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Strong Finish to 2019 Offers Promising 2020 for US and European High-Yield Markets

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In 2019, a wave of bond-to-bond refinancings, as well as significant bank and term loan-to-bond refinancings, punctuated a strong year for debt financings after a slow first quarter. Throughout last year, debt investors balanced the confidence they gained from solid fundamentals with the ongoing uncertainty over Brexit, global economic unease and trade wars. Companies with strong balance sheets and well-known credits reaped the rewards of lower yields and flexible covenants, as interest rates hit — as described by Bank of America Merrill Lynch's head of global research — "5,000-year lows."

A year-to-year reduction in the number of issuances driven by mergers and acquisitions kept the high-yield market from reaching record highs and resulted in refinancings leading the market. In the United States, year-to-date issuances as of the end of November amounted to over $235 billion, an increase of 41% over 2018. Of that amount, new issuances accounted for 41% of overall issuances (for a total of $97 billion), down from 53% in 2018 (for a total of $90 billion). The European high-yield market edged higher as well, ending 2019 with more than €70 billion in high-yield and more than 150 issuances, up from €63.5 billion and 125 issuances in 2018, finishing stronger in the last quarter, with the highest level of issuances since the fourth quarter of 2017. (Sources: Debtwire, S&P Capital IQ and Xtract Research.)

A number of key trends dominated both U.S. and European markets:

Reverse Yankee Bonds. U.S. issuers generally shied away from European markets during the first three quarters of 2019, with reverse Yankee issuances (*i.e.*, bonds issued by U.S. companies outside the U.S., in non-U.S. currencies) down more than 50% from record highs in 2017 and 2018. The decline was driven in part by U.S. issuers preferring the depth of the U.S. markets and finding superior overall pricing by issuing directly in dollars rather than in euros and then swapping into dollars. The fourth quarter of 2019, however, was the busiest for reverse Yankee issuances since the first quarter of 2018, suggesting that 2020 may be promising for U.S. issuers looking to Europe.

Libor. Although market participants have known of the impending end of the London Interbank Offered Rate (Libor) since 2017, solutions have been slow to develop, and the lack of a settled approach has continued to weigh on the market. The European markets gradually developed several variations for alternatives in 2018 and 2019 in the event of the unavailability of Libor — so-called "fallback" language for the European Interbank Offered Rate (Euribor) — although consensus has not been reached. Sterling high-yield issuances saw their lowest volume of the decade, and floating-rate issuances have been limited in recent years, but two floating-rate high-yield issuances came to market in Europe in 2019. The U.S. markets experienced greater stability as market participants began to warm to the Alternative Reference Rates Committee's (ARRC) suggested fallback language. As the end of Libor draws closer, the markets will need to continue to align on the appropriate fallback provisions for new issuances.

Leverage-Based Flexibility. Increasingly, issuers face fewer covenant restrictions when they achieve a particular leverage ratio (typically, debt or net debt to earnings before interest, tax, depreciation and amortization, or EBITDA). For example, since the start of the 2010s, many indentures have provided that limits

on "restricted payments" (including dividends, loans and investments) no longer apply once a leverage test is met. More recently, indentures have given issuers the option to incur unsecured debt upon meeting either a fixed-charge coverage-ratio test (the ratio of interest and similar expenses to EBITDA) or a leverage-ratio test. Similarly, 2019 saw issuers include a leverage-based asset sale step-down clause (as documented by covenant review services) more frequently. These clauses allow the issuer to lower (or "step down") the proportion of proceeds from an asset sale that it must apply to repay senior debt or for other permitted applications in accordance with the asset sale covenant if it meets a leverage test.

Finally, a growing number of bond issuances permit unlimited investments, provided that a leverage test is met. The relaxation of covenant restrictions has typically been conditioned upon some improvement post-issuance — *i.e.*, the ratio that an issuer had to meet to benefit from the covenant relief required improving its leverage ratio. However, the leverage ratios that must be met are, more and more frequently, closer to the leverage of an issuer at the time of issuance, enabling issuers to benefit from additional flexibility through more relaxed covenants by only maintaining or modestly improving leverage.

Anti-Net Short. In 2019, high-yield issuers also were focused on crafting innovative solutions to protect themselves from the recent wave of "net-short debt activism." Issuers have become concerned that bondholders who held short positions in issuers' derivative instruments had found ways to assert covenant defaults to put issuers into default. Different approaches have been explored for dealing with such "net-short" bondholders, including changes in provisions relating to voting mechanics, instructions for amendments, waivers, and actions upon defaults or events of defaults. However, the market has not adopted a single approach to net-short bondholders. Issuers are trying to balance these new and necessary protections with their impacts on investors and the marketability of their bonds; many investors have resisted the addition of any such protections, which they perceive as disenfranchising investors.

Changes in Lease Accounting in IFRS. On January 1, 2019, International Financial Reporting Standard (IFRS) 16 (Leases) came into effect, changing the accounting treatment for leases. Previously, leases had been accounted for as either operating leases or finance leases, but IFRS 16 abolished that distinction, leading to an asset being recorded on the balance sheet at the beginning of the lease and then depreciating over the life of the lease. The impact of this change has varied depending on the industry, but it has affected bond covenants in a number of areas, including net income, which influences capacity for dividends and other restricted payments, and EBITDA, which impacts various line items and therefore borrowing capacity, as well as certain other financial measures used in covenants.

Issuers have taken different approaches to dealing with the impact of IFRS 16 on bond documentation, with some "freezing" accounting standards to a date prior to the adoption of IFRS 16 and others not making any adjustments (and accepting the impact of IFRS on covenant calculations). Some issuers have provided a detailed reconciliation on a pre- and post-IFRS basis in bond offering documentation to show the impact to investors. The U.S. Financial Accounting Standards Board opted not to make a similar change to Accounting Standards Committee 842, despite adopting other changes to the lease accounting rules that became effective in 2019.

Outlook

The market in 2019 ended on a high note, and global bond issuances are expected to increase going into 2020 on account of low interest rates. An influx in M&A supply and strong fundamentals have generated optimism for the high-yield markets next year.