Shifting sands

While US bond issuers would tend to favour flexibility in devising their covenant packages, investors can also fight back

One will periodically read or hear stories of the inexorable decline in quality in US high yield bond covenants. That every new covenant package starts where the last one left off, and then the issuer piles on more exceptions or inserts greater flexibility, all to the substantial disadvantage of the bond investors. But what is the reality?

High yield covenants that are drafted carefully should strike a balance between the bondholders' reasonable and legitimate expectations for the protection of their investment and the legitimate needs of an issuer to grow its business in accordance with its stated business strategy. The three primary objectives of the covenants from the bondholders' perspective are to:

- prevent the issuer from undertaking new obligations that could divert the issuer's cash flows toward competing claimants, rather than toward its pre-existing cash obligations, including debt service on the bonds themselves;
- prevent the issuer from favoring another class of creditors over the bondholders themselves by preserving the relative priorities of claimants; and
- prevent the issuer from disposing assets for less than equivalent value such that the remaining assets are not sufficient to discharge its remaining obligations, including debt service on the bonds.

In crafting these covenants, a balance must be struck between achieving these objectives and giving the issuer the flexibility to grow and execute on its business plan (which is presumably in the bondholders' interest) during the term of the bonds, which might be as long as 10 years.

In putting pen to paper, issuers and their advisers will typically try to formulate a covenant package that meets the current market standards in order to achieve a successful execution. However, the concept of market evolves over time and depends on the type of issuer, the then strength of the high yield market, the prospective ratings on the bonds as well as other factors. Certainly, the active participation of private equity funds, or sponsors, in the high yield market has a substantial impact on the substance of the covenants, particularly the emergence of significant exceptions and carveouts from the basic

covenants. The issuer's stated business strategy will also justify certain departures from market: for example, a startup company may need to borrow substantial amounts after the bonds are issued, so the concept of leveraging new equity (permitting new amounts of debt based on the amounts of the equity raised after the bonds are issued) was created. Similarly, a company with the stated strategy of pursuing joint ventures needs plenty of room to make investments. Conversely, an issuer's cause is hurt when it proposes to include the latest bells and whistles from the market that have no reasonable relation to its business or strategy and only distract from the marketing efforts, whereupon potential investors demand greater yield on the bond or worse, decline to invest.

Unquestionably, the most fertile ground for testing new and more aggressive covenant packages is in the world of sponsor-led leveraged buyouts (LBOs). The acquiring sponsor typically insists on starting the negotiations with definitions and covenants that are drawn from the then most recent successful high yield offering completed by another of its existing portfolio companies. That's where the fun starts.

Financial definitions such as EBITDA, fixed charge coverage ratios and leverage ratios are tweaked in ways to make them almost unrecognisable compared to their commonly understood meanings, such that the calculation of EBITDA, on the one hand, and fixed charges and leverage ratios, on the other, yield unexpectedly high or low results, respectively. But this game has been going on for years, and while there can always be outliers where the addbacks or exclusions are particularly inexplicable, investment banks that have made commitments to provide backstop bridge financing for the LBO typically act as responsible gatekeepers to challenge those proposed revisions that would give pause to any rational lender or else allow the issuer to exercise significant unchecked discretion in making its calculations.

But these sponsor-led LBOs constitute only a small percentage of the high yield deals that have come to market during 2016 and so far in 2017. The majority of deals are refinancings or issuances to raise proceeds for other purposes (for instance, acquisitions or payment of dividends) by established issuers. These transactions are typically marketed on a drive-by basis, where the proposed offering is announced in the morning and priced later the same day, and where the marketing effort is limited to a group investor call and perhaps a few one-on-one calls. In these situations, out of the practical necessities related to the speed of the execution, the covenant package is typically the same as those from the issuer's previous offerings, perhaps with a few tweaks to basket sizes but without any changes to definitions or to the substance of the covenants.

Another factor that comes into play with debut offerings, whether the offering relates to a sponsor-led LBO or to a brand new corporate issuer, is the availability of analysis prepared by independent, third-party subscription-based analysts who scrutinise new covenant packages. Since these debut offerings are typically marketed during the course of a roadshow that may last several days, these analysts have the time to read through the covenants and prepare a written report for their subscribers. And while many of the large high yield investors have their own in-house experts to analyse the strength of the covenants, they are also happy to pay up for the extra opinions of these third-party analysts. These third-party reports pull no punches when the analyst sees new provisions that push the envelope. Occasionally the subscriber/potential investor insists on changes to the covenant package, and if that investor is likely to be an anchor investor, the changes are typically incorporated in the final product. But if the marketing effort seems to be going well and the offering is expected to be heavily oversubscribed, then the investor's complaints are ignored. In this low-yield environment, an attractive coupon can often outweigh a weakness in the covenants.

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Where have we seen sponsors and other issuers in the last year attempt to loosen up covenants the most? A few examples follow.

Portability of change of control provisions

Bond investors typically want to have the opportunity to revisit their investment decision if the issuer comes under the control of an equity holder different from the one that was in place at the time of bond issuance. But in sponsor-led LBOs, sponsors increasingly want to pre-package their portfolio companies with low-cost, long-term fixed price debt so that they are able down the road to offer the company for sale to other sponsors (in a so-called secondary LBO) without triggering the change of control provisions (which require the issuer to offer to purchase the bonds at 101% of the face value upon occurrence of a change of control).

The theory is that if the potential acquiring sponsor knows that it will not need to refinance the existing debt of the target, with all the friction costs entailed with that exercise, perhaps the issuer will be a more attractive takeover target and the acquirer will stretch on price terms for the acquisition. Anecdotally, this flexibility comes at a small cost in terms of bond yield that the issuer needs to absorb, and the acquiring sponsor can typically only take advantage of this feature if, on a *pro forma* basis after giving effect to the acquisition and any other financing undertaken, the issuer satisfies a financial condition, typically a leverage ratio.

Leverage ratio test for unlimited restricted payments

Typical high yield covenants prevent an issuer from making restricted payments (eg paying dividends, repurchasing its equity, prepaying subordinated debt and making minority investments) unless the issuer's fixed charge ratio exceeds a specified level and the issuer has accumulated the capacity to make such payments by posting sufficient net income over the period since the issue date of the bonds.

This structure has been weakened in some deals where the issuer is permitted to disregard those financial tests as long as it demonstrates a *pro forma* leverage ratio that is lower than a

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specified level. In such cases, the issuer is permitted to make restricted payments in unlimited amounts. This is clearly a scary proposition for bond investors, and anecdotally, this feature is really only available to top-tier sponsors and in particularly frothy markets, and is unlikely to become a standard feature in high yield covenant packages any time soon. A related provision that has seen some traction allows the issuer to use a portion of the proceeds of asset sales to make restricted payments so long as its *pro forma* leverage ratio is lower than a specified level (but a specified level that is higher than the one referred to above). This represents a real one-two punch for bondholders – the issuer's asset base is depleted by the sale of the asset as well as by the possible payment of dividends to equityholders with some of the proceeds of the sale, whether or not the issuer has generated sufficient net income over time to justify the payment of any dividends.

Inclusion of the change of control covenant among those covenants suspended following achievement of investment grade ratings

Many high yield offerings include a feature whereby the issuer is allowed to disregard compliance with a specified list of the covenants (eg debt covenant or restricted payments covenant) if the bonds achieve, and for so long as they retain, investment grade ratings. In the most aggressive cases, the covenants are not just suspended, they are terminated pursuant to what is referred to as a fall-away provision. Some recent deals have provided that the change of control covenant is also suspended while the bonds are rated investment grade, thus converting the change of control covenant into a double-trigger provision, requiring both the occurrence of the change of control and the downgrade back to junk status before the issuer is required to make a change of control offer. The double trigger feature has not been common in the high yield market, so it is not clear whether this development in covenant suspension provisions will become a widespread trend.

When new features are successfully introduced into the covenant packages of new offerings, does that necessarily mean that there is no going back? Not so fast. Toward the end of 2016, in response to the decisions in court cases involving the interpretation of bond covenants, a few issuers successfully introduced without much notice a provision that stipulated that the issuer would be obligated to pay premiums to bondholders upon repayment exclusively in the event that the issuer elected to optionally redeem the bonds prior to maturity, and in no event would any premium be payable in the event the bonds were repaid following an event of default.

This development ultimately caught the attention of one of the independent third-party covenant analysts. That firm argued to its subscribers that this type of language would allow an issuer that was unsuccessful in obtaining (and paying for) consents to waivers of non-compliance with one or more covenants to instead intentionally breach such covenant(s) in bad faith and suffer no consequences, upon the declaration of an event of default and acceleration of the debt, other than being obligated to pay back to the bondholders their principal and interest, without the premium that bondholders had bargained for in the event that the debt was repaid early. Putting aside the merits of the arguments on both sides, the most dramatic outcome was the swift mobilisation by bond investors who alerted the investment banks/underwriters that they would not participate in any future offerings that included such language. Some deals that were in the market had to remove the offending provision from their paperwork to successfully complete their offerings, and the language has not resurfaced when this article was written.

The lesson, of course, is that while issuers, and primarily sponsor-backed issuers, will continue to seek flexibility in their covenant packages to be able to run and expand their businesses and seek profit opportunities without the hindrance of undue or unnecessary covenant restrictions, this impulse will not lead to the inevitable dispatch of all covenant protections. Market participants still behave rationally, whether they push back on a case-by-case basis, as is most common, or collectively, as illustrated above.

By William Whelan, III, partner at Cravath Swaine & Moore (New York)

William Whelan, III
Partner
Cravath Swaine & Moore

CRAVATH, SWAINE & MOORE LLP