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Junk Turns Golden, But May Be Laced With Tinsel

By SERENA NG

January 4, 2007; Page C1

Junk has never been so fashionable.

The ranks of companies whose debt is rated below investment grade, known as junk, are swelling, a sign of increased borrowing and a growing appetite for risk by investors seeking high returns.

Back in 1980, the debt of slightly less than a third of U.S. industrial corporations tracked by Standard & Poor's was rated junk. By the late 1980s, more than half were, and now 71% of the pie fits into that category, a record according to a new S&P report.

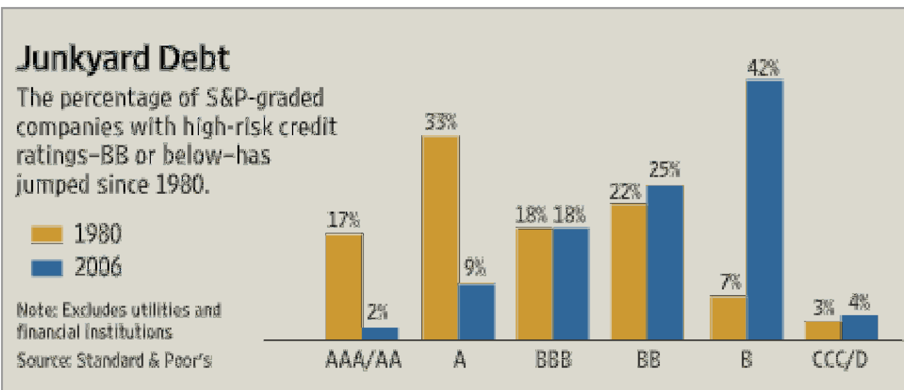
• The Background: More than 70% of U.S. companies rated by Standard & Poor's have below-investment grade, or junk, ratings. That's a record.

• What It Means: It's a sign of investor appetite for risky debt and a result of the leveraged-buyout boom. It could also be a signal some companies are borrowing too much.

• What's Next: Defaults are now low, but this points to a risk that they could rise.

"Junk bonds used to be a bad word on Wall Street," says Joe Bencivenga, who used to be a bond analyst at Wall Street's junk-bond house Drexel Burnham Lambert in the 1980s. "They have since gained a lot more respectability." Mr. Bencivenga is a co-founder and head of research at Plainfield Asset Management, a hedge fund.

The rising tide of junk points to glacial changes in the nation's financial markets, and to more explosive short-term trends.



Back in the 1970s, many companies needed high credit ratings to persuade debt investors to lend them cash. Otherwise, they had to rely on banks. As financial markets became deeper and more sophisticated, investor tolerance for risky bonds rose. Investors get bigger interest payments on bonds from riskier companies, to compensate them for the possibility of a default. Today, many bank loans even fall into this risky category, and they are bundled together and sold to investors almost like bonds.

More recently, a boom in leveraged buyouts is pushing a growing number of companies into speculative territory, a worrisome development to some. Junk-bond booms in the late 1980s and late 1990s ended painfully.

"People forget the bad times and remember only the most recent good times, and I fear that's the case right now," says Edward Altman, a finance professor at New York University who was one of the first academics to study junk bonds in the 1980s.

Ratings services like S&P, Moody's Investors Service and Fitch Ratings assign a range of rankings to companies based on their perceived ability to repay debt. S&P's rankings go from triple-A -- rock-solid companies like General Electric Co. that are sure to pay it off -- to single-D, which are already in default.

Companies with the highest credit ratings pay lower interest rates.

Bond investors make money on interest payments. They can also make or lose money on the underlying value of the bond, which goes up if the perceived risk of default goes down and vice versa.

These days, triple-A companies are nearly extinct. Just six nonfinancial corporations bear the label.

Now the common currency is single-B, a level one step below the official junk standard of double-B. Single-B companies have grown to 42% of the 2,000-odd nonfinancial, nonutility corporations tracked by S&P today, from 7% in 1980.

The club includes names like Neiman Marcus Group Inc. and Toys "R" Us Inc., both recent debt-heavy buyout targets. It also includes Ford Motor Co. and General Motors Corp, whose low ratings result from auto-sector troubles. Four Seasons Hotels Inc., Gap Inc. and even Nasdaq Stock Market Inc. hover a wrung above at double-B.

In all, 70 of the large companies that make up the S&P 500 have junk ratings. Most junk-rated companies, though, are small, young or lesser-known companies, says Nicholas Riccio, an S&P credit analyst and author of the report, titled: "The Rise of B-rated Companies and Their Staying Power as an Asset Class."

The interest companies pay on their debt is tax deductible, unlike dividends paid on stock. That's one reason debt is seen as an appealing way to raise money. Companies that have little debt are often pressured by investors to add more to capture the tax advantage and to reward stock investors by buying back shares, paying dividends or funding expansion plans. The risk is that their chances of default rise as they borrow more money.

Investor appetite for high-yielding, risky debt is a force behind the buyout boom, in which private-equity firms buy corporate stock and finance the acquisition with heaps of new bonds or loans.

Back in the 1980s, companies like R.H. Macy & Co. and Duracell Inc. were similarly loaded with debt in buyouts that sent their credit ratings tumbling. Macy ended up in bankruptcy proceedings, while Duracell managed to pay down its debt and became an investment-grade company before it was bought by Gillette Co. in 1996.

The outlook for investors who hold junk bonds today could be similarly mixed.

Among a sample of around 120 single-B companies that tapped the debt markets for the first time in 1996, just 6% have paid off their debt, according to S&P. A third of the group defaulted or went into bankruptcy proceedings. Another third have been acquired.

On average during the past 20 years, 4.5% of junk bonds have gone into default. In 1991 and 2002 defaults spiked to more than 10% of junk bonds outstanding. The default rate was only 1.3% last year, one reason for the surge of interest in the lower-rated debt. But Mr. Riccio isn't sure it will last.

"Most people think they are smart enough to get out when they should," says Mr. Riccio of S&P. "The question is who will be left holding the bag."

Write to Serena Ng at serena.ng@wsj.com1

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QUESTIONS:

1.) Define the following terms: bond rating, junk bond, investment grade bond.

2.) Who issues bond ratings? What factors go into a bond rating? Are bond rating services a necessary part of the U.S. financial market? If all companies that issue bond ratings suddenly ceased to be, what would the likely effect be on financial markets? Support your answer.

3.) What are the possible ratings issued by Standard and Poors? From an investor's perspective, what are

the advantages and disadvantages of investing in junk bonds relative to investment grade bonds?

4.) What are the trends in bond ratings described in the article? Explain how these trends are related to a) the decreasing importance of bank financing, b) investors' increased appetite for risk, and c) the increasing frequency of leveraged buyouts. Support your answers.