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VIEWPOINT

A New Shell Game? Erosion of High Yield Bond Protection

MELINDA NEWMAN | SEPTEMBER 22, 2017

No one likes losing money, particularly to a con artist. Some might recall the three card monte scam from the 1970s and 1980s, in which the dealer, assisted by accomplices, adeptly separates a naïve mark from his well-earned cash using legerdemain. The streets of NYC have been scrubbed of scam artists, but high yield investors are now falling prey to a new type of shell game. Issuers, along with their facilitators at investment banks and top law firms, are setting the table to pick investor wallets via porous covenants that permit companies to remove assets from bondholders' reach. Remarkably, in both worlds, participants still play the game despite the fact that the odds are increasingly stacked against them.

The new issue high yield market was born in the 1980s when Michael Milken and his team at Drexel Burnham Lambert started underwriting below investment grade bonds for issuers to finance leveraged buyouts (LBOs). Prior to this, high yield bonds were exclusively the domain of fallen angels – bonds originally issued as investment grade, but subsequently downgraded to high yield due to credit deterioration. The innovation of issuing bonds rated below investment grade necessitated a mechanism to protect investors given that the credits were already significantly more risky than the typical corporate issuer. High yield bond indentures usually contain covenants which restrict issuer actions ranging from incurring excessive amounts of debt, siphoning cash, and

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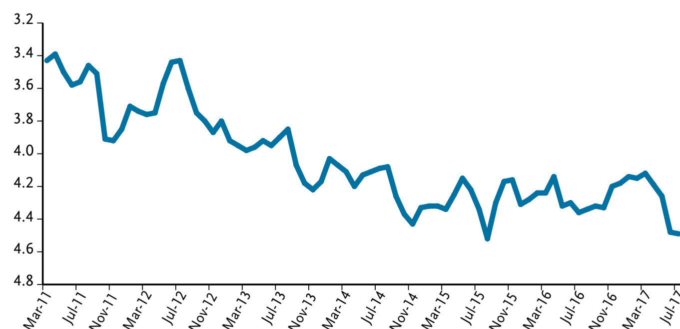
selling or moving company assets away from creditors' reach. Well-structured covenants compel issuers to follow the rules of the indenture and treat bondholders fairly. Should a board choose to pursue a corporate action prohibited by a bond indenture, a bond issuer would be required to redeem the bonds at a premium price to par.

Quantitative easing has helped to stretch valuations in the high yield market, and investors do not appear overly concerned about the potential for late cycle volatility. Strategists almost uniformly opine that U.S. high yield market yields/spreads are attractive relative to opportunities elsewhere, with technicals and fundamentals supported by stronger global economic growth, a modest default rate, and earnings growth momentum. The complacent investor attitude towards valuation has also encouraged a laissez-faire attitude towards protective bond covenants. Moody's Covenant Quality Index is near all-time weak levels (i.e., less protective covenants), confirming high yield investor apathy towards protecting bondholders' rights with covenants. Aggressive moves from emboldened issuers to remove assets from the bondholder restricted group[1] could drive default rates up and recoveries down, amplifying future volatility.

Moody's Covenant Quality Index



Source: Moody's

More Downside with Less Upside

Covenant quality deterioration is increasing potential downside for bondholders while simultaneously chipping away at provisions that provide opportunity for upside returns.

More Downside: Pilfering of Assets Away from Bondholders

In three recent cases, high yield issuers engaged in aggressive transactions that moved valuable assets away from the restricted group that bondholders can look to in order to recoup value in case of a default. The companies all relied on "permitted investments" carve-outs to facilitate these transactions. In one case, the company relied on an additional indenture provision known as a "pass-through basket" to whisk assets out of creditors' reach. That language is now being propagated in a number of other new issue indentures.

- **Issuer A:** Issuer A has been hindered by hefty debt levels since its 2007 LBO. The credit historically benefitted from its equity stake in a publicly-listed affiliate. In December 2015, Issuer A contributed shares of Series B common stock from an entity that guaranteed some of Issuer A's outstanding debt, to an unrestricted subsidiary. The stated purpose of the transfer was to facilitate a buyback of Issuer A's debt at a discount. Litigation between Issuer A, bondholders of four issues of guaranteed notes, and the indenture trustees for those bonds ensued, with the bondholders and indenture trustees contending that the share transfer was an indirect restricted payment ("RP") that violated the bond indenture. A Texas district court found in mid- 2016 that the transfer of the affiliate's shares did not constitute a restricted payment, and therefore did not violate bond covenants. The ruling found that the affiliate's share contribution was a "Permitted Investment" as defined in the indentures, regardless of whether the investment was made with an intent to realize profit. An appeal is now being heard by an appeals court in Texas. The company is reportedly in the process of negotiating a potential debt restructuring with large bondholders.
- **Issuer B:** Issuer B, a stressed fashion accessories retailer, offered to exchange three bonds for a package of new debt, including new secured debt, in mid-2016. The new entity was described in subsequent company filings as an entity that owned a minority stake in all of the trademarks for one of its brands, 100% of the trademarks for another brand, certain internet domain names associated with the two brands, and a mobile application agreement for Issuer B's brand intellectual property ("IP"). The new entity entered an agreement with Issuer B under which it would be paid modest compensation annually for use of the IP. It appears that the company used its restricted payment or permitted investments capacity to effect the contribution of intangible IP assets to the new entity. The exchange offer was successful, and it allowed the company to partially reduce debt levels.
- **Issuer C:** Issuer C is an apparel retailer that was LBO'd in 2011. The company transferred a majority interest in certain U.S. trademarks to an unrestricted subsidiary in late 2016. An expert witness for the term loan administrative

1 Restricted groups are issuer subsidiaries or affiliates that provide direct credit support or guarantees for the benefit of bondholders in indentures. Covenant protections are typically the most robust within the restricted group.

agent subsequently testified that they believe the valuation for the transferred assets could be over $1 billion. The company made the transfer by first moving the assets to a foreign restricted subsidiary, and then from there to an unrestricted subsidiary. The asset transfer was completed in this circuitous manner in order to circumvent an insufficient permitted investments basket. Issuer C also utilized its ability under the credit agreement to invest up to $150 million in non-loan party restricted subsidiaries, which, together with what remained of its permitted investment capacity, was sufficient to facilitate the transaction. The transaction is now being litigated in a state court, and the judge hearing the matter has ordered that discovery be completed by the end of 1Q18. In June 2017, Issuer C proposed a term loan amendment to facilitate an exchange of the company's Payment In Kind[2] HoldCo bonds for senior secured notes collateralized by the transferred trademarks, non-convertible perpetual preferred stock, and common stock. The term loan amendment was approved by a majority of bank lenders in exchange for the company's partial repurchase of the term loan from consenting bank lenders.

Issuer C's use of the pass-through basket should alarm high yield and leveraged loan investors. This pass-through basket language has resurfaced in more new issue high yield indentures recently . The language essentially allows for any transfer of assets from a restricted subsidiary that is not a guarantor to an unrestricted subsidiary. This provision could be more deleterious than it was for Issuer C's creditors. The quantum of Issuer C's asset transfer was limited by capped baskets. More recent versions include "uncapped" language, and could conceivably result in a transfer of most of an issuer's assets to subsidiaries beyond the reach of creditors, because standard high yield covenants permit issuers to make unlimited investments in non-guarantor restricted subsidiaries. Any company whose indentures include the language could therefore take assets that started out in a restricted guarantor, "invest" the assets into a restricted non-guarantor, and then use the pass-through basket to move assets out of the restricted group altogether to subsidiaries that creditors cannot reach. The language is nefarious, and exposes bondholders to material downside risk in a default scenario.

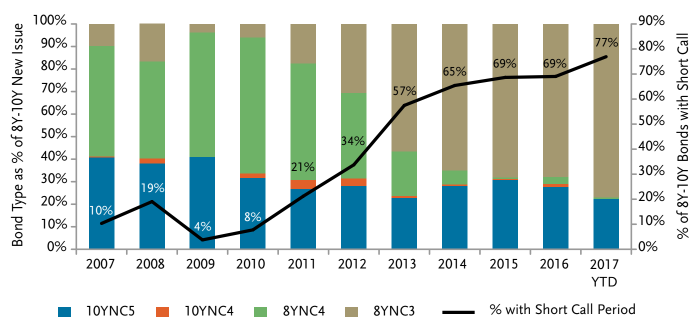
Less Upside: You Lose When You Win

While some issuers have been hard at work figuring out how to strip assets away from the restricted group, the rest of the market has been systematically destroying potential upside for high yield investors by shortening the call period for new issues, and by whittling away at bondholders' rights to make-whole call protection if a bond is called ahead of its first call date.

- **Deteriorating Call Protection**

  Historically, new issues in the high yield market were callable halfway through the life of the bond starting at a price equal to par plus half the coupon. Typical structures were ten-year bonds callable in five years ("10YNC5") or eight-year bonds callable in four years ("8YNC4"). Over time, the percentage of new bonds issued with call periods that are shorter than the historic norm has increased. In 2007, 11% of newly issued eight-year and ten-year callable bonds had shortened call periods (8YNC3 or 10YNC4). Year-to-date in 2017, 77% have shortened call periods.

Shorter Call Protection



Source: Bloomberg Barclays Capital

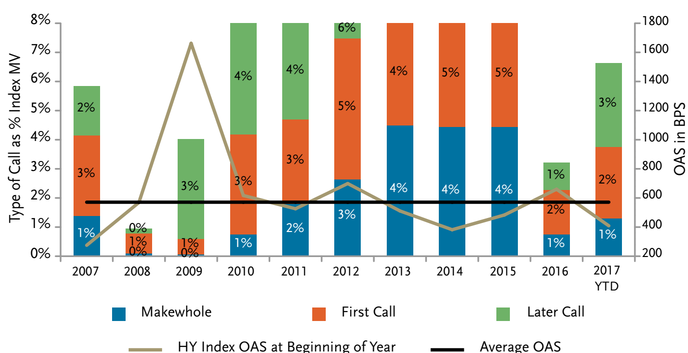
Why should bondholders care about the call structure of new bonds? Call options are a benefit to issuers, not bondholders, as they allow companies to pay off or refinance debt if it is in the company's interest. The investor is the seller of this option. Non-callable bonds and bonds that have not yet entered their call period typically can only be redeemed at the make-whole premium price, which typically equates to a yield of 50 bps over the Treasury yield to the date when the bond can be called. Reducing the call period for a newly issued eight-year bond from four to three years could "cost" bondholders four bond points of 'lost' upside if called one year after issuance.

Make-whole redemptions account for a disproportionately high percentage of the price return generated by high yield bonds in the year they are called. On average, 52% of the price return (defined as price return from year-end before call to call price) generated from bonds that were called

2 Pay in Kind whereby bond interest payments are not paid in cash but instead incremental bond principal.

each year from the Barclays U.S. Corporate High Yield Index was via make-whole redemption premiums to par, although make-wholes only comprised an average of 22% of the number of called bonds each year. Giving up the right to an additional year of make-whole call protection by accepting a shorter non-call period reduces the potential for investors to generate the highest premium price upon an optional redemption.

Percentage of Bonds Called Annually in Bloomberg Barclays U.S. Corporate High Yield Index



Source: Bloomberg Barclays Capital

- **Diluting Covenants That Lead to Make-Whole Redemptions**

  High yield bond issuers have taken a further step to reduce the likelihood of scenarios in which issuers might choose to utilize the make-whole redemption in order to facilitate shareholders' strategic priorities by diluting standard covenants in newly issued bond indentures. Recent modifications to standard RP, equity claw, and premium upon default provisions are all designed to reduce the likelihood of issuers needing to pay make-whole redemption premiums to bondholders to reward shareholders.

  Restricted Payments Covenants: RP covenants govern the amount of dividends, share buybacks, and other distributions to shareholders that high yield issuers can pay while the bonds in question remain outstanding. Two high yield issuers attempted to circumvent typical RP covenants in July 2017 in order to weaken bondholder protection.

  – Issuer D, a company that provides home automation services, issued high yield bonds this summer. The initial prospectus during the marketing process would have allowed Issuer D to sell the company within three years, raise leverage to as high as 6.25x, and keep the bonds in place if there was no downgrade regardless of whether the company had sufficient RP capacity to make a large payment to the sponsor in exchange for its equity in the company. Even if leverage exceeded the 6.25x limit or rating agencies downgraded the credit, the original language would have allowed the company to redeem the bonds at 101% instead of the 117% make-whole price that bondholders would typically have been entitled to for such a the transaction. Bondholders objected to the provision, and the odious terms were revised.

  – Issuer E, an insurance brokerage firm, also issued bonds this summer under an indenture that permits unlimited RP if total leverage is 5.0x or below. The company could be sold, benefitting shareholders, with bonds staying in place if leverage is 6.85x or less and the bonds maintain at least a B3/B rating. A typical make-whole redemption price would currently be around 118, but bondholders have effectively given up rights to it.

In addition, leverage-based RP tests, which allow companies to pay unlimited returns to shareholders as long as leverage is maintained below a certain threshold, are becoming more common. This less restrictive RP test was historically limited to companies that were perceived as having stable cash flows, but the provision is now extremely common. Covenant Review counts at least 200 high yield bonds in its database with a leverage-based RP test.

Equity Claws: High yield issuers have also been aggressive in expanding the potential use of the equity claw. The equity claw was originally intended to give high yield issuers an opportunity to call bonds using proceeds raised from a public equity offering. The feature typically allows for redemption of up to 35% of a bond at a price of par plus the coupon if the remaining 65% of the issue remains outstanding after the claw. Issuers choose to use the equity claw if bonds are trading at a higher price than the equity claw call price, a negative for bondholders. For example:

– Issuer F, an online education systems company, issued bonds this summer with indenture provisions that would allow the equity claw to be used in conjunction with any make-whole redemption of the notes.

– Issuer G attempted to issue bonds in early 2017 with an equity claw that would have allowed the issuer to redeem 100% of the notes versus the typical 35% limit. Bondholders resisted Issuer G's language, but

we expect to see continued attempts by companies to broaden the use of equity claws in order to reduce issuers' obligations to pay make-whole redemption premiums.

No Premium on Default Language: A particularly egregious version of event of default language started circulating in high yield bond indentures in late 2016. The "no premium upon default" provision was concocted in response to the 2016 Cash America International decision issued by the U.S. District Court for the Southern District of New York. The opinion ruled that bondholders are entitled to the make-whole redemption when an issuer voluntarily breaches covenants regardless of whether the issuer acted in bad faith. While the opinion was supportive of bondholders' rights, it suggested that issuers could draft language to allow for bond redemption at par upon voluntary default if they wished to avoid the make-whole. In response, 12 companies from across the ratings spectrum issued bonds under indentures that did just that. Credit investors pushed back, and the language largely disappeared after January 2017, although the language did resurface in an energy issuer indenture issued in April 2017. This covenant trend has the potential to introduce negative convexity to high yield bonds trading above par.

Deteriorating bond covenant and call protection trends should alarm credit investors. The ability to move assets out of the restricted group could substantially increase default risk and impair bondholder recoveries. Shortened call protection and removal of bondholders' rights to make-whole redemptions lowers the potential upside return for high yield investors. Similar to three card monte, odds are increasingly stacked against unsuspecting participants. Investors should more closely scrutinize these trends to fight against the prospect of more downside and less upside. ■

Sources: Covenant Review; Reorg Research; Bloomberg; Barclays Capital; Moody's

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