FTfm General Electric Co

A smart way to play GE trade is via its preferreds

A lot of 'ifs' ahead but the cards may fall right for a 20%-plus return

Who will pick out the valuable parts of General Electric? © Bloomberg

John Dizard YESTERDAY

When you sift through the sad pile of securities with fallen reputations, you expect to find retailers, Florida property developers, Oklahoma exploration companies or trading houses with once-hidden losses. You do not, generally, expect to see a General Electric Co.

GE, whose factories I visited as an awestruck college student, was supposed to be run by the best corporate meritocrats. They were so secure they encouraged comedians on their own TV network to make fun of them.

Yet there it is, with its shares down by three quarters over the past two years, its bonds priced like junk and its executives sent to the corporate equivalent of the Vorkuta labour camp in the middle of the night. Even so, is there something worth buying here, apart from the odd package of subsidiaries or niche businesses?

I think so. Specifically, the 5 per cent fixed-to-floating perpetual non-cumulative preferred stock series D of the General Electric Capital Corp (GECC). These are the remains of a regulatory capital requirement imposed on GECC as a systemically important financial institution, or "Sifi" under the Dodd Frank law.

The original perpetuals were issued in 2012 and 2013, then consolidated into one public issue in early 2016. In recent months they have crashed down from prices close to par to the low 70s. They have now popped up to 78, for a yield of about 8 per cent.

While the financial regulators wanted GE to have this preferred stock in place as what would be called “tier 1” capital for a bank, GE gradually extricated itself from Sifi status. The preferreds were annoyingly expensive capital as long as GE’s future as an investment grade credit was not seriously questioned. The preferred dividend, paid with after tax money, was about 100 basis points more than what GECC would pay in pre-tax money for a 30-year bond issue.

The preferred’s 5 per cent dividend will convert to a floating rate of 333bp over the London interbank offered rate in January 2021. At that time, though, GECC will have the right to call in the preferrers and pay them off. Had GE remained stable, this would have been a near-certainty, so various big bond funds owned the perpetuals.

The preferrers have a yield even higher than GE’s still investment-grade bonds, but for the moment Wall Street assumes that the company will be under too much stress to pay them off on the call date in 2021. Even then GE could still be in the process of completing its restructuring, and there is the distinct possibility of a recession by then.

However, even though the preferrers are tagged as “perpetual”, should the company survive, the board and management will want to pay these off, eventually. The spread over GE’s 30-year paper has now risen to about 150bp, and in more stabilised times would probably remain in the 100bp region. GE no longer has any regulatory requirement for the perps, though the rating agencies give them a 50 per cent weight as equity.

If GE continues to have trouble, the perp preferrers have $68bn of common equity cushion between them and the $100bn-odd debt burden. That gives the perp holders some comfort.

Also, while GECC has the right to suspend those non-cumulative dividends, after six quarters of non-payment the perp holders will have the right to elect two directors to the board. The GE boards and management know that in those circumstances, the unwanted new board members would probably be deep-value activist investors. Vultures. Not fun.

Also, as Jesse Rosenthal of CreditSights points out: “Turning off the dividend would be a flashing signal that GE would be in a mess internally, or have a real liquidity problem. That would say they were in the state that, say, Citicorp was in 2009. They would have a hard time refinancing, even at junk bond prices. The GE management is fully aware that even if they suspended the dividend for even six quarters they would be shooting themselves in the foot for a saving of only about $350m.”

So what developments would give GE the flexibility to call in the shares after the first call date in early 2021?

The first would be a recovery in the parent company's underlying business. For now, it is assumed that GE's oligopolistic position in aircraft engines (and parts) will continue. It is just too difficult for anyone to spool up a competitor in the next decade, given development lead times.

The most troubled business has been the power division which, along with renewables generator manufacturing, has seen a slump in orders and is going through a forced restructuring. Over the next couple of decades, however, even with no electricity demand growth in developed countries, there will be a huge requirement for replacement generation, weighted towards gas-fired turbines such as those that GE produces.

That prospect may be enough to bring in a *deus ex machina* in the form of a giant equity investor such as Warren Buffett, in a reprise of his crisis-era injection for Goldman Sachs. If that happened, then a refinancing of the perps in 2021 or soon afterwards may be possible. Then that 8 per cent-plus return would turn into 20 per cent-plus.

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