Drivebys Systematically Underperform

Patience is a virtue.

Martin Fridson and Greg Braylovskiy

The conventional marketing process for a primary offering in the high-yield market includes a series of meetings with prospective institutional investors that customarily take place in several cities over approximately two weeks. We typically call this the "roadshow." In the equity market, the roadshow is a standard feature of initial public offerings (Chervitz [2004]).

The roadshow is said to play an important role in a high-yield portfolio manager's decision on whether to participate in an offering. Institutional investors claim quality of management is a key focus of their credit analysis, and that they can best assess it by meeting personally with a company's senior managers. Supporting the anecdotal evidence, Fridson and Garman [1998] find that quantifiable factors such as rating, term, and prevailing secondary market spreads explain only 56% of the variance in risk premiums on new high-yield issues. They speculate that the quality of the roadshow accounts for a significant portion of the remainder:

> Under the most pessimistic interpretations, the substantial impact of the roadshow might suggest a triumph of style over substance. Alternatively, a "good" roadshow might be one in which *bona fide* investment merits are communicated effectively (Fridson and Garman [1998, p. 37]).

Despite the high value that investors place on face-to-face contact with management, it has become feasi-

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ble since the late 1990s for certain high-yield issuers to float deals without going on the road. Many offerings are now announced and priced within one day. One advantage of such a quick transaction to the issuer is the chance to capitalize on favorable market conditions that may vanish in the course of a multiweek roadshow.

According to the head of fixed-income capital markets at a prominent brokerage house quoted in Busso [1999], same-day access is not available to all non-investment-grade companies. First-time issuers, says Art Penn, need to conduct one-on-one meetings with investors. Dispensing with the roadshow, he explains, is an option only for "issuers who are relatively well-known, who have been to the market before, who have research coverage around Wall Street, who have pretty active trading coverage" (Busso [1999, p. 66]). Coming to the market without a roadshow frequently means debt was raised a short while earlier. The same-day transaction is frequently an add-on, replicating the terms of a previous issue.

Practitioners have dubbed the non-roadshow offerings *driveby deals*. Elsewhere in the financial markets, *driveby* refers to a venture capital transaction "in which a venture capitalist invests in a startup with the goal of a quick exit strategy" (see "Drive-By Deal" [1999-2004]). Investment banks have attempted to substitute the more neutral description, "quick-to-market deal," but their efforts have met with only limited success.

PERFORMANCE

As in any definable subset of the high-yield universe, portfolio managers wish to know whether drivebys behave differently from other issues. If so, it may be possible to enhance relative performance by overweighting or underweighting the subsector compared to the high-yield index.

In the case of drivebys, portfolio managers suspect that the tendency is toward underperformance. The impression is not a function of the long-run credit quality characteristics. As a rule, portfolio managers will not even consider buying an issue without benefit of a roadshow if its perceived default risk is exceptionally high. As one market source has noted, same-day deals are "for well-known companies where there aren't a lot of credit questions" (Covel [2004, p. 1]).

The main reason the driveby mechanism raises concerns among investors is that it enables issuers to tap the market swiftly just when demand substantially exceeds supply. Journalistic accounts vindicate these concerns. For example, an intensification of driveby issuance in January 2004, according to Covel [2004, p. 1], reflected a sellers' market created by "a combination of high investor demand and scant new issuance."

If drivebys are almost invariably floated during sellers' markets, values may tend to decline over the subsequent period, as supply and demand become more balanced.

ANALYSIS

We have compared the price performance of driveby deals and conventional roadshow deals in the weeks immediately after issuance. Our measurement criterion is the increase (or reduction) in relative risk premium; that is, the yield spread over an index of the high-yield sector. By benchmarking issues against a sector index, we avoid possible distortions related to marketwide price movements. Change in the relative risk premium also mirrors the objective of a portfolio manager whose performance is measured against a high-yield benchmark, namely, to buy bonds that subsequently tighten versus the benchmark.

We calculate the average change in risk premium for the two subsamples over the first week and the first four weeks after issuance. Then, we determine whether the differences in average change were statistically significant.

SAMPLE

The observation period of our study is January 2002 through June 2004. This interval included a wide range of market environments. According to the Lehman Brothers U.S. Corporate high yield index, quarterly total returns ranged from –6.41% (second quarter of 2002) to 10.11% (second quarter of 2003) during the ten-quarter interval. The wide variation in performance minimizes the risk that the results are biased by period-specific or atypical conditions.

We concentrate our analysis on the United States market in high-yield bonds. These are defined as public, non-convertible, taxable bonds rated below Baa3 by Moody's Investors Service or below BBB- by Standard & Poor's, or non-rated but priced in line with yields on speculative-grade issues floated in the same period.

There is some lack of standardization in the definition of a driveby deal. For example, one source characterizes as a driveby a November 2002 offering by Charter Communications that was priced the day after the deal was announced (Sullivan and Rappaport [2003]), while another asserts that such a transaction "isn't technically a

EXHIBIT 1

Changes in Yield Spread versus Lehman Index—One Week After Issue (bp)

	# of Issues	Avg. Proceeds ($MM)	Mean	Median	St. Dev.	High	Low
2002							
Drivebys	47	172.9	18.5	18.5	27.6	-49.8	75.3
Non-Drivebys	206	257.9	-11.0	-11.5	33.3	-128.9	109.0
2003							
Drivebys	135	219.5	3.8	8.1	27.3	-67.9	90.9
Non-Drivebys	393	289.2	-19.7	-16.5	36.6	-139.1	80.6
2004*							
Drivebys	51	303.5	-4.4	-2.1	18.0	-58.4	28.5
Non-Drivebys	279	234.8	-15.4	-9.0	31.8	-180.3	63.0
2002-2004*							
Drivebys	233	228.5	4.9	5.6	26.5	-67.9	90.9
Non-Drivebys	878	264.6	-16.4	-13.4	34.5	-180.3	109.0

* Through Q2 2004.

Sources: Advantage Data, Bloomberg, Lehman Brothers, MCM CorporateWatch.

EXHIBIT 2

Changes in Yield Spread versus Lehman Index—Four Weeks After Issue (bp)

	# of Issues	Avg. Proceeds ($MM)	Mean	Median	St. Dev.	High	Low
2002							
Drivebys	47	172.9	34.5	32.6	64.8	-86.6	224.9
Non-Drivebys	206	257.9	-16.3	-22.2	65.6	-206.6	269.4
2003							
Drivebys	135	219.5	10.5	17.9	61.7	-416.2	208.4
Non-Drivebys	393	289.2	-9.7	-10.4	54.1	-164.4	226.4
2004*							
Drivebys	51	303.5	-7.5	-9.2	25.7	-57.9	47.7
Non-Drivebys	279	234.8	-18.6	-18.8	49.1	-255.7	150.7
2002-2004*							
Drivebys	233	228.5	11.3	11.7	58.0	-416.2	224.9
Non-Drivebys	878	264.6	-13.9	-15.7	55.5	-255.7	269.4

* Through Q2 2004.

Sources: Advantage Data, Bloomberg, Lehman Brothers, MCM CorporateWatch.

'drive-by'" (Covel [2004]). As a practical matter, the key distinction is between deals that entail roadshows and those that do not. For our purposes, we define driveby offerings as deals priced on either the same day or the day following their announcement. All other offerings are defined as non-driveby deals.

According to Advantage Data, 1,111 high-yield issues came to the United States market between January 1, 2002, and June 30, 2004. In connection with our analysis of underwriter performance, we had previously collected post-issuance yield changes on these issues relative to the Lehman Brothers U.S. Corporate high yield index from this database. For one week post-issuance, pricing was available on 899 issues, and for four weeks post-issuance on 972 issues.[1]

Gowri Gurumurthy of MCM CorporateWatch identified 233 driveby deals during our 30-month observation period. Our yield change data covers 203 drivebys for the one-week period and 218 drivebys for the four-week post-issuance period.

RESULTS

Exhibit 1 shows that over the full observation period the mean first-week change in spread for drivebys was a widening of 4.9 basis points. The mean for non-driveby (roadshow) deals was a narrowing (indicated by negative sign) of 16.4 basis points. According to the standard deviations, the difference in means is statistically significant at a 95% confidence level (t-statistic of 8.11%). Drivebys genuinely performed more poorly according to the high-yield sector benchmark than non-drivebys.

It might be the case that the underperformance we see in the first week after issuance dissipated over a somewhat longer observation period. We therefore also examine performance over the first four weeks (*see Exhibit 2.*) In this test, drivebys posted a mean widening of 11.3 basis points versus the index. The comparable figure for roadshow deals was a narrowing of 13.9 basis points. At a 95% confidence level, the difference between the means is statistically significant (t-statistic 5.86%).

The finding of systematic underperformance is robust. Exhibits 1 and 2 show that the overall result is not driven by extreme results in any subperiod. In each year in the observation period, drivebys either widened while non-drivebys tightened or narrowed by less than non-drivebys narrowed. This is true for performance in both the first week and the first four weeks after issuance.

Exhibit 3

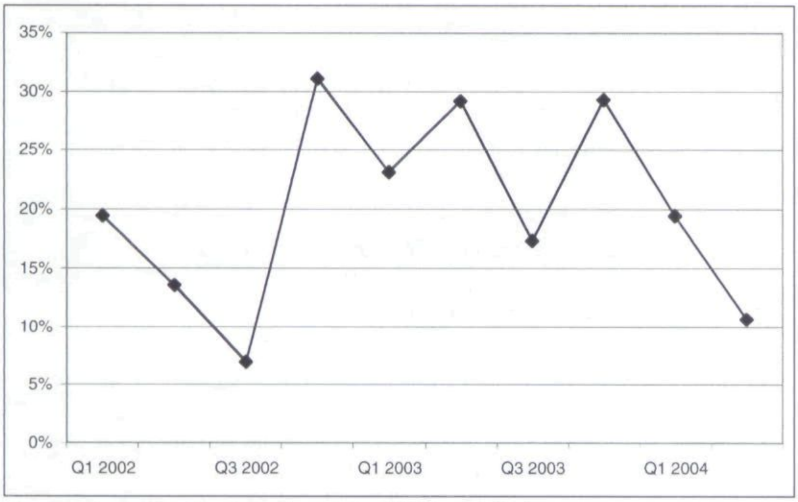
Quality Distribution by Number of Deals

Group/Quality	High	Medium	Low	Total
Drivebys	20.60%	57.08%	22.32%	100.00%
Non-Drivebys	9.00%	50.80%	40.21%	100.00%
Total	11.43%	52.12%	36.45%	100.00%

* Through Q2 2004.
High = BB+ and above; Medium = B+ to BB; Low = B and below.
Sources: Advantage Data, Bloomberg, Lehman Brothers, MCM CorporateWatch.

Exhibit 4

Proportion of Drivebys by Number of Deals Quarterly



Sources: Advantage Data, Bloomberg, Lehman Brothers, MCM CorporateWatch.

Exhibit 3 also shows that the relative underperformance of drivebys is not a function of inferior credit quality. Drivebys were more heavily concentrated in the high-quality and medium-quality tiers than non-drivebys and less heavily concentrated in the low-quality tier.[2]

We also find some evidence to support the demand-supply explanation of driveby underperformance. Exhibit 4 shows wide variance over time in the proportion of high-yield new issues floated as drivebys. Only 6.90% of all issues dispensed with roadshows in the third quarter of 2002, but that jumped to 31.03% in the very next quarter. Furthermore, the incidence of drivebys is correlated with the performance of the high-yield sector. For the quarters when drivebys represented more than 20% of all offerings, the Lehman Brothers U.S. Corporate high yield index total return ranged from 5.91% to 10.11%. For the quarters when drivebys represented less than 20% of all offerings, the total return range was –6.41% to 2.77%.

This pattern is consistent with the hypothesis that driveby deals occur more often when prices are pushed up by an excess of demand for high-yield bonds over the available supply. At such times, by inference, well-known issuers take advantage of investor pressure by floating bonds at premium prices. The rich prices cannot be sustained after the buyer panic subsides, leading to systematic underperformance by drivebys.

THE BOUGHT DEAL OBJECTION

One possible objection to our finding of underperformance by drivebys is that the results may be skewed by particularly poor performance by *bought deals*. In these transactions, the underwriter buys the offering from the issuer before testing demand, thereby assuming full market risk. Under the more usual procedure, the underwriter solicits orders before taking title to the bonds. In this case the underwriter can better discern the market clearing level before accepting liability. It is possible that bought deals fare especially poorly because underwriters overpay issuers relative to the prices at which they can redistribute the bonds.

From the investors' viewpoint, however, the potential skewing of results by bought deals is moot. Underwriters ordinarily refuse to disclose whether a particular offering is bought. As a result, buyers cannot improve their returns by rejecting the subset of drivebys that consists of bought deals. The only truly implementable strategy for enhancing performance is to underinvest in drivebys as a group.

CONCLUSION

High-yield driveby deals systematically underperform non-driveby deals in both the first week and the first four weeks after issuance. Drivebys either widen versus the high-yield index while non-drivebys tighten, or tighten by less than non-drivebys. Accordingly, drivebys in aggregate represent a drag on portfolio managers' relative performance.

The underperformance of drivebys is not an artifact of below-average credit quality. It is generally the higher-rated companies in the speculative-grade universe that can dispense with roadshows. Neither does the documented underperformance of driveby deals during January 2002–June 2004 reflect extreme results in a single subperiod.

It is not easy for portfolio managers to reject all drivebys. Non-roadshow deals tend to appear precisely when the pressure to invest surplus cash is greatest. Allowing cash to represent a high percentage of assets under management is not generally an option for high-yield portfolio managers. Final investors object to paying the comparatively high fee levels associated with the high-yield market only to discover much of their capital sitting in the equivalent of a money market fund characterized by substantially lower fees.

Notwithstanding such obstacles, portfolio managers can benefit from resisting as much as possible the temptation to buy drivebys. The statistics indicate that as quickly as one week after issue the average driveby is available more cheaply, relative to the benchmark, than the level at which it was priced. Patient portfolio managers can usually enhance their relative performance by waiting to buy in the aftermarket.

ENDNOTES

[1]See "Underwriter Performance" in the Sample Research section of www.leverageworld.com.

[2]We define the quality tiers by the senior-equivalent rating of the issuer, which is primarily a probability-of-default gauge in the Standard & Poor's system. This procedure avoids possible distortion that could arise from classifying B+ senior issues of B+ companies in the same risk category as B+ subordinated issues of BB companies. In reality, the total risk (probability of default times the reciprocal of expected recovery in the event of default) is quite different for two such issues. (Note that the high-quality category includes BB+ subordinated issues of BBB and BBB- companies.)

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