Forbes

Hertz ATM Shut Down By SEC

By George Schultze
June 19, 2020

As we head into summer 2020, the US, and indeed the world, is a vastly different place than it was just 12 months ago. To date, there have been well over 117,000 deaths, with more than 2.1 million confirmed cases of COVID-19 in the US. Businesses are slowly reopening despite fears of another massive outbreak if authorities move too fast. And on top of that, there are protests, demonstrations, and heightened civil unrest over police brutality and social injustice, all at a level we have not seen since the 1960s. The demonstrations have amplified economic hardships that many companies were already experiencing thanks to COVID-19.

Leading up to this crisis, money has been so cheap for so many years that lots of firms had taken on unsustainable levels of debt. Hertz is one such company and, as a result, it recently landed in bankruptcy court. Initially founded in 1918 with a fleet of 12 Model T automobiles, Hertz filed for bankruptcy protection on May 22. Advantage Rent A Car, Hertz's direct competitor, filed its own Chapter 11 petition just four days later. As with nearly every bankruptcy, Hertz equity holders will ultimately receive little, if anything, in exchange for their old pre-petition shares when the dust settles. Its bankruptcy filing, one of the largest of 2020, shows $23 billion in total net debt. This massive debt load compares with just ~$410 million in operating cash flow (as measured by EBITDA) over the last 12 months – and that was generated mostly before the COVID-19 pandemic! Clearly, Hertz is now hopelessly insolvent.

In addition to its namesake brand, Hertz also owns the Dollar and Thrifty car rental brands. It sports an interesting, but highly aggressive, business model, in which it provides unowned vehicle inventory to all of its rental locations, with the entire operation financed via asset backed securities ("ABS"). Historically, its ABS lenders would finance large pools of new car purchases through a bankruptcy-remote entity which, in turn, would lease those vehicles over to Hertz, pursuant to a master lease agreement. Since the ABS entity was designed to operate independently of Hertz, it was able to earn higher credit ratings and thus provide Hertz with a much lower cost of credit than if Hertz simply borrowed money directly to buy or lease vehicles. This scheme looked great during the boom years but the house of cards definitively collapsed after COVID-19 caused rental car demand to screech to a halt. In hindsight, ABS financing like this should serve as a giant warning flag for future investors, since its whole purpose is to merely provide cheap financing to a firm which is otherwise un-creditworthy.

In late April, Hartz announced that it had failed to make the current lease payment due on its master lease agreement with the ABS entity. Since lease payments were the primary source of funds to support the ABS structure, this payment failure automatically triggered cross defaults among all of the company's debt. Thus, within 30 days Hertz landed in Chapter 11. That event has resulted in two interesting developments, one of which was predictable and the other quite surprising.

In March, in addition to letting 12,000 employees go and furloughing another 4,000, Hertz management predictably announced that it was cutting vehicle acquisitions by 90%. And now, not only will Hertz not be buying as many new cars as it did in prior years, but it is also looking to sell off a huge part of its fleet of ~700,000 vehicles, at well below market prices. On a recent day, its website HertzCarSales.com offered over 23,000 vehicles for sale within 1,000 miles of Fort Lauderdale and another ~21,000 within the same distance of Beverly Hills. How many cars they can sell and how much cash they can raise remains to be seen, but this is obviously not a good time to be selling used cars. People aren't driving as much, and this has already pressured dealers to offer great deals on new models, which in turn has depressed prices of used automobiles.

To be fair, selling off inventory is a logical move which may or may not help Hertz raise some cash in a hurry, but it's another one of the company's moves that has really raised eyebrows. Market speculators have been attracted to Hertz's stock in recent weeks as the share price fluctuated wildly, falling to $0.56/share on May 26 and then climbing up to $5.56 on June 8. Of course, seasoned distressed securities investors know that this type of "dead cat bounce" is not a sign of fundamental optimism for Hertz stock, but instead a short squeeze in a distressed stock that will surely be wiped out in the near term. We've seen many similar cases over the last 25 years, but none in which the debtor company did what Hertz tried to do next.

On June 11, Hertz's lawyers sought and received bankruptcy court approval to sell 246.8 million shares, worth around $500 million, through a stock offering underwritten by Jefferies. The offering document acknowledged that investors would be taking a huge gamble, specifically warning that they " expect that common stock holders would not receive a recovery through any plan unless the holders of more senior claims and interests, such as secured and unsecured indebtedness (which is currently trading at a significant discount), are paid in full." In perhaps the most brazen sign of what Hertz was really trying to do to shareholders who were willing to speculate on this offering, Hertz called the program an "ATM offering" which they said represented an "at-the-money" stock offering. However, given the clearly terrible outlook for Hertz shareholders, it appears that the firm was just trying to rob a proverbial ATM, in the form of overzealous speculators in its bankrupt stock. In any event, the SEC finally jammed the brakes on this plan and shut down the ATM! As a result, Hertz was forced to obtain $1.0 billion of more traditional debtor-in-possession debt financing which, of course, will need to be paid ahead of all existing pre-petition debt when it comes time to settle claims.

The lesson from Hertz is that we started with far too many over-leveraged firms due to the prevalence of unabated cheap money for years before COVID-19. Coronavirus was only the match which set into motion a giant forest fire of over $1.0 trillion in distressed debt kindling. The sheer volume of this debt increases the likelihood of finding gems within the ashes—i.e., "good companies with bad balance sheets"—for future potential profit. However, speculative froth in bankrupt company shares, as shown with Hertz and numerous other companies, presents an additional opportunity for profit via short selling. It's not for the faint of heart, but trades like this can have a higher probability of success, given the fundamentals.

As all the disruption we have witnessed due to disease and civil unrest percolates through the economy and makes its way onto the financial statements of companies that report to their investors, there will always be winners and losers. Hertz is just one example that clearly demonstrates that overextended companies may attempt all sorts of tricks in an effort to skirt the inevitable consequences.