European High-Yield Market Responds to COVID-19

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While the outbreak of COVID-19 brought primary issuances of high-yield in Europe to a standstill starting in late February 2020 (lasting close to two months), in June the markets resumed the brisk pace of primary issuances that took place in January and February. Total European high-yield issuances by volume in the first half of 2020 were only slightly below the same period in 2019. Both sponsor-backed and debut issuers increased, but issuances by public companies were down compared to the same period in 2019, as many public companies were hesitant to increase leverage during the crisis and focused instead on equity and convertible notes.

Despite the pandemic's impact on businesses, and while markets have been tempered with caution around the current macroeconomic environment, attractive interest rates and investor appetite for new issuances have resulted in a healthy rebound from the February/March slump. A number of key trends have emerged in this area following the return to market, including the pandemic's impact on EBITDA (earnings before interest, tax, depreciation and amortization) and the use of redemption provisions to factor in participation in government aid programs offered during COVID-19. These trends indicate a focus on ensuring the high-yield product remains responsive to the current environment and the challenges the pandemic may pose on businesses.

Impact of COVID-19 on EBITDA

EBITDA for the trailing four quarters — with adjustments — is an important component of high-yield documentation, generally an element in determining an issuer's ability to make restricted payments (such as dividends, payments of subordinated indebtedness and investments) and incur additional indebtedness. Many permitted transaction "baskets" and ratios are calculated, in part, by reference to EBITDA. Many businesses impacted by the pandemic, including those in the travel, leisure, hospitality, transportation, and oil and gas industries, experienced precipitous declines in EBITDA.

The definition of EBITDA in high-yield documentation typically excludes certain "extraordinary, unusual or non-recurring" expenses and allows for EBITDA to be adjusted for certain synergies. A relatively recent trend reflected in some bond indentures allows an issuer to "lock in" the highest 12-month EBITDA experienced over the life of the indenture (*i.e.*, since issuance) for the purposes of measuring covenant compliance and baskets. These provisions may mitigate the impact of COVID-19 on an issuer's EBITDA and the related effect on its covenants. In addition, some bonds issued following the initial outbreak of COVID-19 in the United States and Europe include an explicit adjustment provision in EBITDA to exclude the impacts of COVID-19.

As well as its role in covenant and basket calculations, EBITDA is an important financial measure presented in the marketing of a new bond issuance. (It is worth noting that the definition of EBITDA used for marketing purposes may differ from that used for purposes of indenture covenants, with covenant EBITDA typically being more favorable to the company.) In some post-initial outbreak bonds, issuers have published EBITDA figures that exclude the effects of COVID-19 (referred to as EBITDAC, or EBITDA minus the impact of COVID-19), typically leaving out certain cost but not revenue effects of COVID-19, giving bond investors a clearer picture of the business absent the effects of the current pandemic.

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Leverage-Based Carve-Outs

A now common provision in high-yield documentation gives an issuer the ability to make unlimited restricted payments when a leverage test (typically based on net leverage) is met. An important element of this provision is how the relevant threshold is set versus the issuer's leverage at the time the bond is issued. Approximately one-third of such issuers in the first half of 2020 set the leverage threshold at or below their leverage at issuance. A more recent trend over the past couple years is to permit unlimited "investments" — namely, making loans and acquiring securities including minority interests — if a net leverage test is met. This threshold is typically set at a higher level (*i.e.*, it is easier to meet) than the general ability to make unlimited restricted payments if the leverage test is met. A leveraged-based permitted investment test typically set at or above opening leverage gives issuers who have the strategy of making investments (whether in the form of joint ventures or otherwise) flexibility to continue to pursue that strategy provided their leverage does not increase substantially. Unlike dividends and distributions, bond investors often view investments made in accordance with a defined strategy as positive (or at least neutral) to their investment, and therefore the exceptions for investments are generally more permissive than the exceptions for restricted payments generally.

Investor Focus

Investor scrutiny of covenant packages carried over from 2019, and in some cases bond terms were amended between launch and pricing in response to investor feedback. Based on public sources, one such example is the bond offering for the ThyssenKrupp Elevator buyout.

COVID-19 Redemption Provisions

Many governments across the globe have instituted financial support programs aiming to alleviate the economic burden of COVID-19 on companies. Some issuers of high-yield debt have contemplated both issuing new high-yield debt and participating in existing and future schemes. High-yield bonds are typically redeemable only at a "make-whole" amount (equal to future interest payments plus principal) during a "noncall" period in the first few years following bond issuance. In the post-initial outbreak environment, some issuers that anticipated participating in government-supported schemes (at a lower cost than available in the high-yield market) included a special redemption provision that allows the issuer to redeem up to 40% of the aggregate principal amount of the notes — during the noncall period — with the net proceeds from any COVID-19-related regulatory debt at a premium equal to one-half of the annual coupon. Typically, this provision must be exercised within a narrow window of time shortly after the bond's issuance. More issuers may seek to avail themselves of this type of redemption provision if governments signal an intention to provide further rounds of economic support in the fall and winter.

Post-Closing Security

For some secured bonds, due to the time required to complete formalities if pledging assets to secure the bonds, the issuer is permitted under the terms of the bond indenture to complete the process for putting pledges in place during a specified period of time after bond issuance. In some bonds, guarantees may also be put in place during such a post-issuance period. The typical formalities required to pledge assets to secure bonds, such as notarizations, filings and other steps needed to complete the pledge process, have proven to be a logistical challenge due to health and safety measures put in place to address the pandemic.

As a result, for some new issuances, bond documentation has included longer timelines to put in place post-closing security and guarantees in the event that COVID-19 prevents them from taking the steps required to execute perfection or guarantee, such as if notary meetings cannot take place. In many cases, such extended deadlines may be indefinite.

Amendments, Exchanges and Disputes

The COVID-19 pandemic and significant impact on many industries have led to a number of issuers seeking consents to take actions otherwise restricted under the indenture (*e.g.*, to incur additional debt), "up-tiering" exchange offers and other "liability management" exercises. In some cases, these have resulted in disputes with bondholders as to whether actions taken by the issuer are permitted under the bond indenture. Several such disputes have also led to litigation.

Conclusion

Despite the business interruption COVID-19 has caused, especially early in the year, the European high-yield market remains strong. Adaptation to the current environment and innovation in bond terms and covenants continue to characterize the high-yield market in these unparalleled times.