Market View

by Sergio Grasso

Merlin Entertainments: the amusement appears to be over

Merlin Entertainments, a major global theme park operator, was taken private in 2019 by a consortium consisting of KIRKBI, Blackstone, and CPPIB. The deal included a sizeable 49% equity contribution and valued the company at 11.7x EV/EBITDA, with net leverage at 5.9x at the time of acquisition.

At the moment of the buyout, Merlin Entertainments was rated B1/B+, a downgrade from its pre-acquisition credit ratings of BB/Ba2. Prior to the transaction, the company maintained a relatively low-leverage capital structure and was listed on the London Stock Exchange. Historically, Merlin had accessed financing on very favorable terms in the European high-yield market, supported by strong credit metrics and investor confidence.

The LBO introduced a new capital structure, allowing investors to choose between various instruments across loans and bonds, both secured and unsecured. Investors liked the credit and the transaction at the time, although they were aware of several challenges: the company's ability to generate positive free cash flow was already constrained by significant capital expenditure requirements, the debt documentation and covenant package were considered very weak by market standards, the loan margins were tight, and bond coupons were low given the high levered capital stack. Nevertheless, the proposed financing presented attractive features: the company was well managed, geographically diversified across major markets and maintained satisfactory EBITDA margins with a solid track record of operational performance. Merlin Entertainments had strong traction among high-yield investors, as reflected in its active trading and firm pricing in the secondary market.

This was the starting point, and then COVID-19 changed everything.

The pandemic severely impacted the business, with park closures across key geographies causing a collapse in revenues and rendering financial metrics temporarily irrelevant. It was only by the end of 2021 that Merlin, having weathered the worst of the crisis, began to demonstrate resilience (it is worth noting that the credit was among the first companies to return to the HY European market with a new issue just after Covid fears dissipated). Reopenings across the park portfolio and investments in new attractions helped restore visibility on revenues. Liquidity was preserved, and solid underlying consumer demand supported a slow but steady recovery. Still, it took another 12 to 15 months for the company to reach a more stable footing and regain a positive outlook from rating agencies.

By early 2023, Merlin's seven-year senior secured notes were pricing with yields around 7.25%. Some investors remained cautious toward the bonds due to the duration risk and the company's still-high leverage. In 2024, despite the balance sheet remaining highly levered, the term loans repriced tighter in January, reflecting stronger demand in the leveraged loan market-CLOs- and a perception of improving fundamentals (yes, it was the perception). The loans appeared clearly mispriced in January 2024 for a B3-rated name, but as we know, the CLO machine cannot afford to run short of paper, and the demand for the credit remained seemingly endless regardless of perceived low margins (the loan remained around par until March 2025 because during the repricing wave of late 24, beginning 25, it still offered a contribution of 375 bps over Euribor to CLO portfolios).

Merlin Entertainments last accessed the high-yield market in early 2025 with B3/B- ratings, to refinance its 2026 bonds. The new senior secured notes, in dollar, due 2032 were issued with a coupon of 8.375%, replacing the existing bonds that carried a 5.75% coupon (as of today, the 2032 notes are trading at 87 for a yield-to-worst above 11%). The difference underscores the sharp rise in the company's cost of debt and the market's reassessment of its credit risk.

<u>The recovery and the positive perception mentioned above proved short-lived</u>. In August 2025, Merlin Entertainments was downgraded to CCC, after staying eight months in B- category, and following the first-half results, which showed a decline in EBITDA and a corresponding rise in leverage. The net leverage is in double digits when we read the latest S&P press release and we trust their calculations; I do have a lower ratio according to my information, but I finish anyway in high single digit. Moody's keeps the name as B3 for the time being. Since 2023, Merlin Entertainments has been free cash flow negative, mainly due to a combination of high interest expenses (the credit market environment which imposed higher interest rates), increasing labor costs (wage inflation, an external variable that will be probably conditioned by President Trump new policies), and sustained capex needs (difficult to reduce in the industry). The capex investments, which are essential to maintaining and growing the business, continue to weigh heavily on cash generation. Working capital dynamics have also become more volatile and difficult to forecast, adding further pressure on liquidity.

On the revenue side, pricing power has become constrained if marketing promotions are associated with soft consumer demand and intensified competitive environment. <u>As highlighted by rating agencies (S&P rating release again), the theme park industry is inherently dependent on a series of favorable external conditions</u>.

Performance in the theme park sector depends on a combination of sustained consumer demand, efficient operations, and supportive macroeconomic and financial market conditions. When any of these factors weaken, the business becomes increasingly exposed.

Weather patterns and seasonality further add to the unpredictability, as they are difficult to forecast with precision and can have a material impact on visitors' volumes.

All the challenges are significantly amplified when layered onto a highly levered balance sheet, reducing financial flexibility and increasing vulnerability to external shocks. Those have eroded credit quality, leaving the company with diminished financial flexibility (the opposite of "agile and efficient" qualities wanted by the new CEO) and an appreciably weaker credit profile.

The problems bear consideration.

What to do with the debt remains a key and not easy question. From the investors side: it is challenging to deal with CCC-rated paper, especially when the underlying business shows low single-digit CAGR prospects in the near term, and earnings and cash flows are under pressure from multiple external factors, not entirely under management control. In the immediate future, existing cash on hand and the undrawn revolving credit facility (RCF) should provide a cushion for operations. The maturity profile is manageable, and the 2027 notes should converge toward par, reflecting market belief in a potential refinancing (a lot is riding on the next decisions for the Motion Bondco's bonds trading above 90). The shareholder base is composed of top-tier equity investors, and I am confident they will continue to support a global business with a diversified portfolio of branded attractions and theme parks. However, as seen in other sectors facing similar pressures, the most immediate solution is likely to involve asset disposals to raise cash and improve liquidity.

<u>Over the longer term, I fear the equity sponsors may need to inject additional money to stabilize the capital structure and address structural imbalances in the stack especially if the EBITDA remains around 500 million euro (not dramatically different from 2019, but with more debt and higher interest rates)</u>.

<u>As long as liquidity does not dry up, management has the most valuable resource on its side: time</u>.

The profile of liabilities maturities provides an opportunity to stabilize operations, improve key credit metrics, divest assets, and navigate the persistent headwinds facing the business. Not all CCC credits should be perceived as equal; I would like to think Merlin Entertainments is ultimately a sound business but one that has been impacted by unfortunate timing and external shocks that undermined its original investment case. If the adverse factors cannot be mitigated through internal levers, the company may be forced to pursue more aggressive balance sheet actions or strategic alternatives to preserve operations and avoid further value erosion. With SSNs above 10,5% YTW, <u>a holistic solution</u> may be required before the 2027 maturities.

"What is good for the goose is good for the gander": the expression says it all.