Agincourt Capital Management, LLC

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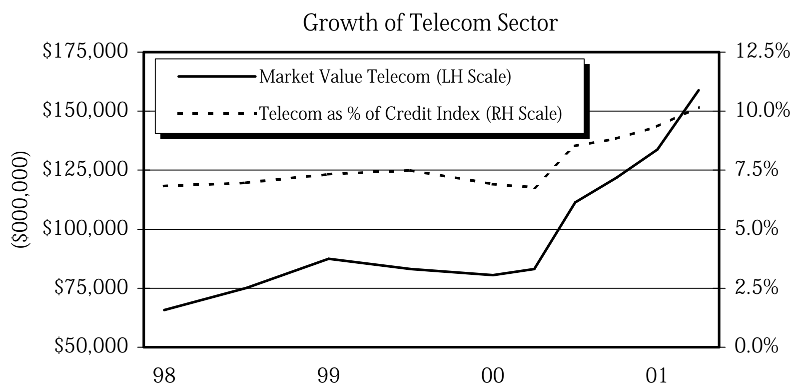
INVESTMENT UPDATE

The second wave of European telecom issuance hit the global bond market in March following the flood of bonds that were issued in the fourth quarter last year. As you may recall, the large, formerly state-owned telephone companies of Western Europe paid billions for the rights to use the air-waves in Germany, France, the UK and other smaller countries to be able to offer an advanced form of wireless technology. While these third generation, or 3G, auctions helped to balance the countries' budgets, they placed a heavy debt burden on the telecom companies. Subsequently, bonds have been issued to "term-out" the short-term bank debt the telecom companies took on to pay for the wireless spectrum licenses.



The most recent issuer was France Telecom (FT), who floated the largest corporate bond offering ever issued: a total of $16.4 billion in proceeds from six tranches in three currencies (mostly US dollars). As with the previous mega-deals, the FT bonds were priced at a considerable concession to outstanding bonds, and were met with enthusiastic investor demand (orders were estimated at $40 billion).

Over the past year, largely as a result of the financing for 3G licenses, the size of the telecom bond market has nearly doubled from roughly $80 billion to almost $160 billion (see chart) and now represents more than 10% of the Lehman Credit (formerly the Lehman Corporate) Index. This sector demands attention from all bond investors, not just because it has become a larger part of their benchmark, but also due to its impact on repricing other corporate bonds. Whether one is buying the European Telecoms or not, all bond portfolios are feeling the effects of these large issues.

In some ways European telecom bonds are emblematic of the overall high-grade corporate bond market. Yields are attractive, yet the ride may prove to be a little bumpy. For most US corporate bonds, the risks are pretty much aligned with the general economy: slowing economic activity may impair the issuers' cash flow, leading to lowered credit safety measures.

The risks to the Euro phone companies are quite a bit different, however. The main concern for investors is that these companies' debt burdens are simply too high to support their long-term credit ratings. Due to increased financial leverage most of these companies' bond ratings have been cut from "AA" to "A"; some are probably headed to "BBB". The telecoms have outlined specific plans to dispose of non-core assets, with proceeds used to reduce debt. This may prove to be more difficult in the current environment than originally expected. A prime example is the lack of investor interest in FT's recent IPO of its Orange wireless subsidiary. With European phone stocks at historic lows, FT received only a fraction of the money they had expected a few short months ago

Likewise, the other major companies will have considerable difficulty over the next year or so divesting non-core assets. With few buyers and many eager sellers, it is a classic case of everyone trying to exit through the same door at once.

On the other hand, there is much to like about these companies' long-term prospects. Their core "fixed line" businesses are (much like our own "baby bells") well entrenched, nearly to the point of monopoly. This provides these huge firms a very large and stable source of cash flow that can be used to service and pay down debt, as well as to fund development of new

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lines of business. At the very least, their tremendous positive cash flow buys the large Euro phone companies more time to complete their divestitures. In fact the ratings agencies agree that there is no liquidity crisis at these firms—the potential penalty for operating with the current level of debt is a drop in the ratings to “triple-B”, or low investment grade.

Of course, the great equalizer in the bond market is yield; wide yield spreads help to compensate for uncertain outcomes. Currently, yield spreads on nearly all telecom bonds (including US issuers) are at or near all-time wides. This has been a recurring theme over the past year: each new telecom mega-deal has been priced attractively to “clear” the market, which in turn re-prices the entire sector. Once the dust settles and the market digests the new bonds, yield spreads narrow.

While yield spreads make the sector cheap, what makes the giant Euro deals compelling is the provision in many of these issues to compensate bondholders if the companies fail to keep their bond ratings above “triple-B”. In the FT deal, as with the recent offerings from British Tel and Deutsche Telecom (although Deutsche’s details are slightly different) bondholders receive an additional 25 basis points (0.25%) of coupon for each downgrade notch (e.g., Baa1 to Baa2 is one “notch”) if the company’s ratings are lowered below “A”. If the company isn’t successful in reducing financial leverage, the ratings agencies may downgrade the bonds, which normally hurts bondholders by widening yield spreads and punishing bond prices. With the coupon step-up language, bondholders are awarded more income in a downgrade scenario. While it has become commonplace for managements’ interests to be tied to the stockholders, coupon step-up language penalizes management for not acting in *bondholder’s* interests. We obviously welcome all covenants that protect bondholders.

How cheap are the Euro telecoms? France Telecom priced its ten-year maturity on March 7th to yield 283 basis points more than ten-year Treasuries. The following week, US cable TV operator Cablevision issued a ten-year bond at +288. Cablevision has been an improving credit, but is still rated *below investment grade* (Ba1/BB+), while France Telecom is rated A3/A-, four notches higher than Cablevision. In addition, FT is 50% owned by the French Government. Of course, the Cablevision bonds have no coupon step-up provision.

Our considered opinion is that there are good opportunities in the European telecom sector among those issuers who have passed our credit examination process (including the “on-site” meetings with Euro telecom issuers in ’00 and ’01) and where we are being duly compensated in the form of very wide yield spreads and downgrade protection. As “core” investments, we prefer the large, diversified and stable US “baby bells”, such as Bell South, Verizon and SBC. But as a yield-enhancing strategy focused on short and intermediate maturities, we are quite comfortable allocating a portion of our clients’ portfolios to the European phone market.

Despite the pummeling stocks are taking, bonds continue to chug right along as we approach the end of the first quarter. Perhaps most surprising considering the condition of the stock market is the relatively strong performance of the corporate bond sector. Mutual fund data indicate heavy flows into bond funds at the expense of stock funds. Despite the headlines of imminent economic gloom and doom, consumers continue to drive the economy, and have pulled back much less than the consumer confidence numbers indicate. Our base case is still for first half growth of approximately one percent, with the economy picking up steam in the second half of the year. While corporate profits may suffer this year, risk to bondholders should be minimized as corporate treasurers take a much more cautious approach to acquisition and capital expenditure projects. A strong balance sheet is more important to corporate bond investors than a drop in EPS.