

# Pizza Express - Senior Secured Bondholders, How Safe Are You?

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## Background

- In our [note](#) of 21/6/19, we initiated on Pizza Express with an Avoid recommendation on both Pizza Express £ 6.625% 2021 senior secured at a price of 88.46 (13.1% YTW) and on the Pizza Express £ 8.625 2022 senior notes at a price of 50.07 (YTW 36.9%), noting that “the risks on both senior secured and senior notes are to the downside still (substantially more so on the latter)”. Whilst we view the UK business as more resilient than is widely thought (but the Chinese business faces deeper challenges than is widely thought), with net adjusted leverage at c. 8x and UK chain restaurants generally being valued at c. 6x EBITDA **we see little prospect of refinancing and that value breaks in the senior secured with a base case recovery of 83% but with risk to the downside (stress case 51%)**
- On 29/7/19, Debtwire reported that “holders of Pizza Express’s GBP 460m 6.625% senior secured 2021 bonds have formed an informal group ahead of an expected restructuring of the UK casual dining chain. The group, which is led by HIG and includes Canyon, Marathon and Cyrus, is informally working with Latham & Watkins”
- Since our [note](#), a common position we have encountered amongst investors has been that: (1) EBITDA (essentially all UK & Ireland given the drop in International in 2018) is c. £80m, restaurant businesses are worth 6x so the business is worth c. £480m versus £465m of senior secured debt, hence senior secured should be broadly covered even with some slippage in EBITDA; (2) yes, we may not hear anything regarding restructuring for some time and bonds may move lower as time goes by without any news on refinancing / restructuring but the carry in the meantime helps our breakeven
- In this blog, we look at some of the **structural weaknesses within the Pizza Express bond indentures which Hony Capital may look to exploit in eventual restructuring negotiations with bondholders**



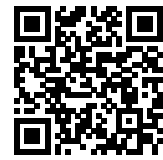
## Separation Terms Of UK & China Likely The Main Negotiation Battleground In Restructuring

- We believe a sensible way for Hony and senior secured noteholders to restructure would be for **senior secured noteholders to take over the UK business with Hony “buying” the Chinese business** (with an indefinite right to use the Pizza Express brand in China). **The price, if any (other than de minimus), which Hony might pay for the Chinese business is clearly a matter to be negotiated.** Where the International business ex-China goes is another point of negotiation
- The above pre-supposes that Hony still sees large potential for expanding the Pizza Express brand in China. We believe it does and Pizza Express’ new restaurant openings in China in 2018 are a testimony to this. **We believe Yum China’s Pizza Hut business provides something of a blueprint for Hony.** Pizza Hut in China earned a 10.3% EBIT margin on c. \$2.1bn of revenue in 2018; has had historical EBIT margins of c. 13%+; and operates over 2,200 restaurants in over 500 cities
- Pizza Express in China is a minnow by comparison with fewer than 50 restaurants and likely negative EBITDA given the c. 1% International EBITDA margin in 2018 which includes profitable countries. **A key challenge for Pizza Express will be in raising *local*, non ex-pat/non-tourist brand awareness as it expands out of major cities and into secondary ones and needs to maintain a menu that is responsive to evolving Chinese consumer tastes (as Pizza Hut also discovered in 2018)**

## Weak Bond Indentures Limit Senior Secured Noteholders’ Bargaining Position

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- **Whilst we believe senior secured noteholders want the UK business and Hony the China business, we think it is necessary to look at the threats each group can credibly make to the other and, in this respect, we believe Hony has the stronger hand if it chooses to use it, with three main tools to undermine the coverage of senior secured noteholders**



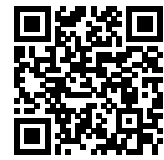
- First, there is a Credit Facilities basket carve-out of the greater of £70m and 75% of Consolidated EBITDA from the additional indebtedness covenant. £70m is the larger currently on our estimates. Whilst we view Pizza Express as FCF neutral to modestly positive and therefore not particularly in need of additional liquidity, we believe **Hony could look to (or bondholders could fear it might) lend into this £70m super senior carve-out (e.g. to fund more rapid expansion in China) and thereby undermine the coverage for the senior secured notes**
- Second, the general carve-out from the additional indebtedness covenant is the greater of £30m and 8% of Total Assets. Total Assets were £1,198m at 31/3/19, **putting the general carve-out at c. £96m**. The liens covenant we believe allows this carve-out to be secured on a pari passu basis by the same Collateral securing the senior secured notes, i.e. **senior secured noteholders' Collateral could be diluted by up to this £96m. Most critically here, we note that up to £15m of the general carve-out can be incurred by non-guarantors. Not only would this be structurally senior, it opens up the path for a JCrew-style sale of the Pizza Express brand to a restricted group entity that is not a guarantor of the senior secured notes, to which non-guarantor Hony could then lend on a secured basis. This would effectively strip senior secured noteholders, who may expect to take over the Pizza Express business in a restructuring, of the Pizza Express brand, undermining the value of the UK business they may take over without the Pizza Express brand**
- Third, the definition of Asset Disposition in the asset sale covenant in the senior secured notes indenture specifically excludes "the licensing or sub-licensing of intellectual property or other general intangibles and licenses, sub-licenses, leases or subleases of other property, in each case, in the ordinary course of business". **We think this could be another way for Hony to extract the Pizza Express brand from the restricted group, essentially through licensing the Pizza Express brand to itself**
- We are not saying we expect Hony to use any of the above. **But we believe senior secured bondholders should be mindful that Hony has these tools to avail of as and when we get closer to restructuring discussions. We reiterate our belief that Pizza Express bonds (both senior secured and senior notes) are likely to continue to drift lower as we get closer to that juncture. We still think there will be a time to go long through the senior secured notes but, in our view, we are not there yet and senior secured bondholders may be less safe than their current asset coverage suggests**



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