Ep. 33: Exploring European Bonds, Loans and Covenants

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Jose Garriga: Hello, and welcome to *OnAir with Akin Gump*. I'm your host, Jose Garriga.

You may recall our last episode touched on trends and proposals in financial restructuring in the U.K. driven by the impact that the COVID-19 pandemic is having on markets and businesses.

Today's show follows on from some of the themes raised in that episode, with Akin Gump London-based financial restructuring partner Liz Osborne returning to the studio, joined by finance partners Amy Kennedy and Stephen Peppiatt to discuss the interplay of debt, bonds, loans and the various flavors of covenants being deployed in this new environment.

Welcome to the podcast.

Amy, Liz, Stephen, thank you all for appearing on the show today. There's a lot of ground to cover, so, over to you.

Liz Osborne: Thank you, Jose, and hello everyone. So, as many of you know, the last 10 years has seen a huge increase in the amount of so-called cov-lite loan documentation. What do we mean by that? Well, principally, documents that lack covenants and other protections, which would trigger an early warning sign about its company's financial health or which would stop a company from stripping out assets. Now, as a partner in the restructuring team at Akin Gump, I have spent many an hour looking at high-yield bonds and leveraged loan documents for creditor clients. And much of this time has been spent worrying about the flexibility that the high-yield bond and leveraged loan documents provide to issuers and borrowers to raise indebtedness on a secured or priority basis. And, indeed, how the lack of protections could be detrimental to existing or prospective investors.

However, in the current crisis caused by COVID-19, we wanted to look at the preponderance of covenant-lite documentation with a more positive hat on. At the moment, we are seeing many companies that, pre-COVID-19, had very sound businesses, but which are currently facing significant liquidity issues. And the ability to get new money into structures quickly may be the difference between those businesses surviving the current crisis or not. And as a result of this, both issuers and investors are now looking very closely at the exact terms of debt documents to see what flexibility there is for additional debt to be raised. Investors with experience of LMA [*Loan Market Association*]-style loan agreements and with less familiarity with today's high-yield bond and leveraged loan terms might be surprised at just how much flexibility there is. And we wanted to use this podcast to talk through some of the key provisions in the documents and explore what opportunities that may give to keeping businesses going.

First, though, we thought it would be helpful to have a quick recap on how the high-yield bond and leveraged loan market has developed over the last decade or so, and how the documents have got to where they have. Amy, I know you have worked for private equity clients on front-end financings for many years and have, therefore, been at the coalface of seeing how this market has developed.

Amy Kennedy: Thanks, Liz, of course. And I think it's really interesting to separate and see the development both of terms in the bond market and also in the loan market, and how they interact and have got to where they are today. So, first of all, taking the high-yield bond market. This has developed over the years to allow borrowers a huge degree of flexibility to grow their business, such that the documentation isn't static from day one, but it really grows as the business grows. And this is, in part, driven by the fact that bond documentation typically includes only incurrence-based covenants, so financial or other covenants that are tested only when the borrower, or the group, actually want to do something, rather than having ongoing maintenance financial covenants and also covenants that have the flexibility to grow with the life of the facility, more generally.

This has allowed borrowers and issuers to manage temporary downturns without potentially having to go out to bondholders, and often bond debt is widely held, so actually getting waivers and consents is quite tricky. So, the flexibility has meant that, often times, borrowers have just been able to continue to run their business, grow with the business and the documentation alongside, and, really, just manage and self-police their own financial documentation.

In contrast, loans were traditionally more rigid, and very much a day one, this is the business that we're lending into, and this is almost the permissions and the baskets that we're going to expect that business to have for the life of the loan, unless that credit comes back to us as lenders for amendment or extension or some other form of change. And we've obviously got a very similar investor class between bonds and loan documentation. And following the 2008 global crisis, there was a huge, unprecedented demand for liquidity, and there was an influx of additional institutions who were able to lend into the debt markets: We've got direct lenders, we've got credit arms of PE funds, we've got U.S. foreign investment, pension funds. So, moving away quite significantly from that traditional lender group. And with that, bank-style debt has followed that of the bond markets. Of course, everybody likes consistency, and sponsors like that particularly where they might be used to bond-style flexibility in their bond documentation, perhaps in the U.S. markets, which were very similar, and that ultimately led to a convergence within the European markets as well.

And, of course, with that divergence of players that I've just mentioned, and the amount of liquidity, frankly, if players weren't happy to be flexible with their documents or to test bond-style covenants, they would be really missing out on opportunities to lend. And, of course, in a market where everybody has capital to deploy, that was less attractive. So, as a result of that, sponsors were able to get increasingly flexible terms. We've moved away from the traditional loan market association, loan agreements, to what we now know as term loan Bs (TLB) with bond-style covenants, and even that pure bank debt has really loosened up. And we've seen the prevalence of covenants such as springing covenants and cov-lite loans and a real mixture of documentation at that high end. But it's certainly been an iterative process to get to where we are.

Liz Osborne: Thanks, Amy. There were a few points that you made there that I just wanted to follow up on, if that's alright. But firstly, before we continue, I just wondered if it was worth clearing up some terminology. So, I regularly hear people talking about cov-lite deals, but I also hear references to cov-loose deals. What's the difference?

Amy Kennedy: I think that's a really good question, and I think the answer is probably that the terms mean different things to different people. And, so, as is often the way, it's probably quite dangerous, in some respects, but I think the commonly understood terminology, at least for cov-lite, is that is an incurrence-based term loan B, so a term loan with a bullet payment at the end, no amortization. And it has what we would call a springing covenant, so that is a covenant which... well, let me take a step back. That term loan B will likely have a revolving credit facility sitting alongside it. So, the term loan B itself may not have a covenant, but that revolving credit facility will have a leverage-based covenant attached to it, and it's known as a springing covenant, because the inevitability is that would only actually apply at the point at which that revolving credit facility is perhaps drawn by 30 or 40 percent. So, that, I think, is what we know as a cov-lite loan, so an incurrence-based term loan B with a springing covenant attached to the revolving credit facility.

The cov-loose loan probably means that you're still referring to that old-style LMA, maintenance covenant-full document, but probably now just with one financial covenant and not the four that we were used to back in the good old days. So, I think cov-loose is a kind of loosening of the LMA, but cov-lite is really what we mean when we're talking about something which looks and smells a lot more like a high-yield bond instrument.

Liz Osborne: Okay, so when you're looking at cov-lite documents, it may be that a springing covenant in the RCF [*revolving credit facility*] is the only contractual protection that you have, but, in practice, how much protection does a springing covenant actually give you?

Amy Kennedy: I think the reality is that the springing covenant provides RCF lenders and other institutions with a degree of protection that there is a financial covenant attached to documentation, but with the springing nature of the covenant set so high at perhaps 30 or 40 percent, and often there are nuances to the drafting, so it may only be in relation to the cash drawn elements of a revolving credit facility and not if they’re drawn for, let's say, letters of credit or ancillaries.

Then actually, if you've got a savvy CFO and noting that, typically, it's only a one-day requirement in order to actually have the RCF drawn at that 30 to 40 level in order for the covenant to be tested, it should be possible to engineer a scenario where, in essence, even if you have an element of the RCF drawn, it never actually has to be required to be tested.

So, I think they don't provide a huge amount of protection, per se. It does potentially give the opportunity for the business itself to carry on and to be able to try to, as we've said earlier, self-police and potentially work its own way out of a difficulty.

The flipside is that, barring any payment default, covenant or other breaches, and perhaps the real, true underlying issues niggling in a credit could actually be avoided and be hidden, in part, for a significant period of time. But, of course, in the current climate, where we're looking for sources of liquidity and trying to avoid default scenarios, that's actually a real positive.

Liz Osborne: Exactly. The current time where companies may need access to liquidity, having that platform and time to put your money in place may, in fact, be helpful. I guess we used to spend a lot of time looking at equity cure provisions in facility agreements. How might equity cure provisions be used in the current climate, and indeed, are they actually currently relevant?

Amy Kennedy: Again, I think that's an interesting question. And it's really, if we look into it, very much an illustrative point as to how these documents have developed, and they've reached the late 300 and 400 pages of drafting because they include so many provisions, but perhaps some of them are not quite as relevant as they used to be.

And I think in relation to the equity cure, a sponsor can freely put money into a group at any point in time, of course. There's nothing that necessarily prohibits that, but it's really how that money is treated and what benefit that money, in any injection, whether that's by way of cash, or your shareholder loan, or other form of instrument, actually benefits the underlying credit.

And the advantage, really, of pushing money, then, through an equity cure, particularly an equity cure which moves the needle on the EBITDA [*earnings before interest, taxes, depreciation and amortization*], from a documentary perspective, means that if a sponsor can, and if the documentation, the drafting, is loose enough to allow them to preempt, to over-cure, or to use other loosely drafted provisions, there still may be a way to inject money through this equity cure mechanic, through the existing architecture and the documentation, but without really actually having any underlying requirement to cure.

But in doing so, if the provisions in the documents as we see them are broadly drafted, it may have the ability for a sponsor to put money in, and, so, have that applied in a way in which that increases EBITDA, but that's very much a documentation-specific provision, and it may have some great flexibility, but not for potentially the reason, if you will, for which equity cures were put in documents in the first place.

Liz Osborne: Okay. Thanks, Amy. So I guess, in general terms, I think it's fair to say we can expect to see a high degree of flexibility in documents, but, Stephen, I suppose we started this podcast by explaining how that flexibility can be viewed as a positive thing, given the current liquidity constraints facing many businesses. Can you give us some detail on how additional debt might go into the structure?

Stephen Peppiatt: Yes. There are a lot of potential baskets that might be available for additional debt. There will be at least one ratio debt basket, and there will be a number of specific baskets, which are limited by reference to the higher of a specified amount of cash and a percentage of proforma EBITDA over the last 12 months, in other words, a grower basket.

The company is always going to have the ability to reclassify debt between the different baskets. Not always the ability to reclassify credit facility debt, but more often than one would like. That ability, when coupled with the existing debt basket—so all existing debt is grandfathered—means it's going to be very difficult to work out exactly what is available and where without the company's input.

It's obviously also going to be important to work out where in the group any new money goes, whether it can be super senior, whether it's pari with the principal debt, whether it has structural priority.

And again, it's going to be hard to work out the answers to those questions without the company input, but we'll see what we can do. Let's assume a fairly typical capital structure. So, there's a credit facility with a TLB and an RCF and senior bonds. All of them secured pari on the same collateral.

I think the first thing to look for is a super senior basket. It's not uncommon for a company to have the ability to designate an RCF as super senior with first priority over distribution on enforcement of the collateral. Typically, there would be a limit, and often set by reference to the existing RCF, but it's not unheard of for there to be no limit at all. And that's clearly a very easy way to get super senior debt into the structure.

Another thing to look at is whether there is scope for an incremental facility under the credit facility itself, which is obviously another very easy way to get debt into the structure, only this time as pari-secured.

Liz Osborne: Stephen, where you have an incremental facility, would you expect for there to be an MFN-type provision so the incremental facility then just don't benefit from enhanced terms?

Stephen Peppiatt: Yes, you would, but it's fairly toothless. It will only apply for six months at best, and it will have limited restrictions mainly over the margin that can be charged, which can't be more than a percent or two over the margin being charged under the original debt. So, I think it should really be thought of more as an anti-embarrassment provision for the arrangers to protect them from accusations of underpricing.

After you've looked at incremental facility capacity, all the other relevant baskets could probably be pari-secured, at least up to a point, either because of the express permission within the document or under the general permitted liens basket. There may be practical issues for taking the benefit of the collateral. It might be easy to accede to the intercreditor agreement, but documents do allow for an additional intercreditor agreement, and it may not be easy actually to get them in place in practice.

Looking at other baskets, ratio debt is potentially the basket with the highest capacity. There will almost inevitably be the ability to incur debt up to a fixed charge coverage ratio of typically two to one. And that's, essentially, EBITDA to interest costs. Given today's low interest costs, you don't need an awful lot of EBITDA to be able to borrow a lot of money.

There may also be a separate basket for pari-secured debt up to a specified leverage ratio, senior secured debt to EBITDA. There may be capacity under the credit facility basket itself. That's really a misnomer. The definition of credit facility in these documents is very, very broad, and pretty much any kind of debt can be incurred under that basket.

Then there's always a general basket. Again, that's going to be a grower basket, and that's typically capable of being pari-secured. Other baskets that might help: There's a contribution debt basket which allows a company to borrow an amount by reference to any new equity or subordinated shareholder debt that has gone in since issue. Usually, it's an amount equal to the new equity or shareholder debt, but you certainly see cases where it can be a multiple of that.

Then there are receivable financings, which people do tend to skim over as an opportunity, but that can be a very quick and easy way of raising secured debt, and it's typically uncapped. The capacity is obviously going to depend on what receivables there are in the business. So, it may not be very available.

Finally, it's always worth having a look at the definition of indebtedness. There are a number of deals out there that will carve out of the definition of indebtedness a number of things that you might well think ought to be there.

Liz Osborne: Thanks, Stephen. So, you touched on the concept of EBITDA just then, and Amy also mentioned it a little earlier in the podcast. So, it's quite clear that this concept of EBITDA is a pervasive one, and it feeds into a number of concepts. And we're all used to seeing EBITDA in a set of financials, but am I right in thinking that determining EBITDA in debt documents is not nearly as straightforward as people might think?

Amy Kennedy: Absolutely, Liz. And I think if we could all read it off a line item in financials, for the purpose of the debt documents, it would be a lot easier sometimes to establish quite how much debt or otherwise may be incurred by the baskets that Stephen's just talked about. And there's probably a couple of reasons as to why it's not clear. The devil is really clearly in the drafting of the EBITDA definition within a document. And there's two features, particularly. The first are the invent of proforma synergies or adjustments that can be applied to increase the EBITDA number. This developed from the application of cost savings and synergies arising as a result of acquisitions or other investments. So, entirely sensible to the extent that you've acquired a business, you may expect to realize synergies, and then you would then be able to apply those in terms of your EBITDA number.

But this definition has morphed over time to be something much wider: cost savings, associated programs, restructurings, redundancies and almost anything that you are potentially doing or altering to your wider business or group companies may or may not fall within that proforma synergy addback. And, initially, coupled to that, the timing of when those proformas were able to be realized used to be fixed. So, perhaps within a six- to 12-month period. Now it's, generally speaking at least, a reasonably believed, or words to that effect, threshold in relation to realizability in perhaps 18 to 24 months. And it's quite hard to disprove a self-certification of reasonable belief.

In addition, initially there were potentially caps applying to the level of any proforma, whether that was an overall cap, maybe 20 percent of group EBITDA, or indeed sub-caps when potentially third-party diligence or the like may or may not have been required. But those two have fallen by the wayside. So, it really is quite an open interpretation here in terms of adding your proformas back. I've heard it described as it's rather like measuring your height whilst standing on a box.

So, that gives you some sort of degree of how that EBITDA definition can be changed or increased by reference to those proformas. And also, there are a number of addbacks to EBITDA as well. Not proformas now, just addbacks. One example of those, which is featured quite topically recently as a result of COVID-19 is the addback of exceptional items. Exceptional items may be an accountancy term, but when it appears in our loan documentation or our bond docs as an undefined term, the ability as to what is classified as exceptional then actually does increase and may offer your CFOs and others significant flexibility in order to amend the EBITDA or to inflate it. And, of course, as we've said, it is pervasive because it has an effect on our grower baskets and our ratios.

Liz Osborne: Thanks, Amy. So, given that flexibility, it sounds like getting debt in on a pari basis may, in fact, be fairly straightforward, but I think we can assume that many new money providers, at least at the moment, will want their money to go in on a super senior basis. And I suppose there will be deals where there is either no super senior basket, or there is insufficient availability in a super senior basket. In that scenario, what scope is there for giving new money priority?

Stephen Peppiatt: There's a lot of scope. Priority debt will be ... It's any debt that's secured on its own assets or which is borrowed or guaranteed by companies lower down the group than the borrowers and guarantors of the principal debt, so, closer to the assets. The first place to look, then, is whether there are any asset-owning non-guarantors who could borrow or guarantee any new debt. Documents can include sub-limit on the amount of debt that goes in at non-guarantors, but not always. In fact, probably not even usually. There may also be a requirement that any non-guarantor that gives a guarantee of other debt also guarantees the principal debt, but there may well not be. And even if there is, it may be limited to specific types of debts and, typically, to other public listed debt, but not to bank debt, or if it is to bank debt, it's only to principal credit facility debt.

The other place to look is for unencumbered assets, though you obviously need to find out what there is, what's available and what permitted lien capacity is there in the covenant. But even if there are limited assets available to borrow against, it's usually fairly easy to shift assets to non-guarantors. LMA-style bank debt will typically limit the ability to transfer assets out of the guarantor group and will typically include a guarantor coverage test so that any material company, 5 percent of the group assets or EBITDA would have to give a guarantee. And you'd expect guarantees from companies that together make up a minimum percentage of group EBITDA.

Bonds don't have that. They do not have a guarantor coverage test. They may have the requirement, let’s say, to give a guarantee where they guarantee other debt. But, otherwise, you don't have the protection. Bonds will not limit the ability to transfer out of guarantors to non-guarantors. They will allow free transfer of assets within the restricted group. So, that's an easy enough thing to do, is just to shift the assets out. And you find yourself with companies that are holding assets that can then borrow, and the new debt will have priority against those assets within those new guarantors.

Another possibility that has been used successfully on several occasions to shift assets is the ability to use permitted investment and restricted payment baskets to put assets into an unrestricted subsidiary. Now, there are never any restrictions on the ability of an unrestricted subsidiary to borrow or to give security. And, so, that unrestricted subsidiary that now holds a chunk of assets can borrow against those, give security over those, and could then on-lend the proceeds back into the restricted group, probably on a subordinated basis to avoid tripping up any other covenants.

Then, finally, if there is no super senior basket as such one can be created by putting money in, typically through the credit facility debt on a pari basis, and then having a behind the scenes intercreditor among the credit facility lenders with turnover provisions so that the new money is, effectively, super senior.

Liz Osborne: Thanks, Stephen. So, clearly, a lot of flexibility and a lot of scope for getting new money in, which, as we've said, in the current climate is no bad thing. But, inevitably, there will be some cases where raising new money will just not be possible. And I guess another source of potential liquidity for companies will be to sell assets. And, therefore, a key question will be whether or not companies are free to use those asset sale proceeds for working capital purposes, or whether or not the debt documentation will force the proceeds to be applied in prepayment of debt. Based on what I have seen in bond documents, investors may be surprised about how limited the contractual obligations are in terms of using asset sale proceeds for prepayments. Amy, can you give listeners an idea of what they should expect to see in this respect?

Amy Kennedy: I think your summary is correct, Liz. We would have traditionally expected that asset disposition effectively resulted in a dollar-for-dollar prepayment of debt, give or take. But I think now there are awfully significant assets which are carved out to the definition. There are also high de minimis amounts for individual transactions, and then, potentially, also overall baskets before prepayments are triggered. There may also be reinvestment rights or also carve-outs for use of the monies by way of OPEX [*operating expense*] as well. So, certainly, it's not a slam dunk that the prepayment proceeds would need to be applied. And indeed, even if they do so, there is typically quite a long lead-in time, potentially up to a year, before any prepayment right is triggered.

Liz Osborne: Thanks. And actually, one question that we end up looking at quite a lot on the restructuring side of things is how the asset sale provisions apply if you have two pari debt issuances with different maturities. I'm interested in your thoughts on what you're seeing in documents and how likely is it that an issuer will be able to use asset sale proceeds to repay shorter dated pari debt without having to make a sort of pro rata prepayment on the longer dated bond issuance?

Amy Kennedy: Yeah, that's a very good point. I think the documentation goes both ways. I'd like to say sort of 50:50. And, so, there's certainly documentation out there which does permit that.

Liz Osborne: So, just one final question from me, I think, which is clearly relevant for investors looking to invest in leveraged loans. Now, we all know that bonds are easily traded, but bank debt has historically contained some restrictions on transfer, and it feels to me like those restrictions have increasingly tightened over the last few years. I'm interested to hear what you guys are seeing at the moment in terms of the shape of those transfer restrictions and whether or not that is a good or a bad thing?

Amy Kennedy: I think, Liz, the point you make is right. Obviously, the bond world has increasingly been very open. The current market in the bank debt is varied. There are approved lists, i.e., lists of lenders to whom the bank debt can be freely approved. So, there are documentation which take that, the so-called “white list approach,” or there's also the unapproved or the “black list approach,” where there may be a set of lenders or institutions who are prohibited from having debt transferred to them. And the documentation varies conceptually on which approach is taken there. There are also, we've seen more recently, restrictions on distressed or loan-to-own investors potentially buying debt, regardless of whether the underlying debt is trading in a default or an event of default scenario, or at significantly below par. And including, in certain documents actually, that applies both to non-voting sub-parts as well as voting participants. So, that can actually be really restrictive in an environment such as the one we find ourselves in at the moment.

I think it's actually a really interesting question both as to how tightly these provisions are actually going to be adhered to in times of liquidity need. If a creditor does actually need some cash, and the most likely route is by a transfer or a trade of its existing debt, is it going to be unhappy if suddenly the relative loan-to-own investor or the like is unable to buy that debt?

And I think it's a question to ask because I think those tight transfer provisions may have been helpful or useful, if you will, protective in a time of negotiation. And it almost feels like a really strong sponsor win, but I do worry whether it's a step too far when actually more liquidity is required. And, rather, it may actually be better and actually have more profit for the credit in the long run is to have the more-open bond-style route.

Liz Osborne: Thanks. And Stephen, you made a very good comment to me the other day, that one of the first things you look at now when you're doing a document review of a leveraged loan is to look at the transfer restrictions and figure out whether or not the client that you're looking at that document for has found their way onto a black list, or is otherwise prohibited from acquiring due to the transfer restrictions.

Stephen Peppiatt: Yes, that's right. I do it first now; otherwise one can spend an awful lot of time looking through a document and finding it right at the back end, having spent several wasted hours.

Liz Osborne: Indeed. Alright. Very good. Well, thank you, Amy and Stephen, it was interesting to turn my generally negative view of cov-lite debt on its head and to look at it in a more positive light given the current acute need for liquidity that many businesses are facing. For me, it will certainly be interesting to see how this wave of restructurings plays out, not least because it will be the first very significant downturn that we have been through where a significant portion of indebtedness has no, or limited, maintenance or financial covenants.

Jose Garriga: Thank you, Liz. Listeners, you've been listening to Akin Gump financial restructuring partner Liz Osborne and finance partners Amy Kennedy and Stephen Peppiatt. Thank you all for making the time to appear on the show today to dive into, and explain the nuances of, this critical topic.

And thank you listeners as always for your time and attention. Please make sure to subscribe to *OnAir with Akin Gump* at your favorite podcast provider to ensure you do not miss an episode. We're on among others, iTunes, SoundCloud and Spotify.

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Until next time.