com, Inc. 6⅛% senior notes of 2028, auctioned last November. By a lender's lights, each was a stinker, but the Ancestry debt is revealingly worse.

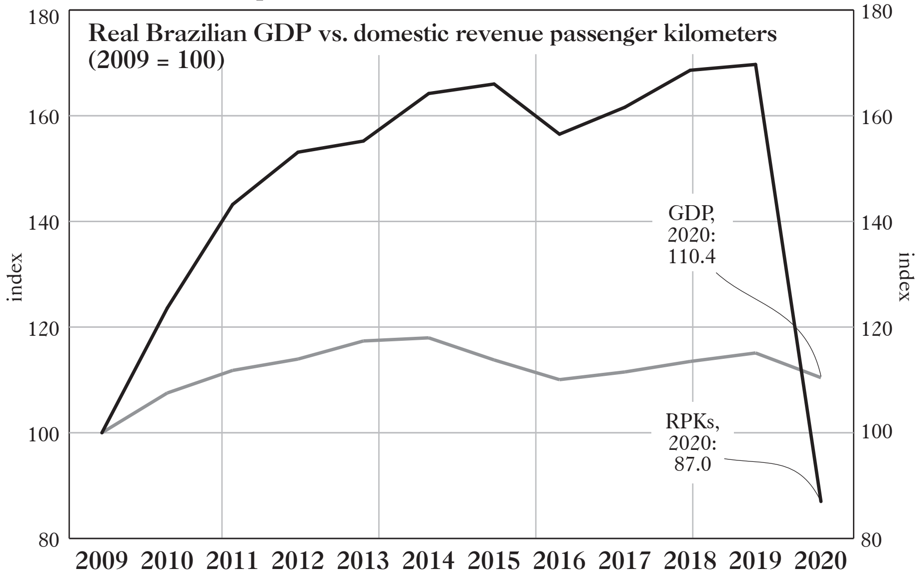
Thus, First Data was prohibited from issuing more debt if the incremental borrowings would trip a fixed-charge coverage test. Ancestry can sell bonds even if the extra debt violates a ratio test in a "pick your poison" clause (see the issue of *Grant's* dated May 14). In the case of default, e.g., a missed coupon payment, First Data's covenants

Inflation on top



sources: Federal Reserve Bank of St. Louis; the Bloomberg

Brazilian air pocket



sources: The Bloomberg; company reports

forbade dividends and buybacks; the Ancestry covenants allow the issuer to make restricted payments until a missed payment actually forces an event of default, i.e., after a contractually stipulated period to cure the default has elapsed. While both bonds allow for add-backs to Ebitda, First Data was free to claim cost savings that materialized within 12 months of the close of an acquisition; Ancestry can add three years' worth of imagined economies.

Naturally, near-term default risk is low nowadays—permissive covenants hardly allow it. Standard & Poor's projects that the 3.1% trailing 12-month default rate on U.S. junk bonds in July will dwindle to 2.5% by June 2022. It's a stunning forecast. For one, as S&P notes, if you applied the one-year average default rate to each bond, rating by rating, you would predict a 6.5% default rate by the middle of 2022. And as recently as December, S&P predicted that today's default rate would rise to no less than 9%.

Which explains why prudence has been a winning short sale in the junk-bond market. "The best performing high-yield maturity basket was the longest; the best performing rating category was the lowest," sums up Martin Fridson, CIO of Lehmann Livian Fridson Advisors, LLC, for S&P's LCD unit. "Furthermore, among the 20 largest industries, the four lowest rated (average Composite Ratings of B2 to B3) all finished in the top half by total return."

Corporate earnings for S&P 500 cohorts, which, in the second quarter, jumped by 89.1% from the year-ago reading, have likewise contributed to the bullish atmospherics. And so, too, has the Goldman Sachs Financial Conditions index, which points to the most inviting corporate markets on record.

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Where, then, to find a few dozen extra basis points of relatively secure income? A non-reader of *Grant's* might be tempted to turn to the Chinese real estate developers, say, to the dollar-pay China Evergrande Group 8¼ secureds of 2022, which change hands at 33.51 for a yield to worst (the very worst) of 404%. True, Evergrande is not exactly anyone's definition of "acceptable risk." Last week the developer disclosed it was skipping a pair of September interest payments, and Bloomberg relays that it's paying suppliers in fractional interests of its own unbuilt properties.

Perhaps, as an alternative, one might consider nonrated domestic bonds, the smaller issues from companies that either won't pay, or, perhaps, can't pay, for a rating? *The Wall Street Journal* reports that such instruments are having a moment. Non-bulge-bracket investment banks typically do the underwriting—think the Piper Sandler Cos. of the world rather than JPMorgan Chase & Co. While business is booming (Piper has more than doubled the size of its deal flow this year), the bonds are the kind that you buy and hold. In a declining market, you often have no choice.

So it's on, now, to the dollar-pay Gol 7% senior unsecureds of 2025, which are priced at 94.40 to yield 9%, or the dollar-pay Gol 3¾ senior unsecured converts of 2024, which change hands at 88 to yield 8.6% (of which more later). To be clear, there's no confusing either with a Treasury bill: Gol is a 21-year-old airline in an emerging market and its bonds are rated Caa1/triple-C-plus.

The 9.68% Brazilian inflation rate reflects, in part, the depreciating real, which has sold off to 5.25 to the greenback from 4.02 at year-end 2019. Brazil's central bank has responded by hiking its intervention rate to 5.25% from 2% at the start of the year. Lacking the Fed's magical reserve currency, neither Brazil nor Chile bailed out its airline industry. In consequence, Latam Airlines Group S.A., a Chilean company that accounted for 34.7% of domestic flights in Brazil in 2019, filed for bankruptcy protection in May 2020.

Nor do national politics exactly beckon the would-be foreign investor to Brazil. President Jair Bolsonaro chose Sept. 7, Brazilian independence day, to attack the country's Supreme Court, which has authorized investigations into his conduct, and to call into question the integrity of Brazilian elections. Ahead of next year's balloting, Bolsonaro's approval rating has plummeted to 25%.

On the positive side of the ledger, *The Economist*'s Big Mac index calls the real 23% undervalued against the dollar, and the Ibovespa, Brazil's benchmark stock index, trades at 7.9 times estimated 2021 earnings versus 21.9 times for the S&P 500.

Constantino de Oliveria Jr., Gol's founder, took a page from the Southwest Airlines Co. playbook by choosing to fly one, and only one, type of jet: in his case, the Boeing 737. Today, Gol leases a fleet of 127 such aircraft, including 10 of the newest, the 737 MAX. The uni-jet approach has allowed Gol to insource maintenance and outsource repair services to other airlines who fly its one-and-only plane. The Constantino family has stakes controlling 64.8% of the economic interests in the airline and 100% of the voting rights.

The Brazilian airline industry was an investor-pleasing oligopoly even in 2019, before Covid. Gol dominated with a 37.7% share of domestic flights, followed by Latam with 34.7% and Azul S.A. (AZUL on the Big Board) with 23.6%. Gol and Latam serve larger cities, Azul smaller ones. (In 2020, Azul was the sole airline on 77% of routes flown.) Since the pandemic, share has become even more concentrated as Avianca S.A., which had a 3.7% slice of domestic demand in 2019, exited the market.

We judge the longer-term outlook for the Brazilian airline industry to be favorable. At 3.3 million square miles, the Great Green Country is just 500,000 square miles smaller than the 50 states. In the virtual absence of passenger rail, "travel by bus has traditionally been the only low-cost option for long-distance travel for a significant portion of Brazil's population," according to the Gol 20-F report on file with the Securities and Exchange Commission.

The happy result, pre-Covid, is that air travel was outgrowing GDP. Thus, in the decade ended 2019, revenue passenger kilometers (RPKs) for the Brazilian airline industry grew at a compound annual rate of 5.6% versus a 1.4% rate for GDP. This period included the tail end of the global financial crisis (Brazilian GDP contracted by 0.1% in 2009) as well as the 2015–16 period, when production fell by a cumulative 6.7%. For comparison, the peak-to-trough decline in U.S. output between 2007 and 2009 was just 3.8%.

Despite the high rate of growth pre-2020, however, the Brazilian air-travel market is far from saturated. In 2019, it logged 0.5 flights per capita, behind regional neighbors Mexico (0.8), Colombia (0.9) and Chile (1.4). To catch up with Mexico, Brazil would have to expand its fleet by 60%; to match Chile, by 180%.

Such tailwinds are well and good, but they would avail the creditor little if his airline filed for bankruptcy protection; Latam is still under court protection. Of Gol and Azul, the former appears much better positioned to capitalize on a rebound in flying and to survive additional bad news.

Admittedly, August flight statistics would seem to reverse that order of preference. Last month, Gol flew 1.8 billion RPKs domestically, a 39% drop from the August 2019 reading, whereas Azul's domestic RPKs climbed 6.5% from August 2019, to 2.1 billion. At a glance, then, the lightly served rural market has proven more resilient than Gol's big city destinations.

More important is Gol's low cost structure, which points to a faster return to positive free cash flow than Azul is likely to muster. In 2019, Gol generated R$4.2 billion ($802 million) in Ebitda. "They have about R$2 billion in lease expenses in 2022, capex is around R$600 million a year and their interest expense is about R$700 million," Josh Gerber, a senior analyst at Carronade Capital Management, L.P., a Darien, Conn.-headquartered hedge fund that is long Gol's bonds, tells me. It makes for a set of fixed costs of around R$3.2 billion and means that Gol may generate positive free cash flow next year even if its revenues do not recover to 2019 levels.

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Gol's single-jet strategy proved fortuitous during the pandemic. Having planned to upgrade its fleet to the ill-starred 737 MAX, the carrier entered the Covid era with short-term leases on many older 737s. Reduced operations left it with a surplus of aircraft, but rather than returning the surplus, Gol negotiated with its lessors to convert a portion of its fleet to fees based on usage ("power by the hour"), from a flat monthly rate, through year-end 2021.

Azul, by contrast, operates a mixed fleet of Embraer, Avions de Transport Régional G.I.E. and Airbus aircraft that range from turboprops to wide-bodies. Lacking Gol's bargaining chips, Azul negotiated subleases for some of its jets with Breeze Airway, an American airline controlled by Azul's founders, as well as other third-party airlines. But those subleases are struck at rates below what Azul itself pays to its lessors.

Azul also negotiated with its lenders to defer contractual lease payments from 2020 and 2021 into future periods. ("That's a free interest loan, a zero interest loan," the company's chief revenue officer, Abhi Manoj Shah, told the December 2020 investor-day audience.) So it is that Azul's minimum lease payments are set to escalate to R$3.5 billion in 2023 from R$3.2 billion in 2022 and R$2.5 billion in 2021. In 2019, Azul generated R$3.6 billion in Ebitda. Thus, even if the airline returns to prior peak profitability, it would not have enough cash flow after leases to service interest expenses and capex.

Azul has had to lean on its suppliers to fund its cash shortfalls. Between the June-end quarters of 2019 and 2021, Azul's days payable jumped to 144 from 56, whereas, over the same span, Gol's days payable increased to 105 from 49. After discovering the leverage they enjoy with their vendors, both airlines may keep longer payment terms post-virus—Azul told me that it targets paying its bills within 90 to 100 days—but this still leaves a significant gap that Azul needs to fill.

Thais Haberli, head of Azul's investor relations, tells me that next year they "don't expect to be cash-positive. If we add all of the deferrals and all the debt created during the pandemic, obviously we are burning cash." The hope, says Haberli, is that Azul turns the corner in 2023.

And it's Azul's management, not Gol's, that, between the first quarter of 2020 and the second quarter of 2021, raised the discount rate it uses to calculate the present value of operating leases, and not by a little. The front office pushed it to 22% from 8.2%. Such cosmetics, of course, change nothing except to make the balance sheet appear less leveraged. Over the same period, Gol raised its discount rate to 12% from 8.5%. A 12% rate would boost Azul's lease liabilities by R$3.5 billion, or 29% of that carrier's market cap.

Even so, Azul has declared its intention to buy Latam's Brazilian operations out of bankruptcy. If the deal goes through, it would be over the loud protests of Latam's management, but to the applause of investors both in Gol and Azul, as the Brazilian industry would become a nice, snug duopoly. However, negotiating the deal would prolong Latam's stay in bankruptcy and Brazilian regulators would need to approve a merger that would leave Azul in control of more than two-thirds of Brazil's air passenger traffic.

"There is a big question mark on how Azul would fund the transaction," Carolina Chimenti, who rates both airlines for Moody's Investors Services, tells me. "If you take Latam's Brazil market size, it is almost the same as Azul's. Azul would be doubling its size, and it has its own cash flow needs at the moment."

In the 12 months ended June 30, both airlines incurred heavy losses. Gol's net debt, including operating leases, now foots to 4.1 times 2019 Ebitda. On the same basis and using a 12% discount rate to calculate the net present value of operating leases, Azul's net debt sums to 5.9 times 2019 Ebitda.

The many disparities between the two lead to an interesting pair trade. The aforementioned Gol 2024 converts are priced to yield 8.6% and are exchangeable for common shares at a $20.25 strike price. While that is a hefty premium to the current share price of $7.32, it was a level at which the stock did trade in 2019.

The dollar-pay Azul 7¼% senior unsecureds of 2026 change hands at $96.80 to yield 8.1%. Any problem that hits the Brazilian airline industry is likely to weigh more heavily on Azul, which has higher operating costs and more stretched liquidity, than on Gol. So prospective investors could buy the Gol converts, short the Azul 7¼s and earn a positive 0.5% spread per annum (versus the 0.4% yield of the three-year Treasury note) with a free call on Gol's stock trading above $20.25 over the next the next three years.

"This is the low-cost, largest airline in Brazil with all of the secular growth ahead of it," Andy Taylor, a managing director at Carronade, tells me. "If you look at airlines in the United States, they are trading at enterprise values that are north of pre-Covid levels. We see a compelling case for Gol to re-rate as that area continues to recover."

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