Feature

KEY POINTS

- The European high-yield bond market has seen significant issuances over the past two years (both in terms of number of issuances and volumes) and has seen numerous debut issuers.
- A driver of high-yield bond growth has been that high-yield bond covenants are typically incurrence covenants rather than maintenance covenants, not requiring the issuer to maintain any financial ratios. A number of bond issuers have used high-yield bonds to refinance credit facilities to take advantage of the flexibility afforded by less restrictive covenants in high-yield bonds.

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High-yield bonds: an introduction to material covenants and terms

European companies with corporate ratings below investment grade are increasingly relying on high-yield bond issuances for debt financing, including for refinancing existing debt, as well as for acquisition financing. The volume of European high-yield issuances increased by 53% in 2013 compared to 2012, with 174 issuers issuing 254 new bonds in 2013. Growth in the high-yield bond market in 2013 was supported by 79 debut issuers, up from 40 debut issuers in 2012. Issuers in the UK, Germany and France led the charge with €18.3bn, €15.3bn and €12.2bn, respectively, of issuances in 2013.[1] As high-yield bonds become an increasingly prevalent form of corporate financing in Europe, an understanding of the complex covenants that govern these instruments becomes important for potential issuers and investors. This article sets out some of the key covenants and other provisions customary in European high-yield bonds.

BASIC TERMS

High-yield bonds are fixed (or sometimes floating) interest rate securities, with a fixed term typically between five and 10 years, and are generally issued to institutional investors. They are issued pursuant to an indenture, which contains a number of restrictive covenants applicable to the issuer and its "restricted subsidiaries" – which are typically all subsidiaries of the issuer (the issuer group). High-yield bond covenants are generally "incurrence" covenants, regulating the issuer group's ability to take certain actions (eg, pay dividends, incur debt, enter into transactions with affiliates). High-yield bonds typically do not contain "maintenance covenants" requiring compliance with financial ratios on an ongoing basis, as is common with leveraged loans. The high-yield bond indenture contains a number of exceptions to these restrictive covenants. The exceptions to the restrictive covenants seek to strike a balance between providing bondholder protection (which can impact pricing of the bonds at issuance) and ensuring that the issuer has sufficient flexibility to operate its business.

High-yield bonds may either be secured or unsecured obligations of the issuer, and may benefit from subsidiary guarantees (which protect the bondholders from being structurally subordinated to other creditors).

An issuer may issue multiple tranches of high-yield bonds in the same offering, which may include bonds in different currencies (eg, euro and dollar tranches), with differing maturities and with different ranking or credit support (eg, senior secured and unsecured or subordinated tranches) and with different interest rate provisions (eg, fixed and floating rate tranches). Where multiple tranches are issued, the covenants are generally the same or similar for all of the bonds.

REDEMPTION

High-yield bonds will not normally contain any mandatory redemption provisions, although there is a requirement for the issuer to *offer* to repurchase the bonds in the case of a change of control and certain significant asset sales. Fixed rate high-yield bonds typically permit redemption of the bonds at the issuer's option in the circumstances described below.

Optional redemption

The issuer can redeem some or all of the high-yield bonds after the end of the non-call period, typically three or four years (in the case of a seven or eight year maturity) or five years (in the case of a 10-year maturity bond) at the principal amount, plus accrued interest, plus a premium. The premium is typically equal to between one half and three quarters of one year's interest payment in the first year that the bonds may be redeemed, with such premium declining each year following the first year the optional redemption feature is available.

Floating rate bonds are typically redeemable after one or two years, at a call premium of 1% or 2% declining to 0% after one or two years.

"Equity claw" redemption

Within the first three years after the high-yield bond is issued, the issuer can redeem up to 35% (or, increasingly, 40%) of the high-yield bond using the proceeds of certain equity offerings by the issuer. The redemption price is the principal amount, plus accrued interest, plus a premium equal to one year's interest payment. When exercising the equity claw, there is a requirement that at least 65% (or 60%, in the case of a 40% equity claw) of the bonds remain outstanding following completion of the redemption, so to the extent that bonds have already been repurchased or redeemed, that reduces the amount of bonds that can be redeemed under the equity claw.

10% redemption at 103%

The high-yield bond may contain a redemption feature which permits, at any time during the first three years of the bond, the issuer to redeem up to 10% of the bonds in any 12-month period by paying 103% of the principal amount, plus accrued interest.

Make whole redemption

The issuer can redeem some or all of the high-yield bond at any time prior to the time

the optional redemption feature is available by paying the principal amount, plus accrued interest, plus a "make whole" premium. The make whole premium is the amount of all interest payments due on the high-yield bond through the optional redemption date, plus the first call premium, discounted to the redemption date.

Tax redemption

If the issuer is required to pay withholding tax due to certain changes in tax laws after the issue date of the high-yield bond, the issuer can redeem the bonds by paying the principal amount plus accrued interest.

RESTRICTIVE COVENANTS

The indenture typically contains a number of covenants restricting the actions of the issuer and its restricted subsidiaries. All subsidiaries of the issuer will be considered "restricted subsidiaries" and subject to the covenants of the indenture, unless the issuer designates a subsidiary to be an "unrestricted subsidiary".

Subsidiaries can be designated as unrestricted subsidiaries at issuance or at a later time if certain tests are met. Unrestricted subsidiaries are not subject to the restrictive covenants of the indenture, but also do not count towards net income and EBITDA of the issuer when determining debt and restricted payment capacity, except to the extent the issuer actually receives cash from those subsidiaries. In addition, transactions between the issuer (or any restricted subsidiary) and unrestricted subsidiaries do not benefit from the exceptions from most of the bond covenants for transactions among the issuer and restricted subsidiaries. Thus, transactions with unrestricted subsidiaries are subject to the indenture covenants as if the unrestricted subsidiary were a third party.

The covenants for high-yield bonds are generally "incurrence" covenants, as opposed to "maintenance" covenants, more customary for a bank facility. The issuer will not typically be required to maintain any financial ratios, but will be restricted from taking certain actions unless it meets an exception from the relevant restrictions.

In addition, transactions among the issuer group are generally not subject to the restrictions of the indenture covenants. Some of the customary exceptions are described below. For a number of the covenants, there are specific "basket" exceptions, eg, credit facility or general debt baskets. More recently, in some indentures these baskets have "asset growers", eg, a basket may be the greater of €10m and a certain percentage of total assets (with the percentage set at the equivalent of €10m on the issue date).

Limitation on incurrence of debt and issuance of disqualified stock or preferred stock

This covenant limits any incurrence of debt by the issuer or its restricted subsidiaries. Disqualified stock (preferred stock which is mandatorily redeemable prior to the maturity date of the high-yield bond) and preferred stock of any non-guarantor subsidiaries are treated as debt for the purposes of this covenant. There is a separate covenant that limits liens, so even if an incurrence of debt is permitted under this covenant, that debt cannot be secured unless the security is a "permitted lien", or in the case of a lien on collateral for the bonds, a "permitted collateral lien." There are a number of exceptions to the general limitation on debt incurrences. Set out below is a summary of the most important customary exceptions.

The fixed charge coverage ratio test

The issuer and restricted subsidiaries (in some cases, limited to subsidiaries that are guarantors) may incur debt if, after giving pro forma effect to such incurrence and the use of proceeds, the "fixed charge coverage ratio" is at least 2.0 to 1.0. Alternatively, the general debt incurrence test may be a leverage test, as is typical for media and telecommunications issuers. The fixed charge coverage ratio is the ratio of consolidated EBITDA of the issuer and its restricted subsidiaries for the four fiscal quarters immediately prior to the transaction date to the aggregate fixed charges for such four quarters. The definition of EBITDA generally excludes unusual or non-cash charges (in addition to excluding taxes, interest, depreciation and amortisation) and will be subject to discussion between the issuer the underwriters.

Credit facility basket

The issuer and restricted subsidiaries (sometimes limited to guarantors) will be able to incur debt under credit facilities up to a fixed threshold. This is an important basket as this is one of the few significant categories of debt that can be secured.

Permitted refinancing debt

This exception permits the issuer group to incur debt which is used to refinance debt in existence on the issue date, permitted acquired debt and debt incurred under the fixed charge coverage ratio test, as well as debt that has been incurred under the refinancing exception. "Permitted refinancing debt" must meet certain conditions (eg, the new debt must not have a maturity date prior to the maturity of the debt to be refinanced and the principal amount must not increase).

Acquired debt

An acquisition of a company is deemed to be an incurrence of debt of the acquired company. The acquired debt exception permits the issuer group to incur debt of an acquired company that becomes a restricted subsidiary (other than debt incurred in contemplation of the acquisition), provided that, after giving effect to the acquisition, the issuer would be able to incur at least €1.00 of additional debt pursuant to the fixed coverage charge ratio test or (in some high-yield bonds) the fixed charge coverage ratio would not be worse than immediately prior to such incurrence. Some recent bonds permit an issuer to use this exception for debt incurred in order to finance the acquisition.

Capital leases

The issuer group can incur debt (including capital leases) for the purpose of financing construction or property improvements, provided the principal amount does not exceed a fixed threshold. In some high-yield bonds, the size of this basket has an "asset grower".

General debt basket

The issuer group will be able to incur debt under the general debt basket, which will be limited to a fixed amount of debt outstanding at any time. In some cases only the issuer and

guarantors can incur debt under this basket or there is a limit on non-guarantor debt of non-guarantors incurred under the basket. In many recent high-yield bonds, this basket has an "asset grower".

Other

There are a number of other exceptions to the debt incurrence covenant, including debt represented by hedging agreements, intercompany debt (ie, debt among the issuer group), guarantees of debt otherwise permitted to be incurred and debt with respect to letters of credit and bankers' acceptances issued in the ordinary course of business. Additional exceptions to the debt incurrence covenant are usually the subject of discussions between the issuer and the underwriters.

The debt covenant will typically give the issuer broad flexibility in designating the exception used for a particular debt incurrence, and to reclassify such debt at a later date – for example, debt incurred under the general basket can be reclassified under the fixed charge coverage test exception if capacity under that exception becomes available after the date of incurrence. Many indentures limit the issuer's ability to reclassify debt incurred under the credit facility basket.

Limitation on restricted payments

This covenant is designed to limit the distribution of cash or other assets to equity holders or otherwise "out of the system". Dividends and other distributions (including repurchases of equity), redemptions or repayments of subordinated obligations prior to maturity as well as "investments" are all considered "restricted payments", and cannot be made unless an exception is available. Set out below is a summary of some of the customary exceptions from the general limitation on restricted payments.

Restricted payment "build up"

The main source of restricted payment capacity is the "build up". The issuer group can make restricted payments using "build up," provided that (after giving effect to the restricted payment) there is no existing default and the issuer group is able to incur at least €1.00 of debt under the fixed charge coverage ratio test (discussed above). Generally, the "build up" is equal to 50% of consolidated net income accrued since the issue date (minus 100% of losses), plus certain capital contributions to the issuer and returns on or of restricted investments.[2]

Other exceptions to the limitation on restricted payments

The issuer group is allowed to make certain restricted payments regardless of the amount of the build up, although some of these payments will reduce the amount of the "build up" (to the extent of the payment). Some of the main exceptions are described below.

- Dividends paid by partly owned subsidiaries (eg, joint ventures).
- A restricted payment made with the proceeds of a substantially concurrent offering of capital stock of the issuer.
- Restricted payments using "excluded contributions".[3]
- Payments to the issuer's controlling shareholders and payments for management or advisory services, with some fees subject to a cap during any 12-month period under tax sharing arrangements.
- Repurchases of equity from management.
- Exception for any distributions where the leverage test is met. This is not a traditional exception from the restricted payment covenant, but has recently shown up in some European sponsor deals.[4]
- Post-IPO dividends, which can be paid regardless of general restricted payment capacity, up to the greater of (i) 5-6% of net cash proceeds from the IPO and (ii) 6-7% of market cap (or the greater of the percentage of the IPO market cap) and the market cap at the time of the dividend payment), with (ii) being subject to a leverage test.
- Dividend payments on preferred stock which are permitted to be incurred under the debt test.
- Other restricted payments in an aggregate amount not to exceed a general basket.

Permitted investments

The indenture restricts investments outside the issuer group. The definition of "investments" is broad and includes loans, acquisitions of securities and advances, as well as other investments which are considered an investment under the accounting standards of the issuer. Regardless of the amount of the "build up" or the fixed charge coverage ratio, the issuer group is allowed to make investments that are "permitted investments". There are a number of categories of permitted investments, including:

- investments in unrestricted subsidiaries and joint ventures in a related business in an aggregate amount that does not exceed a fixed threshold;
- investments that do not exceed a threshold (the general permitted investment basket).

Investment baskets usually exceed the amount of the general restricted payment baskets, as investments are preferable to distributions from a bondholder's perspective and, in some cases, have "asset growers". In addition, there are a number of additional permitted investments, which generally cover ordinary course investments.

Transactions within the issuer group (eg, dividends by subsidiaries to the issuer, or investments in restricted subsidiaries) are generally not subject to limitation under the restricted payment covenant.

Transactions with affiliates

This covenant generally covers transactions between the issuer group and "affiliates," which includes any company directly or indirectly controlling the issuer or controlled by the issuer or under common control with the issuer. This covenant is designed to limit "self-dealing" transactions with related parties which could result in value leakage from the issuer group. Transactions among the issuer group are not restricted by this covenant. A direct or indirect holder of at least 10% of the stock of a person may be considered an affiliate for purposes of this covenant. Generally, transactions with affiliates must meet the following requirements:

- such transactions must be no less favourable to the issuer group than those that could be obtained in an arm's length transaction;
- transactions with a value over a certain threshold must be approved by disinterested members of the board of directors;
- transactions with a value over a certain

(higher) threshold require an independent fairness opinion (which can be costly and time consuming). In some recent sponsor deals, there is no such opinion requirement.

There are certain exceptions to the requirements described above, including for transactions pursuant to agreements in effect on the issue date, transactions with a value below a *de minimis* threshold, certain permitted investments, ordinary course commercial transactions (eg, purchase and supply agreements) on arm's length terms and restricted payments which comply with the restricted payment covenant.

Limitation on dividend and other payment restrictions affecting restricted subsidiaries

This covenant prohibits restrictions at restricted subsidiaries that limit the ability of those subsidiaries to pay dividends (so-called "dividend stoppers"), transfer assets or make loans to the issuer. This covenant is designed to ensure that the issuer has adequate access to the cash flow of its subsidiaries in order to service payments on the high-yield bond and other obligations.

There are a number of exceptions to this general limitation, including exceptions for restrictions in existing obligations and those imposed by law. Some of the additional exceptions include:

- restrictions existing under credit facilities permitted under the indenture;
- customary provisions in joint venture agreements;
- encumbrances imposed by extensions, renewals, etc, of a permitted restriction, provided the encumbrance is not more restrictive than prior to the renewal, extension;
- encumbrances and restrictions imposed by any instrument relating to debt, provided that the instrument is customary in comparable financings and is not materially less favourable to the bondholders than is customary in such financings.

Limitation on asset sales

This covenant requires that proceeds of significant divestitures be used to invest in other assets or reduce debt. Generally, this covenant requires for asset sales:

- receipt of fair market value;
- that 75% of consideration consists of cash (although replacement assets or other assets usable in the issuer's business are generally considered cash for the purposes of this test);[5]
- net cash proceeds be applied within 365 days to repay certain debt (that is *pari passu* with or senior to the bonds), or acquire all or substantially all of the assets or a majority of the voting stock of a company or invest in long term assets or make capital expenditures. The priority of debt repayment is specified in the asset sale covenant (ie, what debt can be repaid before offering to repurchase the high-yield bonds).

Customary exceptions from this covenant include many ordinary course of business dispositions of assets, including the following: (i) dispositions of cash, inventory and other assets acquired and held for resale, or damaged, worn out or obsolete assets; and (ii) any disposition in a transaction or series of related transactions of assets with a fair market value of less than a *de minimis* threshold.

To the extent that the issuer group does not use the proceeds from asset sales in accordance with the requirements set out above, the issuer is required to use the excess proceeds (in excess of a *de minimis* threshold) to make an offer to purchase the high-yield bond at 100% of the principal amount plus accrued interest. In practice, asset sale offers are relatively uncommon due to broad permitted use of proceeds from an asset sale.

Limitation on liens

This covenant is designed to limit the amount of debt that is effectively senior to the high-yield bond through the grant of liens securing other debt. If the issuer group incurs liens other than "permitted liens," this covenant requires that the high-yield bonds be equally secured.

A typical high-yield bond has numerous permitted liens, most of which are technical in nature, and designed to ensure that liens incurred in the ordinary course of business, or securing items that are generally not considered to be debt, are not prohibited by the high-yield bond indenture. Exceptions include liens securing capital lease obligations (up to a threshold) and acquired liens. There is also a general permitted lien basket, which is typically quite small.

For secured bonds, any lien on bond collateral must be a "permitted collateral lien", which typically includes liens securing debt under the credit facility basket, liens securing certain hedging obligations, possibly liens securing debt under the general basket and liens securing debt incurred under the general fixed charge coverage ratio test, subject to a senior secured leverage test.

Consolidation, merger or sale of assets – issuer/guarantors

There are limits on mergers of the issuer and guarantors into other entities or the transfer of substantially all of the assets of the issuer or a guarantor. This covenant requires that the issuer/guarantor or its successor remain incorporated in a certain jurisdiction (eg, the European Union), and, in the case of a merger of the issuer, that the fixed charged coverage ratio test be at least 2:1 (or not be worse) after giving effect to the merger.

Financial reports

The high-yield bond indenture will require the issuer to publish an annual report, quarterly reports for the first three quarters of the year and event-based reports. This covenant typically requires the issuer to provide to bondholders an annual report within 120 days after the end of the issuer's fiscal year and a quarterly report within 60 days following the end of each of the first three fiscal quarters in each fiscal year. The reports are usually required to include:

(a) audited annual consolidated financial statements (in the case of annual reports) or unaudited consolidated financial statements (in the case of quarterly reports) of the issuer;
(b) a "management's discussion and analysis of financial condition and results of operations";
(c) a presentation of EBITDA;
(d) a description of the business, management and shareholders of the issuer; and
(e) a description of material risk factors.

Biog box

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In some high-yield bonds, the issuer is required to conduct an investor conference call following delivery of each annual or quarterly report. If the issuer has agreed to register the high-yield bond with the US Securities and Exchange Commission (SEC) (which is unusual for European high-yield bonds), the reporting covenant requires the issuer to file reports required under SEC rules and regulations.

Change of control

This covenant requires the issuer to make an offer to purchase all of the high-yield bonds at 101% in the event of a "change of control." Change of control trigger events may include the following:

- a "person" or "group" (other than a permitted holder) becomes the beneficial owner, directly or indirectly, of more than a threshold percentage (30% to 50%) of the total voting stock of the issuer;
- a majority of the issuer's board changes (excluding changes approved by the then existing board);
- a transfer of substantially all of the issuer group's assets to a third party;
- adoption of a plan of liquidation and dissolution of the issuer.

Some high-yield bonds include a double trigger change of control covenant, meaning there is only a requirement to make a change of control offer if there is a change of control event, which is followed by a ratings downgrade. More recently, some bonds contain a "portability" feature, which is an exception from the requirement to make a change of control offer in connection with a sale of the issuer or its business where a leverage test is met. A change of control provision in a bond differs from a prepayment event in a typical credit facility, as it only requires an offer to repurchase the bonds following a change of control – depending on the trading price of the bonds – bondholders may not accept the offer.

EVENTS OF DEFAULT

An indenture will typically include a series of conditions that, if breached, will trigger a default of the indenture. Events of default typically include:

- failure to pay principal when due and payable at maturity, upon acceleration or redemption;
- failure to pay interest (30-day grace period);
- covenant defaults – typically 60-day grace period after written notice to the issuer by the trustee or to the issuer and the trustee by the holders of 25% or more in aggregate of the principal amount of the high-yield bond;
- cross acceleration to other debt of the issuer group in excess of a threshold;[5]
- others include unsatisfied judgments in excess of a threshold, bankruptcy and invalidity of guarantees.

AMENDMENTS AND WAIVERS

As a general matter, any amendments to or waivers from compliance with the covenants will require approval of the bondholders. Such amendments may be more difficult to obtain than similar amendments to a bank loan as high-yield bonds are more widely held than bank debt. Amendments typically require approval
as follows:

- no consent of holders is required for amendments that are administrative in nature or to cure ambiguities;
- consent of 90% of holders is typically required for a change in principal amount, maturity, interest rate, time for payment, currency, ranking, etc, (essentially the "money" terms). For bonds registered with the SEC (which is unusual for European high-yield bonds) these amendments require the consent of each holder affected (to comply with US legal requirements);
- the consent of a majority of holders is required for anything else (typically covenant amendments or waivers).

CONCLUSION

High-yield bonds permit the issuer group to operate its business with a significant amount of freedom while providing investors with greater yield in a time of low interest rates. The complex terms of the indenture, if properly drafted, provide the basis upon which issuers can maximise operational flexibility while providing bondholders with greater protection. ■

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1 Debtwire Analytics, Bonds Fly to Record High on All-time Low Yields: European High Yield Report (January 2013).

2 Bonds issued in series typically grandfather restricted payment build-up to date of first bond issue (so the issuer doesn't need to reset restricted payment capacity with each new bond issue). Also, when bonds are issued to replace a bridge, restricted payment build-up is typically backdated to date of bridge. Grandfathering in other contexts is not really common.

3 "Excluded contributions", generally found in bonds for issues controlled by private equity firms or "sponsors", are equity contributions or issuances of subordinated shareholder debt (debt from parent or an affiliate that is subordinated and does not pay cash until after bonds mature) which can be designated as "excluded contributions" so that they are available for restricted payments at any time, whether or not there is restricted payment "build-up." In some bonds, excluded contributions can only be used for investments, in others for any restricted payments.

4 Covenants of high-yield bonds issued by portfolio companies of private equity firms (or, "sponsor deals") tend to have less restrictive covenants, in particular with regard to restricted payments.

5 Some recent deals allow the issuer to designate certain proceeds up to a threshold (designated non-cash consideration) as cash for purposes of the 75% cash requirement.