DEBT CAPITAL MARKETS BRIEFING

High yield bond provisions: crossing the Atlantic

Fluctuations in exchange rates and interest rates in the US and European markets, as well as a desire to issue debt in local currencies, for example to finance acquisitions, has led some US issuers to sell high yield bonds in Europe and European issuers to access the US market. In the first two months of 2015, two US companies have come to the European high yield market, with possibly more to come.

High yield bonds spread from the US market to the European markets in the 1990s and became an important source of financing in Europe in the 2000s. European high yield bonds are typically issued under a New York law governed indenture that contains covenants that were originally derived from, and are generally similar to, covenants in a US high yield bond. However, the US and European markets are separate and distinct, and differences in covenants have developed, particularly in recent years. The differences can be more stark in sponsor deals (that is, high yield bonds issued by private equity portfolio companies) as sponsor deals tend to include more issuer-favourable covenants.

Redemption

If an issuer redeems any of its bonds during a certain period following their initial issuance, the issuer is typically required to pay a "make whole" premium, which includes interest that would have been paid up to the first redemption date, plus a premium. This is known as "call protection". There are exceptions to call protection, and these exceptions differ between US and European markets.

Equity claw. An equity claw redemption permits the issuer to use the proceeds of public or private equity issuances to redeem a portion of the outstanding bonds, traditionally 35%, as long as a certain percentage of the originally issued bonds remains outstanding, traditionally 65%. Recently, in both markets, some bonds have permitted redemption of 40% of the originally issued bonds using the equity claw. Generally, 65% or 60% (depending on whether the equity claw is 35% or 40%, respectively) of the originally issued bonds must remain outstanding after using the equity claw, limiting the usefulness of the provision if any of the bonds have been redeemed previously. However, in some US sponsor issuances, just 50% of the bonds must remain outstanding after the equity claw redemption.

Floating rate bonds. Floating rate bonds typically have much shorter call protection and a lower initial redemption premium than fixed rate bonds. In the US, most floating rate bonds are investment grade rated but in Europe, floating rate high yield bonds are common. In both the US and Europe, an issuer can typically redeem its floating rate bonds one year after issuance by paying 101% of the principal amount. However, recently in Europe, some bonds have permitted the issuer to redeem the bonds at par (that is, with no premium) immediately after the no-call period (just one year after issuance).

Change of control

On a change of control of the issuer, a high yield bond typically requires the issuer, or its buyer, to make an offer to repurchase all of the bonds at 101% of the principal amount, plus accrued interest. In different ways, both the US and European markets provide some flexibility for an issuer that undergoes a change of control.

Portability. Since 2013, portable change of control provisions, where the issuer is not required to make an offer to repurchase on a change of control if it meets a leverage ratio on a pro forma basis, are becoming increasingly common in Europe, particularly for sponsor issuances. Portability appeared in the US in 2013, but has not caught on. In the US market, issuers with stronger credit ratings may have a double-trigger change of control provision, requiring issuers to make an offer to repurchase only if the bonds also suffer a ratings downgrade following a change of control. Unlike the double-trigger, portability does not depend on a third-party rating agency and therefore provides certainty as to whether an offer to repurchase will be required. The double trigger also has been featured in some European issuances but the portable change of control provision is more popular with issuers.

Drag-along right. In the US, a growing number of bonds permit the issuer to "drag along" non-participating bondholders if at least 90% of the outstanding principal amount of the bonds is tendered in a change of control offer. This allows the issuer (and its buyer) to clean up the issuer's capital structure and avoids a hold out by a small minority of bondholders, which is particularly useful to an issuer where the change of control occurs before the end of the no-call period. Drag-along rights remain rare in Europe.

Issuer call. Recently in the US, a limited number of bonds have given the issuer a call right to redeem all of its bonds on a change of control for a set price, often at a substantial premium and usually for a limited period post-issuance. This contrasts with the traditional change of control provision which requires the issuer to offer to redeem the bonds, but does not require holders to accept the offer. The feature tends to be deal specific, for example, where a sponsor is contemplating a near-term transaction. This provision has not yet been seen in Europe.

Debt covenant

A high yield bond limits an issuer's ability to incur debt, with certain exceptions, including the satisfaction of an interest coverage or leverage ratio. The debt covenant also includes a series of carve-outs (including "baskets"). Both US and European markets provide issuers with flexibility to incur debt under the covenant, however, there are differences between these markets.

Secured debt in unsecured bonds. Traditionally, unsecured high yield bonds contain negative pledge provisions, which restrict an issuer's ability to secure other debt unless the bonds are equally and ratably secured, with certain baskets and exceptions. However, approximately half of the unsecured issuances in the US in 2013 and 2014 permit the issuer to incur secured debt without complying with the negative pledge covenant, provided that a leverage ratio is met. In Europe, this type of exception to the negative pledge covenant in unsecured issuances is not common. Unsecured bonds in Europe, however, do permit some secured debt, typically limited to a (usually small) basket.

Subordinated shareholder funding. Subordinated shareholder funding is debt advanced by an issuer's shareholder that is deeply subordinated to the bonds and cannot be repaid in cash before the bonds mature. Many recent European high yield issuances exclude this from the definition of debt, so such funding is not limited and does not count towards coverage or leverage ratios in the bonds for other debt issuances. European investors accept subordinated shareholder debt as it is truly subordinated to the bonds and enables a parent company to provide the issuer with funding that can never be repaid prior to the bonds. In the US, this exception is not customary.

Restricted payments

The restricted payment covenant in a high yield bond limits dividends and other distributions, prepayments of subordinated debt, repurchases of the issuer's equity, and certain investments. It prevents issuers from extracting cash from the business (or investing cash in uncontrolled entities) except to the extent of restricted payment build-up and certain carve-outs.

Typically, the restricted payment build-up permits restricted payments of up to 50% of the issuer's net income (less 100% of losses) plus the net proceeds from certain equity issuances plus returns on certain investments accumulated from the date of issuance of the bond, provided that the issuer meets the fixed charge coverage ratio and there is no default. Recent issuances have indicated some key differences between the US and Europe in carve-outs to the restricted payment covenant.

Starter basket. Traditionally, an issuer started with zero restricted payment build-up, and this remains the case for the European high yield market (with the exception of regular issuers of bonds, where the start date is often fixed in the first bond issuance and later issuances use the same start date). In contrast, some US issuances provide for a fixed dollar amount starter basket for the traditional restricted payment build-up, increasing the amount of restricted payments that can be made and permitting the issuer to immediately avail itself of the restricted payment build-up.

Leverage ratio exception. The leverage ratio exception permits the issuer to make any restricted payments if it is able to meet a certain leverage ratio regardless of restricted payment build-up. Nearly all recently issued European sponsor deals have a leverage ratio carve-out with the maximum leverage typically between 2:1 and 3:1. In the US, it is less common, although the US market showed some willingness to accept this carve-out in 2014.

Post-IPO dividend carve-out. In most US sponsor deals, there is a carve-out from the general limitation on restricted payments for payment of dividends following an initial public offering (IPO), with dividends limited to a percentage of IPO proceeds received by the issuer, typically 6%. This carve-out is also common in Europe, although in Europe the carve-out typically permits post-IPO dividends up to the greater of a percentage of IPO proceeds and a percentage of the issuer's market capitalisation subject to a leverage test. This more flexible carve-out has recently been seen in a limited number of US deals.

Asset sales

A high yield bond places certain restrictions on asset sales. The US market provides issuers with greater flexibility for asset sales above a de minimis threshold.

Percentage cash required. Traditionally, US and European bonds have required that 75% of the consideration from an asset sale be cash or cash equivalents. However, in the US, lower percentages have become customary for particular industries, such as 70% for home-builder issuers. The European market has remained steadfast at 75%.

Proceed usage period. In both the US and European markets, proceeds from an asset sale may only be used for certain designated purposes and, typically, must be so used within 365 days (with another 180 days available if a binding commitment is in place). If the proceeds are not so used the issuer must make an offer to repurchase the bonds (at 100% of principal amount plus interest) if there are net proceeds in excess of a specified amount. The US market has begun to allow issuers up to 450 days to use the asset sale proceeds. The European market has started to follow the US trend, with a few recent bonds giving the issuer additional time to use the asset sale proceeds.

Affiliate transactions

High yield bonds typically regulate affiliate transactions by requiring transactions that exceed a specified threshold to be on arm's-length terms, while those above a higher threshold require approval of a majority of the board of directors or a majority of disinterested directors, and for those above an even higher threshold, an independent fairness opinion is required. In a growing number of US high yield issuances, issuers are not required to obtain fairness opinions. Although less common, this trend is beginning to be embraced in the European market (mostly sponsor deals).

Reporting

In the US and Europe, bond indentures require quarterly and significant event reporting. Bond reporting requirements are usually more onerous in the US, requiring issuers to become a US Securities and Exchange Commission (SEC) reporting company or issue reports consistent with SEC reporting requirements and hold quarterly conference calls with bondholders. European reporting requirements tend to be lighter, with quarterly conference calls, although not traditionally required, increasingly being required.

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