December 21, 2011

High Yield Bond of the Week:
Rite Aid (RAD) 9.75% of 2016/13c secured first-lien bonds at 6.11% YTW

- Collateral is great quality, and it is probably worth more than total secured debt
- RAD same-store-sales have been edging up lately -- +2.0% y-o-y in recent quarter
- Strong market position with 4,500 stores
- "Generic wave" of many drugs coming off patent helps profitability
- Consumer confidence has risen sharply, and nationally retail sales are strong

Rite Aid (RAD) is a dodgy credit. No way to get around that, since the unsecured debt is rated as low as CC by Moody's. Unless you think Moody's is out of its tree, RAD has one of the highest risks of default of any corporate issuer – even higher than most CCC's.

I don't disagree. However, every now and then I think like a banker and recommend something mostly for the conservative amount of collateral coverage. Even if this credit defaults, the investor in this bond will get par back. And it's not likely to default while prospects are looking slightly better. Even a staples-heavy store like Rite Aid gets a boost from Christmas when retail sales are healthy, as they are now.

With no maturities in 2012 and a mere $186 million due in 2013, with any amount of luck investors in this security will be called out in 2013 and avoid the $3.1 billion mountain of maturity – the secured bank loan and the other bonds coming due in 2014-2015. However, with only marginally-positive free cash flow in the coming year, RAD will need to refinance in order to be able to call in this 9.75% debt. But that shouldn't be too hard since it can replace secured debt with more secured debt – the CCC window is occasionally open to secured debt, even today, and this particular RAD secured debt is even higher-rated at B3/B+/BB-.

This bond combines two features I tend to like – it's not only over-collateralized, but it's a cushion bond too! Extension risk is negligible, meaning it is more "bullet-like" than almost any other callable bond. Only if the company were near default would the call date not substitute very well as a maturity date. As I said, RAD is very unlikely to be nearing default before 2014. Even with net debt-to-LTM EBITDA of 7.1x as of the most recent quarter-end, EBITDA covers interest 1.7x, and it's a pretty sure thing that this Christmas will be slightly better than last year. So the ratios will be stable-to-slightly improving for one more holiday season, leaving only one more holiday season between now and the call date. The credit risk of this bond is falling commensurate with likely time left on the bond.

6.11% is a great yield to book for what in all likelihood will be only a 1 ½-year security. This frees up high-yield investors to buy other investments farther out the curve and get additional spread for the longer spread-duration product.

Rite Aid has been given up for dead at least twice before, just in the eleven years I have been following it. First in 2000, as all spreads widened and the recession loomed, then in 2008-2009 along with almost every other CCC. With a mere $1 billion of market value of the equity, RAD management understands it is mainly running the company for the benefit of bondholders, and is therefore very cautious with regard to any expansion, keeping capex low.

So saving the best for last, why am I so bullish on the collateral? Because it's overwhelmingly "scrip", that's why! You have only to see what all stores, from Wal-Mart to Meijer and many others, think of the value when they offer to fill a competitor's Rx for free if you switch to them! That's worth about $20 right there. On a larger scale, chains with drugstores also buy faltering smaller chains just to get the prescription lists. Valuing RAD's 290 million prescription scripts (annually) at a wholesale value of $20 per script gives collateral value of $5.8 billion, and even valuing the other "chattel" property of everything else covering the bonds at zero, once still derives excess collateralization of about $0.8 billion for all the secured debt. This $5 billion total of all secured debt includes $1.24 billion in secured *second*-lien ("second priority") debt, which is subordinated to first-lien ("first priority") secured debt (which includes the 9.75% bonds I'm recommending). So from a first-lien-only basis there is about $2 billion in over-collateralization using the $20/scrip assumption. RAD also has general corporate assets which I won't estimate, but probably total over $100 million.

So the worst thing the investor has to fear is getting par back, and yes, the amortized price-to-the-call by 2013 would be slightly higher than that – about $105. A small chance of a mere 500 basis points loss (getting back par on a bond which has only amortized down to $105) is weighed against outperforming short instruments by 400-500 bps per year. Of course I wouldn't recommend the bonds if I thought they had even a 10% chance of default by then, which is still a high number, in my opinion, given the lack of triggers for default. However, if one realistically says there's a 3% chance of default in the coming 1 1/2 years, that would subtract about 15 bps from the expected return (105-100)(.03), plus the time value of waiting in BK without a coupon, a loss which I won't estimate since it's so variable. To me those are good odds in the investors' favor – a 97% chance of outperforming almost any other short instrument, and a 3% chance of moderate underperformance.

Buy Rite Aid (RAD) 9.75% secured bonds due 6/12/2016/c 2013 (B3/B+) at $109.5 for a YTW of 6.11%, a yield spread of 601 bps over the 1-yr Treasury. That's an Option-Adjusted Spread (OAS) of 595 bps! Option-Adjusted Duration is only 1.3 years. I rate this secured debt BB-, the same as Fitch does. Bloomberg CRAT rates the issuer's senior unsecured debt BB, but they can't lease-adjust the debt and interest. Nevertheless it's food for thought – but I would rate the unsecured debt, which I don't recommend, at CCC. To me an unusually high expected recovery should elevate the

secured bond way beyond the norm for rating differentials. The raters are not allowed to do this, since they tend to highly emphasize chance of default, as is proper for investors concerned with how it would look. They also don't allow for bonds which are likely to be called prior to almost any other bond – they have to look at maturity, so this bond's main strength is not given any extra rating, as I think it should! I also recommend the other secured RAD first lien debt rated the same (B3/B+), the 8's of '20/'15c, but at $111.07 their YTW of 5.60% is not as good. The other secured bonds are second lien bonds with lower ratings and therefore have lower liquidity, in my opinion. They are probably a good bet, but they're a little iffier in terms of total collateral coverage, especially if one uses a lower scrip value assumption such as $15 per scrip.

If these bonds or other Rite Aid bond issues intrigue you as unusual combinations of safety and high short-term yield, please call your CCM (Carolina Capital Markets) representative. He or she can find the best bond for your needs at the most competitive price!

Good luck and good investing,

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