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VIEWPOINT

Party Like It's Almost 1999?

JAMIE FARNHAM | MAY 9, 2018

With all respect to Prince, his song unintentionally foretold the unbridled capital markets optimism of 1999 with scant worry about what may lie ahead. While the equity markets drank the dot com 1.0 boom Kool-Aid by creating a new meaning for the term unicorn, the leveraged finance market joined the party by financing venture debt. Here is a simple definition of venture debt:

> *A complement to equity financing, venture debt provides growth capital that extends the cash runway of a startup company, enabling the enterprise to achieve its next milestone while minimizing equity dilution for employees and investors.*

In other words, venture debt lends to companies that do not have positive cash flows or significant assets to use as collateral. As predictable as the seasons, if money is willing to be lent there will assuredly be founders to accept it, Murphy's law be damned! With painful memories from the late 1990s having faded for some and with other investors not having been in the business long enough to remember, the high yield market is once again facilitating venture debt. We believe the recent Tesla and WeWork high yield financings serve as ominous harbingers of dangers lurking ahead.

Iridium serves as a worthy lesson to dust off. In mid-1998, the company was a capital markets darling as it raised billions to build a network to provide global telephony services via a group of satellites. Born within Motorola, it turned first to the equity market and then eventually to high yield markets to help finance this vision. Its Achilles heel was a continuous hemorrhaging of free cash flow at precisely the same time it raised expensive 13% and 14% coupon high yield bonds. Iridium's very survival depended upon further access to capital or else it would hit a funding wall. A 1997 document for its high yield bonds even indicated the following:

- The word "will" appears 1,167 times in the 1997 offering document for Iridium LLC's high yield bonds. This is important because it acknowledges the company "...is a development stage enterprise with no operating history" and "...currently has no source of revenues."
- The Iridium service was not actually functional when the high yield market bought the company's bonds. In fact, Iridium didn't even expect commencement of commercial operation to begin until a year later in September 1998 by which time it would have expended $5.1B to build the system.

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Mr. Farnham joined TCW in 2009 as the Director of Credit Research and a Specialist Portfolio Manager in the Fixed Income group. Previously with Metropolitan West Asset Management LLC (MetWest), Mr. Farnham served as a Portfolio Manager where he led a team of credit analysts and oversaw the firm's proprietary credit research process within the corporate, high yield, and leveraged loan markets. Prior to that, he was a Private Equity Investor at Primus Capital after working as an Investment Banker at Merrill Lynch in New York, focusing on new issue origination of equity and fixed income securities, as well as mergers and acquisitions. Mr. Farnham holds an AB in Economics from Princeton University and an MBA from the UCLA Anderson School of Management.

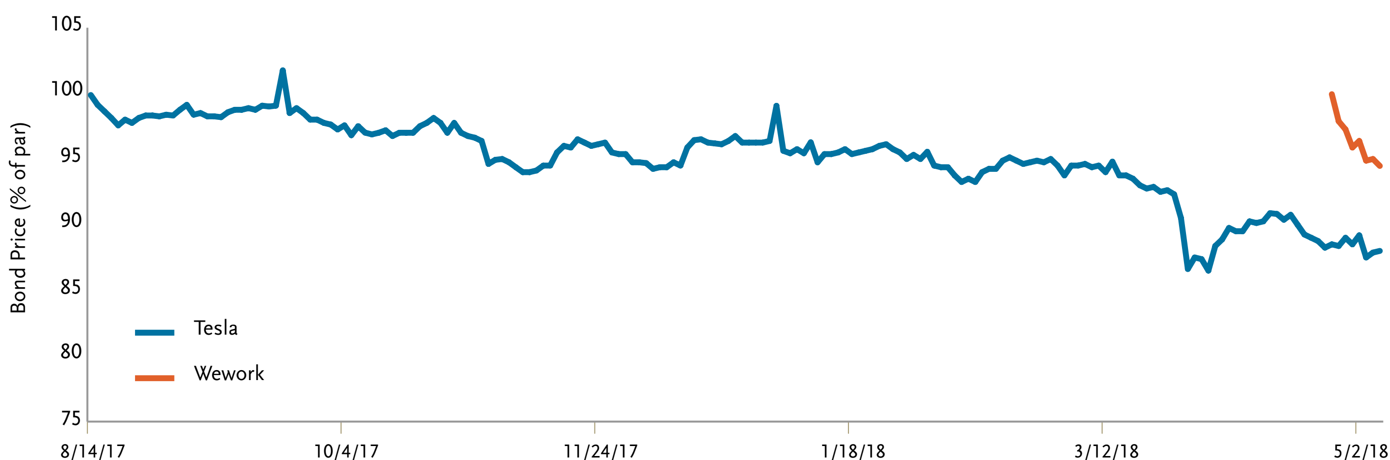
Of course, this all ended badly. Iridium's technology didn't end up working well. The company was laden with expensive contracts with Motorola and the market simply would not continue to finance it, either in the credit or equity markets. In fact, Iridium wasn't even able to finish the 1999 party, hitting the wall and filing for bankruptcy in August 1999. Bondholders were left figuratively wondering: Did I really lend to a company without thinking of how to repossess collateral circling in orbit 200 miles into space?

1999 in 2018?

In our view, recent financings by WeWork and Tesla both echo Iridium with some similar characteristics, including significant negative free cash flow, lofty business ambitions and dependence upon the capital markets to continue.

- WeWork raised $700M of seven year 7.875% senior notes in April 2018. The company's marketing efforts to high yield investors aimed to persuade financiers to focus on non-GAAP measures instead of traditional real estate metrics. The non-GAAP measures include an emphasis on the number of members as well as the head-scratching term 'Community-Adjusted EBITDA,' which ignores many relevant costs of the business. One market participant went so far as describing that this financial measure "...deserves its own place in the Bull___ Hall of Fame." (Michael Lewitt, *"The Credit Strategist."*) This may also remind veteran high yield investors of Competitive Local Exchange Company (CLEC) financing in the late 1990s. In that era, exchanges seeking funding emphasized net PP&E in lieu of traditional cash flow metrics. Just like those exchanges, our assessment is that WeWork is spending far more cash than it generates and is dependent on the capital markets while remaining vulnerable to traditional business cycles.
- Tesla raised $1.8B of eight year 5.3% senior notes in August 2017 and has since traded down nearly 12% in price. This is the same company that bailed out another struggling company of the chairman/CEO's by acquiring it in 2016. Despite likely needing incremental financing to continue development, the CEO bristled at questions posed by providers of capital on a recent conference call. For a business that is still burning copious amounts of cash, the relevant question is whether hubris mixed with Murphy's law is potentially a deadly combination. For high yield investors whose upside is merely earning a 5.3% coupon plus repayment, the relevant question is whether that potential is enough versus being 'Iridiumed.'

Venture Debt Bond Trends



Source: Bloomberg

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For every Amazon success, thousands of failed startups litter the road. Stretching to finance venture debt is another indicator of late-cycle poor underwriting within high yield. In our view, one simply needs to acknowledge that growth equity is meant to generate equity returns commensurate with the risks of unproven businesses and business models. In that sense, 5% and 7% handle coupons don't seem even remotely in the correct zip code. Then again, even Prince himself sang about living in that 1999 moment and not dwelling on the future. It certainly appears that the high yield market continues to sing along – for now. ■

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