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Finding Value in a Broken Deal

- Considering Various Outcomes, These Bonds Are Cheap
- A Mix of Stocks, Bonds, and Low-Cost Airlines

Finding Value in a Broken Deal

Considering Various Outcomes, These Bonds Are Cheap

A Mix of Stocks, Bonds, and Low-Cost Airlines

This airline had a plan to merge,
The judge said, "This won't fly!"
We now believe its bonds could surge,
Read on to find out why.
- Martin Fridson

Fifteen-year-old Lorenza Tapia hated the flashing red light.

Whenever the young Subway restaurant "sandwich artist" left the counter for a much-needed bathroom break, the security-camera bulb would light up, the camera would snap a photo of her as she exited… and she'd immediately get a text from her manager telling her to get back to work.

She also hated the peeling paint… the cockroaches… the broken refrigerators… the ants in the bathroom… and the thousands of dollars in wages and tips that her boss, John Meza, somehow "forgot" to pay her.

But in 2021, Lorenza and her family were struggling to survive in a one-room apartment. She desperately needed a job. And John Meza, who operated a chain of 14 Subway fast-food restaurants in the Petaluma, California area, was one of the few folks who'd hire a 15-year-old for long hours and late shifts.

That was because he didn't care about child labor laws… health and safety regulations… or a few other important things, like having an up-to-date business license.

By 2022, Lorenza and two of her teenage Subway coworkers – all fellow students at San Antonio High – had had enough of the mistreatment. One of their teachers encouraged them to file reports with the California Labor Commissioner, contesting their lost wages. And that opened up a whole can of expired mayo for John Meza…

Turned out, Lorenza and her friends weren't Meza's only victims. As the high-profile case gathered steam, the franchise owner ultimately had to shut down all 14 of his Subway locations and pay over $1 million in damages to former employees, many of them underage. (Lorenza now works at a properly licensed food truck, where the pay is better and she can take a break anytime she needs to.)

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Sadly, the Meza tale is not unusual for Subway. The sub shop's hands-off approach to franchisee quality – most anyone who can fog a mirror can get a franchise and run it however they like, at least until the lawsuits begin – has long created problems for the chain. Quality across its stores varies wildly, with a 2021 California class-action suit claiming that tuna subs in that state were "completely bereft of tuna as an ingredient." (*The New York Times* sent some of the sandwich filling for DNA analysis and confirmed that whatever was in it, it wasn't tuna.)

Thousands of Subway locations have been shuttered over the past decade, and between 2015 and 2022, the company's sales in the U.S., where most of its stores are located, eroded from $11.5 billion to $10.3 billion. (During the same period, competitor McDonald's worldwide franchise sales rose from $66 billion to $109 billion.) Of course, having a registered sex offender as its brand ambassador didn't help Subway's public image either.

But Subway still controls 20% of the market share for U.S. sandwiches, and if *someone* could just get those operational problems under control...

Maybe a company like private-equity giant Roark Capital, which specializes in fast-food franchise models, and operates rival sandwich shops Jimmy John's and Arby's...

That "five-dollar footlong" might turn into a million-dollar baby.

In August 2023, Roark indeed made a $9.6 billion buyout offer, and Subway gratefully accepted, hailing the deal as a "major milestone in Subway's multi-year transformation journey."

But that's where the story takes a hard left turn.

If you thought this was another of our signature "activist investor saves struggling company" tales... you've come to the wrong sub shop.

Enter the Biden administration antitrust policy.

A Merger Most Foul

For over a century, the venerable Sherman Antitrust Act – passed in 1890, when Big Railroad threatened to swallow up all the smaller train lines – has formed the core of anti-monopoly policy. Sherman 101: *Restricting competition in the free markets is bad*. The Biden administration, however, has subtly transformed this idea: *Business combinations are suspect whether or not they threaten competition*.

To the current Federal Trade Commission ("FTC") – headed by Biden appointee Lina Khan – a merger proposal can look like an attempt at monopolization... even if the combined companies command only a small fraction of overall market share.

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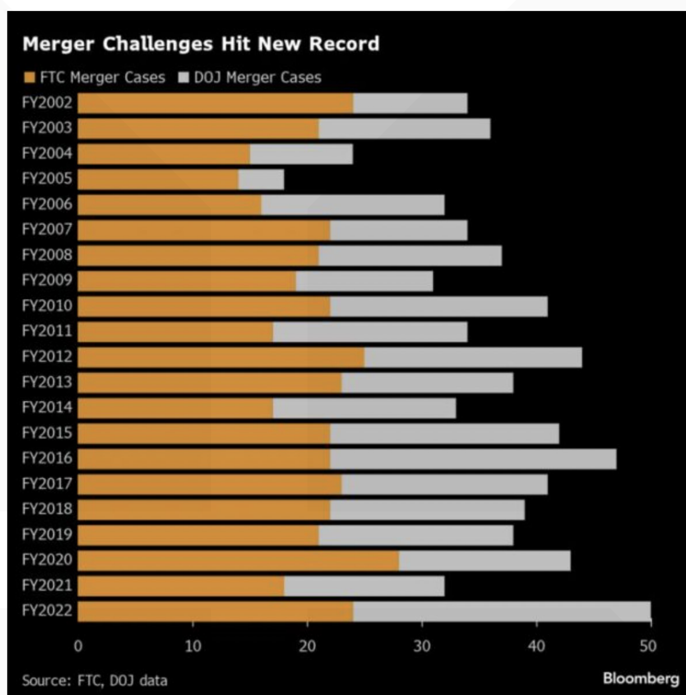
Since taking the reins at the FTC in 2021, killjoy Khan has taken aim at a record number of potential mergers, many of which are in little danger of disrupting “competition” in any way. In 2022 alone, the FTC and its enforcement partner, the Department of Justice (“DOJ”), filed 50 challenges to block various merger deals – the highest number of challenges on record since 1976, when the U.S. started requiring pre-merger antitrust review.



Granted, some of Khan’s antitrust actions make sense. Mega-corporations can and do squelch free enterprise (that was, after all, the reason for the original Sherman Act).

Khan’s right: Amazon probably shouldn’t be allowed to snap up iRobot, the company that makes the popular Roomba vacuum cleaner. Visa shouldn’t indiscriminately buy out all other payment processors. And UnitedHealth Group, the largest health insurer in the U.S., shouldn’t purchase four major healthcare companies (the potential conflicts of interest boggle the mind).

But not *all* mergers spawn monopolies, and that’s where Khan goes wrong. Many of the FTC’s latest merger-killers are just overkill.

Midwestern grocery chains Kroger and Albertsons are planning to join forces? Monopoly alert. ExxonMobil wants to purchase hydrocarbon-explorer Pioneer Natural Resources? Think again. Chipmaker Qualcomm wants to buy Israeli semiconductor company Autotalks? It’s a merger. Burn it with fire.

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Oh, and let's not forget "Big Sandwich" – the Roark-Subway deal. To Khan, adding a struggling sub shop to Roark's portfolio of sandwich stores *also* crosses into monopoly territory, despite the fact that, post-merger, Roark would control just 40,000 (20%) of the U.S.'s 200,000-plus fast-food restaurants. That's a decent-sized sandwich, but not enough to cause Sherman-Act-level indigestion.

Regardless, Biden's FTC and DOJ have set up punitive regulatory roadblocks for Roark-Subway and a score of other deals. By design, the red tape won't be unsnarled anytime soon. The FTC investigation of the potential Roark merger, which kicked off in November 2023, could take more than a year to resolve. And in the meantime, poorly run Subway franchises across the U.S. will continue to serve fake tuna and exploit child labor.

Khan's DOJ colleague Jonathan Kanter – who works closely with the FTC chair in a relationship best described as "bad cop/bad cop" – is positively gleeful about the way the two of them have been shutting down deals:

"I think when we look at the entire body of work – at least that I've been involved in, which is now a little over two years – we see trial victories, we see updated merger guidelines, we see abandoned transactions, we see deterrents. Those are the ingredients of success, and I'm really proud of the work that our team has done to achieve that level of notable success."

A philosophy that defines success as "abandoned transactions" isn't anti-monopoly. In many cases, it's anti-capitalism.

And it's now flipped one of our recent recommendations on its head… as Biden's DOJ ruled in January 2024 to block the proposed Spirit Airlines-JetBlue Airways merger on dubious anti-monopoly grounds.

Never mind that, again, combining the two budget airlines would grab only a tiny fraction of market share, as the "big four" airlines (American, United, Delta, and Southwest) already control 80% of the skies.

In this issue we'll look at what that decision means for our JetBlue bonds… our Spirit shares… and our next steps from here.

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The Deal That Didn't Go Down

In the December issue of *Distressed Investing*, "**More Planes, More Profits**," we reported on the potential of **JetBlue Airways (Nasdaq: JBLU)** acquiring **Spirit Airlines (NYSE: SAVE)** in an all-cash deal of $6.6 billion. We knew the Justice Department's decision about whether to allow the sale would come in January 2024, a few weeks after our report was released. We recommended that for every $1,000 face amount of JetBlue's 0.5% convertible bonds maturing April 1, 2026, investors should also buy 10 shares of Spirit Airlines stock, which would protect the investment whether or not the two companies were permitted to merge. We recommended selling the Spirit stock once Massachusetts District Court Judge William Young announced his decision.

On January 16, Judge Young decided *not* to allow the merger. This was good news for JetBlue bondholders (because the company would not be adding Spirit Airlines' debt to its own existing debt) and bad news for Spirit stockholders (as their hope of getting $33.50 per share had slipped away).

And in the midst of the market tumult in the aftermath of the rejection of the deal, a sharp decline in the price of Spirit's 1% convertible bonds maturing May 15, 2026, has created a very appealing new opportunity.

We will discuss how the Spirit Airlines story is likely to play out. We show why Spirit's 1% convertible bonds that we are recommending look undervalued by at least 19% – and over time could appreciate 50% or more from the current price of $420.

Please note: These bonds are risky. As we will discuss, a bankruptcy filing by Spirit is a real possibility. In the case of a bankruptcy, the value of these bonds wouldn't necessarily go to zero, but they would likely decline significantly. For background information on bankruptcy and its impact on bonds, please see our special report **"Learning to Love Bankruptcy."**

First, A Step Back

In February 2022, Spirit agreed to be acquired by Frontier (Nasdaq: ULCC) airlines for $5.8 billion in cash and stock, or roughly $28 per share. This transaction would bring together the two largest ultra low-cost carriers ("ULCC") in the U.S. It would create the fifth-largest airline with a 9% market share – behind Southwest Airlines with 13%.

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The combined Frontier and Spirit would likely cut prices to gain market share. This additional price competition would put low-cost-carrier JetBlue ("LCC") at a competitive disadvantage versus a new larger rival. JetBlue therefore wanted to torpedo the merger – and approached Spirit to propose that two companies combine.

Over the next five months, JetBlue kept upping its offer for Spirit. Finally, on July 27, 2022, Spirit terminated its merger agreement with Frontier. The next day, it agreed to accept JetBlue's all-cash offer of $33.50 per share. This transaction valued Spirit's business at $6.6 billion, $800 million more than the Frontier deal valued it at.

On March 7, 2023, the Department of Justice ("DOJ") filed a suit to block the merger. It alleged that since LCC JetBlue was acquiring ULCC Spirit, there would be less competition for budget-conscious flyers. The DOJ argued that the merger would end up costing passengers $1 billion per year through higher ticket prices.

JetBlue pointed out that the combined company, which would have a roughly 9% share of U.S. flights, would be able to compete more effectively against American Airlines, Delta Air Lines, United Airlines, and Southwest Airlines with added routes and lower fares. Together those four airlines control a whopping 80% of the U.S. market. A bigger number-five airline would give the big four a run for their money.

The trial started on October 31, 2023, in U.S. District Court in Massachusetts and ended on December 6. On January 16, 2024, Judge William Young ruled in favor of the government. The judge agreed that the combination of JetBlue and Spirit would reduce competition from low-cost carriers. This would lead to higher overall ticket prices, he said.

Good News For JetBlue, Bad News For Spirit

This legal decision had an immediate impact on the trading price of both companies' bonds and Spirit's stock, which dropped from $14.92 to around $8 per share. (JetBlue's stock price did not move significantly.) These price changes were largely as we expected. In the report dated December 15, 2023, we wrote:

> *"If the merger falls apart, JetBlue's bondholders will be the big winners. The company will remain sensibly financed and less risky, and the odds are very high that these bonds would end up paid off on time and in full. We estimate the bonds will trade up from their current price of $700. We estimate the resulting price of around $850 would represent a yield of roughly 8% on a bond maturing in a little more than two years. The Spirit stock could trade down to $5 per share."*

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Since the announcement...

- JetBlue's 0.5% convertible bonds maturing April 1, 2026, have risen from $684 before the announcement to just over $846. At the current price their annual yield is 8.56%.
- Spirit's stock closed at $14.97 per share the last trading day before the announcement. It fell to $7.92 per share when Judge Young issued his decision on January 16, sinking as low as $4.47 per share on January 18.
- The decision also clobbered Spirit Airlines' 1% convertible bonds due on May 15, 2026. These bonds were already at a distressed price of roughly $660 *before* Judge Young's decision was announced – and fell to as low as $320 per bond afterward.
- On February 12, legendary activist investor Carl Icahn announced that he had acquired 9.91% of JetBlue's stock. Icahn also disclosed that he is seeking a seat on JetBlue's board, with a goal of helping unlock the company's underlying value.

In this report we will take a close look at Spirit Airlines' operations and its financial condition. We will also discuss what we see as the three most likely ways the Spirit story is likely to play out and how each one will move bond prices. We'll call the three scenarios the **Good** (another sale transaction), the **Not So bad** (a bond exchange offer), and the **Ugly** (bankruptcy).

Taking a Look at Spirit Airlines

Spirit was founded in 1983 as Charter One Airlines, a charter operator offering vacation packages. In 1992 the company renamed itself Spirit Airlines and purchased its own aircraft. It began flying in the U.S., the Caribbean, and Latin America.

The company kept a tight rein on its operating costs. It flew one type of airplane (Airbus), which helped keep maintenance costs low. From the beginning, Spirit offered rock-bottom ticket prices for a "no-frills" experience. The company charged additional fees for seat selection, bringing a bag on board, and snacks. These "ancillary revenue" items often end up exceeding the price of the seat. Today, this approach still appeals mostly to budget-conscious flyers.

Spirit is now the seventh-largest U.S. airline. It flies 536 routes in the U.S. and 128 routes internationally. Spirit's focus cities are Atlanta, Atlantic City, Chicago, Dallas, Detroit, Fort Lauderdale, Houston, Las Vegas, Miami, and Orlando. It's the largest ULCC. Frontier and Allegiant Air are its nearest competitors.

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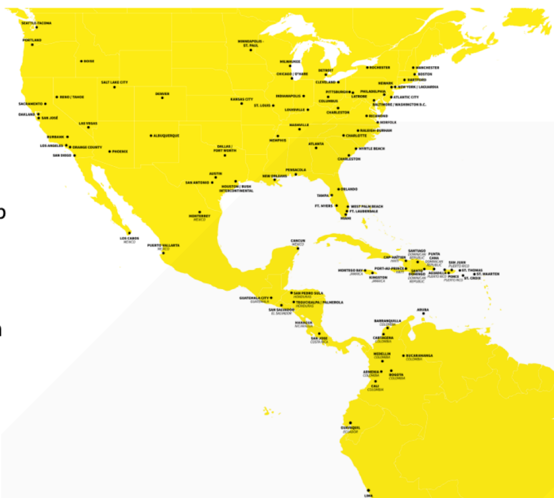
Spirit Is the Largest ULCC in the Americas

- Over 800 daily flights serving 92 destinations
- Diversified network; primarily low frequency, point-to-point
- Heavily weighted towards younger leisure/VFR demographic
- Large domestic network; service to all of the Top 25 U.S. metros[2] and many large U.S. leisure markets
- Domestic network enhanced with service to 33 destinations in Latin America and the Caribbean

~84%
Domestic Capacity [1]
(100% in the Americas)



1. Based on scheduled capacity for March 2023.
2. Map as of March 7, 2023. Includes announced new destinations where service has not yet begun.

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Spirit prospered as a private company. It went public in 2011 and continued growing rapidly through 2019. Revenues jumped from $690 million to $3.76 billion over that period. Operating profits before interest and rent (the most widely used statistic to measure airline profitability) rose from $274 million in 2011 to $924 million in 2019.

When Spirit went public in 2011 it had a fleet of 37 aircraft it owned outright – and no debt on its balance sheet. By the end of 2019, Spirit had a fleet of 145 Airbus A320 aircraft. It owned one of the youngest and most cost-efficient fleets in the industry. Spirit also owed $3.2 billion to its lenders and aircraft lessors that it borrowed to finance its additional planes and equipment.

Spirit's Aircrafts, Revenue, and Profits From 2011-2018

Year	Aircrafts	Revenue	Operating profits before interest and rental expense ($million)
2011	37	$690 million	$274
2012	45	$783 million	$325
2013	54	$986 million	$485
2014	65	$1.15 billion	$598
2015	79	$1.17 billion	$793
2016	95	$2.23 billion	$786
2017	112	$2.57 billion	$748
2018	128	$3.26 billion	$804

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The Pandemic as Roadblock

Going into 2020, Spirit was larger, more profitable, and deeper in debt, than it had ever been. Then the pandemic began in March 2020, and travel restrictions gutted Spirit's business.

Annual revenue declined from $3.76 billion to $1.77 billion. For the year, the company lost $673 million *before* interest and aircraft rental. It borrowed an additional $1.3 billion to stay afloat and ended 2020 with $4.5 billion in debt and aircraft leases.

Airline traffic began to recover slowly over the course of 2021, and the snapback picked up steam in 2022. In February 2022, as mentioned before, Spirit agreed to be acquired by Frontier for $5.8 billion. In August, it accepted JetBlue's $6.6 billion all-cash offer, and it ended its deal with Frontier.

Spirit's revenues rose to an all-time high of $5.1 billion in 2022. Operating profits before interest and rental expenses rebounded to $406 million, *but* operating costs had increased by roughly $1.5 billion. After taking into account these higher operating costs and the capital expenditures for *more* airplanes, the company used $326 million in cash during the year. Spirit ended 2022 with 194 aircraft and more than $5.6 billion in debt and aircraft leases.

Spirit's Aircrafts, Revenue, and Profits Since 2020

Year	Aircrafts	Revenue ($billion)	Operating profits before interest and rental expense ($million)
2020	157	$1.77	($673)
2021	173	$3.18	$89
2022	194	$4.99	$406
2023	204	$5.40	$312

Spirit's management was optimistic going into 2023. Travel was rebounding nicely. The company planned to take advantage of that growth by adding 19% to its capacity with 10 new aircraft and reconfigured seating. Results for the quarter ending March 31, 2023, justified these expectations. Ticket prices were high and fuel costs were low. Financial performance exceeded management's expectations.

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The sale to JetBlue was on track, pending approval by the government.

Despite estimates that it would increase, the U.S. travel market started to slow down early in 2023, according to a January 2024 report by the U.S. Travel Association (the leading trade association in the country):

> *"Domestic leisure growth decelerated through [the last] three quarters of 2023 as consumer spending slowed amid higher borrowing costs, tighter credit conditions, and the restart of student loan payments."*

Spirit's quarter that ended June 30 was disappointing for a variety of reasons. Demand for travel during the peak U.S. travel season was weaker than projected. Spirit was slow to cut its flights. With more seats to fill and expenses high, the company cut fares to generate cash. Making a tough situation worse, Spirit (and JetBlue and others) canceled flights because of extended weather disturbances as well as a chronic shortage of air-traffic controllers.

Demand for travel in the U.S. remained weak through the end 2023. Results for the second half of the year were also hurt by a recall of the engines used in Airbus 320neo airplanes. Spirit had the largest fleet of these aircraft. (It owned 82 of them at the time.) In response, over the course of roughly two years, the engine manufacturer Pratt & Whitney is checking each engine – grounding each plane for up to 10 months.

While the A320neo aircraft remain safe to fly, Spirit expects to have an average of 41 planes out of service in 2024 – and an unspecified, smaller number in 2025. Pratt & Whitney has committed to making its customers whole. The details are currently being negotiated. Between airplane rent (roughly $6 million per year per plane the company does not own) and lost profits, we estimate the engine maker will end up paying Spirit $300 million to $400 million. Spirit is likely to receive these "make whole" cash payments in stages during 2024 and 2025.

For the full year, Spirit generated $312 million before interest and aircraft rental expenses. The company burned $555 million in cash after all costs and capital expenditures.

Spirit's Outlook for 2024

In its newly released forecast, the U.S. Travel Association sees ticket sales in the U.S. increasing roughly 2.5% in 2024 over the last year. It projects that air travel will increase, with business travel growing faster than leisure travel.

Most U.S. carriers are planning to add seats in 2024. If too much capacity comes online, it's unlikely that U.S. carriers will be able to raise prices overall during the year.

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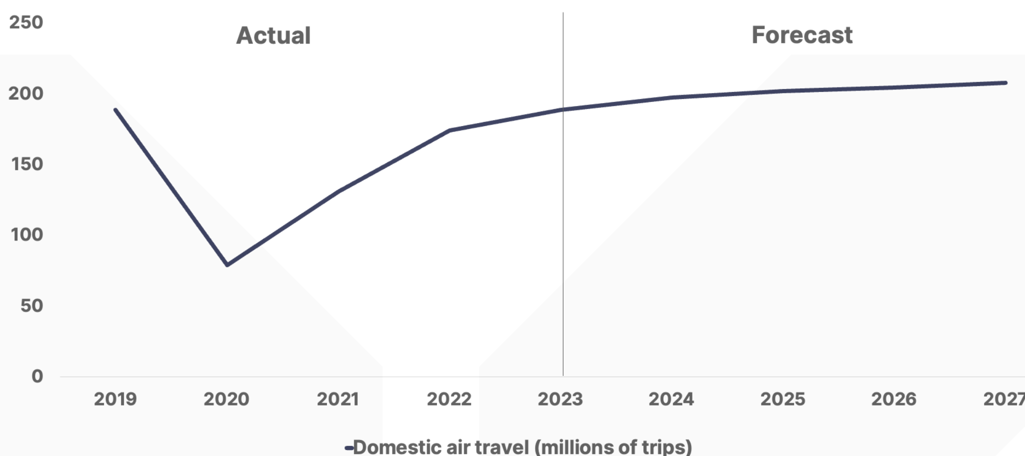

Spirit has responded to its weak 2023 results and this outlook by agreeing with Airbus to delay deliveries of 11 new aircraft worth about $1.4 billion. Because demand for all types of aircraft *worldwide* is still very strong, it will be a win all around if these aircraft go to foreign markets (while it will reduce current costs for Spirit, it also helps international carriers meet increased demand).

In its year-end conference call on February 8, Spirit's CEO said that the company is seeing bookings for the spring pick up. He expects the company to start generating positive cash flow in the quarter ending June 30 and for the rest of the year. The company disclosed that it expects cash capital expenditures to decline to $240 million in 2024, from $308 million last year.

Given all these factors, Spirit's results for 2024 should be better than in 2023, *before* layering in planned expense cuts. Management indicated it is looking for savings of at least $100 million in 2024 from staff reductions and elimination of certain flights during non-peak periods. We estimate Spirit's 2024 operating profit before interest and rental expense will be roughly $500 to $550 million, which is up from $312 million in 2023.

Generally, we expect that demand for travel within the U.S. will grow. We anticipate that Spirit will post better results in 2025. For now, we are using a range of $600 million to $1 billion of operating income. At the midpoint of $800 million, this is a year-over-year increase of roughly $500 million.

At the end of 2023, Spirit had $1 billion of cash. Given improving operating results, reduced capital expenditures, and only $40 million of debt maturing (in April) this year, we expect the company will use no more than $300 million in 2024.

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In addition, Spirit's is likely to receive $300 million to $400 million from Pratt & Whitney as compensation for the 82 A320neo engines that will be out of service. Spirit should receive most of these compensation payments in 2024 and 2025.

Spirit's real problem, however, is the $1.65 billion in debt it has coming due in 2025 and 2026. The company's ability to refinance this debt will depend heavily on its performance in 2024 and 2025. Unless the company's results (or at least its near-term prospects) brighten significantly, Spirit could have trouble raising the funds to replace $1.1 billion of debt maturing in 2025 and $548 million maturing in 2026.

Amount and Timing of Debt Coming Due

Year	Debt Maturing	Description
2024	$40 million	Secured by equipment
2025	$1.1 billion	Secured by loyalty program and other intangible assets, $25 million unsecured 4.5% convertible bonds
2026	$548 million	$500 million unsecured 1% convertible bonds, $48 million secured by equipment
2027	$0	N/A
2028 and on	$686 million	Secured by equipment

Three Scenarios for Spirit Airlines

If it looks like Spirit will be unable to refinance these debt maturities, here are the details of the three *possible* scenarios we envision:

1. **The Good**: Sale of the company
2. **Not So Bad**: Persuading bondholders to accept new bonds maturing later, and potentially negotiating a reduction on the amount they are owed
3. **Ugly**: Seeking to reorganize using Chapter 11 of the U.S. Bankruptcy Code

We will discuss these potential outcomes and offer our best estimate of the impact of each one on the market price of Spirit's 1% convertible bonds. To estimate the fair value of these bonds we will assign a probability to each outcome. Then take a weighted average.

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The Good: Sale Scenario

As discussed above, in July 2022, JetBlue agreed to pay $33.50 per share for Spirit's stock. Including debt and adjusting for cash, the offer valued Spirit Airlines at $6.6 billion.

Because the 2023 revenue and profit numbers declined for both JetBlue and Spirit from when the deal was crafted, if the ruling is appealed and the sale goes through, JetBlue would end up with a risky, debt-heavy balance sheet – having to assume all that Spirit owes with a smaller stash of cash. Without the acquisition, JetBlue would be in good financial shape.

In its contract to acquire Spirit, JetBlue agreed to do everything possible to line up all required government approvals. This promise means the company is compelled to appeal Judge Young's decision until July 24, 2024. That is the date when both companies are free to walk away from the transaction.

The U.S. Circuit Court of Appeals in Boston has agreed to review Judge Young's decision. This trial is scheduled to *start* in June. Even if the trial proceeds rapidly and the judge reaches a decision quickly, JetBlue and Spirit will still need to address a lawsuit by the Department of Transportation that is *also* seeking to block the deal.

In short, the odds of JetBlue clearing the legal roadblocks by July 24 to buy Spirit are slim to none. On January 25, JetBlue announced that it may not be possible to meet all conditions required to complete the merger in time.

That said, JetBlue's desire to expand its fleet, routes, and its staff of pilots has not gone away. It's conceivable that the airline might come back with a *much* lower price for Spirit. At a significantly lower cost, JetBlue could afford to make concessions not possible under the current agreement (such as selling routes or gates) to receive government approval. With Spirit shares trading at roughly $6.38 per share, shareholders might be willing to accept much less than $33 per share.

Frontier's Missed Opportunity

For a number of years Spirit and Frontier (the two largest ULCCs in the U.S.) both considered merging with the other. The two companies have similar operations and pricing structures. Together they would become the fifth-largest U.S. carrier.

In February 2022 Frontier agreed to pay Spirit shareholders roughly $28 per share, mostly in stock. (The package would be worth about $16 per share today, reflecting the decline in Frontier shares.) Including debt it would assume, Frontier's offer valued Spirit at $5.8 billion.

Frontier would be able to purchase Spirit if it used its own stock as currency. For example, if Frontier offered $10 per share in stock for each Spirit share, its shareholders would still own a majority of the company.

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- Frontier shareholders would own 54.6% – the 220 million shares they own now
- Spirit shareholders would own 45.4% – 183 million shares equal to $10 per Spirit share
- Total: 403 million shares

The problem is that the total of Spirit's debt and aircraft leases is now roughly $1 billion more than it was in 2022 when first Frontier, and then JetBlue, agreed to purchase the company. Another negative is that Spirit's operating profit deteriorated in 2023. Plus, there's that $1.65 billion in debt coming due in 2025 and 2026.

As a practical matter, we think Frontier and JetBlue would be more interested if Spirit's results improve – or if its bondholders agree to take new bonds maturing two or three years later.

Not So Bad: Exchange Scenario

Let's say you own one bond ($1,000 face value) that was issued by Company A. Imagine Company A's bond was trading at a distressed level when you bought it – say you paid $750. One day, troubled Company A offers to buy back its bonds for $650 cash. What do you do?

You can hang on to your bond. If Company A's operations improve enough, the company may be able to pay the full $1,000 when it comes due. That's a win. If operating results continue to deteriorate, the company might need to file for bankruptcy. Depending on how bad things get for Company A, you might end up with much less than $650 – and possibly nothing. That's a big loss.

How does that $650 in cash look? What if the company offered $700 in cash per bond? Or $550?

This is an imaginary example of a distressed exchange. A company in tough circumstances like Spirit might propose a distressed exchange to reduce its debt *without* filing for bankruptcy. In real life, that $650 or $700 or $550 might be in cash or it might instead be in the form of a new bond – quite possibly paying a higher interest rate or secured by better assets.

There's often a price that persuades bondholders to agree to the exchange. That amount is frequently related to how much bondholders think they'll receive if they don't sell now, but hold on to maturity. Sometimes a company sweetens its offer to get enough bondholders to agree. Other times, bondholders don't accept it (usually when they believe the odds of a bankruptcy are low) and the full amount will still be owed at maturity.

On February 8, Spirit announced it had hired financial and legal advisors to address the $1.1 billion of 8% bonds scheduled to mature on September 20, 2025, and the $500 million of 1% convertible bonds slated to come due on May 15, 2026.

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In all likelihood, the company will offer bondholders some amount of new longer-dated debt and stock in exchange for these bonds. If bondholders agree to these exchanges, Spirit will get another two or three years to improve its operating results – raising the odds it will be able to pay off the new bonds at a future date.

We believe that a distressed exchange would have a good chance of happening. With enough time, good decisions, and growing demand, Spirit might become profitable again.

In the alternative scenario of a bankruptcy, the payout might be very low.

Ugly: Bankruptcy Scenario

Many airlines have filed for bankruptcy since the Airline Deregulation Act passed in 1978. Most of them have used the Chapter 11 process to get rid of overpriced aircraft leases, renegotiate contracts (sometimes including labor agreements), and reduce their debt. The bondholders often end up owning most of the stock. Shareholders are often left with no more than a small amount of stock.

American, Delta, United, and the former US Airways are examples of successful reorganizations. Those companies paid their bondholders some percentage of the money they were owed and emerged from bankruptcy as stronger competitors.

If Spirit could not pay off any of its bonds at maturity (or get bondholders to exchange for new, longer dated bonds), it might need to reorganize under the Bankruptcy Code. A judge would have to approve a value for the business, and also agree how the different bondholders would share that value. We estimate it would be worth between 5.0x and 7.5x operating profit before interest and rental expense. Using our 2025 profit estimate of $600 million to $1 billion, we get to a valuation in the broad range of $3.0 billion to $7.5 billion.

- Low end of range $600 million x 5.0 = $3.0 billion
- High end of range $1 billion x 7.5 = $7.5 billion

The company's total debt and leases, adjusted for cash, is $5.9 billion – which is near the middle of this range. This means that if Spirit's operating results in 2025 come in at the high end of the range, the company's bonds and leases should receive full value. On the other hand, if it looks like operating results for 2025 will fall near the low end of the range, there's a good chance that unsecured bonds like the 1% convertible issue would be worth very little *or nothing*.

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For example, in the table below, multiply our midpoint number of $800 million in operating profit (column 3) by a 6.5x multiple to get a $5.2 billion valuation – which is $700 million less than the $5.9 billion in net debt and aircraft leases. But at a 7.5x multiple and $800 million in operating profit, there is just enough ($100 million) to cover the debt and leases. These scenarios in the table below show that Spirit's operating profits need to improve substantially above what they are to make the business worth more than the total debt and leases of $5.9 billion.

Amount by Which Value of Spirit Airlines Is Over (Under) Debt Value of $5.9 Billion – Adjusted for Cash ($millions)

2025 Operating Profits Before Interest and Rent Expense ($millions)	$600	$700	$800	$900	$1,000
Valuation multiple					
5.0X	($2,900)	($2,400)	($1,900)	($1,400)	($900)
5.5X	($2,600)	($2,050)	($1,500)	($950)	($400)
6.0X	($2,300)	($1,700)	($1,100)	($500)	$100
6.5X	($2,000)	($1,350)	($700)	($50)	$600
7.0X	($1,700)	($1,000)	($300)	$400	$1,100
7.5X	($1,400)	($650)	$100	$850	$1,600

It's not uncommon for companies in good financial shape to purchase a bankrupt competitor. We could imagine JetBlue or Frontier proposing to acquire Spirit as part of a plan of reorganization (which is the agreement that lets a company come out of bankruptcy). It would all depend on the price paid, but this scenario would likely be good for Spirit's bondholders.

The biggest risk in a Spirit bankruptcy is that it might not remain a going concern. If its results do not improve much from current levels, it may have to cease operations. Lessors might repossess the planes and lease them at higher rates to other airlines. Pilots and crew (who are comparatively low-paid at Spirit and are still in fairly short supply in the industry) might leave for other airlines.

In contrast to the major hub-and-spokes airlines that are the backbone of the U.S. (and global) air-transportation system, Spirit's point-to-point flights could be replaced easily. Other ULCCs and LCCs like JetBlue and Virgin Atlantic could add routes to capture Spirit's customers. This scenario would lead to a liquidation of the company – selling off the assets piecemeal. In a liquidation, the payout for unsecured bonds like the 1% convertible bonds due May 15, 2026, would be very small.

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Estimating the Upside

Buying these Spirit bonds is a lot like buying its stock. If there's a favorable outcome, the bonds will trade up, and unfavorable results will make the bonds go down. Instead of looking at the *yield* on these bonds, we look at the price where we think the bonds will trade in the different outcomes.

But in an important way, buying the bonds is better than buying the stock. The stock can only have value if the bonds get full payment.

Recapping the Three Scenarios

Here are potential outcomes for each of the three scenarios.

- Our best estimate is that if JetBlue or Frontier makes a new offer to buy the company at a lower price, the bonds will trade up to around $800 from the current price of $420
- In a successful debt exchange, we estimate the bonds will be valued at roughly $700
- In the case of a bankruptcy, the bonds will likely trade down to $100

Our base case makes the odds on the various possible outcomes as follows:

- Sale of the company: 20%
- The company refinances the bond or has a successful distressed exchange: 55%
- A bankruptcy: 25%

In this table we show this base case, and then vary the probabilities for the three outcomes. We calculate the expected value of the 1% convertible bond due May 15, 2026, in each case. We compare that to the current trading price of $420.

The table shows that at the current price the bonds are anywhere from 19% to 51% undervalued.

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Scenario Analysis of Expected Trading Price Compared With Market Price of 1% Convertible Bond

Base Case				
Outcome	Likelihood		Expected Trading Value	Current Fair Value
Sale	20%	x	$800	$160
Exchange	55%	x	$700	$385
Bankruptcy	25%	x	$100	$25
	100%			
Current Fair Value				**$570**
Current trading price			$420	
Appreciation to Fair Value			36%	
Higher Chance of Sale or Exchange, Lower Chance of Bankruptcy				
Outcome	Likelihood		Expected Trading Value	Current Fair Value
Sale	25%	x	$800	$200
Exchange	60%	x	$700	$420
Bankruptcy	15%	x	$100	$15
	100%			
Current Fair Value				**$635**
Current trading price			$420	
Appreciation to Fair Value			51%	
Lower Chance of Sale, Higher Chance of Exchange				
Outcome	Likelihood		Expected Trading Value	Current Fair Value
Sale	10%	x	$800	$80
Exchange	65%	x	$700	$455
Bankruptcy	25%	x	$100	$25
	100%			
Current Fair Value				**$560**
Current trading price			$420	
Appreciation to Fair Value			33%	
Lower Chance of Sale, Higher Chance of Bankruptcy				
Outcome	Likelihood		Expected Trading Value	Current Fair Value
Sale	10%	x	$800	$80
Exchange	55%	x	$700	$385
Bankruptcy	35%	x	$100	$35
	100%			
Current Fair Value				**$500**
Current trading price			$420	
Appreciation to Fair Value			19%	

How Spirit Bonds Benefit Compared With JetBlue Bonds

In December, we recommended JetBlue's 0.5% convertible bonds due April 1, 2026. In this month's report, we are recommending Spirit's 1% convertible bonds due May 15, 2026. The relationship between Spirit and JetBlue is complicated. Certain outcomes could help one or the other. Other outcomes could help or hurt both companies.

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Here's a quick overview of what would help the bondholders of Spirit and what would help the overall strength of JetBlue:

How Potential Events Play Out

	Spirit	JetBlue
JetBlue is permitted to buy Spirit	Positive	Negative
JetBlue buys Spirit at a significantly lower price	Positive	Modest Positive
JetBlue does not buy	Negative	Positive
Frontier buys Spirit	Positive	Modest Negative
Level of travel and/or ticket prices rise	Positive	Positive
Spirit bondholders agree to extend maturities	Positive	Neutral
Spirit files for bankruptcy	Negative	Positive

Risks

The main risks apply to the financial strength of Spirit Airlines whether it gets purchased or remains independent. This said, the *effects* of the following risks are potentially more serious, given Spirit's low profit margin and high debt:

- Fuel price
- Salaries and benefits cost increases
- Maintenance costs
- Delays and cancellations from weather or air-traffic-control backups

The Spirit 1% bonds are convertible into Spirit stock. We attribute no value whatsoever to this conversion feature. In May 2026 the bonds will receive the *higher* of their $1,000 face value or the value of 24.97 shares of stock. So if the stock goes above $40.05 per share by May 15, 2026, holders will end up receiving more than $1,000 per bond. With the stock currently trading at $6.38 per share and given the high level of Spirit's debt and leases, we view this conversion feature as very close to worthless. The last time Spirit's stock traded above $40 was in January 2020, just before the pandemic.

Here is the SAVE stock price chart going back to 2011:

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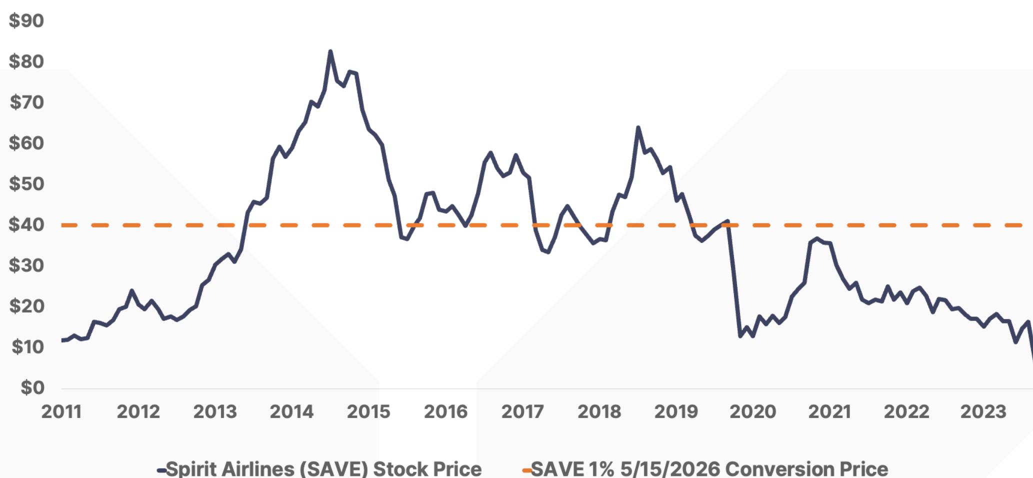

If Spirit's stock price does go above $40.05 per share before the bonds mature in May 2026, holders can convert the bonds into stock that will be worth more than the $1,000 face value.

Discussion of Bond Terms

Spirit's 1% convertible bond due May 15, 2026, is a $500 million bond issue that is senior unsecured. This means that in the event of bankruptcy, bondholders would get paid along with all other unsecured debt, *after* secured bonds and bank loans are satisfied. And as of December 31, there is roughly $2.8 billion in debt secured by certain aircraft and Spirit's loyalty program. All of the company's $525 million in senior unsecured bonds ($500 million for the 1% convertible bonds and $25 million in 4.75% convertible bonds coming due May 15, 2025) would get paid ahead of all stockholders. These bonds would be repaid fully before any stockholder would get a penny.

Action to Take: We recommend Spirit Airlines' 1% convertible bonds due May 15, 2026, at or below $470 plus accrued interest (CUSIP# 848577AB8). Taxation of deep discount bonds like this one can be very complicated and costly. It's best to put them in an IRA or other tax-deferred account.

Bond Box

Because of the high likelihood that this bond will be exchanged for one that matures later than May 15, 2026, we are not using our regular "Bond Box." We have included our estimates of the potential outcomes for this bond in the section entitled "Three Scenarios for Spirit Airlines" above.

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How to Buy This Bond With a Live Broker

If you are putting in a phone call to your broker, here's a quick breakdown of the steps you'll go through.

1. **Tell your broker the number of bonds you'd like to acquire.**
2. **Provide the name of the borrower, the coupon, and date of maturity.**
3. **Provide the CUSIP number.**

CUSIP stands for "Committee on Uniform Securities Identification Procedures" and is a unique series of numbers and letters assigned to every traded security. Providing the CUSIP will ensure that you're buying the right security. The CUSIP of the bond we recommend in this issue is 848577AB8.

Specific Instructions for Buying Spirit Airlines 1% 5/15/2026 Convertible Bond

Now, the bond we are recommending today is not always tradeable online, so instead you will need to place your trade by phone. We've confirmed that the Spirit Airlines 1% 5/15/2026 convertible bond is available through Schwab and at full-service brokerage firms.

> Recall that the bond market is much less popular (and there's much less trading volume) compared to the stock market, so don't be surprised if you are dealing with a broker who knows little about the bond market. This is part of the reason why, in the bond market, there are fewer market participants and less overall interest, so it's easier to scoop up bargains when opportunities arise.

The instructions for placing an order are usually standard across the brokerage platforms mentioned above.

Here's an example of how the conversation with your broker might go:

Investor: "Hello. I am interested in buying Spirit Airlines 1% 5/15/2026 convertible bond. Can you get me the bond quote so I can decide whether or not I want to buy?"

Broker: "Yes, can you confirm with me the CUSIP?"

Investor: "The CUSIP is 848577AB8."

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Broker: "We don't have these bonds in our inventory. However, we can place open market orders which allows for this bond to be traded and sold through an alternative trading system ("ATS"). We can get you a quote. How many of these Spirit Airlines 1% 5/15/2026 convertible bonds are you looking to purchase?"

Investor: "I'd like to purchase 25 of the Spirit Airlines 5/15/2026 convertible bonds."

Broker: "Okay, I will get you a quote and call you back. Bye."

This is where the first conversation with the broker will come to an end… but within the next 24 to 48 hours of the next trading day, the broker should return your call and will give you the quote (the price) of the bond. This call is when you will place and confirm your order.

After your initial call to receive the quote, the broker will call you back in most cases and after he confirms he's speaking to the correct person, he can go ahead and place your order.

Here's how the second call might go:

Broker: "Hello, this is John Doe, the fixed-income specialist you spoke to earlier. I am calling to give you a quote for the 25 Spirit Airlines 1% 5/15/2026 convertible bonds you inquired about. The price for the size of your request to buy 25 bonds is $45.30 plus accrued interest. Would you like to go ahead and place the trade?"

Note: The $45.30 price he quoted is really $453 for the cost of each bond. When quoting bonds, brokers will most likely drop the last zero, so $45.30 becomes $453.00. Now, if the investor decides to purchase 25 bonds, his total will be $11,388.25 ($453 × 25 =$11,325) plus $63.25 for accrued interest ($2.53 × 25 = $63.25) and any commission or service fee.

Investor: "Yes. The total comes out to $11,388.25 plus the service fee. Is that correct?"

Broker: "Yes, it is correct. I will go ahead and make the transaction. You will get an email confirmation over the next 24 hours. Have a great day!"

As always, if you have questions, please call Lance, your personal Porter & Co. Concierge, at his team at (888) 610-8895, or internationally at +1 (443) 815-4447. We do not endorse any specific brokerage and are offering this guide for informational purposes only.

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P.S. To read more about bankruptcy and how it plays out in the bond world, check out "**Learning to Love Bankruptcy**."

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