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Dodging The Windstream Default Fallout

Great Speculations
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Shrinking revenue and crushing debt have steadily pushed Windstream WIN -46.67% Holdings (WIN) toward bankruptcy for months. Now a Manhattan federal court ruling will likely shove the wireline phone company over the edge.

Unless it can successfully appeal the decision, Windstream will have to pay $310 million to hedge fund Aurelius Capital Management LP. That's what the judge ruled is owed for a technical default, which the company allegedly triggered by spinning off communications infrastructure assets as Uniti Group (UNIT) in early 2015.

The news has shaved another two-thirds off Windstream's share price, which is now 99 percent below where it was at the Uniti spinoff. And despite two 1-for-5 reverse stock splits since, the stock is again in danger of breaking under $1 and being delisted from the NYSE.

Windstream's total debt of more than $5.8 billion is currently 104 times its total market capitalization, reflecting rising odds of a total shareholder wipeout. Debtholders may not fare much better: The company's October 2020 bonds recently yielded more than 70 percent to maturity. That's a clear sign investors are betting they'll get less than par value in a bankruptcy process.

The longer management waits to file Chapter 11, the greater the risk other creditors will claim entitlement to cross-defaults on its other obligations. But even if Windstream wins a stay of the ruling and is able to successfully appeal, it still faces an evaporating underlying business.

When the Aurelius decision was announced, management postponed this week's release of fourth quarter results until "no later than March 18." But in light of the company's recent asset sales and weak results at other wireline telecoms, we can already infer negative trends of recent quarters accelerated rather than reversed.

Windstream's third quarter revenue, for example, was 5.2 percent lower than a year ago. The company lost customers across all business lines, including the enterprise segment where competition from larger and stronger rivals trimmed sales by 4.5 percent. The company also lost 2.4 percent of its consumer Internet and 15 percent of its digital television users.

Management previously touted these operations as growth drivers to offset the erosion of traditional telephone service. Ironically, they're now shrinking at an even faster pace. That's also happening at the former Earthlink Holdings. The company paid $673 million in stock for that company in February 2017, only to sell it for $330 million cash in December.

I have been warning investors to sell and stay away from Windstream since the Uniti spinoff announcement in summer 2014. I believed then that the transaction was a sign of underlying weakness. And the shares are since down by more than 99 percent.

I still see no reason to stick with Windstream, as it hurtles toward an eventual Chapter 11 filing no matter what happens in the courts. But the greater risk to investors now is collateral damage from its demise. And no company is more at risk than its former spinoff Uniti Group.

It's no surprise Uniti shares lost half their value the day of the Aurelius ruling. Organized as a real estate investment trust, the company has historically paid out more cash in dividends and capital spending than it's earned. That's been manageable because the fee-based Master Lease Agreement with Windstream provides 70 percent of revenue.

To be sure, Windstream can't carry on business without the assets operated by Uniti. But the MLA is also the company's most significant single expense at $491.5 million for the first nine months of 2018. Put in perspective, that was more than twice operating income and equal to 72.5 percent of total interest paid on the company's debt, which rose 6.3 percent from the previous year.

That makes the MLA an obvious target for renegotiation in a bankruptcy proceeding. Odds are payments would be significantly reduced, since a large percentage of the assets relate to the fast-shrinking legacy wireline phone business. And whatever money no longer flows from the MLA will come right out of Uniti's pocket.

Even if Windstream wins its appeal, stays out of bankruptcy and doesn't attempt to renegotiate the MLA now, the Aurelius decision still makes a dividend cut all but inevitable at Uniti. That's because the company is now for all practical purposes cut off from the capital markets with a dividend north of 19 percent and bonds of October 2023 yielding more than 13 percent to maturity. They're effectively shut down from efforts to diversify revenue away from failing Windstream.

The big question is how deep will the cut be? With 179 million shares outstanding at last count, a quarterly dividend of 60 cents costs Uniti about $430 million a year. Because it's a REIT, the company won't likely hold in that full amount. But an immediate 50 percent cut would establish a cash cushion against a reduction of the Windstream MLA, while enabling the company to continue to diversifying revenue streams. That's critical with Moody's rating the balance sheet just Caa1 with a negative outlook, and $540 million of the $750 million credit line now drawn.

A cut that big is likely to take the stock down even more. Even then, however, we would not be interested in Uniti, which is a heavily indebted minnow trying to survive in a pool of well-capitalized and hungry sharks, competing for a shrinking number of potential customers.

What's really surprising is how few telecom analysts still seem to appreciate the short and longer-term risks to Windstream and Uniti. Four of the 11 research houses tracked by Bloomberg cut their buy recommendations only after the ruling. Just two currently rate the stock sell. Short interest, meanwhile, is almost 26 percent of Windstream's float but just 8 percent of Uniti's.

That suggests more risk to Uniti shares in coming weeks. And that means more downside for those who simply hold and hope, rather than cash out what's left.

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