Opinion **Capital markets**

The junk bond nightmare of hair roots and split ends

In a fresh Covid-19 wave, Sally Beauty may beg for cash with nothing left for collateral

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Sally Beauty has excelled at raising cash in tough times but the US retailer is not immune to Covid-19 © Cindy Ord/Getty

Ellen Carr AN HOUR AGO

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Covid-19 has reminded the high-yield bond market that we are just one dye job away from *au naturel*. Sally Beauty, a junk-rated hair-and-nail-product retailer, and a financial parable for our times, feels the pain of our spreading roots.

Sally Beauty has been a leader — if that is the right word — in raising cash in tough times. Back in 2008, it was among the first to draw its revolver credit line pre-emptively, on that grim day after the shotgun wedding between Merrill Lynch and Bank of America. High-yield bond investors were more worried then about the revolver's lead underwriter (Merrill) than Sally Beauty, whose business proved resilient in the ensuing financial crisis. The recession might have cancelled Vegas, but we could at least pretty ourselves up for a night out.

With Covid-19, Sally Beauty has led the way again, with a revolver draw on March 23. This time the rationale is different. In 2008, it wanted "to preserve financial flexibility" in light of the "dislocation of the financial markets". Today, it seeks "support of its operations out of an abundance of caution". In April, it even issued a second-lien bond.

The words "second-lien bond issue", laughable in 2008, show that markets today are far from being in the dislocated mess of 2008. Junk investors are buying issues from good companies (Lamar Advertising), perhaps bad (chemical and ammunition group Olin), and ugly (Royal Caribbean Cruises), thanks to the US Federal Reserve's bridge loan to the junk market, facilitated by BlackRock. Granted the terms are buyer-friendly — high yields, backed by collateral — after years of sub-5 per cent coupons and paltry covenants.

But if markets are functional for now, those fundamental roots are not. Sally Beauty has a more defensive business model than many (J Crew does not sell personal protective equipment). Yet it is not immune to Covid-19. All its stores closed for a month. True, it sells everything you need for DIY hair care, mostly via its online segment. But asking that channel to pick up the slack on the other missing 95 per cent of sales is a fantasy.

Moreover, even if US states continue to reopen, and Sally Beauty only has to trim the cash on its balance sheet, there could be a second wave of Covid-19. The retailer might then find itself begging for money with nothing left to pledge as collateral, and inadequate cash flow to service the debt it has. In short, that is why some in the junk bond market are so nostalgic for 2008.

We know how to run “reasonable” downside cases where revenue losses reverberate through cash flow statements. We can assess liquidity sources, and make assumptions about what happens if the bond market shuts, or banks become insolvent. The paradox of Covid-19 is that it shows how close to *au naturel* — and default — normally healthy junk-rated companies are. It also shows the power of the Treasury and the Federal Reserve to render models meaningless.

Currently, it is as hard to invest in a portfolio of junk-rated companies insulated from Covid-19 as it is to get on your reopened salon’s schedule — many such bonds trade above their redemption prices. Meanwhile, you can buy all the lower-rated energy names you want, cheap. Sally Beauty is one of the companies in the middle. Operationally, they have glimmers of hope, thanks to economic reopening. As for their bonds, they bestride a wide trading range emblematic of the tug of war between corporate cash burn and Fed-fuelled bond buying. Figuring out which will dominate takes the impossible: a pandemic crib-sheet and a White House inside track.

Early in the pandemic, it was reasonable to wonder if the crisis would end leverage as we know it. Only a couple of months later, it is just as plausible for both companies and investors to believe that crisis-era central bank support is here to stay.

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