Debt and Disruption in Capital Markets

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From the ancient Greek philosophy that "the only constant is change" to Schumpeter's "gale of creative destruction," innovators and disruptors need capital to invent, design, and bring their products to market.

The more exotic sources of funding are venture capital and private equity; the more mundane are public equity. But the most overlooked is likely the debt market, where pricing may signal a concern or validation of a disruptor's progress.

In terms of capital market history, decades are better than calendar years for framing how innovation and disruption occurs. Three to four decades ago, creative ideas were being explored in long-distance telephony (by MCI), cellular communications (by McCaw Cellular), and cable television (by Comcast).

MCI was disrupting a very well-capitalized incumbent with near-monopoly power, AT&T. And McCaw was gaining an early-mover advantage by buying government-auctioned bandwidth (spectrum) while others were slow to the punch.

Comcast, meanwhile, was founded by Ralph Roberts with the purchase of a low-subscriber-base cable system in Tupelo, Mississippi, in 1963.

The common link between these companies was the use of debt to fund at least a portion of their capital structures. Given new technology and untested products and services, these companies' debt was frequently rated below investment grade (high yield or junk bonds).

The ratings were likely deserved in that the companies were negative-free-cash-flow enterprises as their business models ramped up to scale (assuming their idea had commercial merit).

Debt investors can be rewarded handsomely if enterprises such as these achieve scale, or when consolidation occurs. Comcast, via the use of debt to acquire and consolidate competitors as well as adept management, now has a market capitalization of $172 billion as of 11/26/18, with entertainment assets and a single-A debt rating (reflecting multiple upgrades over time).

McCaw Cellular offered double-digit coupons to its investors before selling to the much-higher-rated AT&T. And MCI had a muddled end, first ending up part of WorldCom, then Verizon.

However, I'd be neglectful if I didn't point out that sometimes disruptors can themselves be disrupted. Also a few decades ago, the on-demand video business model was a store in a mall that rented classic or new movies on tape; it was known as Blockbuster Video.

The company's publicly traded equity appreciated rapidly, and to fund further growth, Blockbuster issued a high-yield bond with an 11.75% coupon.

While appearing to be an attractive and fair yield to compensate for risk, Blockbuster was disrupted by a "better mouse trap"—Netflix. Blockbuster filed for bankruptcy, and investors didn't receive an 11.75% coupon until maturity, or much of their principal back.

(There is debate in the investment community about whether the management of Blockbuster made unforced errors in running the business; what is not a matter of debate is Netflix's more convenient service model of mailing the rentals back.)

This leads us to today. Who are the current innovators and disruptors issuing paper to fund their operations? They are common names—companies we know and use, if not daily then frequently.

In transportation, Uber Technologies recently issued an unrated bond with an 8% coupon. (Notably, Uber is currently a private company, although it is rumored to be considering an equity IPO.)

Meanwhile, Netflix has moved its business model into content creation. The company is a regular issuer of high-yield bonds (rated Ba3/BB-) and is currently a negative-free-cash-flow enterprise. However, the company's equity market capitalization is $114 billion as of 11/26/18, and it recently issued a bond with a 6.375% coupon.

Lastly, and perhaps the poster child for innovation and disruption, is the electric vehicle (EV) company Tesla. Tesla issued a high-yield note in 2017 with a coupon of 5.3%.

If the note were issued today, Tesla would pay closer to 7.8% to raise Caa1/B- (current ratings) funds. The jury is still out on how the competitive landscape will evolve, with many competitors vying for scale in the EV and autonomous driving industry.

A key takeaway for investors is that debt capital markets are an important, and sometimes critical, factor in evaluating disruptor companies as their business models mature.

As debt investors, we pay attention to equity prices and valuations. Similarly, we believe it behooves equity investors to regard the pricing and valuation of a company's debt securities as another market price signal for a potential investment opportunity.

We don't know what innovation and disruption the future holds. However, we are confident that some companies will seek financing in the debt markets to fund their creative enterprises.

Having a perspective of those who did and did not traverse the landscape from innovation to successful commercial adoption, and why, will aid us when risks and opportunities unfold.

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