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High yield bond to IPO—a natural progression

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The steps taken in a high yield bond issuance can be leveraged as a company considers an IPO. Below is a road map for high yield bond issuers contemplating an initial public offering.

More ready than you think

A high yield bond issuer has taken some obvious and some not-so-obvious steps that can be leveraged for an initial public offering, whether in the form of a listing on the London or a European stock exchange, a SEC registered offering in the US or a listing elsewhere.

Disclosure

Many of the principal sections of a high yield bond offering memorandum (risk factors, business, management's discussion and analysis and industry) are a good base of disclosure which can be used for an equity offering document. As almost all high yield bonds are done to a "Rule 144A" disclosure standard, the original offering memorandum provides a significant amount of information in a readily usable form for the listing process. In addition, given ongoing reporting obligations in the high yield bond covenant package, even if some time has passed since the issuer's high yield bond offering, a substantial amount of the business and financial disclosure can be easily updated with pre-existing materials. While some time will need to be spent focusing on the key equity messages for the transaction (equity investors prefer a growth story, compared to bond investors who seek evidence of strong cash flows to service debt), many of the more legal sections can be quickly tailored and updated for the equity deal by legal counsel.

Due diligence

The due diligence process for an equity offering should not differ materially from a bond offering. This means that the due diligence framework for the original high yield bond prepared to a "Rule 144A" standard will in most cases still apply, and it should be an update exercise rather than a complete renewal of the process. This offers significant process and cost efficiencies. Even if this just means reinstating a data room from the original deal, this is meaningfully less procedural work than for the original transaction.

Public company actions

By issuing a high yield bond, a company has begun to act like a public company. The company has disclosed its financial statements, corporate, shareholder and management structure, and provides updates to the market in relation to material events, including quarterly results. Both through the reporting covenant and the fact that the majority of high yield bonds are listed, disclosure obligations continue through the life of the bond. Although those obligations generally fall short of the requirements of a company with publicly listed equity, these initial steps nevertheless provide a platform to develop good practices, which an equity listing can take to the next level.

In addition, particularly after the introduction of the Market Abuse Regulations and their application to certain common listing venues for high yield bonds, management of a high yield bond issuer have become more familiar with the concepts of material non-public information and insider dealing, and the requirement to ensure the correct information flow both internally and externally. These information flow systems and controls will need to be enhanced prior to an IPO, particularly given the likelihood of directors and officers owning equity (versus the far less likely scenario of them holding bonds), but the initial development of the relevant systems and controls following a high yield bond creates a corporate discipline that can be built on.

Bond covenants

While often an IPO works as a deleveraging event (in particular for high yield bond issuers), the typical high yield issuance is structured to survive an IPO, and in fact the high yield bonds can play an important ongoing role in the capital structure of the newly public company. Many high yield bond transactions are designed to provide for a future IPO, with certain deals including provisions for debt push-down or other mechanisms to facilitate a qualifying IPO, balanced against the protections expected by high yield bond investors, in particular their preference for a single point of enforcement (i.e. a share pledge) in the unlikely event that the bondholders or other creditors would need to take future actions against the IPO-ing company.

In connection with and post-IPO, certain bond covenants are activated and may be utilized by the newly public company going forward. While these do vary from deal to deal, the following are often included in the bond terms:

- Equity-claw – ability to call up to a specified percentage of the bonds (35/40%) at par plus coupon during the non-call period of the bonds. This opportunity to deleverage during the non-call period without paying a make-whole may be used to de-lever a company to its target post-IPO leverage if not achieved pre-IPO;
- Restricted payments – the Restricted Payments covenant restricts the payment of dividends and stock repurchases, both of which may be relevant to a company post-IPO. There is often a post-IPO dividend restricted payment carve out, for a specified percentage of the IPO proceeds and/or a percentage of the market capitalization, which may depending on the construct, be subject to a leverage ratio. In addition, depending on the use of the IPO proceeds, it may be possible to increase restricted payment capacity within the bond restricted group via capital contributions (or similar);
- Change of control – in a typical high yield transaction, an IPO would not trigger a change of control, which would have required the company to make an offer to noteholders to put their bonds at 101%. Given most high yield bond change of control covenants work on a negative hold basis (no one person will own more than 50% of the equity), an IPO typically does not trigger this.

A high yield bond issuer which is contemplating a listing should ensure their high yield bond documentation allows for the flexibility for the proposed IPO.

Key considerations

While the above preparatory work is helpful, there are a number of additional steps required for the equity listing process that a high yield bond process will not have required. The following points should be at the forefront of a potential IPO candidate's mind:

Pre-Deal Structuring

A main difference between the high yield bond process and the IPO process is that the high yield bond process is less interested in the existing and post-IPO equity arrangements (other than for disclosure and ratings), which of course are critical to the IPO process. Whether for a traditional corporate issuer or a sponsor portfolio company, identifying (and in some cases creating) the right IPO vehicle, organizing the existing equity (and in some cases shareholder debt) and understanding future requirements for management incentive plans and similar arrangements is a workstream critical to the IPO process that will need to be independently evaluated with the assistance of accounting, business and legal advisors. In the unlikely event that a bond consent may be required to complete the IPO, that process needs to be identified early in the process and integrated into the timeline.

Jurisdiction-specific considerations

The corporate and securities laws of the listing jurisdiction, along with the listing rules for the particular exchange, will each need to be taken into consideration by an issuer when selecting a listing venue. Each jurisdiction has different requirements that govern both the initial listing process itself and ongoing obligations as a public company. For instance, although significant accommodations are in place for foreign private issuers listing in the US, there are still a number of specific corporate governance and ongoing reporting requirements that will need to be met, including under the Sarbanes-Oxley Act. Similarly, the UK has regulations including the City Code on Takeovers and Mergers and the UK Corporate Governance Code to which a UK public company must adhere. Jurisdiction-specific regulations may require the establishment of certain additional corporate governance and public reporting infrastructure. Legal counsel can guide an issuer through the establishment and maintenance of these internal processes in line with the relevant statutory principles.

Financial Statements

Depending on the listing venue, financial statement requirements may vary from what was required in connection with the high yield bond process. For example, a premium listing on the London Stock Exchange requires that an IPO candidate have both year end and semi-annual audited financial statements. Confirming financial statement requirements as early as possible in the process is key to ensuring a company is able to complete its IPO within its planned timeframe.

Reporting

Following an IPO, a company will be subject to the ongoing reporting requirements of the relevant jurisdiction and stock exchange where it is listed, which will likely be more onerous that those which the company is currently subject to in connection with its high yield bonds. In most cases, the bond reporting requirements will still continue to apply as a separate obligation, but the ongoing reporting requirements for the company's publicly listed equity can be adapted to ensure that they also meet reporting requirements under the bonds. Certain high yield bond transactions have also included specified provisions to address this point, including permitting a change in the reporting entity, or allowing the reports of the equity listed company in lieu of the of the relevant high yield bond issuer or applicable parent guarantor.

Conclusion

A high yield issuer has developed processes, procedures and documentation which set them well on their way to issuing public equity. That being said, it is important to look ahead, preferably at the time of issuing a high yield bond, to leave sufficient flexibility for a future IPO, as well as recognizing the key next steps to evolve to a public equity issuer.

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