Virgin is Another Disaster for Listed Note Buyers

The listed Virgin Australia bonds (VAHHA) look set to go down as one of the worst investments ever to appear on the ASX. After being issued in November 2019, the bonds didn't even make it to their first interest payment in May 2020. This beats the mere nine months that Axsesstoday survived after it issued ASX listed debt in 2018. Those who have followed the ASX listed note market (which includes both corporate and financial securities) since its early days will remember names like ABC Learning, Allco, Babcock and Brown, Great Southern, Gunns, Paperlinx and Timbercorp. The predominantly retail buyer base has long struggled to recognise the risks of these securities that institutional debt investors routinely avoid.

Virgin is a good case study in the structural and business weaknesses that so often come with listed notes. The primary structural weakness was that Virgin's listed bonds were unsecured, with the debt ranking equally with a large group of unsecured creditors. Whilst Virgin's secured creditors will get most or all their money back, the unsecured creditors will get little or nothing. Last year Virgin had almost nothing left to hock, so it turned to Australian listed note buyers and the US high yield bond market to get its last debt hit.

The primary business weakness was that Virgin had a long history of losses, constantly struggling to make a fist of being the number two airline in a duopoly. If an airline can't make money in the good years, what hope does it have of surviving some economic turbulence? The main positive for Virgin was that its shareholders had a history of tipping in more money. However, as predicted in my review published before the notes hit the ASX shareholders would eventually stop throwing good money after bad.

What many retail investors fail to realise is that ASX listed debt and preference shares are often used by issuers to obtain cheaper and looser terms than institutional investors are willing to grant. The companies get what they want, the investment banks and brokers earn a fee with the retail buyers being underpaid for the risk. If you go drinking at the last chance saloon don't be surprised if you end up with a few bruises. Not every listed note is bad, but it only takes one bad security in a portfolio of twenty to wipe out a year's worth of income.

There are those that argue it is only the corporate securities you need to worry about; that the banks will always pay their preference share dividends and hit their call dates. If we review the results from overseas missed call dates are becoming much more common. In Australia, holders of BENHB, NABHA and SBKHB have endured miserable returns for over 20 years hoping for their securities to be called. The possibility of banks being forced to miss calls on their securities, if their share price is below the threshold level set at issue, is a rarely mentioned risk that is now in play.

In the last financial crisis several large European and American banks fell over with their subordinated securities wiped out. Whilst defaults haven't happened on bank preference shares in Australia, the coming downturn in house prices accompanied by substantial unemployment will be a much stiffer test than 2007-2010. It is not unforeseeable that bank preference share dividends get turned off for a period.

The volatility in listed notes over the last two months has been a wake-up call for many investors. Some who thought they were invested in low risk securities were shocked to see falls over 10% in a few weeks. These moves were small compared to the last financial crisis when some Australian major bank preference shares traded in the 60's and some smaller Australian bank preference shares traded below 50. The bounce back since late March has created an opportunity for listed note holders to reconsider their positions and exit at a minimal loss.

Written by Jonathan Rochford for Narrow Road Capital on 21 April 2020. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

Disclosure