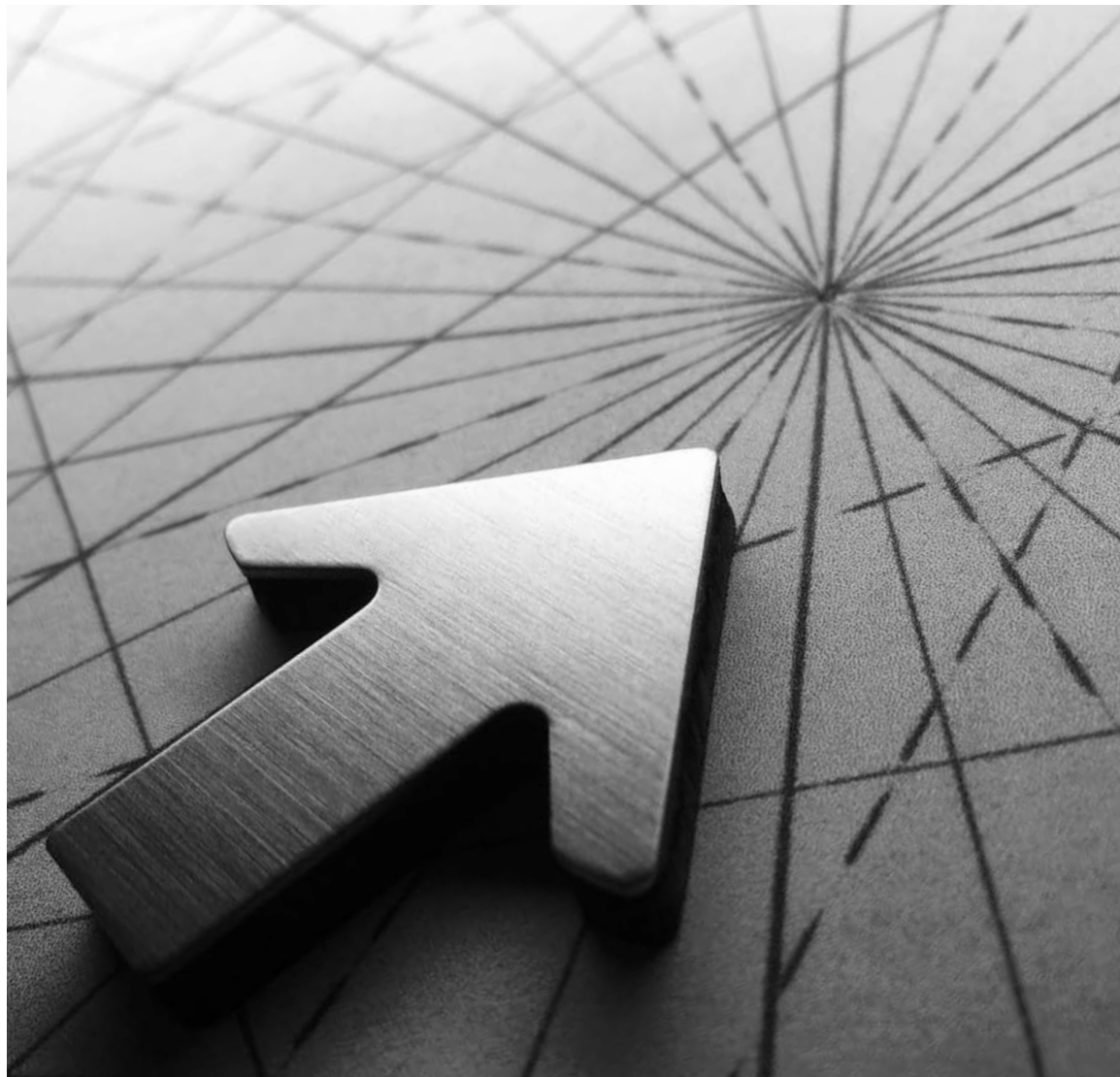


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High yield bonds and leveraged loans

A CONVERGENCE OF TERMS

2018







Over the last decade or so, Europe has witnessed a gradual (but accelerating) “convergence” between the traditional LMA-style leveraged loan, Term Loan B (TLB) and high yield bond markets. In this article, we explore some of the factors contributing to this phenomenon which include, among others, increasing sponsor influence and a converging investor base, driven by changes in the macro-economic environment and industry regulation.

In this article we highlight some of the key commercial terms in which we are observing a continued evolution of “convergence” across the various product types. Although typically described as multilateral or bilateral convergence, we note the general trend is better described as a unidirectional shift. The overall trend in the market being a shift away from LMA-style loan terms toward “covenant-lite” structures (i.e. structures with one or two financial covenants instead of the four in traditional LMA-style loans) to US-style TLB (or high yield in disguise) structures (i.e. structures with New York law governed high yield style incurrence covenants, with a springing financial covenant for RCF lenders only and minimal loan-style call protection). In turn, TLB structures are gradually adopting features more traditionally found in high yield bonds.

Current indication is that the factors contributing to the convergence trend will continue to evolve. If that is the case, products which historically represented two separate asset classes will gradually become increasingly indistinguishable and pricing spreads will narrow. In that regard, competition between traditional bank lenders and other debt investors will intensify and borrowers will have much more flexibility in choosing the method of financing that best meet their pricing demands and debt capital management priorities.

Recent Trends

The trend in the European leveraged loan market towards “covenant-lite” structures and US-style TLBs or “high yields in disguise” is unmistakable. In the first half of 2017, “cov-lite” loans represented more than three-quarters of all senior secured leveraged loans in the market, compared to less than half in all of 2016 and just a quarter in 2015, and the trend appears to be continuing for the second half of 2017.



Below is a snapshot of the four major types of leveraged products currently in the market:

High Yield Bonds

- Sold under registration exemptions
- Restricted group/incurrence covenants (no maintenance covenants)
- Increasingly available for smaller deals (c. €350m)
- Bullet maturity

Traditional LMA Leveraged Loans

- LMA-style undertaking package
- Four maintenance covenants
- Large number of restrictions
- Certain deal-specific exemptions
- Traditional finance sources (e.g. banks)
- Amortized payments

US Term Loan B

- Syndicated loans
- No maintenance covenants, with springing RCF maintenance covenant
- Increasingly bond-like flexibility
- Non-traditional finance sources (e.g. CLOs)
- Bullet maturity

European Cov-Lite/Cov-Loose

- Cov-Lite has similar covenants to US TLB
- Cov-Loose typically has 1-2 maintenance covenants (net leverage plus interest cover or single net leverage covenant)
- Tested quarterly
- Amortized payments

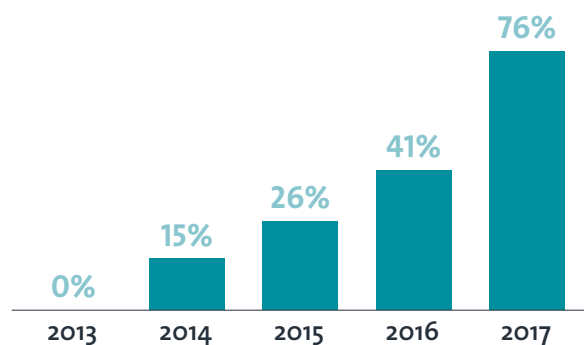


“Although typically described as multilateral or bilateral convergence, we note the general trend is better described as a unidirectional shift.”

In the first half of 2017, over a third of these “cov-lite” deals were “high yield in disguise”, compared to only about a quarter in all of 2016.

As part of this shift away from traditional LMA-style leveraged loan structures toward bond-like structures, the key differences between the various leveraged product types are also diminishing, with the leveraged finance landscape becoming more and more of a blended continuum of commercial terms informed by a variety of factors such as the borrower credit story, sponsor strength, new-money M&A supply, new market entrants and competition among banks and other investors.

Covenant-Lite European TLBs



Source: XtractResearch

How did we get here?

Traditionally, term loans and high yield bonds stood at distinct ends of the market. Term loans contained maintenance financial covenants, numerous undertakings that often entailed active on-going lender involvement and amortized payments. High yield bonds on the other hand contained only incurrence covenants, offering the issuer significant operational flexibility, with minimal bondholder interference and bullet repayments. As such, they were treated as two separate asset classes, with different market expectations and pricing considerations.





“The general shift in the market is towards a more relaxed incurrence-based covenant package and away from a restrictive maintenance-based covenant package.”

Key differences in worldview between loan lenders and bond investors:

Loans	Bonds
Commercial banks	Institutional investors
Flexible balance sheets	Inflexible balance sheets
Focus on credit risk and refinancing risk	Focus on pricing risk, maturing risk, liquidity risk
Want deleveraging	Want permanent capital
No mark to market	Mark to market
Sophisticated credit function & workout capability	Unsophisticated credit function and no workout capability
Focus on amortization	Expectation of refinancing
Focus on asset preservation	Focus on cash flow
Tight contractual controls and ease of obtaining consents/ waivers from lender/holder groups	Fewer contractual controls but difficult to amend
More limited transferability; lend to hold	Tradability/transferability, distribution approach and risk analysis
Secured structures more common	Unsecured structures more common
“Single point of enforcement”	Chapter 11 influence on structural protections
Real underwriting risk	No real underwriting risk – market prices

However, the distinction between loans and bonds has been blurring over time, with the trend being that maintenance covenants have become watered down or eliminated altogether, while bond-like features replaced traditional loan terms in loan agreements.

There are two primary drivers behind this changing market dynamic. First, institutional investors now dominate the European leveraged finance market rather than commercial and investment banks. Whereas banks are staffed with large teams capable of monitoring covenant compliance on a regular basis, institutional investors generally do not have the resources to regularly monitor a borrower's financial condition via traditional maintenance covenant health-checks. Second, a change is taking place in the loan origination process from a "lend-and-hold" model, in which the arranging commercial banks made and held the bank loans to maturity, to an "originate to sell" model, in which arranging banks syndicated the loans to public investors, typically with no expectation that they hold any of those loans for any length of time, if at all.

These paradigm shifts can be traced back to changes in the macro-economic environment and financial industry regulation as a result of the global and Eurozone financial crises from 2008 to 2012, as well as the rising influence of private equity sponsors:

- **Macro-Economic Environment**

A number of macro-economic factors, largely stemming from the recent global and Eurozone financial crises and more recent political and economic volatility, have led to a supply/demand imbalance that has shifted the market toward more issuer/borrower friendly terms (i.e. towards the incurrence-covenant model):

- the search for yield in a low interest rate environment, resulting in higher appetites for risk;
- muted LBO activity and related increase in capital dry powder that needs to be utilized;
- increased competition among banks and growing numbers of direct investors/direct lending funds; and
- the need for portfolio diversification.

- **Financial Industry Regulation**

The global and eurozone financial crises resulted in stricter regulations on banks and higher capital requirements (for example, under Basel III), leading to pressure on banks to reduce their loan books, particularly in relation to longer term liabilities. At the same time, institutional investors (such as insurance companies and pension funds), hedge funds, and collateral loan obligation (CLO) funds were facing pressure (for example, under Solvency II and other regulatory regimes) to diversify and to ensure the profitability of their portfolios and to match investments to their long-term liabilities. In search of yield, investors have begun looking at higher-risk products that they would not have otherwise or previously considered, such as leveraged loans. This has led to (i) a convergence in the investor base for leveraged loan products, (ii) the reduction of the relative percentage of the capital supplied by traditional banks, and (iii) the increasing dominance of hedge funds, institutional investors and CLOs in the leveraged loan market.

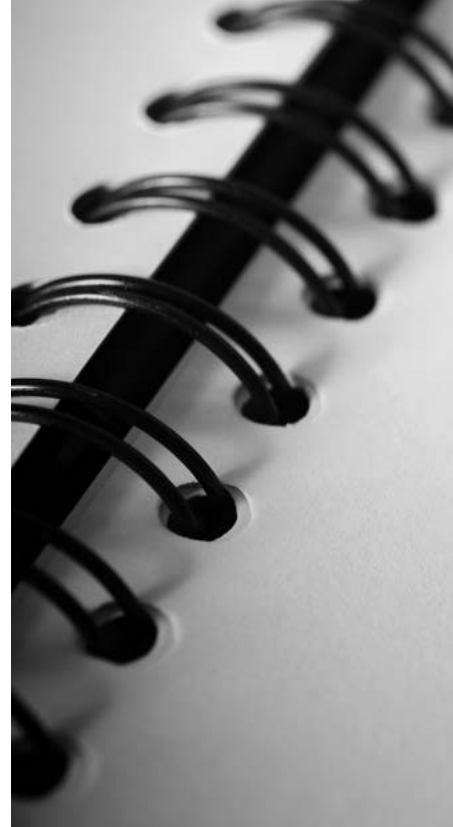




- **Sponsor Influence**

The relative shortage of deals and the increased amount of capital dry powder over the past decade have provided private equity sponsors with increasing leverage over arrangers and investors. Top tier private equity sponsors are financial product-agnostic; they frequently raise capital in both the TLB and high yield bond markets, and are equally well-versed in both. From their perspective, the convergence of terms between bonds and loans is to their benefit because it generates pricing tension between the bond and the loan markets. They are then in a position to pick and choose the deal that delivers the best combination of pricing and terms, or alternatively to split the capital structure between the two in the proportion that makes the most economic sense. For large deals that have both a bond and a loan component, sponsors typically push for, and are often able to achieve, an alignment of covenant packages across the instruments, with the more permissive incurrence bond regime typically prevailing. In addition, since the pricing spread between the bonds and loans has tightened, more focus is now being placed on the commercial terms and execution process as the differentiating factor when selecting the appropriate type of financing. Sponsors and their portfolio companies want the most flexibility possible such that management can focus on running and growing the business instead of covenant compliance, while still maintaining the ability to strategically exit the asset (e.g., via an IPO or sale) without mandatory prepayment, make whole and/or call premiums.

With the rising dominance of product-agnostic institutional investors focused more on yield than value investing, and traditional banks adopting more of an “originate and sell” model (with a correspondingly diminished role in on-going compliance monitoring) coupled with influential sponsors driving for more flexibility, the gradual shifting of loan terms towards a bond-style covenant package has become the observed trend in the market.



Areas of Convergence

As noted above, the “convergence” of bond and loan terms is arguably more of a unidirectional shift of loan terms towards a bond-style covenant package (i.e. more incurrence and less maintenance) than the other way around. That said, the high yield bond market has seen some loan-style terms crop up on occasion.

Set forth below are some areas in which the leveraged loan market is currently seeing an increased penetration of bond-style terms:

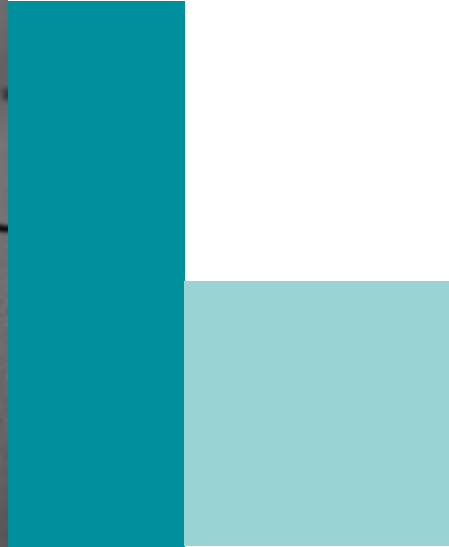
HIGH YIELD

- | | |
|--|------------------------|
| • Yield/OID | • Contribution Debt |
| • Restricted/Unrestricted Subsidiaries | • Events of Default |
| • RP Builder Basket | • EBITDA Add-Backs |
| • Holdco Debt Payments | • Mandatory Prepayment |
| • Ratio Debt | • Dilution |
| • MFN Deterioration | • Portability |

TLB/LOANS

- **Yield/OID:** original issue discount (or OID), a bond feature, has now become a standard component of TLB loan pricing. As a result, leveraged loan pricing is now thought of in terms of an overall “yield” (terminology originating with bonds), rather than a margin over LIBOR or EURIBOR. This is an important economic distinction for purposes of the “most favoured nation” (“MFN”) provision, and whether the term “interest rate” or “yield” is used therein is highly negotiated.
- **Restricted/Unrestricted Subsidiaries:** one of the first bond-like features that began appearing in term loan agreements was the concept of “restricted subsidiaries,” which limits the application of covenants and events of default to the borrower and only certain designated subsidiaries, whereas the “unrestricted subsidiaries” are excluded from covenants and EBITDA and other financial calculations.
- **Restricted Payments – Builder Basket:** there is an increasing trend in loan agreements to use the measure of 50% Consolidated Net Income (CNI) to calculate dividend capacity rather than a percentage of excess cash flow that is not required for prepayment.
- **Restricted Payments – Unlimited Payments on Holdco Debt:** an aggressive feature even in the high yield market but has started to appear in TLBs (e.g. Stada). This feature effectively allows a company to use its debt capacity to raise debt at the parent level for purposes of paying a dividend to shareholders without being constrained by the restricted payments covenant.¹

¹ Some high yield bonds have a separate basket permitting unlimited restricted payments to service holdco debt, provided that the proceeds of such debt are contributed to the restricted group, and at least one member of the restricted group guarantees such debt (effectively making such debt an obligation of the group).



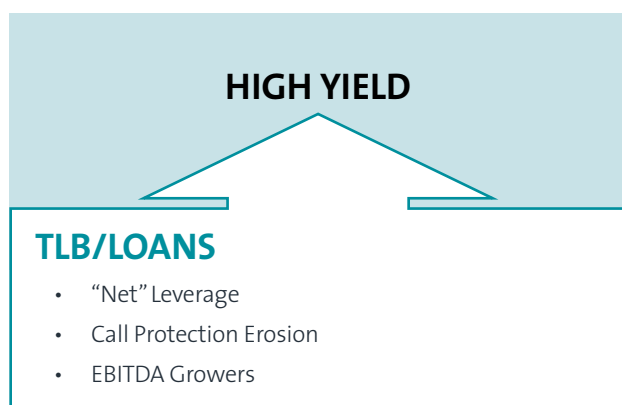
- **Debt Incurrence – Ratio Debt:** in high yield bonds, issuers are permitted to incur unlimited debt subject to meeting a pro forma FCCR test. Many TLBs/cov-lite loans in the large cap market likewise allow borrowings in an unlimited amount subject to a ratio-based test (often set at closing date leverage) plus an additional “free and clear” basket (based on a half-turn or a full turn of EBITDA).
- **Debt Incurrence – Incremental Debt:** MFN protection (which is not a feature in high yield bonds) is now becoming increasingly inapplicable to certain types of incremental debt.
- **Debt Incurrence – Contribution Debt:** a high yield bond concept which allows the borrower to incur debt equal to 100% (or occasionally up to 200% - more so in the U.S. market) of equity proceeds it receives from its investors. This concept is now appearing occasionally in TLBs, though it has not yet become mainstream.
- **Events of Default:** the extension of grace periods for interest payment defaults (to 30 calendar days) and covenant defaults (to 60 days), and the use of a “cross-acceleration” concept instead of a “cross-default” concept in leveraged loans are all the result of high yield bond influences. Additionally, a change of control is no longer a mandatory prepayment event, but rather an event giving rise to a put right.
- **General – EBITDA:** EBITDA add-backs are becoming harmonized between bonds and loans and more borrower/issuer friendly, such as the inclusion of add-backs for extraordinary, unusual or non-recurring items, and project cost savings and synergies.
- **General – Dilution of Mandatory Prepayment Terms:** the lack of a “mandatory prepayment” concept in high yield bonds has resulted in the erosion in terms loans of the equity sweep and excess cash flow sweep concepts and mandatory prepayment requirements from asset sale proceeds, equity proceeds and insurance proceeds etc.²
- **General – Portability:** the ability to effect a change of control (under certain circumstances) without the need to repay bondholders is an aggressive high yield bond feature that is experiencing a revival in the high yield market. This feature is slowly spreading to European leveraged loans (though it is receiving pushback in the US).

² Asset Sale prepayment provisions in term loans now often exclude a range of dispositions (including for anticipated expenditures and investments and certain restricted payments), include per-transaction and/or aggregate materiality thresholds (below which the prepayment requirement does not apply) and are subject to permissive reinvestment rights during 12 to 18 month reinvestment periods. Significantly, as greater flexibility to incur secured indebtedness has been built into loan documentation, asset sale prepayment covenants now often permit the borrower to share asset sale proceeds on a ratable basis with other pari passu secured debt. Finally, TLBs now often afford lenders the right to reject mandatory payments, the result of which is that the prepayment requirement now resembles more closely the traditional “asset sale offer” in a high yield bond. In addition, the excess cash flow sweep will now frequently be reduced dollar-for-dollar by voluntary prepayments or repurchases, even if made non-pro-rata among the TLB lenders. Some sponsors are now negotiating no annual excess cash flow sweep, or at least pursuing step-downs on asset sales sweeps (for example, levels may start at 100% and go down to 50% once the borrower has achieved a particular leverage rate).



“Current indication is that the factors contributing to the convergence trend will continue to evolve. If that is the case, products which historically represented two separate asset classes will gradually become increasingly indistinguishable and pricing spreads will narrow.”

In contrast, below are the few limited areas in which leveraged loan concepts have surfaced in high yield bond offerings:



- **Net Leverage:** while historically high yield bonds used a “gross” leverage test for its covenants, many leverage tests are now calculated on a “net” basis, i.e. gross debt less cash on hand (as has historically been done in the leveraged loans). This may have unintended consequences in a product that generally has a more permissive restricted payments regime than leveraged loans, thus providing more opportunities for sponsor/ issuers to inject equity to temporarily improve the leverage ratio for purpose of permitting incurrence of a non-ordinary course liability, only to take the cash back out shortly thereafter.
- **Erosion of Call Protection:** call protection used to be a strong distinguishing feature for bonds. However, recent trends such as the shortening of non-call periods, combined with aggressive equity claw back

and other redemption rights (e.g. 10% of the bonds at 103% annually) have significantly eroded bondholder protection against early redemption. Further evidence of convergence in this area can be seen in floating rate bonds (“FRNs”), with their one year, 101/100 call schedule. Comparing this with floating rate loans: at best, some loans will have the benefit of soft calls at 101 for six months or one year, but generally loans are always callable. Often, even the limited soft call provisions in leveraged loans have exceptions for repricing transactions in connection with an IPO, a change of control, a material acquisition, or an acquisition not permitted by the agreement – sometimes even for dividend recap transactions.

- **General – Total Asset or EBITDA-Based Grower Baskets:** a high yield bond feature which gives flexibility to issuer to increase dividend or debt capacity based on a growth metric without the need to seek bondholder consent. EBITDA growers are more borrower/issuer friendly because it is subject to adjustments

As illustrated above, the leveraged loan market is seeing more of an infiltration of high yield bond-style terms into leveraged loan documentation instead of the other way around. In that regard, the general shift in the market is towards a more relaxed incurrence-based covenant package and away from a restrictive maintenance-based covenant package.



Loan or Bond?

The convergence of loan and bond terms leaves borrowers/issuers with the question of which to choose. A quick comparison is set out below:

Traditional credit facility	TLB	High yield bonds
Maintenance covenants (often now only in revolving facilities)	Maintenance covenants (often now only in revolving facilities)	Incurrence covenants only
Limited or no prepayment penalties	Limited (6 months soft call) or no call protection	Non-call period (2 – 5 years) and thereafter repayable at decreasing premium (e.g. fh coupon and stepping down to fb and par depending on tenor). Typical call features: 5 year NC2, 7 year NC3, 10 year NC5
No disclosure requirements	No disclosure requirements	Documentation process longer and more costly – requires OM disclosure and roadshow
External ratings not required	Private rating usually required	Rating required (typically Moody's/S&P)
Amendments relatively common and straightforward	Amendments relatively common and straightforward	Expensive to amend - requires consent solicitation and payment of consent fee
Typically matures 5-7 years	Typically matures 5-7 years	Typically matures 5 – 10 years
Traditional loans have amortized payments	Bullet maturity	Bullet maturity
Floating Rate (with interest rate hedging)	Floating Rate	Fixed or Floating Rate
Private reporting (monthly or quarterly + annually)	Private reporting (monthly or quarterly + annually)	Public reporting (quarterly + annually)
Investors are traditionally banks	Investors are traditionally banks, institutional funds, private wealth management accounts, CLOs, also insurance companies; broadly syndicated	Investors are mutual funds, hedge funds, insurance companies, pension funds, private wealth management accounts

As a result of the convergence trend and recent supply/demand imbalance, pricing spreads between TLBs and high yield bonds have narrowed. Together with the fact that TLBs potentially offer quicker execution timeframes and lower transaction costs compared to high yield bonds, TLBs have surged in popularity, with sponsors opting for loans rather than bonds to finance their LBOs, or opting to refinance their existing bonds with loans. However, it remains to be seen whether this level of activity in the TLB market can be sustained, particularly if any of the macro-economic factors described above changes the TLB pricing becomes less favorable.

Notwithstanding the popularity of TLBs, the high yield market offers certain benefits that the TLB market does not. The high yield markets, in Europe and especially the US, are deeper and more liquid than the TLB market. It also offers investors broader scope for secondary trading. In addition, while the initial transaction cost for a high yield bond may be higher than that of TLBs, and a high yield bond offering may be more time-consuming, once a sponsor/issuer has gone through the process of preparing an offering memorandum (particularly up to Rule 144A standards), it is that much

closer to being prepared for an IPO, with much of the work already done and with management already familiar with the disclosure process. Indeed, in many cases high yield bonds are better suited than TLBs regardless of pricing or transaction costs, such as for issuers that have highly cyclical businesses where longer-term capital commitments in the form of bonds are more suitable than loans (which typically have shorter maturities and carry early repayment requirements), or in certain jurisdictions such as Italy where local lending rules are more restrictive toward non-Italian lenders making loans to Italian corporates.

Currently, there is little indication that any of the factors contributing to the convergence trend is going to change soon. In that regard, we expect competition between traditional bank lenders and other debt investors to continue to intensify in the foreseeable future, with borrowers continuing to enjoy unprecedented flexibility in the choice of financing method that best meets their needs. The challenge therefore, is for lenders and investors to find the right balance between borrower/issuer flexibility and lender/investor protection in this competitive environment.



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