The Refinancing Wall Looms Large: When Algebra & Optimism Collide

In our August piece, The Solvency Debate Continues, KCR updated our 2021 missive Junk Stocks Funded by Junk Bonds. We observed that 2023 had seen speculators return with a ferocious appetite for low-quality stocks. Our focus in that piece, and again today, will be on a group of companies that failed the Federal Reserve's test for financial fragility as defined by interest coverage ratios ("ICRs"). These are companies that cannot afford to pay the interest on their debt out of operating income.

=

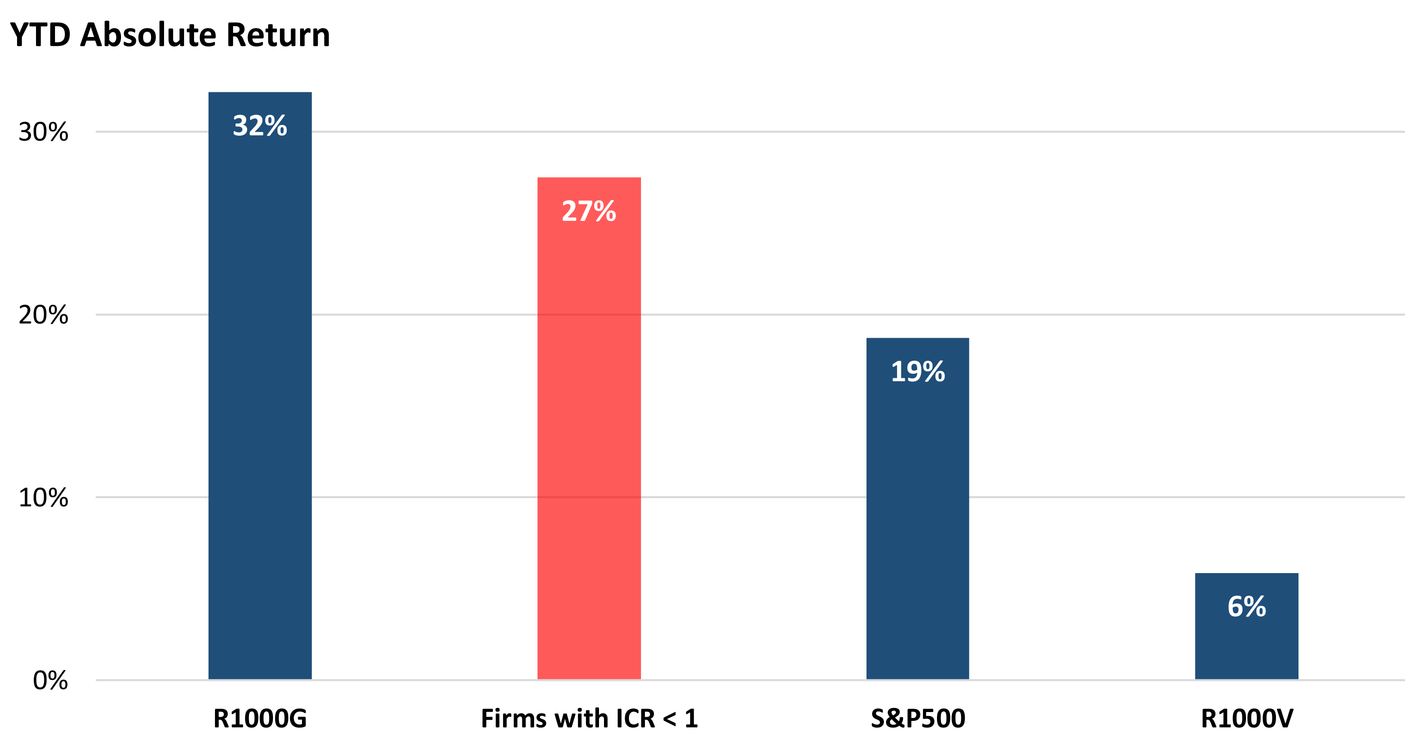
We highlighted the following:

- The **market cap** of companies that could not afford to pay their interest expenses out of operating profits had soared to a new record of $2.2 trillion dollars[1]
- The **number** of stocks that could not pay their interest expense was approaching 20% of all the listed stocks in the market – an all-time record[2]
- That we felt this simple metric was a far better measure of financial health than waiting for rating agencies to tell you if the investment grade rating of a company's leverage is high yield or not

The purpose of today's piece will be to explain in simple and clear terms the devastating impact rising interest rates **have yet to inflict** on these stocks. Many of these stocks have large amounts of debt maturing in the next few years. **The higher interest rates at which these companies will have to refinance their debt have created a potential solvency crisis that their equity investors seem totally blind to.**

Before diving in, the chart below shows the year-to-date performance of (in order of appearance):

- The Russell 1000 Growth Index, **the firms that cannot pay the interest on their debt (Firms w/ ICR <1)**, the S&P 500 and the Russell 1000 Value Index
- **Incredibly, the low-quality garbage has nearly matched the parabolic multiple expansion of high-quality growth stocks that has driven the R1000G Index**



Source: Kailash Capital Research, LLC; Data from 8/31/2023

1 As discussed in that paper, this record omits the Covid lockdowns
2 IBID

The Towering High Yield Maturity Wall

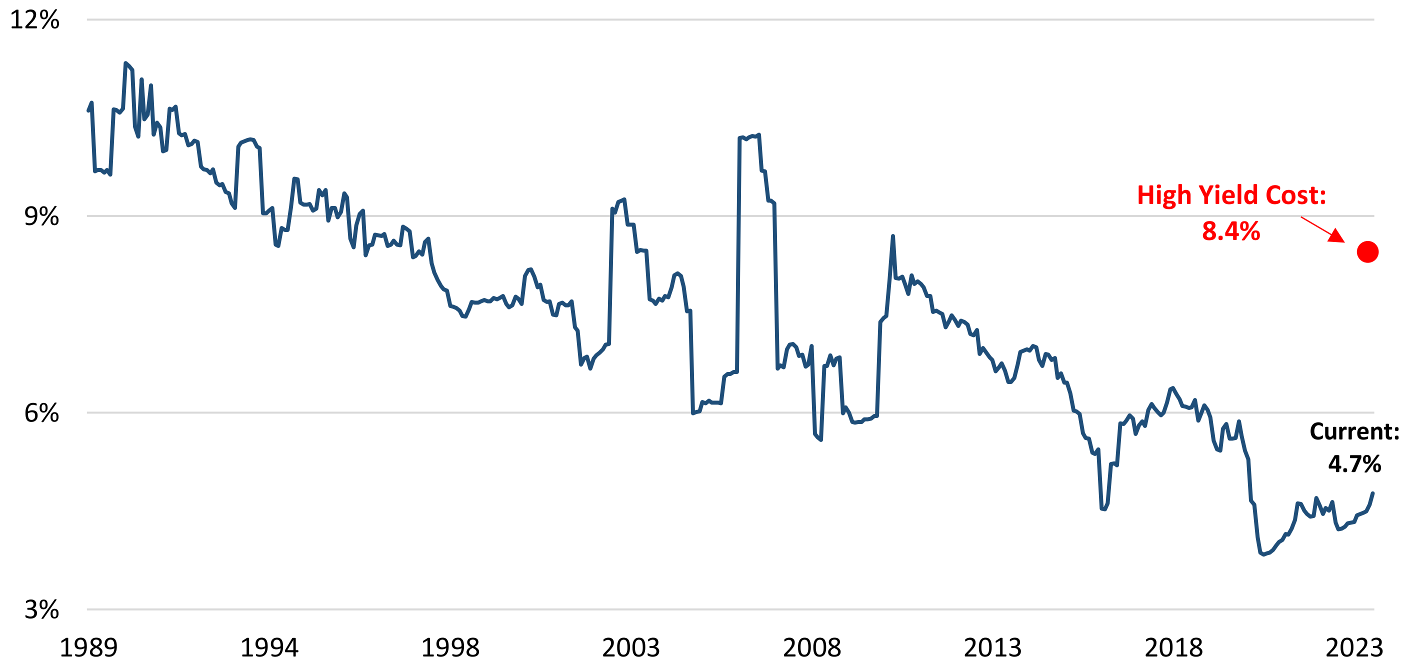
The chart below shows just how brutal rolling over upcoming maturities will be for speculative-grade firms.

- The line shows the trailing interest rate being paid on debt by companies that cannot afford to pay their interest expense out of operating income is only 4.7% today (Firms with ICR < 1)
- The red dot shows the current cost of high-yield debt
- The reason these low-quality companies are paying yields that approximate US Treasury bonds is that they borrowed this money when interest rates were near zero percent
- As a reminder, the stocks that make up that line are currently valued at $2.2 trillion dollars

Simple takeaway: the Fed's rate hikes have yet to hit the income and cash-flow statements of this $2.2 trillion group of stocks, and when it does, the impact will be devastating.

Average Interest Rate on Debt held by Firms with ICR < 1

Firms that cannot pay their interest expense are only paying 4.7% on their current debt



Source: Kailash Capital Research, LLC; Data from 4/30/1989 - 8/31/2023

As we showed in our previous paper, between 1989 and 2009, the percentage of US stocks that could not afford to pay their interest expenses out of operating profits was relatively stable at about 10%.

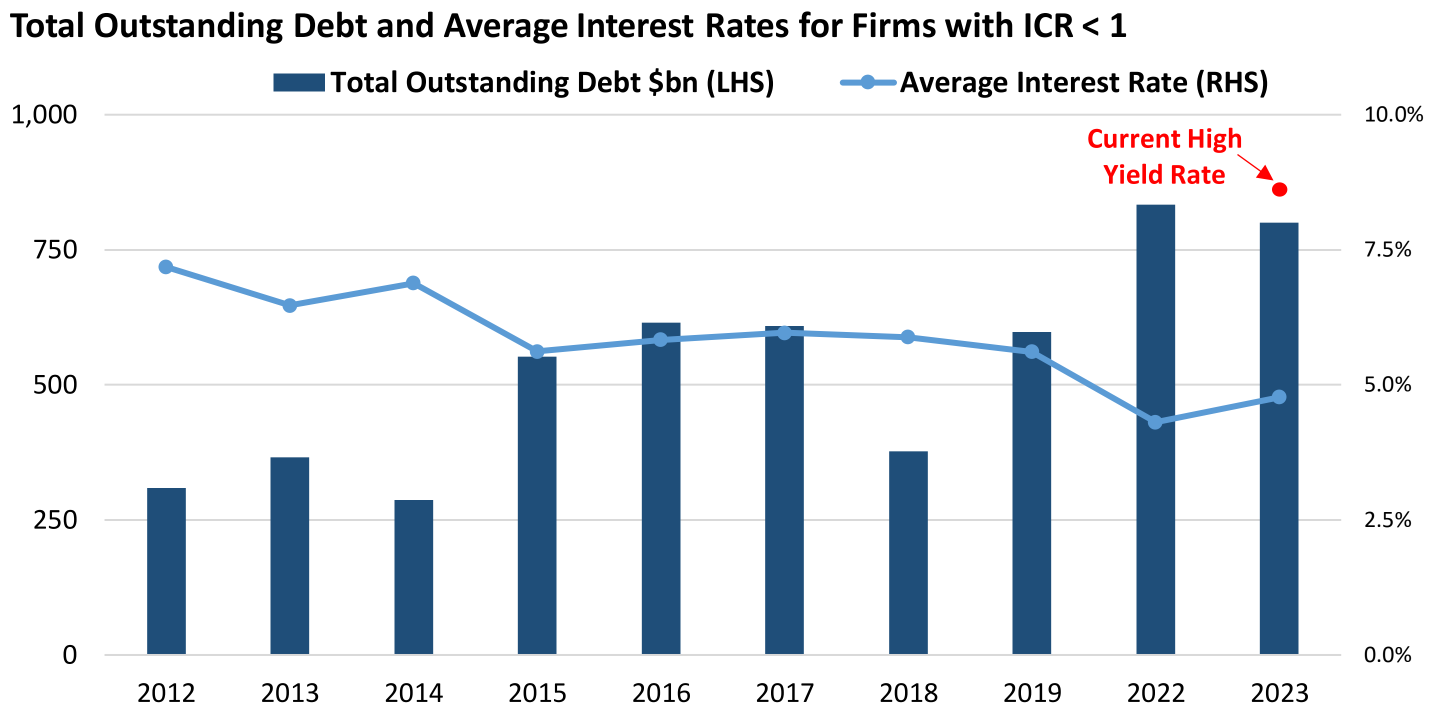
Immediately before the GFC, the percentage of stocks fitting these awful criteria troughed at 7%.

Even more important – between 1989 and 2008, there was no substantive market cap of stocks that fit this criterion other than a brief period during the dot.com bubble.

For the bulk of modern American history, most companies had operating profits greater than their interest expense. **This makes sense.** Why would you lend to a company that couldn't pay the interest, much less the principal, on the debt?

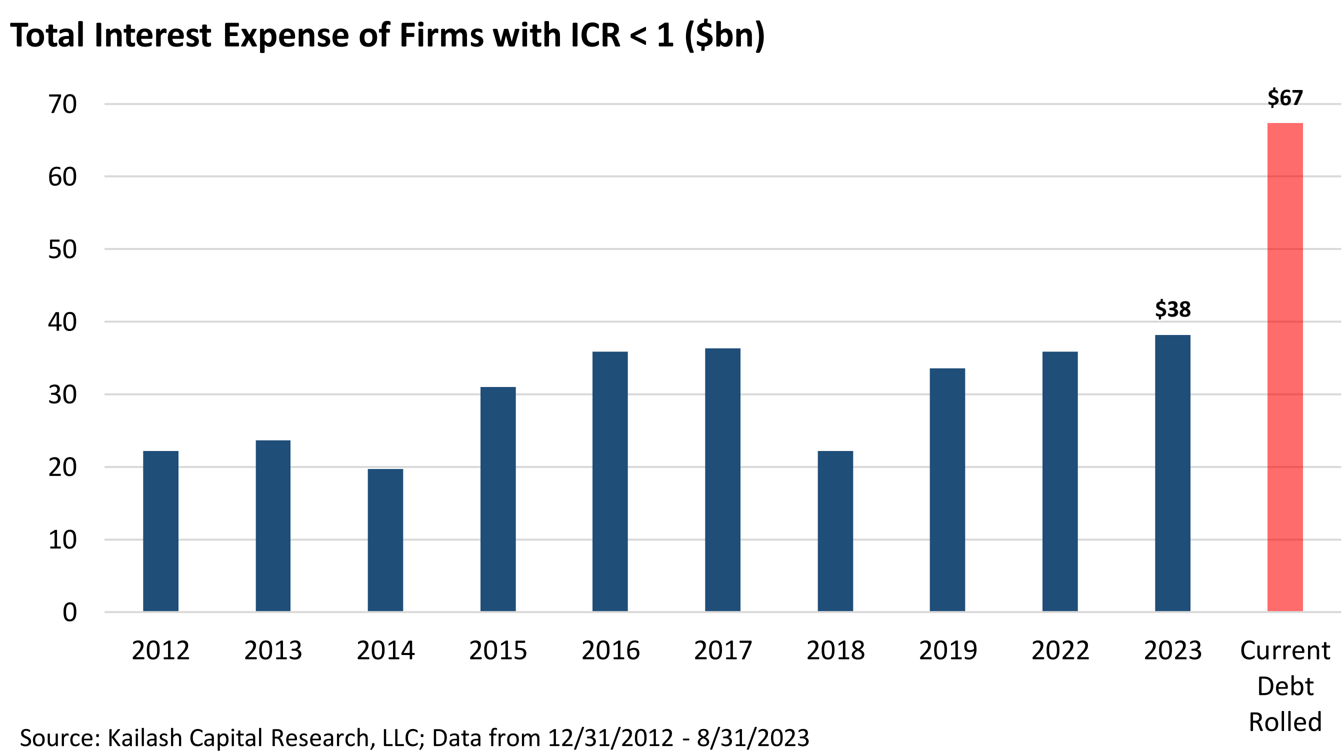
Yet the decade+ of ZIRP interest rate policies ignited a period of financially irresponsible conduct that has left us with a record number of stocks with record valuations that are effectively insolvent.

Scaled in 100s of billions of dollars, the navy-blue bars show the total debt outstanding of stocks that cannot pay their interest expense from 2012 through today.[3] The light-blue dots show the average interest rate on that debt (RHS). The red dot is, again, the current cost of high-yield debt today (RHS).



Source: Kailash Capital Research, LLC; Data from 12/31/2012 - 8/31/2023

The chart below shows the interest expense paid by these financially fragile companies by year from 2012 – today.[4] The last bar on the right shows what would happen if they had to roll their debt over at current high-yield rates. These companies would go from paying $38bn in interest expense to nearly $70bn.



Source: Kailash Capital Research, LLC; Data from 12/31/2012 - 8/31/2023

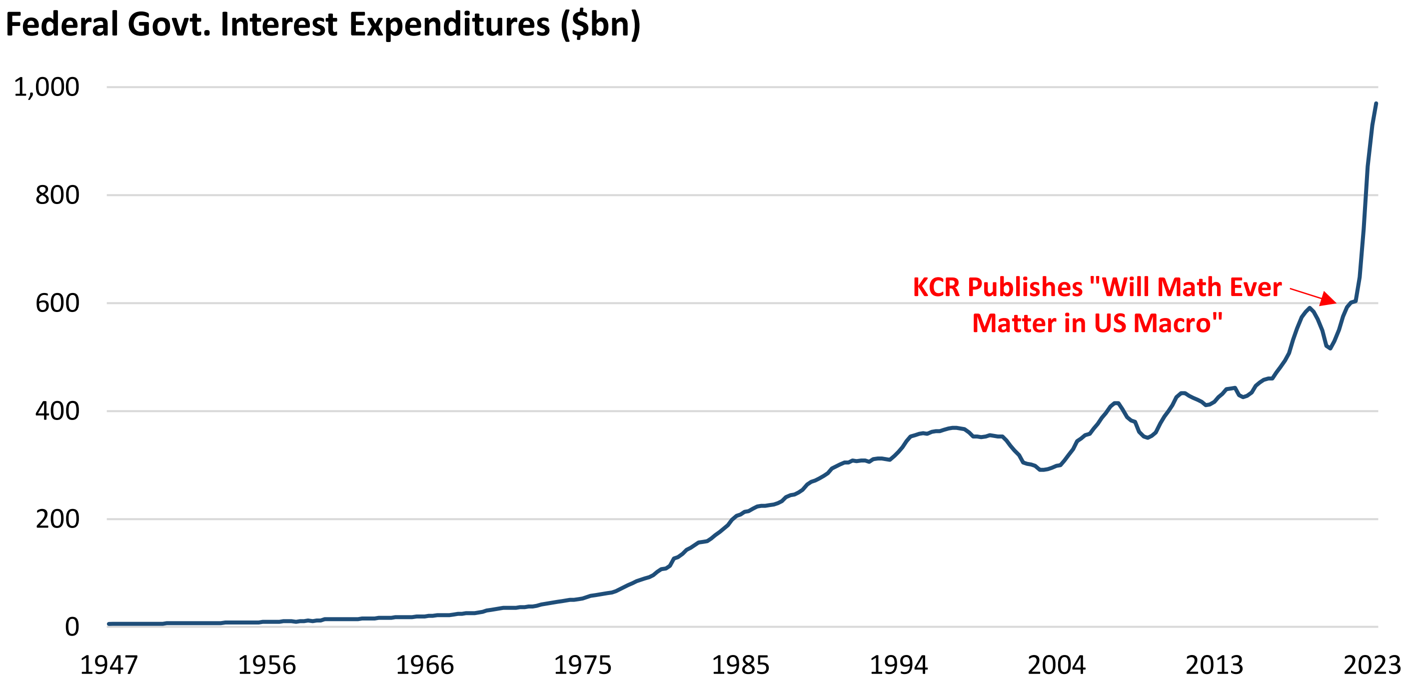
It is easy to forget the meaning of numbers in this age where $100s of billions are bandied about.

[3] We have removed 2020 and 2021 due to the Covid lockdowns which sent the operating profits of many well-run companies plummeting.
[4] IBID

For longtime KCR readers, those charts above might look eerily familiar. Why? We used the exact same setup in one of our rare macro-forays.

Titled Macro Research: Will Math Ever Matter in the US, we walked through the dire implications of US debt and deficit spending using precisely the same chart format. Our point in that piece was that out-of-control US deficits coupled with a looming maturity wall were about to cause an epic spike in our nation's interest expense.

Relying on simple arithmetic (like this piece), that is exactly what is playing out today. We were not making forecasts in that paper, simply observing the inevitable. We wrote it because we couldn't believe more people were not talking about the inevitable crisis.



Source: Kailash Capital Research, LLC, St. Louis Fed; Data from 1/1/1947 - 4/1/2023

Well today that crisis is top stories. Even worse, the news on this front is going from bad to worse. Why?

"$7.6 trillion of US government debt will mature in the next year, adding pressure on rates."
-Business Insider

The US bond market is going to have to roll another $7.6 trillion of debt in the next 12 months at vastly higher interest rates. **Let that sink in.**

Finding countless other ways to look foolish, we do not make macro forecasts here at KCR. But our admittedly anecdotal view is that the Fed **must** cause a painful recession here to crush inflation and get interest rates down. If they do not, the violent spike in interest expense in the chart above will spiral out of control.

Consider what that means for the stocks we highlight in this paper. These are stocks that:

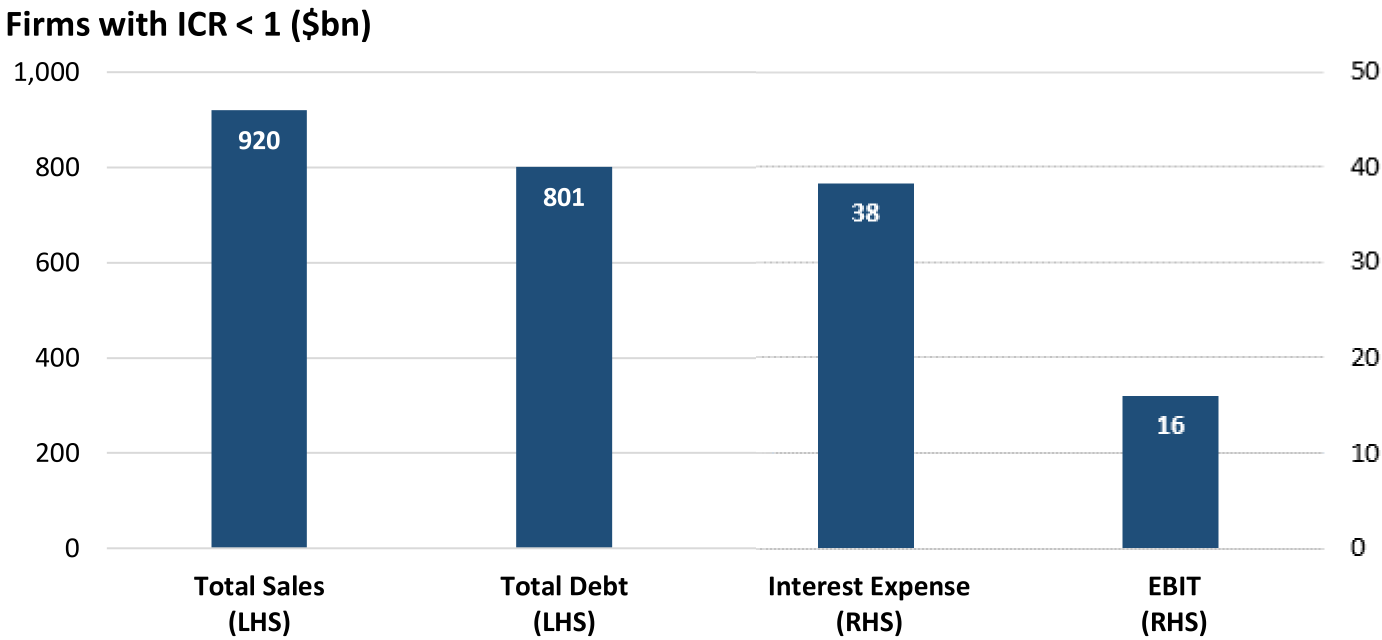
- Can't pay their **current** interest costs out of operating profits today
- We know that despite this red-flag of insolvency, the debt owed by these companies has prevailing rates that are **below** the interest rate on US Treasury bills and bonds
- If they had to roll their debt today, their interest expenses would double

So, to get rates down, the Fed needs a recession which will likely exacerbate the financial troubles of these stocks. If the Fed doesn't get rates down, they have to roll their debt at ~100% higher interest costs.

Where is the winning hand in this setup for equity owners of stocks like these?

The chart below brings the implications of all this home in a rather ruthless fashion. The bars are a simple walk-down of the aggregate features of all the stocks that can't afford to pay their interest expenses.

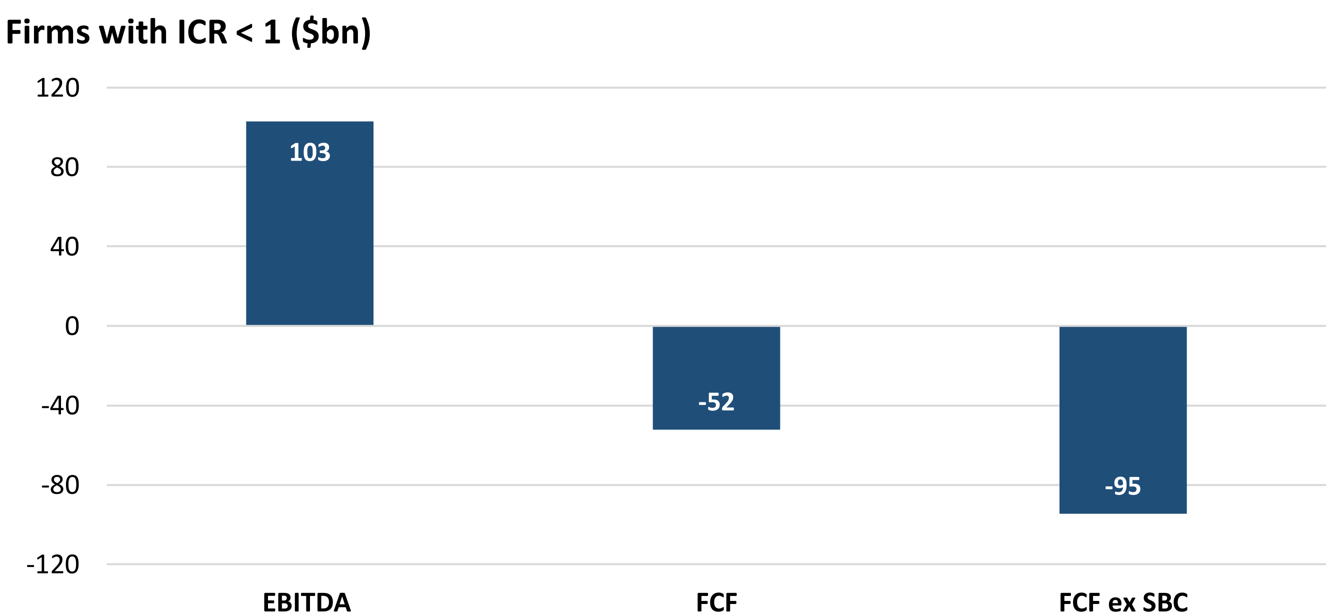
- First Bar: these companies have total sales of $920 billion dollars
- Second Bar: they owe a total of $801 billion dollars
- Third Bar: they are currently paying "only" $38 billion in interest expense but….
- Fourth Bar: they only have operating profits of $16bn



Source: Kailash Capital Research, LLC; Data from 8/31/2023

Simple conclusion: if they had to roll their debt today and pay $70bn in interest expense, it would shatter these already horribly fragile income statements. Even worse, if you are of the persuasion that operating profits are not a good proxy for cash-flow and that maybe our focus on EBIT is misplaced. **You are wrong.**

The chart below shows the EBITDA of these firms, their actual reported free cash flows (FCF), and their free cash flows after backing out stock-based compensation**. These companies are losing -$95bn today.**



Source: Kailash Capital Research, LLC; Data from 8/31/2023

At 4.7% interest rates, these companies have run-rate losses approaching -$100bn. And they are valued at $2.2 trillion dollars? WHY?

These stocks represent one of the most arithmetically inexplicable wagers we have ever seen.

Even worse, time is not the friend of these companies or those who have chosen to invest in these stocks. In a terrific article by Tasos Vossos and Eleanor Duncan, they highlight that the junk-bond maturity wall has never been so close. Bold in the quotes below, ours:

The world's riskiest borrowers are starting to run out of easy money…Junk-rated companies staring down a $785 billion maturity wall ***are in a race against time*** *to replace debt…On average these companies now have 4.7 years to put fresh financing in place****, the least amount of time ever****… Much of the financing that's coming due stems from the pandemic, when the Fed swooped in to make credit cheap and easy to access for the most vulnerable companies, even pledging to buy certain types of high-yield debt.* ***More than 40% of the maturity wall, or debt that needs to be refinanced by 2024 and 2025, was taken out then.***

In our piece, Equal Weight S&P 500 Indexes, we explained that by merely equal weighting the stocks in the Russell Large Cap Index **and** removing loss-making firms, investors could avail themselves of a portfolio of companies that were higher quality and growing faster than the broad benchmark…for a 50% discount to the index.

With a simple two-factor sort offering such a powerful improvement over the broad benchmark, **who is buying these financially fragile firms today?** We have no answers for you there.

What we can do is show you the fundamentals of:

- First Row: the financially fragile firms featured in this paper
- Second Row: the Russell 1000 Index
- Third Row: the Russell 1000 Index Equally Weighted with Loss-Making firms removed

This just isn't complicated. If you own these fragile firms, we encourage you to ask yourself "WHY?"

	Equity Duration	FCF/EV*	P/S	P/E	P/B	ROE	Net Margin	Total Yield	3 Yr Sales Grth	3 Yr Earnings Grth	36m Beta**
Firms with ICR < 1*	64	-2.3%	2.3x	-16.1x	3.6x	-36%	-76%	0%	97%	-239%	1.28
Russell 1000	43	3.3%	2.4x	24.7x	4.1x	39%	16%	3%	56%	138%	1.07
R1000 EW ex Money Losers	29	4.5%	1.4x	16.4x	2.5x	35%	14%	4%	71%	154%	1.03

Source: Kailash Capital Research, LLC; Data as of 8/31/2023; *ex Financials, **vs. the S&P500

As always, KCR encourages prudence when others behave speculatively as they are today. We would also remind readers that over 12,000 Americans are turning 65 years of age every day now. **Life's bills do not always come due at market tops.**

507 stocks qualify for this unfortunate screen. KCR does not claim to have "the recipe" for exposing those most vulnerable to this upcoming debt shock. There are an incredible number of ways to cut this universe of potential equity wrecks. Looking at several sorts, our team settled on showing the stocks that:

- Had negative EBITDA or….
- The **portion of their debt due in less than 1 year** was greater than EBITDA
- Had a minimum market cap of at least $1bn and…
- Scored in the worst 20% of one of KCR's ranking methodologies, which take into account earnings quality, valuation, balance sheet items, and analyst behavior

The exhibit below shows the 45 stocks that met those miserable criteria.

If you want to ensure you don't have any of these low-quality stocks sitting in your portfolios, please click here to connect, and we can sort this 507-stock universe on any criteria you might want. Thank you!

Upgrade to our Premium Plan to view KCR's Speculative Equity Wrecks

Premium Plan

We will prorate any surplus balance towards your new plan.

Speculative Equity Wrecks?

KCR Agg Score	Ticker	Company Name	Market Cap ($m)	Total Debt ($m)	EBITDA ($m)	FCF*	FCF/EV*

Disclaimer