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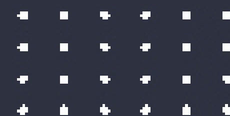
EXCLUSIVE REPORT

The Greatest Legal Transfer of Wealth in History

Your Complete Guide to Distressed Investing



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Your Complete Guide to Distressed Investing

Friends,

The world's economy is on the precipice of a debt crisis unlike any that's ever happened before.

Because of soaring inflation, the world's central banks can no longer deliver the stability that markets have gotten used to. The economy now faces a complete reset of interest rates, sovereign debt loads, and corporate debt loads without the "cushion" of central bank largesse to soften the collapse.

And... while that opens the door to a potential market meltdown... **it also means a tremendous amount of money will be changing hands.**

We call this once-in-a-lifetime market scenario "the greatest legal transfer of wealth in history."

How will we profit? Two words: **Distressed investing.**

The following in-depth guide will show you why and how distressed investing works... how you can cash in thanks to bonds and equities... and how Porter & Co.'s Distressed Investing team, led by credit expert Martin Fridson, finds deeply discounted opportunities for pennies on the dollar.

We'll start, as we always do, with a story...

During the second week of March 2020, cruise line giant Carnival Corp. announced that it would ground its fleet of 18 ships. One of its ships had become a hotspot of a mysterious and frightening new virus called Covid-19. Over the next few weeks, fears escalated that the company's giant floating Petri dishes could become sea-borne luxury coffins.

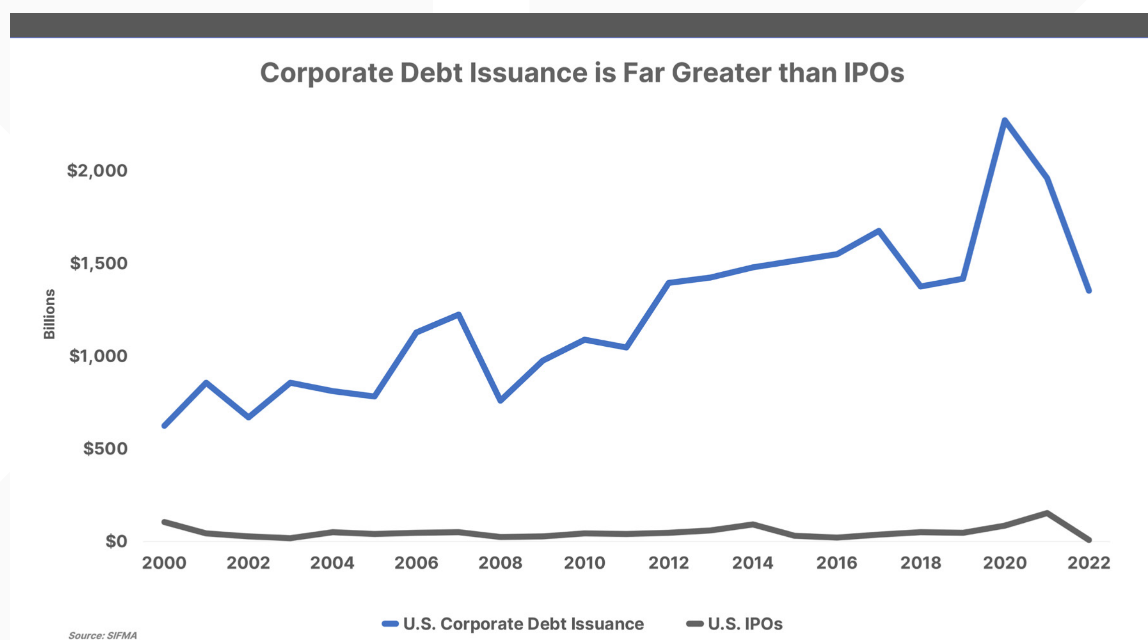
Carnival's share price plummeted 83% between January and April 2020. As the reality of the pandemic settled in, it looked like there was a real chance that the entire cruise ship industry would go the way of the horse and buggy. At the time, it looked like Carnival Corp. was facing an existential threat.

Nevertheless, in April the company raised an incredible $6.25 billion in a bond issuance – including $4 billion at the nosebleed interest rate of 11.5%. At the time, that was around 3 times what a normal home buyer would pay in interest for a mortgage. It was 3.6 percentage points more than the government of Argentina

had to pay in June 2017 on a 100-year bond (which it shortly thereafter defaulted on).

Carnival was at the extreme end of the risk spectrum of debt investment... in June 2020, Standard & Poor's lowered its credit rating to BB-, making it non-investment grade, or high yield, or as the media prefers to say, "junk."

Carnival was able to raise so much capital thanks to the Federal Reserve's money-printing mission – which triggered an epic gorge on cheap money by corporate America. U.S. companies raised just under $2 trillion in bonds in 2021 – more than 12 times that year's IPO issuance.



The vast majority of the companies that sold enormous amounts of debt in 2020 and 2021 were far better credits than Carnival. Disney, which raised over $28 billion during the pandemic, will be able to repay its bondholders almost no matter what. So will AT&T and Verizon.

But some debtors will go belly up. As interest rates have risen, it has become more difficult for those companies to roll over their liabilities (that is, to replace existing debt with new debt)... even at a significantly higher interest rate. A recession would compound an already challenging situation for heavily indebted companies.

One result of this dynamic – that is, of way too many companies raising debt at artificially low interest rates, and being unable to repay it, while their businesses face the headwind of a broad economic slowdown – is that a lot of solid

companies with an ample cushion of liquidity will also be treated by investors as if they also won't be able to make their payments.

As a consequence, the bonds of these reliable and financially robust companies will collapse in price… even though the chances that they won't be able to make their bond payments are very slim.

In other words… they're the baby of demonstrably good bonds, being thrown out (that is, sold off) with the bathwater of probably-going-bust bonds.

And that's where this report – featuring what's easily the least-understood, most under-the-radar, highest-upside asset class – comes into play.

You see… many bonds that, to much of the market, **appear** to be close to default… in reality **aren't**. Bonds that are thrown out with the bathwater can often deliver higher and more reliable returns than stocks… for years. They can deliver triple-digit returns… on an established schedule… and there isn't any guesswork involved in how you'll be paid.

This may sound ridiculous. After all… the stock market gets much more airtime than the bond market. The talking heads on CNBC will tell you what stock to buy – not which distressed bond you should be loading up on. Neither you nor anyone you know has probably ever heard these words at a cocktail party: "Let me tell you about this great distressed bond my broker recommended."

But as you'll see in just a moment, distressed debt – and, more broadly, distressed investing – presents seasoned investors with a unique opportunity to profit from fear in the market in ways that are safer than just regular stocks.

This is a huge market that offers extraordinary investment opportunities… and it's hiding in plain sight.

Before we get to that, though, let's look at how we arrived at this inflection point.

The Fed's Money-Printing Mission

Money doesn't grow on trees – that takes too long. If it were up to the Fed, money would replicate at the speed of the common cold (excuse me, we mean Covid) virus.

As of mid-2022, roughly 79% of all dollars that had ever been made were created over the previous 17-month period. That was due in part to the $6 trillion or so in Covid-19 stimulus.

And it's what's behind a federal budget deficit that in 2020 amounted to an emerging-market-gone-wild level of 14.9% of GDP, the highest for the United States since World War II. (Budgetary excess poster child Argentina posted a deficit in 2020 of a comparatively prim 8.5%.)

And when an economy is awash with liquidity – that is, lots of cash – capital flows to companies that are higher-risk and more speculative. It's the inevitable result of there being too much money looking for a way to generate a return.

Think of a family budget. If money is tight, it's allocated to the most important, mission-critical efforts and projects for the family: Food, rent or mortgage, car payments, education. And the return on that investment – nutrition, a roof over your head, a way to get to work, and building for the future – is immense. You'd be hungry and on the street without it.

But then... the family wins the lottery. Suddenly, there's more cash than smartly chosen things that will generate a good return to spend it on. Second cousins who come out of the woodwork are scoring cars and small business loans.

As a result, businesses start inhaling capital like Al Pacino's Tony Montana in Scarface.

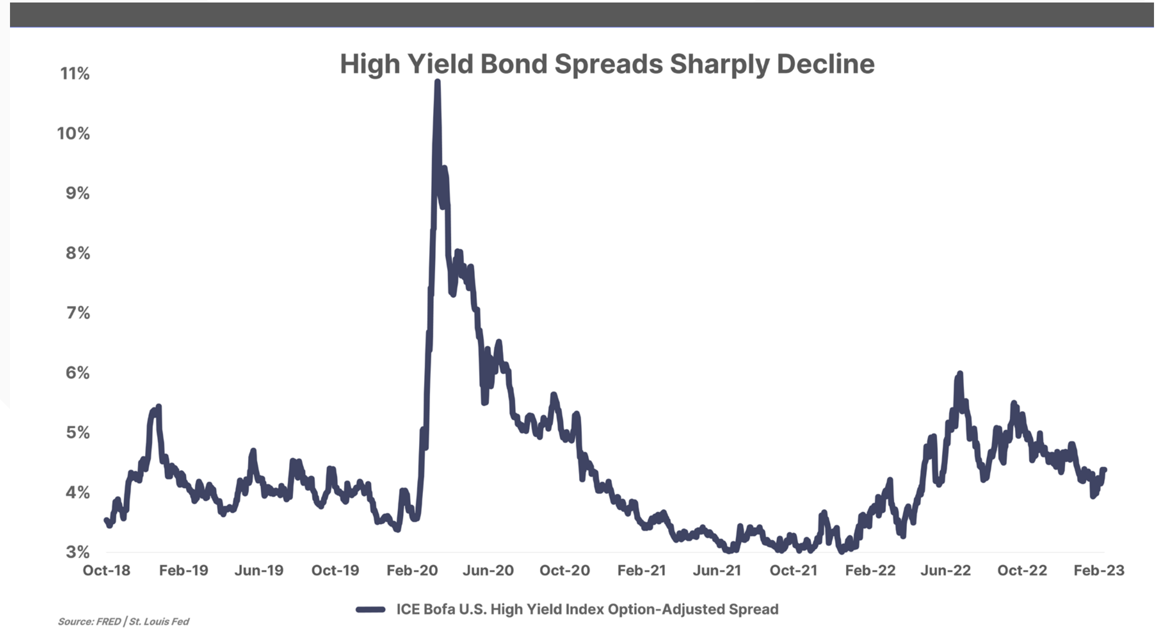
The companies used the cover of the evolving pandemic to draw down credit lines, sell bonds, and take out loans as if preparing for the zombie apocalypse (which, as far as anyone knew at the time, was the case).

Covid-19 brought economic uncertainty and it looked like the U.S. would enter a prolonged recession, which caused negativity to reach all-time highs. Many investors feared that a global economic shutdown companies would cause companies to fail to make their interest payments or fulfill repayment obligations.

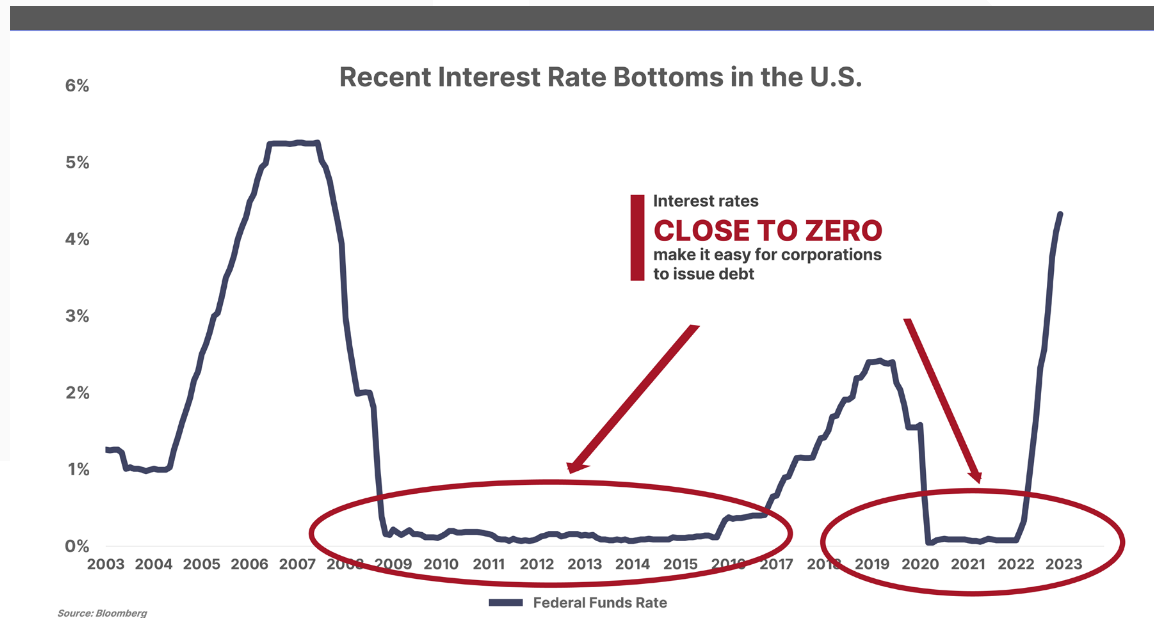
This caused spreads to rise and the government intervened with aid and stimulus in the form of lower rates. The feds also injected liquidity into the system to prevent economic collapse. (You may or may not have done a home renovation project or two with your stimulus money. No one is judging.)

But there ain't no such thing as a free lunch, really.

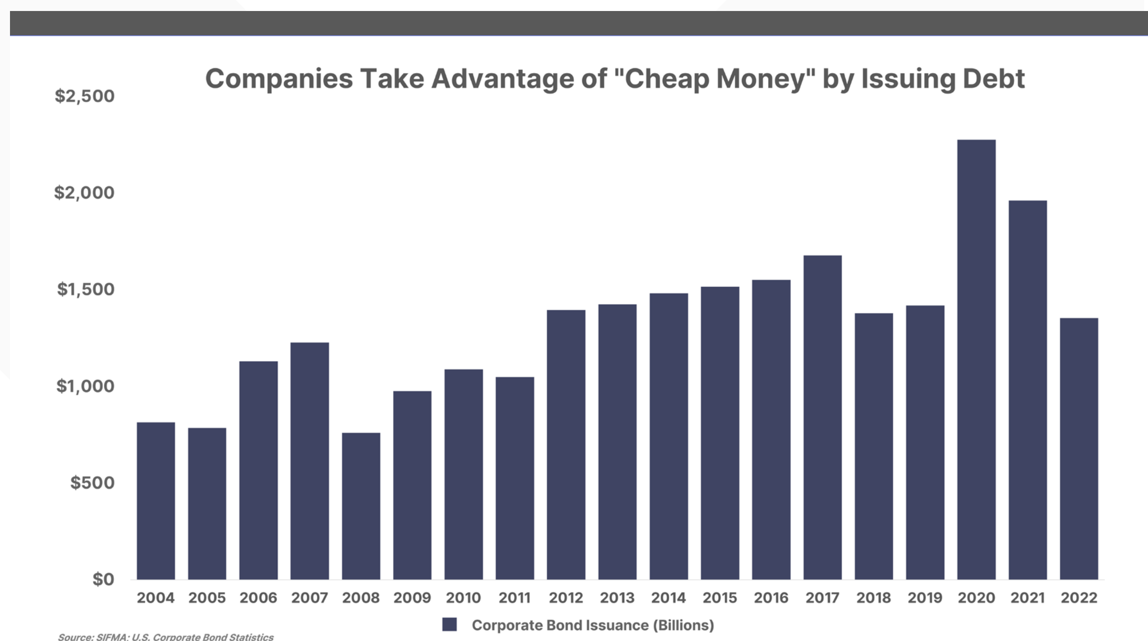
Yields fell sharply, as we see between June of 2020 and July of 2021. Watch the progression here...



Liquidity flowed into the system and corporations now had access to debt requiring very little by way of interest cost, as you can see from the rock-bottom rates in the United States Fed Funds Rate chart:



When interest rates are close to zero, it creates an environment where creditors are willing to renew financing on unproductive assets, as it ensures their previous borrowings will be repaid. The cost to borrow was extremely cheap in the ultra-low-rate environment, so companies looked to raise capital.



Corporations could now issue bonds with lower interest rates, meaning that bondholders were accepting small risk premiums for weak credits.

The boom of cheap money was great for bankers. And it was great for companies. For investors? Less so. But they didn't have much choice – in a world of 0% interest rates, even getting 3.5% for AT&T sounds pretty good.

Until the music stops, that is.

We're About to Discover Who Has No Swim Trunks

Wallis Warfield Simpson, the colorful divorcee who married England's King Edward – which precipitated his abdication – reportedly had a pillow embroidered with the motto, "You can't be too rich or too thin."

That's wrong on both counts – it's definitely possible to be too thin, and believe it or not, it **is** possible to have too much money.

From the second quarter of 2019 to one year later, total borrowing by U.S. companies (excluding financial institutions) increased by 16% to an all-time high, according to data from the St. Louis Fed.

Also bolstered by strong profitability, total cash balances (which include borrowed funds) of U.S. companies were up an incredible 54% as of March 31, compared to a year earlier. At that point, they were more than double the levels of early 2019.

That's a lot of cash – and it's created a case of mo' money, mo' problems.

The too-much-money phenomenon has actually been going on for a while. "The global economy's bizarre problem: Too much money," headlined Quartz in April 2015, decrying the 400% growth in the Federal Reserve's balance sheet during the period since 2007. In June 2019, Axios warned,

> *A truly bizarre trend is having an impact on the economy — wealthy people and corporations have so much money they literally don't know what to do with it."*

Sound familiar?

And what exactly have companies done with all that cash?

Some companies reinvested into their businesses, made smart acquisitions, strategically expanded their operations, and bolstered research and development. In other words, they did the kinds of things you'd hope they'd do to generate returns for shareholders and grow.

Other companies were less smart... and we are now discovering just which ones they are.

When interest rates are close to zero -- as they have been during the past easy money era -- it's easy for both good **and** bad companies to get credit, which

makes it harder for investors to distinguish the sound bond investments from the rotten ones. As Warren Buffett is famous for saying,

> *"Only when the tide goes out do you discover who's been swimming naked."*

(Warren, as we all know, wouldn't be caught dead without one of his 20 special suits tailored by Chinese entrepreneur Madame Li.)

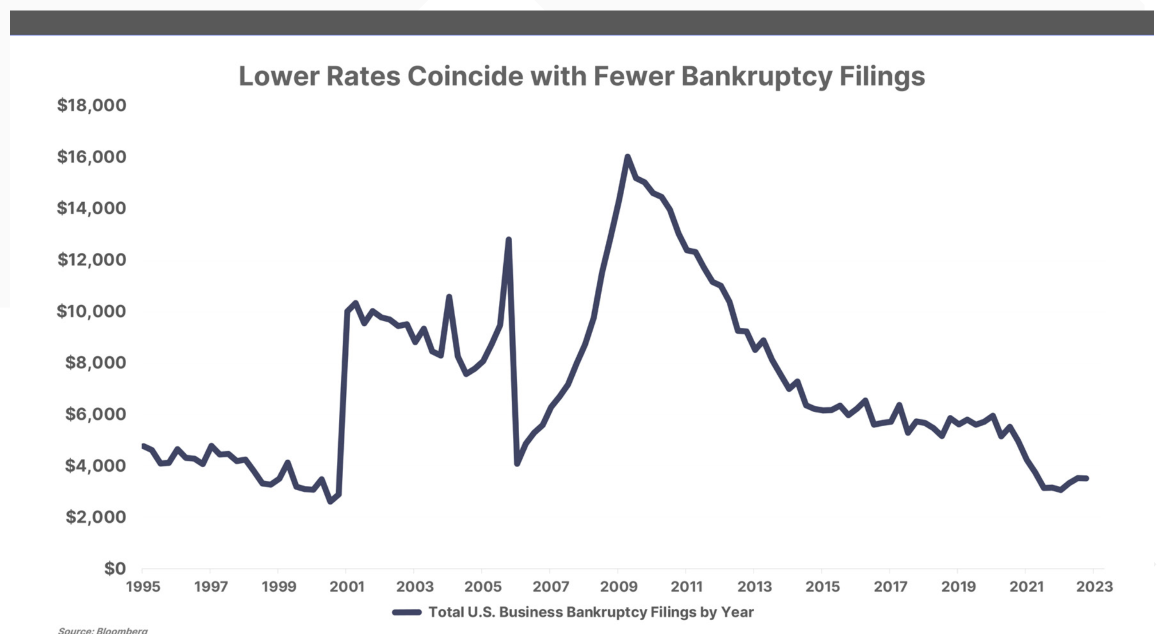
When interest rates are low, capital is more readily available, allowing companies to pursue more aggressive growth strategies that are riskier but reap higher potential profits…a condition also known as a "liquidity rush."

Investors respond similarly. When bond yields are unusually low, investors look to equities, as the environment created by meager interest rates makes the returns on those assets that much more attractive.

During the Covid-19 boom, there was a large supply of liquidity that resulted in a "risk-off" rally in public equities. The number of companies that went public in 2020 and 2021, compared to 2022, indicates just how frothy the market really was.

- 134 IPOs in 2022
- 1035 IPOs on the U.S. stock market, a record in 2021
- 480 IPOs in 2020, which was a record until the following year

During the easy money era, as you can see in the graph below, there was a dramatic reduction in bankruptcies in the U.S. (which, notably, also happened right before the 2008 crash):



But a funny thing happened on the way to financial nirvana: The Fed turned hawkish, in March 2022.

By year-end, Jerome Powell and his Open Market Committee associates had jacked the key Federal Funds rate all the way from 0.25% to 4.50% to combat rampant inflation. Unstable companies that took out debt during the pandemic are at even greater risk than healthy ones that went overboard in borrowing.

Some companies were on the brink of bankruptcy and issued debt to ensure they'd make it through the pandemic. But these issuers are faced with entirely new problems now that the Fed has raised rates and the "liquidity rush" is over.

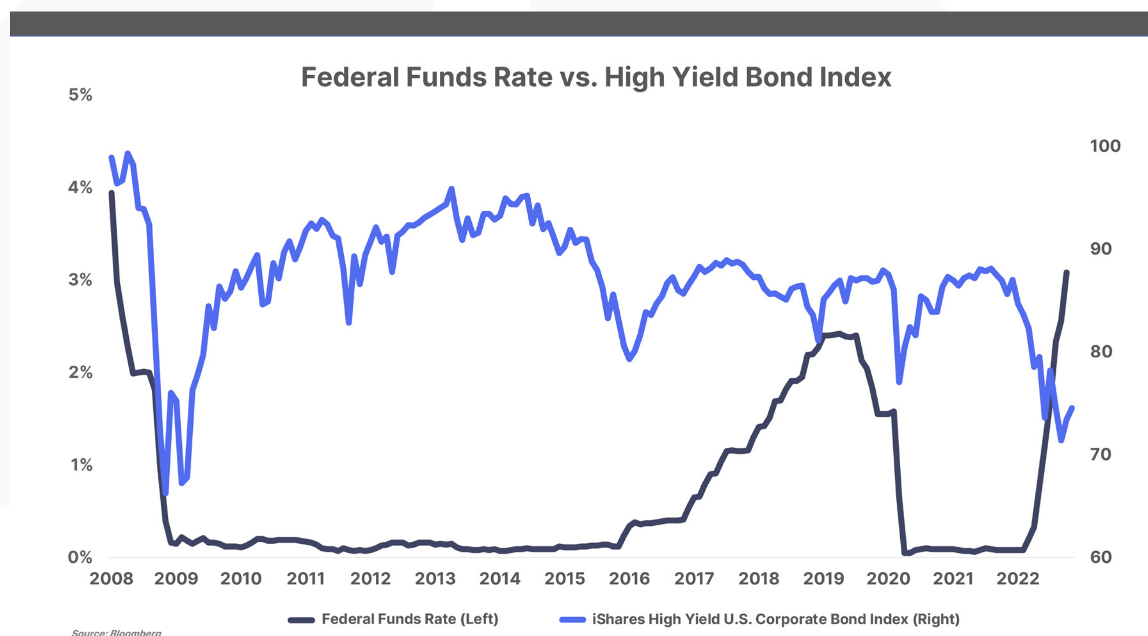
Companies that still have weak balance sheets, or are burning through cash, will now face challenges accessing capital in an environment of higher rates.

Some of those companies that borrowed cash when interest rates were at or near historic lows will leave the buyers of their debt holding the bag.

But many other bond issues that the casual observer might think will go bust… actually won't.

That's where we come into the picture.

When interest rates rise, bonds (high yield bonds in particular) fall in value, since bond prices and interest are inversely related. (Just look how the High Yield Bond Index and the Federal Funds Rate tend to move in opposition to each other.)



The interest rate on short-term government bonds represents the risk-free rate

of return in the economy. As it rises, investors demand higher yields on corporate bonds, which carry credit risk. Prices fall, leaving the bond universe ripe for the picking.

Unlike the stock market, where dozens of analysts cover the biggest companies (for example, 46 analysts were recently following Amazon) – and even many small-cap companies have a bevy of eagle-eyed followers – the bond market flies relatively under retail investors' radar.

In fact, many brokers don't even like to sell bonds because it's more work for them, and there's much less volume. They may even advise against buying high yield bonds.

That means distressed debt is a surprisingly well-kept secret – and today, we want to show you the best way to profit.

Would You Rather Be the Ex-Wife or the Girlfriend?

Quick question: Financially speaking, would you rather be divorced from a millionaire, or dating one?

If you're the ex-wife, and you had a good lawyer or a prenup, if things go south in the relationship you're legally entitled to certain assets from the marriage. You'll likely receive a nice chunk of spousal or child support, and maybe a mortgage payment. (Of course… flip the genders on this scenario if it's the woman who's in the driver's seat, financially speaking, of the relationship… that is, would you rather be the ex-husband or the boyfriend?)

And, here's the thing – as the ex, you get paid first.

Before the shiny new girlfriend, who might get Cartier jewels or a Ferrari – but isn't legally entitled to receive anything.

Bambi might have more fun – and get big, flashy presents from time to time – but you're the one with enduring and legally supported financial security.

And long after Bambi and your ex-husband have gone their separate ways, and he's started dating Savannah or BrittneyLynn, you'll still be getting paid… first.

This is exactly what it's like to be a bondholder.

Investing in bonds can be extremely profitable and less risky than investing in equities. This is because the terms of bonds are concrete and backed by law as

bondholders have a legal claim to a company's cash flows versus equity investors who are last in line for a company's cash flows or profits.

Many individual investors often fail to recognize the benefits of investing in bonds... The concept is quite simple: **bondholders get paid first.**

In times of distress, great opportunities arise from buying the debt of stable, healthy companies. The average recovery rate of principal for unsecured corporate bonds is around 40%, so you have a much better chance of coming out alive as a bondholder than as a shareholder. (Even if your millionaire ex-husband made some bad real estate deals, he still has to pay that damn child support.)

One of the advantages we have as individual investors is that the institutional market for distressed debt is limited to a relatively small number of managers with expertise in this specialized area. Insurance companies, pension funds, and endowments have some flexibility to own non-distressed high yield bonds, i.e., those rated below Baa3/BBB- by Moody's and Standard & Poor's.

But bonds that are (or appear to be) in danger of failing to make scheduled interest payments are another matter. Distressed bonds are further out on the risk spectrum than many of these institutions customarily venture. Getting involved in them would undermine the confidence of policyowners, pension plan beneficiaries, or philanthropic organizations – as the case may be – that they'll always be able to meet their obligations.

It's exactly that kind of skittishness that enables us to grab juicy returns. We don't have to fight off a horde of investors who are clamoring to buy the same distressed bonds we're looking at. Since the competition to own these debt issues is thin, we can be patient and buy only bonds of companies we are most confident will stay in business and pay their principal and interest on schedule.

It's like being the only auto-financing company in a town. That sort of operation can be highly selective about which applicants it approves for loans. And because it doesn't have a lot of competition to contend with, the auto-financing company can demand higher rates than lenders in more crowded markets.

We're doing the same thing with distressed bonds, except we're determining whether a company will be able to pay its upcoming debt obligations and using the scarcity of demand in the market to scoop up assets that are in better shape than they appear.

Because there's comparatively sparse demand for these assets, the "bid/ask" spreads are wider than they typically are for stocks.

This difference arises because there's broader demand for the equity of large public companies such as Apple and Walmart. They're big, stable companies with little to no bankruptcy risk. And because the value of equities is tied to the profits

that a business generates, stocks have unlimited upside.

The thinner demand and less frequent trading of bonds is positive for us as investors... making it easy for us to take advantage of bargains that appear. When pessimism reigns, it creates opportunities for the contrarian investor and that is just what makes distressed debt such an attractive market.

As a stockholder, you're Bambi. You don't know the value of the gift you're going to get... or if you're even getting one at all. Maybe your boyfriend will decide against getting you the Lexus and just send you out for a manicure. And, after all, you can't really complain...

As an equity owner you aren't guaranteed that you'll receive any dividends or that you'll ever recoup your original investment. Stockholders are entitled only to **future profits** – and those may very well be hypothetical. Your hopes of having your shares go up in value depend on the company racking up unexpectedly strong earnings.

Bondholders, on the other hand, know exactly what they'll receive, both when the bond is repaid in full (at face value) and in interest payments along the way. To make all those legally promised payments, the company doesn't have to prosper. It just has to survive to the maturity date of your bond without sinking into insolvency.

Another advantage of bonds over stocks is that bondholders don't run much risk of getting left with an empty bag when a company goes bankrupt. That's often the fate of common stockholders, since they're at the bottom of the heap when it comes to distributing whatever company value remains.

Historically, the recovery rate for unsecured corporate bonds is ~40%. And this is why we love owning bonds.

As you'll see, distressed debt presents seasoned investors with a unique opportunity to profit from fear in the market in ways that are safer than stocks.

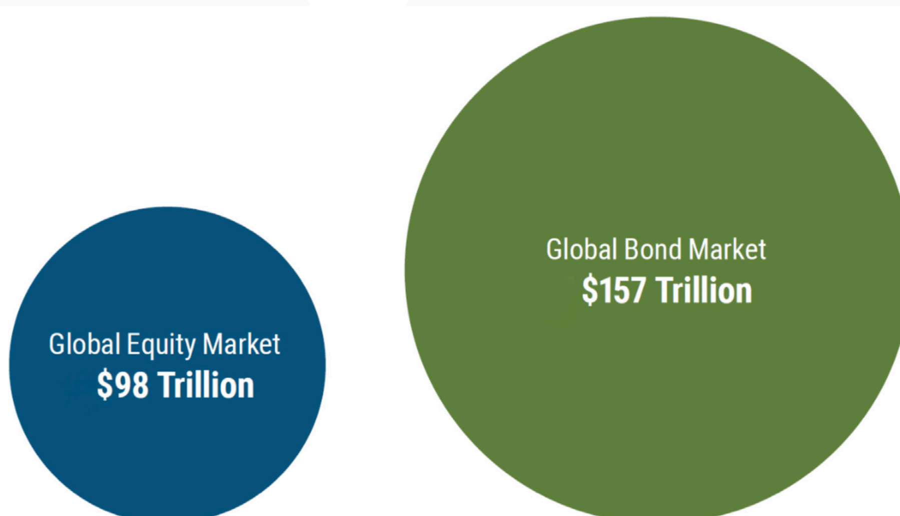
For a quick refresher on how bonds work – as well as a handy comparison table of bonds and stocks, how and where to purchase bonds, and a useful script for talking to your broker – please see our Startup Guide at this link.

CLICK HERE FOR STARTUP GUIDE

Here's Why We Like Bonds More Than Stocks

The bond market is huge. The total size of the global bond market is actually **bigger** than the global equity market.

Quite a lot bigger, in fact.



PIMCO, Haver Analytics, Bloomberg

Investment theory tells us that higher returns require greater risk. But... **that's not always true.**

As you will see, distressed debt presents seasoned investors with a unique opportunity to profit from fear in the market in ways that are **safer** than stocks.

A larger market than the stock market – and one that's less risky? Here's how that's possible.

Just like the stock market, the bond market will fluctuate. Amid the disruption, risks are sometimes mispriced, enabling investors to buy securities at prices lower than their intrinsic worth – sometimes at extreme discounts to fair value.

Like stocks, corporate bonds allow you to invest in some of the best companies around the world. But there's less risk associated with bonds because the payout of bonds is agreed upon and the timetables are backed by law.

One of the reasons we like bonds is that they're **binary**, meaning they either pay their debt obligations or they don't. It's a 0 or 1 proposition, just like computer programming. And that makes things pretty black and white...

Because the bond's terms are concrete, the day-to-day price changes won't matter to bondholders the way they do for stockholders, as long as the bond issuer pays its interest and principal as promised. If a company misses even one payment, it's in default.

When a company defaults, the lenders can force the company into bankruptcy and liquidate its assets to pay creditors. Alternatively, the company may continue in business by settling with bank lenders and bondholders for some percentage of their claims. But either way, bondholders recover a larger portion of their investment than shareholders, who frequently end up emptyhanded.

The Secret to Investing in Distressed Debt

So, you might be wondering... **how does debt get to be distressed**?

Debt becomes distressed when the market believes that a company has insufficient funds to service its debt obligations.

Let's say company ABC issues a bond due in three years with a face value of $1000 and 7% annual interest payments, payable every six months.

Now, let's assume that a year after the bond was issued, ABC experiences operating challenges. This leads to increased fear that the company will default on its interest payments.

When fear or skepticism arises in connection with a company or its industry, reflecting concern uncertainty about the bond issuer's ability to make good on its scheduled future payments, investors will flock to sell their bonds. And since there are more sellers than buyers, most likely at a lower price than they paid.

A company may find itself in this situation because of a weak balance sheet, yet be viable from an operational standpoint. Even so, prevailing sentiment and market conditions can cause its bonds to trade well below their intrinsic value.

As bondholders rush to sell their bonds, the supply available on the market multiplies, resulting in sellers outnumbering buyers, and the bond's price drops.

Now that the bond is trading at a discount to its future cash flows, it's trading at a fraction of its face value.

Because bonds are contractual, companies must pay back the bondholders if

they're to remain in business. So, if the company has the means to pay its debt obligations, it will.

Consequently, buying the bonds of companies backed by sufficient assets or future cash flows enables holders to collect the full principal when it comes due.

This is where the opportunity lies, and we scoop in to buy dollars for pennies.

But of course, there's still the question of how we find companies that just **look** scary (but have a low actual risk of default).

The "Sunny Jacobs" Test

The lady pictured here – with the appropriately infectious grin – is Sunny Jacobs.

Sunny wasn't always so shiny. At age 28, she was wrongly sentenced to death for the murder of two police officers – and spent 17 years in prison, some of them on death row.

Fortunately for her, an organization called the Center on Wrongful Convictions took up her cause, and after getting the justice system to review the facts of the case, she was released in 1992.

A few years later, she married another wrongly accused death row survivor, and

today they live happily in West Ireland, hosting other exonerees on their farm.

The key thing to remember about Sunny is that she was wrongfully accused. A jailhouse informant had been pressured into committing perjury and testifying against Sunny. A careful examination of the facts showed that another person was the actual murderer.

But none of that would have come to light without lots of investigation. If not for the Center on Wrongful Convictions, Sunny Jacobs would be dead today.

Fortunately for her, the Center decided to bet on an innocent woman – and the evidence backed her up.

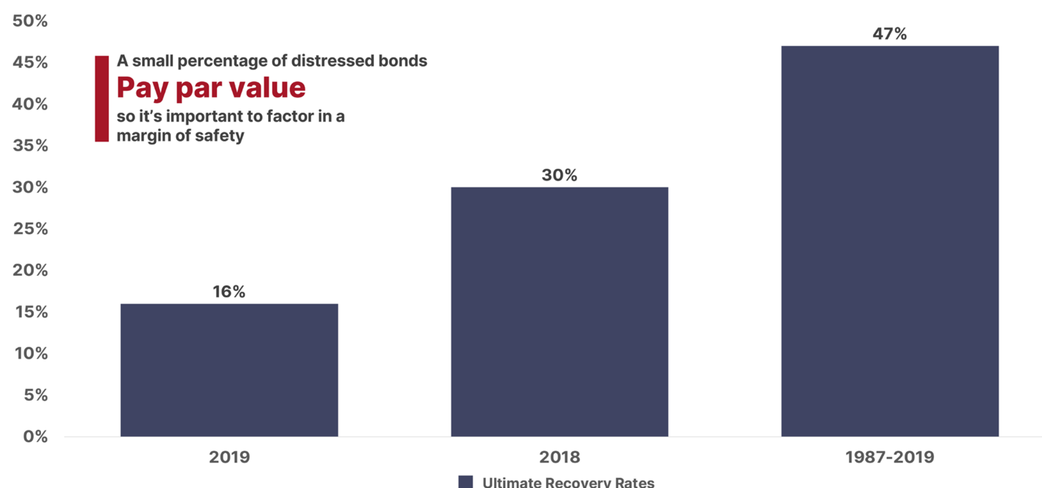
When we look for investable distressed debt, we perform what we like to call the "**Sunny Jacobs test**."

We're looking for innocent companies that have been wrongfully accused. Companies that are victims of irrational market fear across a broader sector – or maybe, a short-term bad decision – but companies that still have fundamentally good balance sheets and a strong likelihood of paying back their debt.

And like the Center for Wrongful Convictions, we do an exhaustive investigation to make sure our convict is really on the up-and-up.

We analyze a corporation's cash flows and balance sheet to determine whether it will generate enough profits to pay what it owes to business creditors (as they are first in line to receive payment), and then whether the bonds are backed by enough assets to pay the bondholders in the event – however unlikely we consider it – that they default.

This isn't always the easiest task, as **many** distressed companies are **not** in fact able to pay back the full amount they owe. (The chart below shows what percentage of their money bondholders historically received back in the event of default, and it's not always a rosy outlook.) Accordingly, our investigation has to be exhaustive.



For the distressed bonds we'll recommend, we'll factor in a margin of safety to ensure that the chance of default is minimized.

What, specifically, do we look at?

As distressed debt investors, it's critical for us to understand a company's business model and finances, in particular its cash flows and capital structure.

We start by scrutinizing the company's financial statements. The balance sheet provides a sense of the company's financial health with a "screenshot" of its assets, owners' equity, and liabilities. The income statement details profits or losses from operations during a certain period.

Especially important in credit analysis is the statement of cash flows, a roadmap of where the money came from and where it went. A company can't pay its interest with the accounting assumptions that partly make up the income it reports. To be confident that the company will meet its debt obligations, we need to see sufficient cash being generated.

We pay particular attention to free cash flow, which is the amount of cash that a company generates after making enough capital expenditures to maintain its asset base. Suppose a threat to the business arises that may cut into the company's revenues. Increased uncertainty about future free cash flow causes the market to apply a higher discount rate to current cash flows, meaning that the value of the company's assets declines. That reduces the expected recovery for bondholders in the worst-case scenario of a default.

In assessing a decline in earnings and cash flow, it's essential to distinguish

between cyclical changes, and an existential threat to the company's business model.

For example, tire manufacturer Goodyear went through a period when its profit margins suffered because the cost of its plastic raw materials rose. But plastics prices are cyclical, and there was little risk to Goodyear going out of business.

On the other hand, Blockbuster is an example of a business model that did face an existential danger, due to the rise of streaming platforms such as Netflix. (There's now just one lonely Blockbuster left in the U.S. – in Bend, Oregon – that's a tourist destination and curiosity.)

The "Sunny Jacobs" method consists of three main steps:

- When you identify that a company is in financial distress...
- Break down the company's business model to determine its profitability on a per-unit basis and project its future cash flows...
- And understand the demand for the company's products or services and the health of its balance sheet...

Then you can find diamonds in the rough, and you can make returns that double your money.

For these reasons, investing successfully in distressed debt can be similar to investing in growth stocks.

When investing in growth companies, it's critical to understand a company's balance sheet, because these types of companies typically need plenty of capital to fund their evolving businesses.

In a similar way, by analyzing a company's capital structure, the terms of its debt, cash flows, and the demand of the company's products, we determine if the company can meet their debt obligations.

It's by fully examining these moving parts inside of a company, that we gain an edge in determining whether the security on sale is a bargain... or if it's actually overpriced junk.

This right here is why we feel at ease buying at pennies on the dollar.

As Howard Marks, renowned distressed debt investor and co-founder of Oaktree Capital Management, recalls from the 2008 financial crisis, there is a level of contrarianism necessary to figure out where the real opportunities lie.

> *"Most purchases of depressed, distressed debt made in the fourth quarter of 2008 yielded returns of 50 to 100 percent or more over the next eighteen months. Buying was extremely difficult under those trying circumstances, but it was made easier when we realized that almost no one was saying, 'no, things can't be that bad.' At that moment, being optimistic and buying was the ultimate act of contrarianism."*
>
> *- Howard Marks, The Most Important Thing*

The elevated returns you can earn in distressed debt are created by market mistakes that are only temporary. They lead to a whole lot of innocent companies being wrongly accused – and a cornucopia of mispriced bonds.

How "Bond Bargain" Math Works

Since we've done our credit check and conservatively projected the company's future cash flows along with the company's assets, we've determined that the company is backed by enough assets to pay us – the bondholders – if they were to miss a payment and default.

Going back to our earlier example, even if we pay $700 for a bond on the market, the corporation must pay back the principal $1000 in addition to the interest charged on the principal.

Assuming the interest payments are 7%, bondholders would get a cash yield of 10% per year. Since $700 was the initial layout, the bondholder would earn $70 in annual interest. Thanks to our analysis and ability to look past what the market is pricing assets at to determine whether the corporation will be able to fulfill its debt obligations, we are paid $1000 for the bond and $70 per year in interest ($140 over two years, since there are only 2 years left to go on the bond).

This results in about a 62% gain on our original purchase price of $700. Try making 62% on a stock in two years with as little risk and as much downside protection anywhere else!

It's important to keep in mind that you'll pay a small amount of accrued interest to

the bondholder sold the bond to you, but for the purpose of this example we'll skip that assumption to simplify the math.

(You'll also have to pay taxes because unlike municipal bonds, corporate bonds aren't federally tax-exempt. The interest you earn on corporate bonds is taxable, but you can delay the impact by holding the bond in a tax-exempt account such as an IRA.)

The Math in Steps

1. Buy Company ABC's Bond for $700.
2. Collect $140 in interest payments over two years (7% interest on the $1000 principal over two years).
3. Receive $1000 when Company ABC pays off the total debt – a $300 gain.
4. Generate $440 in profits on your $700 investment – a 62.8% gain after two years.

For the bonds we recommend, we must be confident that the borrower has enough resources to pay the interest and principal at the time of maturity, with a substantial margin of safety. And what we'll be recommending will be on "fire sale," which gives you an ideal opportunity to generate spectacular gains.

By investing in the debt of companies that we believe will pay off their bonds at full face value, you can see past the "junk bond" label and recognize a **safe, high-yielding asset.**

Let's take a quick look at how one of these cases played out in real life...

How Rite Aid Bonds Went on Fire Sale – And Then Delivered 4.5x

Viewed through the "Sunny Jacobs" lens, Rite Aid was a basically good kid who made one mistake and definitely didn't deserve to die.

Investors who gave this "comeback kid" a chance and bought its distressed bonds, were rewarded with a big payoff.

In 2008, Rite Aid was America's third-largest drugstore chain, and the biggest on the east coast.

Rite Aid overcame a disastrous tenure with a CEO from the mid to late '90s who nearly bankrupted the company by going on acquisition sprees and falsifying records. In 1999, the CEO was removed and Rite Aid restructured, paid down its debt, and sold assets as well as new shares to make up the losses.

From 2003 to 2006, Rite Aid was profitable. But the following year the company acquired a drugstore chain with 1,850 stores. The acquisition was financed with $1 billion in equity and $2 billion in new debt.

The financial strain created by Rite Aid taking on new debt was compounded by a credit market contraction during the 2008-2009 financial crisis and a cash burn caused by integration costs from the acquisition. Rite Aid's credit rating was downgraded from B- to CC+.

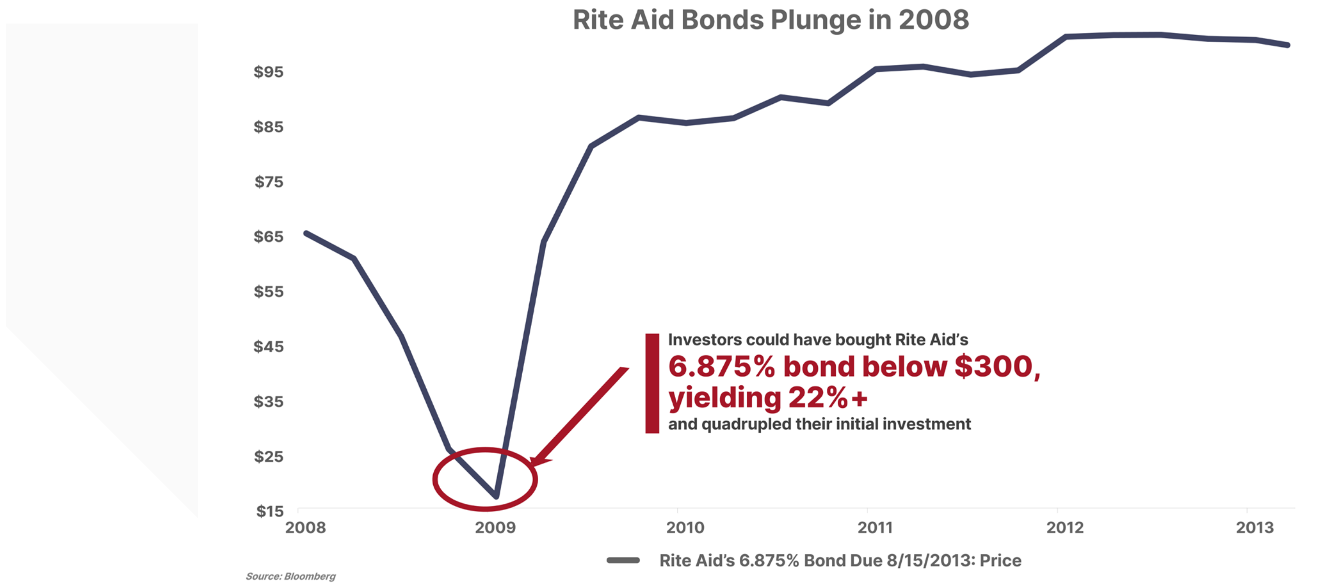
A reason to believe Rite Aid could bear up under the financial pressures was that it was an extremely well-known and established brand… and its vast capacity for dispensing prescription drugs represented an extremely valuable asset.

The new acquisition gave Rite Aid large-scale distribution on the east coast while capturing efficiencies and reducing costs. The problem was, integrating the acquisition was expensive, and sales growth was slow at the time.

Rite Aid's business was well-equipped to generate plenty of cash to pay off its debts. Even in the case of bankruptcy, the company's assets were still valuable, as the demand for prescription drugs doesn't change in a downturn.

Clearly, Rite Aid's business wasn't facing an existential risk. But it had operating risks because of its capital structure and the previous management mistakes that put the company deeply in debt in the first place. But going back to 2003, Rite Aid had been profitable and the acquisition was likely to bolster its sales growth and margins over the long run. The board was restructured and a conservative projection of Rite Aid's future cash flows indicated the company wouldn't likely be at risk of defaulting.

Nevertheless, Rite Aid's bonds went on fire sale in the first quarter of 2009 after the company reported that it would report losses for the prior year and into 2009. But these were the result of noncash expenses. The price plunge created an amazing opportunity…



From the end of the third quarter of through the middle of 2009, **Rite Aid's 6.875% bond due 8/15/2013** was trading at a gigantic discount to par value.

You could have bought the bond for $300, yielding 22.9%, and quadrupled your original investment, including interest you collected, so long as the issuer didn't default. Sure enough, Rite Aid made good on all its interest obligations and returned the full principal to bondholders.

More than 4x your initial investment... and that's why we love distressed debt.

Let's walk through the investment return from buying Rite Aid's **6.875% Bond due 8/15/2013** on December 15, 2008. See graph on next page.

The Rite Aid Corporation 6.876% Bond due 8/15/2013 at $291.52 _ CUSIP#767754AD6

Summary

December 15, 2008	Amount Invested	$314.50
August 15, 2013	Total Interest from Principal	$1,343.80
	Profit	$ 1,320.82 (interest bondholder is entitled to from Dec 15 to maturity is $320.82)
	Current Yield	23.6%
	Total Return	327.3%
	Term	4.67 years
	Issue Size	$185 Million
	Credit Rating	CCC+
	Callable	No

Details

December 15, 2008: Purchase the bond.

	Accrued Interest*	$22.98 per bond
	Total Cost	$314.50 per bond
	Receive interest payment	$34.38 per bond
February 15, 2009	Receive interest payment	$34.38 per bond
August 15, 2009	Receive interest payment	$34.38 per bond
February 15, 2010	Receive interest payment	$34.38 per bond
August 15, 2010	Receive interest payment	$34.38 per bond
February 15, 2011	Receive interest payment	$34.38 per bond
August 15, 2011	Receive interest payment	$34.38 per bond
February 15, 2012	Receive interest payment	$34.38 per bond
August 15, 2012	Receive interest payment	$34.38 per bond
February 15, 2013	Receive int. and prin. payment	$1,034.38 per bond
August 15, 2013		

*The accrued interest from August 15, 2008 through December 15, 2008, the settlement date, was earned by the seller and is added to the price of the bond. The first interest payment you receive will be on February 15, 2009 for $34.38.

Conventional bond investors face interest-rate risk, downgrade risk, and price risk arising from quarterly earnings disappointments. Those risks don't concern us in buying a distressed corporate bond. All we care about is the company's ability to make good on its contractual bond obligations until the maturity date arrives, even if it has to limp to the finish line.

Distressed Bonds as a Gateway to Distressed Stocks

The Rite Aid story illustrates the huge upside in many distressed debt investments, where you're first in line to get paid. A side benefit of looking into badly beaten-up bonds is that once in a while this activity turns up a truly phenomenal opportunity in an unfairly accused company's stock.

Being last in line to get paid can be fatal if you're a shareholder in a company that doesn't make it. Basically, a company goes bankrupt because the value of its liabilities exceeds the value of its assets. In that situation, the company's net asset value – the value of its equity – is less than zero. So when the bankruptcy court finally resolves all claims of the company's suppliers, bank lenders, bondholders, and preferred stockholders, common stockholders frequently wind up with a big, fat goose egg.

But if the company **doesn't** go bust, things can work out amazingly well for common shareholders. Whether you're talking about standings in a sports league, grade-point rankings in a high school class, or where you stand in the food chain for getting paid by a distressed company, being at the bottom means you have the furthest to rise. Even when most investors think a company is sliding into bankruptcy, the market is still willing to pay a meaningful percentage of face value for its bonds, based on the recovery statistics we've discussed. But when it comes to the common shares, the market often assigns a trifling value of just pennies. Investors regard those shares as an option on a longshot proposition that the company might actually make it.

That disdain creates a chance to earn big returns if we're very confident that the company is being misperceived as a basket case – when it's actually one that will get through the storm intact.

Consider Avis Budget Car Rental. On November 30, 2008, around the Great Recession low point in the high yield bond market, the company's 7.75% bond due 5/15/2016 was priced at $255. One year later, it had risen all the way to $895. Taking into account the interest paid along the way, the return came to 281%.

But take a gander at what happened to Avis's stock over those same 12 months. It catapulted from 70 cents to $13.12, for a mindboggling 1,183% return.

That kind of result will make the most jaded investor sit up and take notice. But don't draw the wrong conclusion from this example. Diving to the bottom of the heap, the common stock, isn't the right strategy in every distressed situation.

Many times, there's enough uncertainty about the company's chances of avoiding

bankruptcy that you're better off limiting your downside by owning the bonds than maximizing your upside by buying the stock. Also, the stock may pay a negligible – or as in Avis's case, no – dividend. So if the company doesn't get back on an even keel right away, you may make more money by collecting those bond coupons and getting a price kick at the end than by holding the common shares.

There's one more reason why buying the stock may not be the better alternative. Namely, it may not be an alternative at all! With so much private equity capital available these days, lots of prominent companies have never gone public. In addition, many high-profile public companies have gone private.

As long as a private company is willing to publish its financial statements in Securities and Exchange Commission filings, it can issue bonds in the public market. Those bonds are available for purchase by individual investors. But in the case of a private company, you don't have a choice between playing a distressed situation as a bondholder or a stockholder. The equity is all in the hands of private equity shops and the management.

The bottom line is that distressed stock plays are an offshoot of distressed debt investing that occasionally uncovers an outstanding opportunity. It's kind of like conducting a geological survey in a region known for silver deposits but discovering gold instead. When we come across that kind of hidden treasure, we'll present a distressed a stock idea to you.

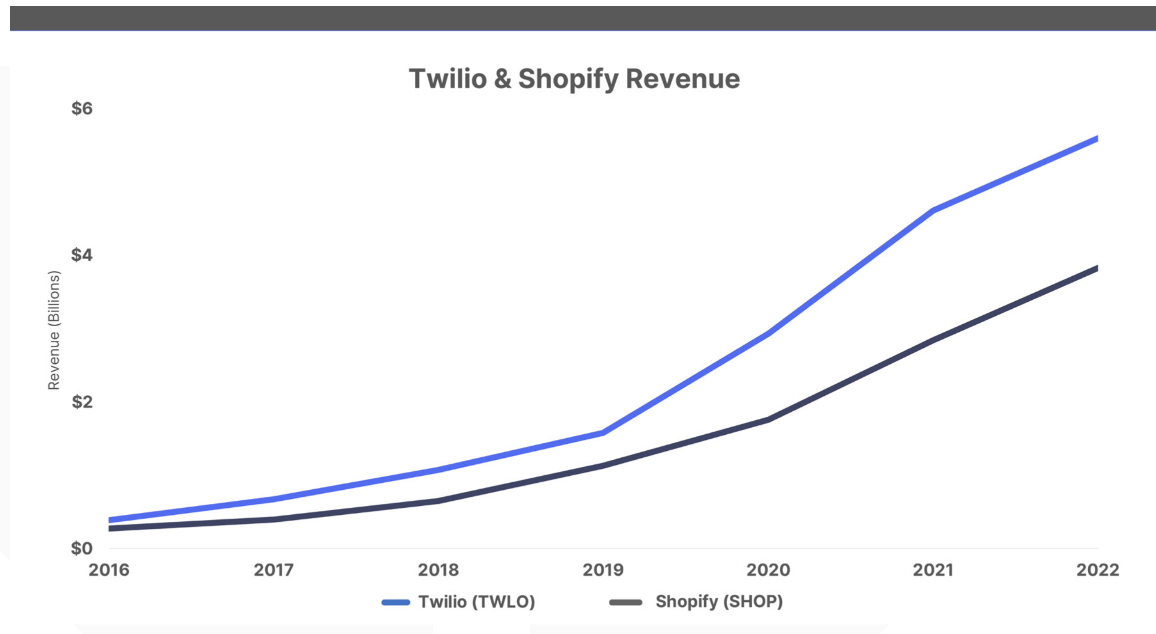
To be clear, we're not talking about microcap stocks or fly-by-night companies. Rather, these are equities that sometimes turn up as we scour the universe of bonds that are trading at distressed levels, looking for a company that doesn't truly belong in that crowd.

Two Distressed Debt Deals We're Eyeing

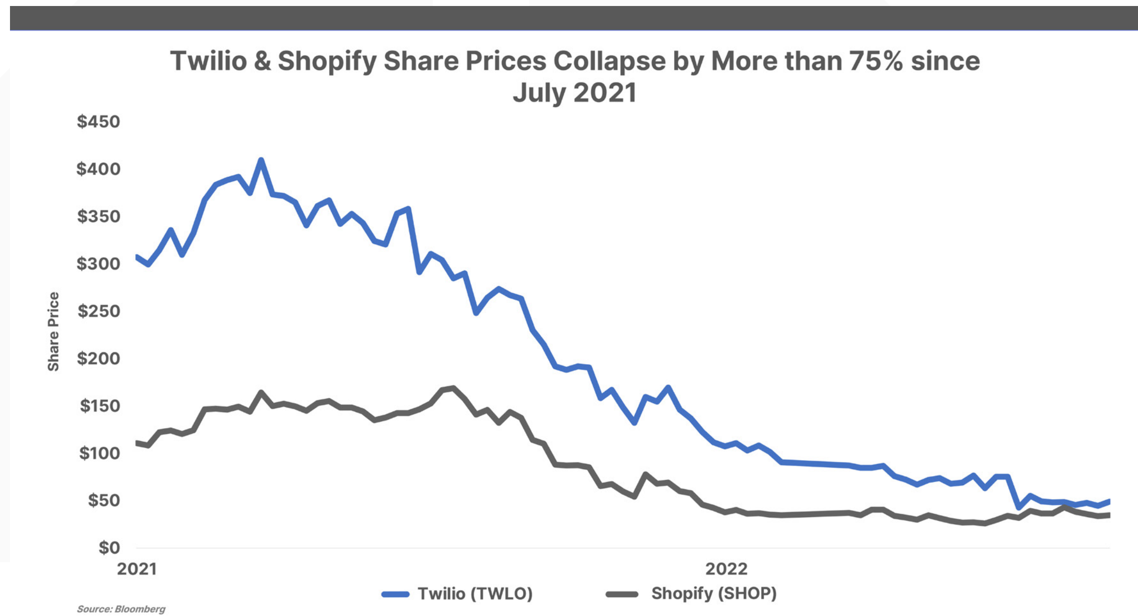
Two distressed debt opportunities that we have an eye on are software company Twilio and e-commerce firm Shopify.

These two companies have debt trading at a discount at about 80 cents on the dollar today. They both have revenues between $3.5 and $5 billion but are still growing at 20% or more.

Twilio and Shopify have cash positions greater than 3.5 times their current debt loads. Because these companies are in growth mode, they aren't focused on profitability today, but rather on building revenues. Shopify and Twilio's revenue have continued to grow and compound since each when public in 2016. In the past 5 years, these companies have nearly 10 x their revenues.



Since July 2021, the share prices (thereby valuations) of these companies were slashed. While the fundamental businesses of these companies are significantly better than they were 5 years ago, at this writing, the stocks are still trading between prices they traded for in 2018.



Twilio powers programmable communication tools for Uber, Airbnb, Salesforce, Stripe, DocuSign and even Shopify, to name a few customers. Shopify is a

multichannel ecommerce company that's changed the way merchants sell online, and is used by more than 1.75 million businesses.

These types of companies won't go away during a recession and their long-term prospects are bright, but that doesn't mean that their bonds can't fall even further...

As interest rates rise, the value of future free cash flows diminishes as the risk-free rate of return increases today. But companies such as Twilio and Shopify, which are well-capitalized and operate in parts of the economy that are in high secular growth trends, will persevere through a recession.

We'll be presenting many more distressed debt buys like these in the coming months, so keep an eye on your inbox. And please don't forget to read our Bond Startup Guide at the link below before you act on any of our recommendations.

We look forward to partnering with you in **Porter & Co. Distressed Investing.**

CLICK HERE FOR BOND STARTUP GUIDE