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Toys 'R' Us Poses a Test for Junk-Bond Markets

Toy retailer's attempt to refinance in a weakened market could influence other offerings

Children visit a Toys 'R' Us store in Los Angeles. The retailer is trying to replace $1.6 billion in junk-rated bonds coming due through 2018. *PHOTO: LIZ O. BAYLEN/GETTY IMAGES*

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Wall Street has long wondered what would happen if a wave of refinancing meets with a weakened junk-bond market.

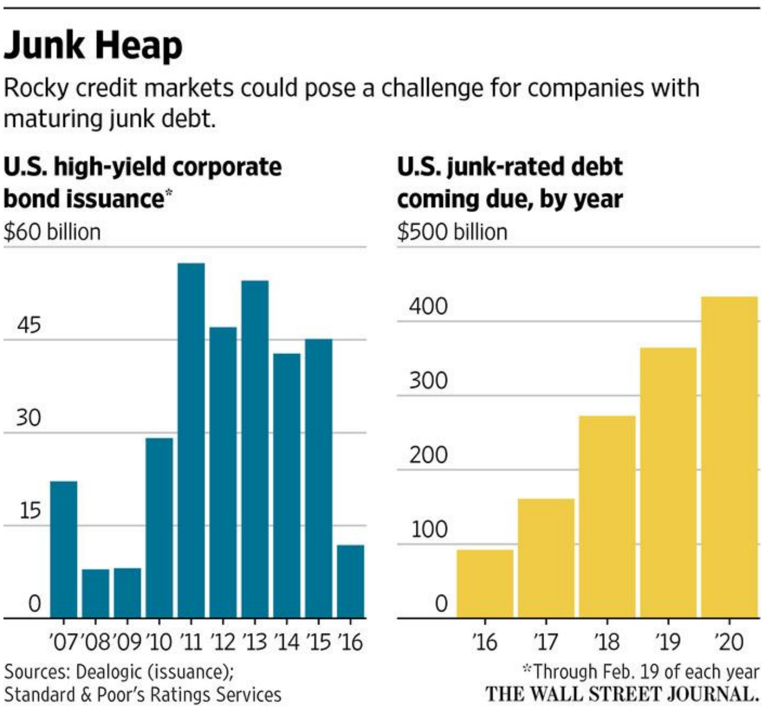
Toys "R" Us Inc. will be an early test case.

The 68-year-old toy retailer is trying to replace $1.6 billion in junk-rated bonds coming due through 2018. But the cratering high-yield market is complicating its efforts.

Turmoil in the energy industry and fears of slowing economic growth have crimped demand for high-yield bonds, especially for companies like Toys "R" Us, whose debt Fitch Ratings grades deep in junk territory at triple-C. Companies with junk credit ratings have issued just $11.8 billion in bonds so far this year, down sharply from the $45.1 billion issued over the same period last year, according to Dealogic.

The toy retailer is worried the credit climate could worsen further and is moving quickly, even though it doesn't have to repay its debt for months or years. It has prioritized refinancing three bonds coming due in 2017 and 2018, and hopes to complete a transaction by the end of April, a person familiar with the matter said.

Other heavily indebted borrowers face similar pressure to refinance amid risks of a prolonged swoon for the market. U.S. companies have a total of $1.32 trillion in junk debt maturing between now and 2020, according to Standard & Poor's Ratings Services. That includes $92.3 billion coming due this year, followed by $160.9 billion in 2017 and $272.5 billion in 2018.



The outcome of Toys "R" Us's efforts could have implications for what it will take to get those deals done. Depending on investors' appetite, the efforts could show that companies need to plan to pledge more assets or pay a lot more for new funds.

Toys "R" Us is weighing whether to mortgage its European operations to ease its credit crunch, a plan its bondholders support.

"A year ago, I would have said they'd probably be able to refinance," said James Goldstein, a retail analyst at research firm CreditSights. "But under current market conditions, it's going to be tougher to pull off."

In a sign of the pressure, a Toys "R" Us bond coming due in August 2017 recently changed hands at 83 cents on the dollar, according to MarketAxess. A 2018 bond traded at 73 cents.

The outcome of Toys "R" Us's efforts could have implications for other junk-rated companies, especially those that were loaded with debt in leveraged buyouts. The toy retailer's debt is left over from a leveraged buyout by Bain Capital LLC and KKR & Co. more than a decade ago.

Radio giant iHeartMedia Inc. is grappling with a $20.6 billion debt load largely stemming from its 2008 leveraged buyout led by Bain and Thomas H. Lee Partners LP. The company, formerly Clear Channel Communications Inc., has $905 million in debt due in 2018 and $8.3 billion maturing the following year. Its bonds bearing 10% interest due in 2018 recent traded at 31 cents on the dollar, according to MarketAxess, reflecting investor doubts about their repayment odds.

"Our operating business is strong and therefore provides us with the flexibility to manage our capital structure in a prudent manner," an iHeartMedia spokeswoman said in an email.

Bain and KKR have spent more than a decade trying to resuscitate Toys "R" Us, which once was lauded as a "category killer" but has since struggled with an onslaught of competition from online sellers and big-box discounters. The work has started to bear fruit: Toys "R" Us reported strong holiday sales last month after years of declines.

Now the buyout firms need to address the billions of dollars in debt they along withVornado Realty Trust took on to fund their $6.6 billion acquisition of Toys "R" Us in 2005. The company's debt load currently stands at around $5.4 billion.

In 2014, Toys "R" Us hired Michael Short, who helped lead AutoNation Inc.'s turnaround after the financial crisis, to serve as its chief financial officer. It also tapped Chetan Bhandari, a former leveraged-finance banker at Goldman Sachs Group Inc. and former restructuring adviser at boutique bank GLC Advisors & Co., to be its treasurer.

The company had been refinancing bonds coming due by issuing loans secured by its U.S. stores and inventory. The loans garnered stronger double-B ratings and required lower interest rates than the company would have paid on new unsecured bonds. The deals left Toys "R" Us with fewer domestic assets to mortgage, so the company had hoped to turn back to the bond market once its operations showed improvement, according to people familiar with the matter. Now, however, the selloff in high-yield bonds has dimmed the outlook.

Bondholders have suggested Toys "R" Us mortgage its lucrative European operations, people familiar with the talks said. The company operated 287 stores in Europe as of Jan. 31, 2015.

Under such a plan, the bondholders would swap their debt for a smaller amount of higher-ranking bonds secured by the cash flow from the company's international businesses, the people said. Some of the existing bonds, which are already secured by some assets, could also be refinanced with cash from a new bond sale, they said.

Uncertainty about whether the bonds will be paid off and what holders might be offered in an exchange has attracted distressed-debt investors including Blackstone Group LP's credit fund GSO Capital Partners LP and hedge fund Brigade Capital Management LP, according to people familiar with the matter.

The retailer's improved performance has some bondholders thinking now is the time to make a deal, according to people familiar with the talks. Sales rose 2% in the latest holiday season. Cost savings, including $22 million a year from decisions to close the retailer's flagship stores in Manhattan, resulted in a 28% increase in earnings before income taxes, depreciation and amortization for the year ended Jan. 30.

"From an operating perspective, I'd say they have the winds at their back," said Charles O'Shea, a senior analyst at Moody's Investors Service.