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Junk Bond Investors Get Primed at the Oil Pump

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The surge of junk bonds from the oilpatch may be giving energy companies a liquidity lifeline but sometimes that comes at the expense of investors who have already lent them cash.

The new debt sales are often being layered on top of existing bonds, sending prices of the earlier-vintage debt tumbling.

Companies like **Energy XXI** Ltd.**EXXI -3.55%** and **Resolute Energy** Corp.**REN 0.00%**, which carry junk ratings, have sold new debt recently. Investors and analysts say deals like these will allow most struggling energy firms to avoid default or bankruptcy this year, though problems could materialize in 2016 if oil prices stay low.

An index that Moody's Investors Service uses to measure the liquidity risk of energy companies with junk credit ratings has more than doubled to 9.6% in February from 4.5% in December. The index measuring liquidity risk for all other corporations has remained unchanged over the same period at 2.9%.

Many of the new bonds are backed, or secured, by company assets. That means if there's a bankruptcy, its holders can skip ahead and get paid before owners of existing unsecured bonds that are backed only by the company's promise to repay. Even if the new debt is unsecured, meaning that all the bonds are supposed to get paid at the same time, the additional debt means there is less money available for each bondholder in a bankruptcy.

A recent $1.45 billion bond sale from Houston-based Energy XXI, which produces oil and gas from the Gulf of Mexico, illustrates the potential pitfalls for existing bondholders. The new bonds mature in 2020, are backed by company assets and offered a 12% yield, according to S&P Capital IQ LCD. After the deal was announced, prices on the company's existing, unsecured bonds due 2019 fell 15% to 48.50 cents on the dollar from 56.78 cents, according to trading data from MarketAxess.

Resolute Energy's legacy unsecured bonds have fallen 44% to 28 cents on the dollar since the company borrowed $150 million of new secured loans in January.

To some extent, bond investors may be falling victim to their own willingness in recent years to accept fewer protections in exchange for higher yields.

When Energy XXI issued unsecured bonds in 2010 and 2011, the bonds included a then-unusual covenant allowing the company to back any additional debt it borrowed with company assets. Other energy companies, including **Halcon Resources** Corp.**HK -4.79%**, adopted similar clauses in their bond documents, according to bond covenant research firm Covenant Review. In the past, the amount of new debt that could be directly tied to company assets was limited.

A spokesman for Energy XXI declined to comment and an official at Resolute did not comment. Halcon could not be reached for comment. A spokesman for Resolute declined to comment.

Some countries are also using the robust junk bond market to get much-needed money.

Venezuela, which depends heavily on oil exports, has been trying to sell a U.S. refinery company it owns, Citgo Petroleum Corp., to plug holes in the national budget. When CITGO failed to draw attractive bids, Venezuela called the sale off and instead used CITGO to raise debt.

The company issued $2.8 billion of debt in February and paid a dividend to state-owned oil producer Petróleos de Venezuela SA, or PdVSA, with the proceeds, according to LCD. Bond fund managers demanded a 12% yield to buy triple-C rated bond secured by Citgo's assets.

The company's existing bonds dropped 9% on the announcement of the bond sale and now trade 4% below their pre-deal price, according to MarketAxess.

Eaton Vance Management bond portfolio manager Henry Peabody says he is steering clear of new energy company debt for now. The bonds' prices could fall quickly if interest rates start to climb or if oil prices remain weak, presenting "tremendous downside," he says.

"If things go wrong you could see more senior debt layered on top of you," Mr. Peabody said.

– Mike Cherney contributed to this post.