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NEWS ANALYSIS

The Bankruptcy Run Isn't Slowing

High debt and low cash mean more candidates for 2003. Credit analysts have a whole list of possible filers

What a year. Only three weeks into 2002, Kmart (KM) collapsed. Global Crossing (GBLXQ) came next, then Adelphia Communications (ADELQ), WorldCom (WCOEQ), UAL (UAL), and Conseco (CNCEQ). By yearend, half of the 10 largest corporate failures in history, as measured by assets, had occurred. Indeed, the year's bankruptcies were so colossal that Kmart's Chapter 11 declaration -- No.6 on the all-time list when it was filed -- no longer even merits a Top 10 ranking.

Don't expect 2003 to be any better. With the economy still waiting for a lift, analysts at credit-rating outfits predict that roughly 1 in every 13 companies with noninvestment-grade debt, or 8%, will default and declare bankruptcy in the next 12 months. While that's about the same ratio as in 2002, it's double the average over the past 20 years.

Among junk-rated companies in the troubled telecom and cable-television sectors, analysts forecast that the failure rate could hit one in five, while the hard-hit textiles and software sectors could see one in six junk-rated companies go bust. "We've never seen the outlook for defaults higher than today," says Tim Kasta, managing director of Moody's Investors Service's KMV unit, which predicts default risks for banks.

WARNING SIGNS. So how do credit analysts and bottom fishers spot possible bankruptcies on the horizon? For starters, many companies have signaled to the markets on their own that they are entering the danger zone in their Securities & Exchange Commission filings. In addition, analysts look for trouble by sifting through the huge piles of high-yield debt companies took on in the anything-goes 1990s. Junk bonds outstanding rose every year since 1994, leaping 25% in the past three years alone, to a current $810 billion. Other warning signs: debt payments coming due and high rates of burning through cash.

Now, many companies are discovering they can't cut expenses fast enough to pay the bills. Financier Wilbur L. Ross Jr., who has made a fortune bargain-shopping in bankruptcy court, estimates that fully 25% of all junk bonds trade at 10 percentage points above the 10-year Treasury note, his definition of "distressed debt."

Entire sectors, such as textiles and unregulated electricity, are struggling to avoid bankruptcy. And it's not just a couple of sectors, either. Companies currently caught in severe cash squeezes range from American Airlines Inc. (AMR) to Aurora Foods Inc. (AQR), whose well-known brands include Duncan Hines and Lender's Bagels. The likes of Metris Cos. (MXT), the nation's 10th-largest credit-card issuer, and Greyhound Lines Inc. (LDWIF) also face rough going.

IN A BIND. The year's first headline bankruptcy could happen almost any day now, with credit analysts pegging NRG Energy Inc. (XEL) as perhaps the most likely candidate. The Minneapolis-based wholesale electric-power generator, which already is in default on its debt, is fighting an involuntary Chapter 11 petition brought by former executives. FAO Inc. (FAOQ) is also on the brink. The children's-toy retailer, which owns the Zany Brainy Inc. and FAO Schwarz Inc. chains, has until Jan. 10 to reach new terms with its banks before it runs out of cash. NRG execs acknowledge they're in a bind and say they are trying to negotiate a deal with creditors. FAO declined to comment.

Others may not be far behind. Two other big power companies -- Mirant Corp. (MIR) and Allegheny Energy Inc. (AYE) --issued bankruptcy warnings in late December. And two more may be done in by the collapse of their energy-trading operations -- Dynegy Inc. (DYN) and Aquila Inc. (ILA) -- have alerted investors that they might not be able to last past the second quarter, when huge debt payments come due.

Vulture funds and short sellers, meanwhile, are circling over several other giants, including American Airlines parent AMR and telecom-equipment makers Lucent Technologies (LU) and Nortel Networks (NT). Management at each insists bankruptcy isn't in the cards. They say they'll survive thanks to restructurings, the cash they've salted away -- and an eventual upturn in demand. "We're doing everything we can to avoid bankruptcy," AMR Chairman and Chief Executive Donald J. Carty assured employees on Dec. 13.

A LAST RESORT. Yet each of these companies is burning through at least $2 billion a year and has no hope of a turning a profit until 2004. Credit analysts say that means each still could fail if the economy stalls. Carty conceded as much in his message to employees: "No company can keep borrowing money to operate, any more than you can buy your groceries with borrowed money every day."

Other at-risk companies are also trying to salvage themselves. Aurora Foods is auctioning off its frozen-food brands. And Metris, after firing its chairman and CEO on Dec. 15, is trying to sell $150 million worth of unsecured debt to individual investors. Execs at both Metris and Aurora say filing for bankruptcy would be a last resort and neither expects to do so. Meantime, the power companies are also trying to sell assets. Says Dynegy CEO and President Bruce A. Williamson: "We're not in bankruptcy mode -- we're in restructuring mode."

Analysts caution that these 11th-hour actions may only postpone the day of reckoning. To get relief from bondholders, for instance, money-losing Qwest Communications International Inc. (Q) agreed to pay 13.5% on its new debt, vs. the average 7.5% it paid on its old bonds. Even if the economy continues to muddle through, Mariarosa Verde, managing director of Fitch Ratings' credit-market research, doesn't expect bankruptcies to settle back to more normal levels until 2004.

And if there's another downturn? "All bets are off," she says. In the meantime, scavengers such as Ross will have no problem finding plenty of bargain-basement assets.

By Michael Arndt in Chicago, with bureau reports