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Reliance Group's Troubled Debt

Bonds Plunge

Prices Imply Default

PRICES FOR RELIANCE Group Holdings' publicly traded bonds have fallen sharply in the last few weeks and are now trading at levels that imply a significant risk of default.

On August 24, both the 9% Senior Notes due on November 15, 2000 and the 9¾% Senior Subordinated Notes due on November 15, 2003 closed at 99½. By September 14 they had collapsed to 95⅛ and 89⅛ , respectively.

At current prices, the yields to maturity for these issues are 13.62% and 13.21%—about 750 to 800 basis points above the yields for Treasurys.

Although markets aren't reservoirs of wisdom, the pricing in bond markets tends to be more meaningful than the pricing in equity markets. The yields on most "A" rated bonds, for example, will be similar. In general, the bond market displays a reasonably rational behavior that is easily quantifiable: lower-rated bonds yield more than higher-rated bonds.

The stock market isn't so rational. Internet stocks, for example, aren't priced based on credit quality or earnings, but on vague perceptions of the future. The insurance business isn't especially rational, either. Customers generally don't demand a lower price from a lower-rated company, provided that the company in question has what is perceived as the requisite rating to compete in its line of business (often an A- from Best).

Given that markets are irrational—particularly over the short term—one must ask whether the price of Reliance's bonds is telling us anything of importance. Specifically, does the 13.21% yield to maturity on Reliance's debentures mean anything?

We believe it does.

First, it means that buyers of corporate debt aren't inclined—right now—to own Reliance's debt, despite the fact that it carries a staggeringly high yield. The 13.21% yield to maturity implies that bond buyers have serious doubts about Reliance's ability to repay its debt in full, when due. As a result, they want a very high yield to compensate them for the greater risk of default.

Although Reliance's bonds are trading at distressed levels, Reliance's stock is at 4½. Although this is down about 80% from its high, Reliance Group nonetheless still has a market cap of $516 million. It's axiomatic that if Reliance Group's $710 million of debt isn't worth 100 cents on the dollar, then its common stock is just about worthless.

And yet, the price of Reliance Group's common stock says that not only are the company's bonds money good, but there's at least $516 million left over for shareholders.

The bonds' prices, on the other hand, say that there's a significant risk that the bonds aren't money good (and therefore the stock has little value).

As for the insurance market, it doesn't post its opinion of the New York Stock Exchange every day. And, in any event, it's most concerned with Reliance Insurance *Company*, Reliance Group's main operating subsidiary.

Because of its financial structure, lower ratings, heavy dependence on commercial business, reserve problems, diminished financial flexibility, and involvement in Unicover, Reliance Insurance Company deserves a "vulnerable" credit rating—at least until it has refinanced or raised a significant amount of capital. Unless commercial-insurance buyers are getting significantly lower prices or significantly better coverage, they have little (if anything) to gain and much to lose by doing business with Reliance Insurance Company as it's presently structured.

As for Reliance Group's stock and debt, we're not buying either. If we had to buy one or the other, however, it would be the bonds. Even if one *loved* the stock at these prices, he'd have to have a great deal of certainty about its value to forgo the 13.21% yield on the 9¾s of '03, which, by definition, carry much less risk. ■

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