Opinion **Markets Insight**

# Jane Austen plot unfolds in the high-yield debt market

Shotgun marriage between credit investors and companies to be tested amid recovery from pandemic

**ELLEN CARR**

Jane Austen novels all end with happily-ever-after weddings © Hulton Archive/Getty

**Ellen Carr** YESTERDAY

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The story of the high-yield bond market in 2020 was a marriage plot. For those of you unfamiliar with this literary device, Jane Austen perfected, if not invented, it with her well-known novels, all of which end with happily-ever-after weddings.

But as the many "smug marrieds" who subsequently divorce can attest, the real story is what comes after the sassy but ultimately proper protagonist makes a good match. The marriage plot can thicken when the reality of life with your spouse sets in. In the same way, investors in the bonds of some pandemic-pummelled companies may find that the happy ending of high coupons was in fact the beginning of a long, troubled union to leveraged balance sheets.

Take Macy's, the beleaguered department store chain. Macy's found its Mr Darcy in US Federal Reserve chairman Jay Powell last year, when the central bank rolled out its unprecedented fallen angel facility to buy bonds of companies downgraded to junk because of coronavirus concerns. The Fed's liquidity could not save JC Penney and Neiman, both of which defaulted last year. But thanks to the appetite it kindled for yield, Macy's was able to raise $1.3bn in secured debt to pay down a revolving credit facility, a line of funding that can be drawn on when needed.

The replacement of the revolver, which is generally viewed as short-term financing, with a five-year bond was effectively a shotgun wedding, like the one in *Bridgerton* necessitated by a compromising kiss between Daphne and Simon. The chief financial officer of Macy's doubtless breathed a sigh of relief — without bank lenders agitating for their money back, the company has time to build its way back to the "normalised" cash flow. Happily ever after, indeed.

Yet for Macy's and a host of other high-yield bond issuers, the marriage plot of 2020 is only the beginning of the story. Some sectors, like casinos and cruise lines, are likely to see an eventual rebound to 2019 levels of cash flow. If you got back on a Royal Caribbean ship after the 2019 norovirus outbreak, it seems likely that you will set sail again when you can. The timing is uncertain, which means that credit analysts' primary job for the next year is liquidity analysis. Will RCL be back in business before its $4bn in cash runs out? At its current burn rate, that time would be in 12 to 18 months.

But the bigger story for RCL is what happens to the almost-$8bn of new debt that piled up on its balance sheet in 2020. The company used every crayon in the credit box to build up its resources — revolver facilities, term loans, UK commercial paper, export credit facilities, secured bonds, unsecured bonds and convertible bonds.

Three-quarters of its debt matures in the next five years. Even if cash flow rebounds to 2019 levels by the end of 2021, the ratio of RCL's debt to earnings before interest, tax, depreciation and amortisation will be close to six times — almost twice as high as at the end of 2019. With much of its free cash flow spoken for to build new ships, RCL appears to be stuck in an unhappy marriage to a highly-levered balance sheet for years to come.

And, even so, it might be in a better boat than Macy's. The pandemic fractured retail spending habits, pulling forward a decade's worth of change in a couple of quarters.

Forces before the pandemic — an onslaught of online competition, brand dilution and changing wardrobe habits from "casualisation" of clothes to "rent the runway" — have intensified. And with Amazon muscling into clothing (puffer jacket, anyone?), profit margins seem likely to compress even further. Putting all of this together, forecasting a return to 2019's level of cash flow would be imprudent — yet Macy's has another $1.3bn in debt to service.

The happy ending for Macy's is not doomed. Thanks to years of cyber investment, it was able to keep up with consumer demand on its website during store closures. The pandemic also allowed management to commit to a pre-existing cost reduction programme. The sharp shift to the web provided a unique, if hard-earned, insight into how best to serve its multichannel customers. And the failures of other shopping-centre anchors might bolster market share. Meanwhile, Macy's is sitting on $1.6bn in cash (against $700m at the end of 2019), which gives it some flexibility to pay down debt.

So Macy's investors may yet live happily ever after. But it is inevitable that some of the companies that issued bonds in 2020, and the investors who bought them, will need couples' therapy. The big story in 2021's high-yield market may be the unravelling of last year's marriage plots — and the ensuing plot twist of Chapter 11.

*Weaver Barksdale may hold interests in companies mentioned*