NARROW ROAD
CAPITAL

The Winner Is… Busted Companies

Some commentators have gone as far as saying capitalism is broken as the share market is a on a tear when the economy is suffering so badly. Whilst the recent surge can be largely explained by central banks flooding markets with excess capital by buying almost anything, there are some anecdotes that point to fundamental tenets of capital markets being forsaken. In several ways, busted and bankrupt companies have been winning when the normal course of events would be for these companies to be the biggest losers. Here's three things to ponder.

Retail Investors are Buying Shares of Bankrupt Companies

What do you do if you love a punt but can't get to a casino and your favourite sports are shut down? How about the stock market where recent trading has made Las Vegas look tame! In both the US and Australia, the number of retail investors opening accounts has been at record pace. In the US, a surprisingly high number of Americans deposited their $1,200 stimulus cheques into brokerage accounts and have let loose. Brokers like Robinhood are facilitating no commission trading of shares, ETFs and options so you don't even have to worry about the trading costs burning up your account. If you've lost your job or are stuck working at home, you might be able to earn some money in your downtime. If a football player can why not you too?

These new investors have taken a shine to the most speculative shares including Tesla, which now boasts a market capitalisation of $173 billion. This makes it the mostly highly valued car maker in the world after surpassing Toyota, an extraordinary feat considering Tesla loses money selling a relatively small number of overpriced cars. But even crazier has been the buying of shares in bankrupt companies like Hertz and a handful of oil and gas players where basic maths implies that shareholders will be wiped out. For Hertz, the unsecured debt is trading at 40 cents on the dollar, pointing to a $1.8 billion shortfall for these bondholders. This makes the $403 million market capitalisation a massively overpriced, way out of the money call option. Company insiders agree, and have been selling their shares.

The trading in shares has been strong enough that Hertz is now considering selling new shares. There doesn't appear to be a precedent for such an overly indebted bankrupt company to sell new shares, especially when the proceeds would be used to reduce the losses for bondholders. The bankruptcy court has given approval for the share sale to proceed so the next few weeks will see a bizarre test of market sanity.

Bonuses Before Bankruptcy

As well as Hertz, JC Penney, Chuck E Cheese and a slew of other bankrupt or nearly bankrupt companies have paid out bonuses to their senior executives. The companies typically call these "retention" payments which as one company put it are meant to "continue incentivising our team to drive results". More cynical observers see these payments as rewarding failure and reducing the return to creditors of the companies.

Distressed Debt Exchanges

For years I've been one of many debt veterans warning that covenant lite debt would come back to bite lenders. We are now seeing the outworkings of giving away standard creditor rights with some borrowers bullying creditors into taking haircuts on their debt. Borrowers are threatening to shift assets out of the security net or to issue more senior debt thus devaluing the position of existing lenders, if those lenders aren't willing to swap their existing debt for lower value replacements. Both sides are lawyering up, but the lenders are in a difficult position having willing given away the standard protection mechanisms when they bought the debt.

Written by Jonathan Rochford for Narrow Road Capital on 13 June 2020. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

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