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Is the Bad News Over? Not Yet, Says a Debt Watcher

By GRETCHEN MORGENSON

Just as bull markets often end when corporate news is rosiest, bear markets often expire when the grimmest headlines rule. So investors can be forgiven if they hope that the WorldCom fiasco is the last nightmare on Wall Street that they will have to endure this round.

Eager to believe that the disturbing drumbeat of bad corporate news is ending, investors bid up stock prices on Friday in an abbreviated trading session. The Standard & Poor's 500-stock index rose 3.7 percent, while the Nasdaq surged almost 5 percent.

But Sean J. Egan, managing director at the Egan-Jones Ratings Company, a credit analysis concern in Wynnewood, Pa., said investors should steel themselves for more corporate falls from grace. The revelations may not be as cataclysmic as WorldCom's almost $4 billion accounting boo-boo, of course. But Mr. Egan said a combination of heavy debt, deteriorating business models and risk-averse capital markets will keep woes at some companies front and center.

Egan-Jones makes a practice of alerting investors to corporate credit problems well before they are acknowledged by management. The firm also analyzes companies' bonds for clues to future downgrades from the big three ratings agencies, Moody's Investors Service, Standard & Poor's and Fitch.

As early as November 2000, for example, Egan-Jones cut its ratings on WorldCom to the lowest investment-grade level, citing its deteriorating profit margins and credit quality. One year ago, when WorldCom bonds were trading around par, or 100, Egan-Jones cut its rating on the company's debt to junk status. The bonds didn't fall below 90 until March of this year. They have been trading around 15 cents on the dollar in recent days.

Looking for risks at other companies, analysts at Egan-Jones essentially examine a company's ability to meet its obligations, on time and in full. At the same time, they assess a company's ability to tap the capital markets for funds, a luxury for many companies today. Indeed, in the second quarter, the issuance of investment-grade bonds fell by 18 percent from the corresponding period of 2001, while junk-bond issuance fell 4 percent.

Mr. Egan named several companies that he thinks will face significant problems in coming months. Although some have already seen the prices of their securities decline, he thinks that they have further to fall.

The airline industry is perhaps the most troubled, Mr. Egan said. He likened it to the movie theater industry, where in recent years more than half the players ended up in bankruptcy. Huge debt levels at airlines, combined with a dearth of profitable business travelers, mean that many companies may be forced to restructure.

In addition to US Airways, airline companies with vulnerable securities include UAL, parent of United, and Continental Airlines, Mr. Egan says. UAL stock is now at $9.86, down 26 percent for 2002, and Continental Airlines is at $14, down 48 percent.

Another company whose debt is pushing it closer to the edge is Ford Motor. Shareholders' equity fell to $7.4 billion last March from $28 billion in 1999. Debt has risen to $165 billion. "If things don't improve quickly, they are going to be in tough shape," Mr. Egan said. Ford shares closed at $15.69 on Friday, down 1.7 percent for the year.

Finally, there is Xerox, which remains vulnerable in his view even after the recent bad news about its previous accounting practices. The company's operating earnings cover just over half its estimated annual interest expense, Mr. Egan said. Xerox closed at $6.52 on Friday, down 43 percent this year.

Unfortunately, the taming of the new-era stock market madness will go on for a lot longer than most investors would like. In other words, bottom-fishers beware.