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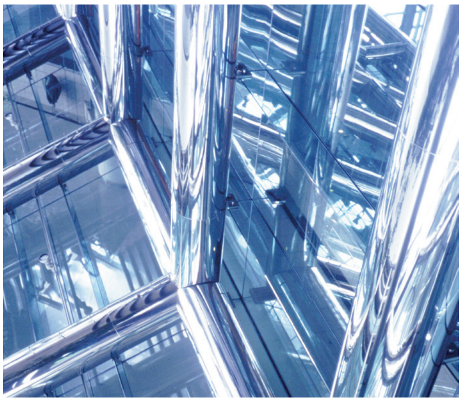
European High Yield and leveraged loans: Has the convergence gone too far?

The growth of the High Yield (HY) market in the leveraged finance arena has, save for a few short term downturns, continued unabated since the onset of the financial crisis.

The financial crisis and the continued restrictions on bank liquidity caused by regulatory requirements and pressure to de-lever has created the opportunity for HY to play a prominent role in European leveraged finance. HY's emergence as a competitor to bank finance as a primary source of capital in Europe and its contribution to increasing choice for borrowers was considered in detail in the White & Case thought leadership piece – Coming of age: The changing face of international leveraged debt – as was the convergence of terms between HY markets and debt markets and the US and European markets.

The effect of liquidity and convergence of HY and leveraged loan terms and, particularly, the increase of covenant lite and covenant loose loans, has been cause for discussion for investors across both markets for some time. Since July 2014, we have seen some covenant lite/loose deals flexed as investors began to search for greater protection or higher yield. July 2014 was also the month that saw six firms meet with the Association for Financial Markets in Europe (**AFME**) to discuss issues in documents governing bond sales. Prior to this, in April 2011, high yield investors wrote a letter to sell-side banks calling for more disclosure in offering documents. Last month, expressing unease with the continued erosion of protective covenants in bond documentation and continued concern about disclosure, 21 investment firms wrote an open letter to the AFME High Yield Board requesting that the AFME Recommended Market Practices Disclosure by Issuers of the Non- Investment Grade Debt Securities be expanded and upgraded to deal with some of these matters. Below we consider some of the topics raised in the investor letter that impact most directly on the loans market.



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Disclosure

In the investor letter, investors called for improved disclosure in respect of any loan financings and intercreditor agreements suggesting such documentation be included in the offering memorandum or made available on Bloomberg or the issuer's investor relations page. Investors believe this would assist with openness and transparency and ensure all investors are on an equal footing, as these documents are frequently only summarised in the offering memorandum or provided to investors on a bilateral basis. There has long been some reluctance on part of both the sponsors and the sell-side banks to make loan financing documents more publicly available, but if the loan market and HY market are to compete on an equal footing then disclosure and transparency across both might be welcome. It could create efficiencies across the loans landscape as terms become more standardised as is more often the case in US loan financings and HY deals where documents are more freely available. In this context, it is worth remembering the City Code on Takeovers and Mergers already requires greater disclosure of financing documentation on UK public bids. Furthermore, given terms on larger private M&A financings often become known to the market through syndications and subscription databases, this begs the question why some level of greater disclosure should continue to be resisted. However, unlike in the US where registered transactions require that material agreements are filed on the EDGAR database, there is no complementary European regulation which requires, or infrastructure available to support, a public repository, so any such action would be voluntary.

Portability

Another matter identified in the investor letter is the growth of portability provisions. This is a term often requested on loan transactions but much less frequently agreed. Sponsors may request it as part of a strategic sale anticipated in the near term or, alternatively, as a nice to have. In the latter case, we would anticipate most sponsors being unlikely to prefer to pay for an uplift in pricing for the flexibility of a portability provision. However, in a competitive market where it is harder to distinguish between financing bids (unless on pricing or looser covenants) the portability provision may do just that. While a sponsor may not need a portability provision, if it is added as a sweetener, then it may swing the choice of financing bid on otherwise identical pricing and covenant terms.

In the event a portability provision is included, the investor letter highlights a number of concerns around the flexibility that such provisions currently include. In particular, the letter highlights that any portability feature should require a degree of deleveraging to become operative (and preferably with leverage step-downs over time). Further, it is noted that with leverage being tested on a *pro forma* net basis, this may allow a potential buyer to game the provision by temporarily leaving cash on balance sheet or by taking aggressive positions on acquisition synergies, in each case to artificially reduce leverage to enable porting of the capital structure. However, very often restricted payment convenants are structured to prevent this occurence.

Carve-outs and Synergies

The investor letter also focusses on the increased scope of 'carve-outs' over the last several years which has diluted the protections offered to investors. In particular, many of the 'carve-outs' are now subject to grower constructs, meaning that the size of the baskets will grow over time when indexed against specified financial metrics of the issuer/restricted group. Commonly, the size of many baskets now grows as EBITDA of the business increases (compared with grower baskets linked to total assets which have historically had greater acceptance in European bank and bond markets). Under an incurrence based covenant package, as issuers get increased flexibility to, for example, incur debt or make restricted payments during periods of good EBITDA performance, there may not be a consequential need to consider the risk of later performance decline (as covenants are only tested at the time such action is taken).

The use of synergy add-backs to EBITDA can also result in greater flexibility than is comfortable for some bond investors according to the investor letter. In contrast, in the loan markets, the scope of such add-backs is often restricted to 10-20% of EBITDA and/or subject to verification by the borrower's auditors.

Voting, Ranking and Security

Investors also discussed the dilution of the security package. While it has been long accepted that senior secured noteholders' interest in collateral can be diluted subject to a senior secured leverage ratio test, in recent years covenants have allowed other categories of uncapped debt to be secured pari passu with the notes regardless of senior secured leverage levels. This includes in many cases acquisition debt, purchase money debt and 'contribution debt'. The investor letter requests more probity around these provisions to ensure, where possible, that all such categories of debt are subject to effective senior secured leverage controls.

Further, investors continue to emphasise that senior secured notes and bank debt that are secured on a *pari passu* basis should enjoy equal voting rights. While the market has generally accepted *pari passu* treatment in recent bank/bond structures, we expect that it may still raise concerns among certain members of the bank community in cases where senior secured notes are being raised alongside existing bank debt.

Conclusion

HY investors have been beneficiaries of the increased competition between the loan and HY markets. As noted by Gary Simmons of AFME, the convergence of the markets and borrower protections has been seen by AFME as a 'positive development' and access by European sponsors to US markets to fund European acquisitions 'should increase efficiencies'[1].

There is a balance to be drawn between the needs of the sponsor and the business to run its operations flexibly without being subject to the stranglehold of covenants, against the needs of the investors to invest in less risky financings or, alternatively, to obtain pricing they believe is commensurate to the higher risks involved due to certain weaker covenants. Although sponsors are currently benefiting from a very liquid and asset starved investor base, it is not necessarily the case that sponsors are being unreasonable with their requests.

Overly tight covenants (and, particularly, baskets which do not scale or build in line with the growth of the business) may prevent a sponsor from running its target business effectively or maximising opportunities without the need to obtain investor or lender consent which, given the time to obtain, could see the window of any opportunity missed. This is an imbalance which can go beyond the justifiable protection of investor/lender downside. On the other hand, the continued erosion of covenant protection raises legitimate investor concern regarding the ability of the covenant package to control both value leakage and the incurrence of imprudent leverage. Further tensions created by the adoption of HY in Europe and the regulatory setbacks in the bank lending market has created a window where more 'covenant-lite' term loan B financings may be necessary for the bank market to remain competitive and this dynamic may lead to further erosion in covenant protections.

We will have to wait and see if market sell-side participants take note of the issues highlighted. A period of settled terms would be welcomed by many market participants, provided those terms can reflect an appropriate balance between investor concerns and issuer/borrower needs. Time to allow both the buy-side and sell-side to fully understand the consequential effects of some of the covenants would also be of value. Certainly the aims of the investors to increase transparency and have better and more deal efficient structures to develop a broader investor base and more efficient pricing in both primary and secondary markets would seem a positive result for all parties.

However, care is still required to avoid an excessively standardised approach where terms are used without considering whether they are appropriate for a given credit and simply because they have featured in most recent issuances. There should always remain room for bespoke terms required to reflect individual characteristics of any particular credit.

1 See Gary Simmons, 'Afme's Gary Simmons on high yield education' (IFLR, 22 September 2014) at http://www.iflr.com/Article/3382552/Afmes-Gary-Simmons-on-high-yield-education.html.