Carnival Corporation – an unimaginable event with imaginable consequences

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The COVID crisis has delivered countless twists and turns in financial markets, yet the grounding of Carnival Cruises was particularly striking. So dramatic was the damage to the company's balance sheet that the event should become an essential case study for every credit analyst. In this article we outline the insights RLAM's credit research framework provided and, more broadly, what these extraordinary events continue to tell us about the cornerstones of effective credit analysis?

The word 'discipline' gets thrown about so much in investment markets that it often feels like a meaningless platitude that adds little to the conversation. After all, who wouldn't think that discipline is important when investing? The problem is that during periods where the credit waters are calm and tranquil, the principle can seem highly theoretical. You can go a long time in credit when nothing notably bad happens, and it can become tempting to build your investment thesis on a benign status quo.

The danger with this approach for credit investors is that, due to the severely asymmetric risk profile of credit, they are exposed to the latent risk of a downturn in fortunes, yet often excluded from the upside enjoyed by shareholders during the good times. What's more, bond market liquidity can vanish in the eye of the storm, preventing investors from taking rectifying actions and leaving them at the mercy of decisions they made months, or even years, earlier.

The recent plight of credit investors in Carnival, the world's largest cruise operator, provides a fantastic and, crucially, non-theoretical lesson in exactly why discipline is so important at the point of investment.

From the outset though, we must profess that our avoidance of the company was in no sense the result of exceptional foresight. Indeed, the acceptance that everybody's foresight is limited is one of the key foundations of our credit research process. Rather than attempting to predict the future, our process is focused on whether we are being sufficiently compensated for observable credit risks and the potential volatility of our initial lending position.

Before the shipwreck

Just a few months ago, Carnival was seemingly universally regarded as a high quality investment grade opportunity. Its 'A' credit rating placed it among the strongest listed company issuers. This perception of strength enabled the company to raise €600m from a 10-year bond with an annual coupon of just 1% in October of last year.

So without claiming any advanced visibility on the coronavirus crisis, how did our credit research framework, focused on sustainability of lending structure, consider this investment opportunity? In the first stage of our process, we consider the opening lending position. In other words, how does the credit look at the point you buy it?

At the time, Carnival looked reasonably strong. It was well capitalised and had acceptable headline leverage given the market value of its business. However, using an approach to leverage which captures additional, and potentially 'off balance sheet', economic liabilities (e.g. pensions, operating leases, prepayments) the actual leverage position was less rosy. Carnival had considerable extra financial commitments that required timely payments.

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This relatively high initial indebtedness would ideally be offset by a business model that smooths, rather than exacerbates, leverage. We assess this propensity for the business to change over time in the second stage of our credit research framework, where we evaluate the potential volatility of the company's lending position. We consider factors like the stability and visibility of future revenue streams, cost flexibility and ability to generate cash from profits.

Carnival provides a consumer discretionary (desirable but non-essential) service, which means that it depends heavily upon customers feeling financially flush enough to keep booking its cruises. Despite this heightened potential for variability in revenues, Carnival has an extremely high proportion of fixed costs, which need to be paid irrespective of the revenues generated – a concept known as operational gearing. While operational gearing is often cited as a virtue when businesses are riding high, given the growth boost it can provide, it increases the dangers on the way back down. Furthermore, a high degree of fixed overheads will often force businesses to reduce prices aggressively during slowdowns to try to maintain volumes.

In addition, from a cashflow generation perspective, Carnival's business model is extremely capital intensive. It has to invest heavily to maintain its existing assets and grow its future revenue streams. Building the latest and largest cruise ship, to tempt the next group of cruisers to pay premium prices, does not come cheap.

When we identify a company with high leverage, variable revenues, high fixed costs and constrained cash conversion, it puts even more emphasis on the third and final stage in our credit research framework: a focus on credit enhancements. In other words, what are the tangible protections that reduce our risk in lending to the company if its creditworthiness deteriorates?

Unfortunately, the convenient comfort blanket that an investment grade rating provides lenders meant that Carnival, like the majority of issuers, had only superficial debt covenants (restrictions on the borrower) that gave no effective protections for bondholders against deterioration through additional leverage and subordination.

An imaginable outcome

Carnival made global headlines in early February when Japanese authorities quarantined passengers aboard the Diamond Princess ship for two weeks due to COVID-19. More than 1,500 cases of the coronavirus were reported on Carnival's ships, resulting in dozens of fatalities. The tragedy prompted the US national health institute, the Center for Disease Control and Prevention (CDC), to declare a temporary no-sail order in March, suspending all of Carnival's cruises.

Given the substantial fixed costs that Carnival nevertheless needed to keep paying, the company decided that it needed to issue fresh debt in late March to boost its liquidity and tide itself over through the challenging period. Yet in order to entice fresh financing from bond investors suddenly concerned about the risks inherent in Carnival's business model, the company had to make major concessions in its bond terms.

Having successfully issued unsecured bonds in October, the new investors required security and now benefit from charges over the company's cruise ships, subordinating the previously 'senior' unsecured bondholders. And despite this credit enhancement, the historic coupon rate of 1% needed to rise to an astonishing 11.5% to attract fresh investment.

Not only were existing lenders disadvantaged by their subordination in the company's capital structure hierarchy at a time when the company's value was under severe pressure, but they also witnessed a mammoth increase in priority interest costs. The cost to Carnival of servicing the new bonds alone is around $500m per annum, which compares to historic annual interest costs of between $100m and $200m. While existing bondholders may be relieved that Carnival now has additional liquidity, this unmistakeably represents a monumental and long-term shift in economic value from incumbent to new bondholders.

Perhaps unsurprisingly, the sheer violence of the change in Carnival's capital structure resulted in an equally violent impact on the economic fortunes of the unsecured bondholders. Despite no default and not even, at the time of writing, a downgrade to sub-investment grade, holders of the 1% euro-denominated bonds issued in October 2019 are now sitting on mark-to-market losses of over 50%. And, should the credit rating agencies fully catch up with the situation and downgrade the debt to junk, fund and index rules could force investment grade investors to sell the bonds, crystallising the economic losses.

Fundamental truths

Carnival bondholders were undoubtedly unlucky. Nobody could have predicted the series of events that the company would face so soon after it issued its bond last October. Yet, that is precisely why credit investors need a disciplined focus on the 'potential' volatility of the bonds they are buying at the point of investment. An eminently observable combination of high economic leverage, economically-sensitive revenues, low cashflow margins, high fixed costs and capital intensity is a potent cocktail that needs mitigating either through enhanced bond structure, enhanced bond pricing or, ideally, both.

Investors will miss salutary lessons if they discount the Carnival crisis as an unavoidable 'tail risk' or 'black swan' event. Though the catalyst that exposed the latent risks for bondholders may have been idiosyncratic, can it really be argued that the inadequacy of a 1% coupon for unsecured 10-year financing only became apparent with hindsight?

RLAM's disciplined credit research is certainly no guarantee against volatility, which is why we also run highly diversified portfolios with an emphasis on secured lending. Given the unavoidable truths that the future is uncertain and credit risk is inherently skewed, a rigorous investment process focused on evaluating the sustainability of lending positions is imperative. The best credit analysis always starts by imagining the unimaginable.

Contact us

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