WORTHLESS: Why Bankrupt Companies Soared in the June 2020 Stock Market

Description

Earlier this month, a number of bankrupt or near-bankrupt stocks soared, as the stock market rally kicked into overdrive. At one point, **Hertz** stock rose 887%, while **J.C. Penny** rose a more modest 200%. Both of these companies filed for bankruptcy protection after the COVID-19 downturn ravaged their businesses. Car rentals and clothing were two of the industries hit the hardest by the pandemic, so it should come as no surprise that these companies ran into trouble.

What *is* surprising is how well they fared in the markets. The rallies in Hertz and J.C. Penny caught many commentators off guard; Jim Cramer opined that they must have been manipulated. Whether or not that's the case, it's clear that investors are showing serious interest in bankrupt companies. The question is, *why?*

Theories to explain the rally

There are a few theories circulating to explain why bankrupt stocks soared earlier this month.

As previously mentioned, some think that the bankrupt stocks are being manipulated by Wall Street insiders hoping to unload them on unsuspecting retail traders. That theory could be true, but it ultimately depends on the motivations of those involved, and proponents like Jim Cramer haven't provided any evidence on that front.

There's also the theory that the affected industries are set for a rebound. Bankruptcy doesn't necessarily mean that a company will go out of business. If the post-bankruptcy re-structuring is successful, it may live on. This actually happened with **Air Canada** (TSX:AC) in 2003. If Hertz and J.C. Penney survive their restructurings, then they may go on to become thriving businesses.

Finally, there's the theory that some of these bankrupt companies will become acquisition targets. Bankrupt companies can still be very valuable to acquirers, particularly if they still have valuable assets. In a recent *Forbes* article, retail analyst Walter Loeb noted that companies like **Simon Property Group** and **Sycamore Partners** were considering buying J.C. Penney. That could explain why its stock was bid up earlier this month. Acquisitions are usually at a premium to a stock's market price, so a J.C. Penney buyout could enrich shareholders, even though the company is broke.

Implications for Canadian investors

It’s one thing to note that American markets are going into “bankruptcy mania,” but quite another thing to infer that the same will happen to Canadian equities. So far there have been few reports of publicly traded Canadian companies going bankrupt as a result of COVID-19, although mall REIT collection rates tell a grim story.

One company that has been *rumoured* to be on the brink of bankruptcy is Air Canada. With over 90% of its routes cancelled, the company posted a whopping $1.05 *billion* net loss in the first quarter. So far, Air Canada has managed to avoid bankruptcy in no small part thanks to a $1.6 billion financing issue. But there’s no saying it *can’t* happen in the future. With management projecting that revenue will take three full years to get back to 2019 levels, AC is in for a lot of pain. Time will tell whether that leads to bankruptcy.

In the meantime, it’s probably best for investors to avoid AC stock. Like Hertz and J.C. Penney, Air Canada went on a rally in early June; also like those stocks, it later collapsed. A one- or two-week rally is nothing to base investing decisions on. For now, investors should assume that AC is in for continued losses.

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Date
2025/08/27
Date Created
2020/06/23
Author
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