THE AUTHORITY ON BOND
AND LOAN COVENANTS

Bond Covenants for Alpha Generation and Risk Management

Presented to the Government Investment Officers Association – March 21, 2018

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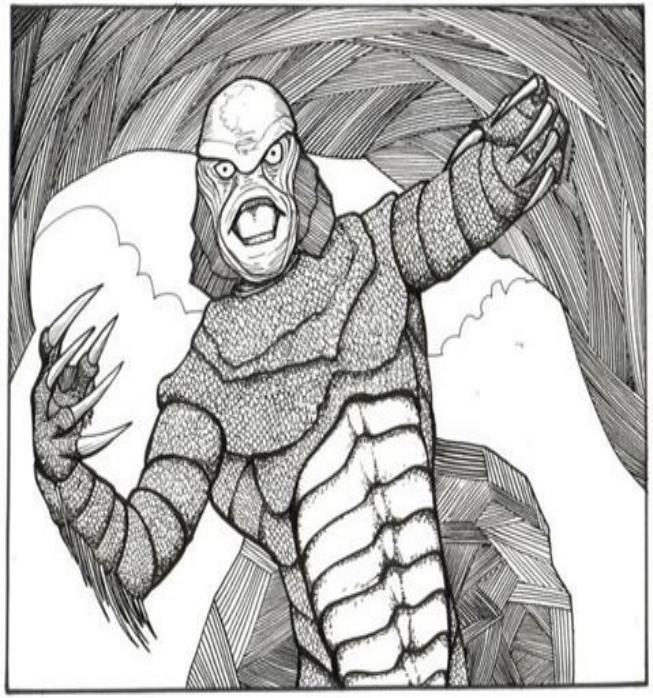
Remembering Terrdrs of the Past…The Big High Grade Issuer LBO Wave 2006-2008

The Real Disasters:

- Alltel
- Clear Channel
- Harrah's
- TXU

The Forgotten Wins:

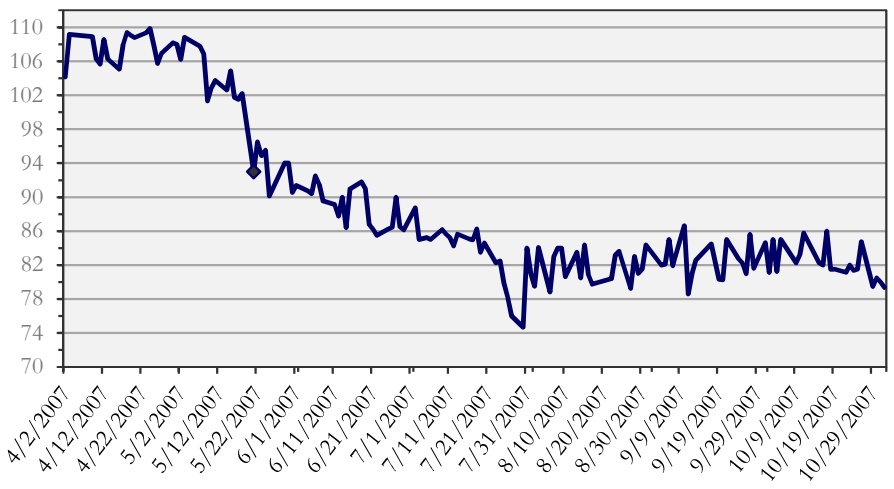
- B.F. Sault REIT
- Hilton
- Manor Care
- TXU (?)



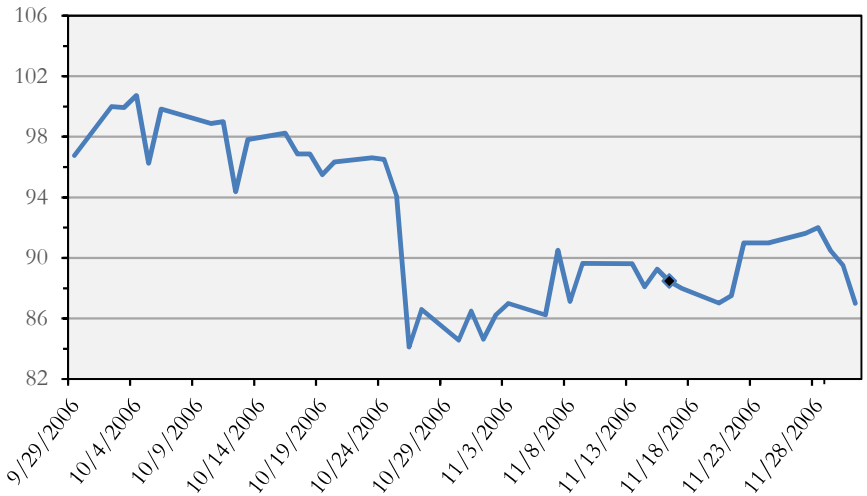
Aaargh….I've come to eat your returns!

TERRORS OF THE PAST

Alltel 7.875% Notes due 2032 - 05/21/07 Announcement

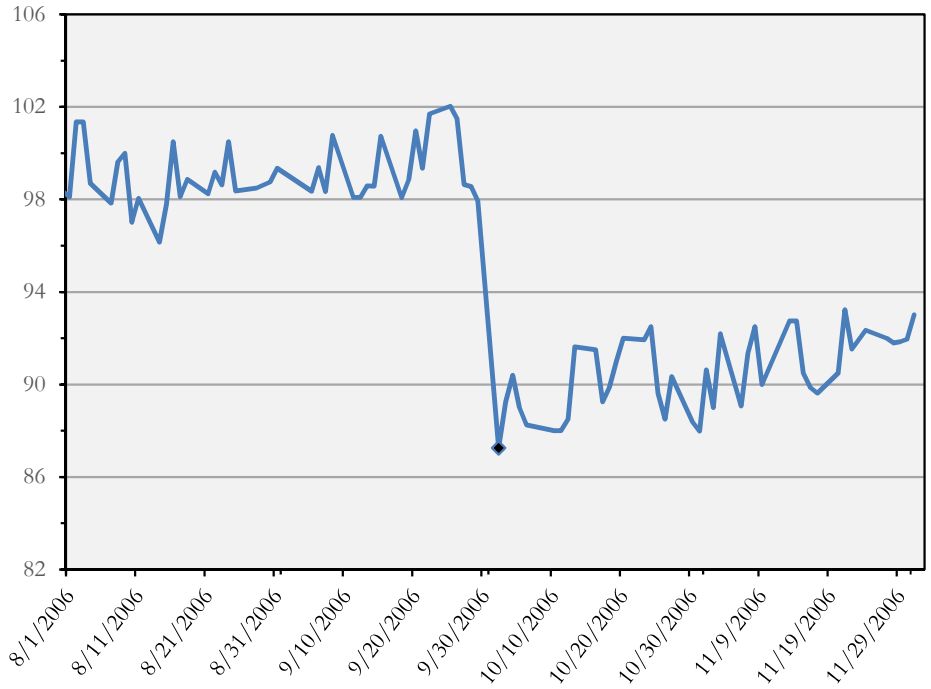


CCU 7.25% Debentures due 2027 - 11/16/06 Announcement

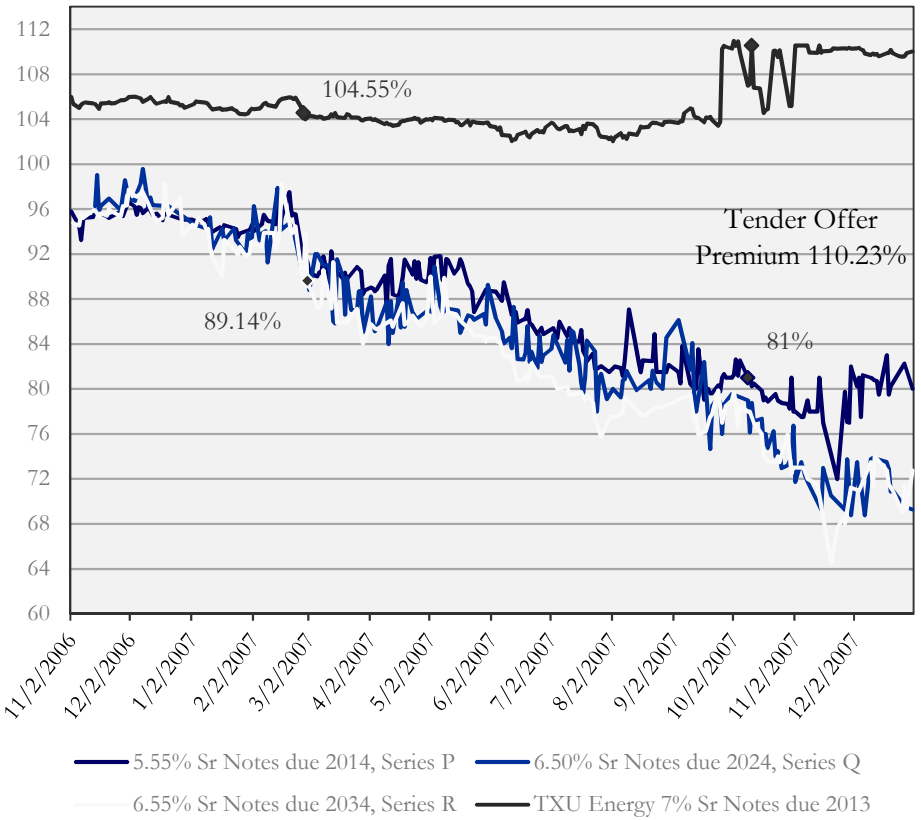


TERRDRS DF THE PAST

Harrah's 6.25% Senior Notes due 2016 - 10/01/06 Announcement



TXU Legacy Bonds - 02/26/07 Announcement



Change of Control Covenant

Purpose: Grant bondholders the option to get money back if the company gets new owners

Basics: Put right at 101% of par if a "Change of Control" occurs

Change of Control usually includes:

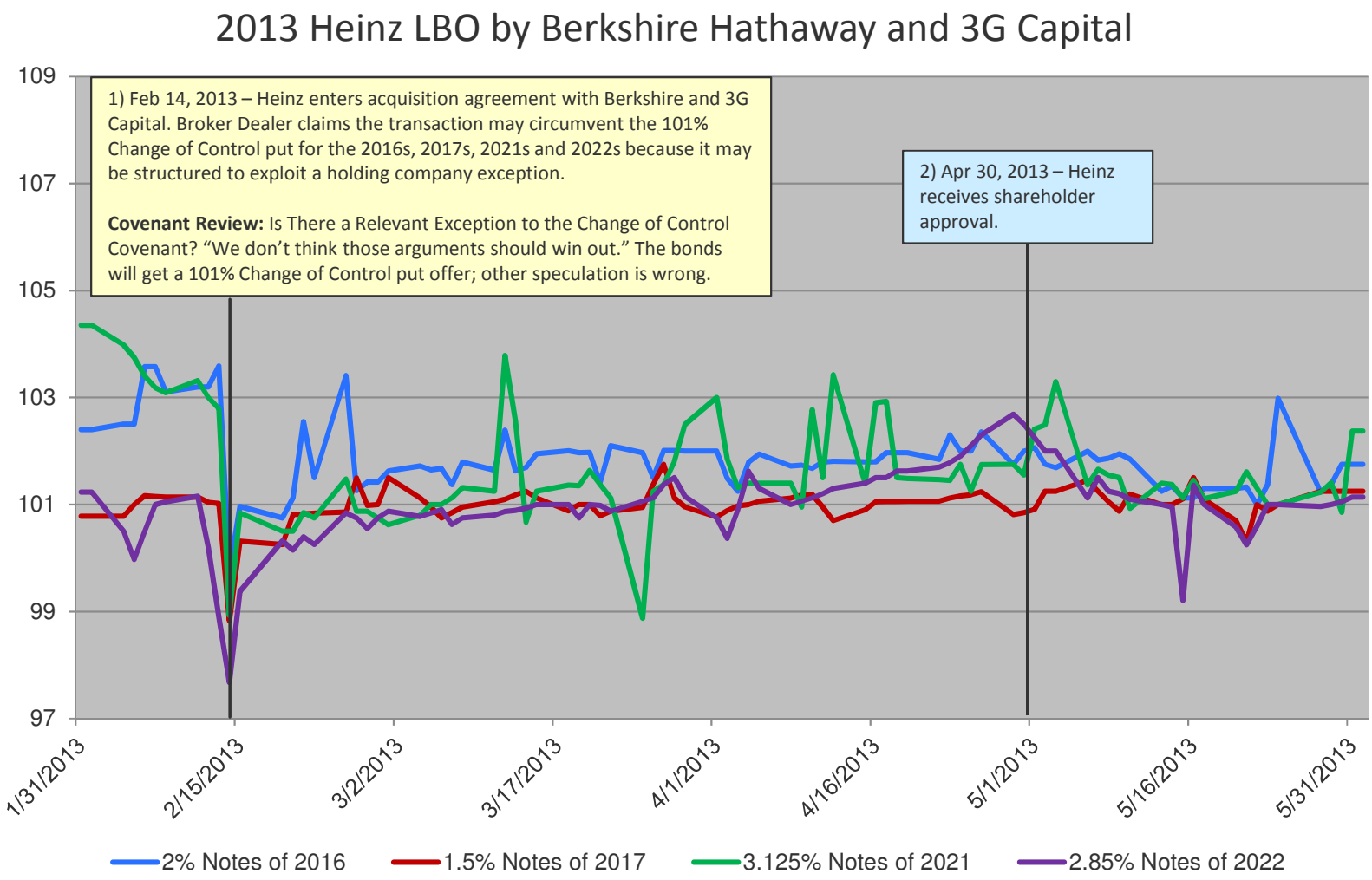
- Change in majority voting control
  - But: "Permitted Holders" that do not trigger a Change of Control
- Sale of "substantially all assets"
- Merger of two public companies (sometimes)
- Continuing directors

Nobody Wants to Read This

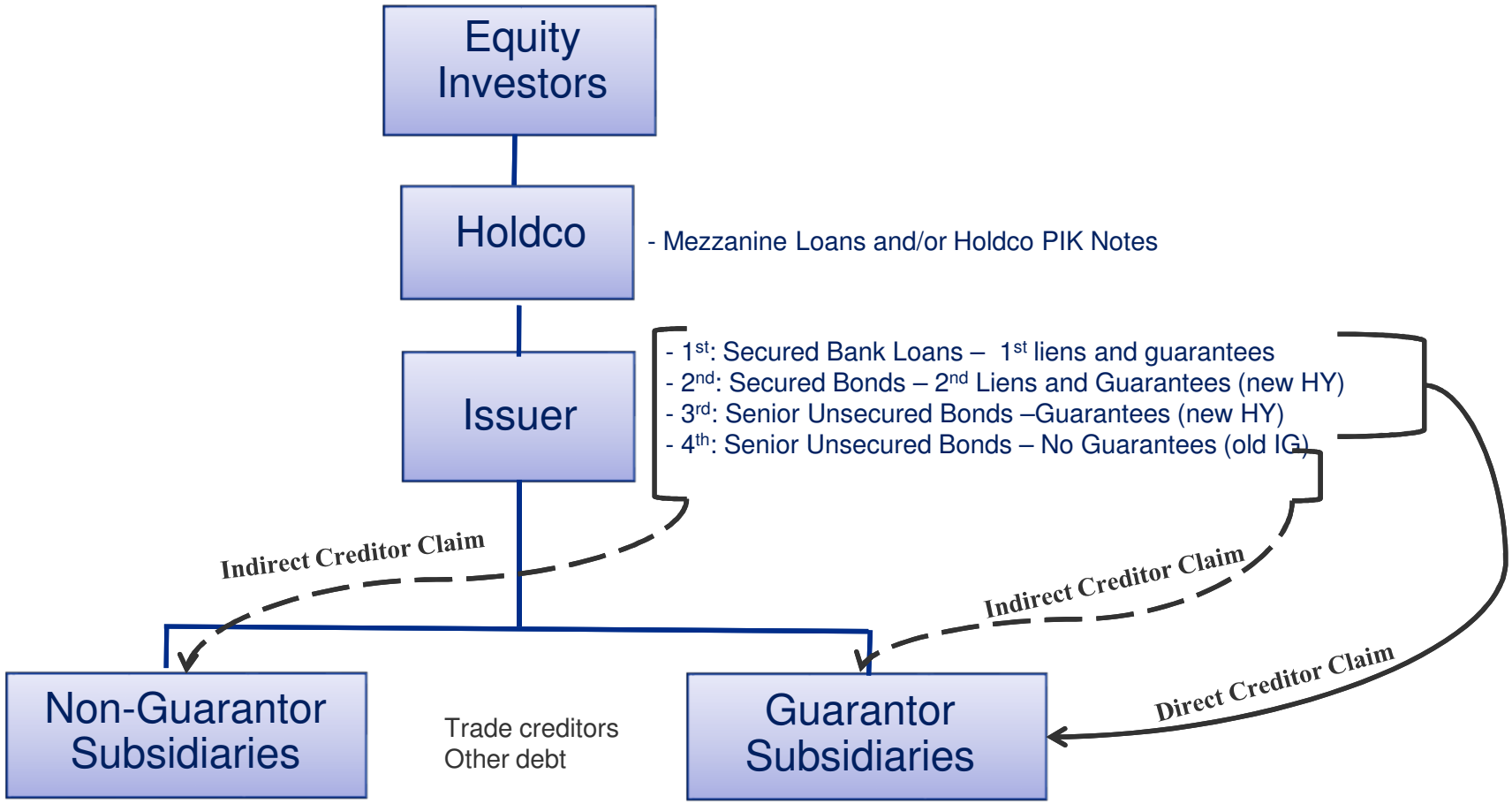
Change of Control "Holding Company" Exception

"Change of Control" definition states: "Notwithstanding the foregoing, a transaction will not be deemed to involve a Change of Control if (1) the Company becomes a direct or indirect wholly-owned Subsidiary of a holding company and (2)(A) the direct or indirect holders of the Voting Stock of such holding company immediately following that transaction are substantially the same as the holders of the Company's Voting Stock immediately prior to that transaction or (B) immediately following that transaction ***no person (other than a holding company satisfying the requirements of this sentence) is the beneficial owner, directly or indirectly, of more than 50% of the Voting Stock of such holding company***."

Heinz LBO: Making Money on CoC Put



A Post-LBO Capital Structure



Liens Covenant

Purpose: Protect seniority position

- Limit amount of debt that may be effectively senior
- Don't want the next senior note deal to be secured

Basics: Two types of "Permitted Liens": voluntary and involuntary

Permitted Liens usually include:

- A specified amount of bank debt or secured debt ratio
- Capital leases / purchase money liens
- Small general basket
- Special concern for carveouts for debt-related liens that do not have specific dollar caps
- Many miscellaneous exceptions for involuntary permitted liens

Liens Covenants – What Has Changed

Many potential LBO target issuers continue to use legacy Liens covenants that expose holders to significant risks of effective subordination – so there may be a 101% put, but little chance to a consent / tender.

- Some first time issuers have used decent Liens covenants (e.g., Jones Lang LaSalle and Verisk Analytics) and others have not (e.g., FMC Technologies and Flowserve Corporation).
- Few pre-2007 issuers have changed their Liens covenants post-2007.
- Starwood: Made it worse over time.
- US Cellular – Liens covenant does not apply to most assets.
- Clorox – Liens covenant retains old "Principal Property" idea.

Liens Covenant

***The Credit*:**

Eastman Chemical $500,000,000 4.8% Notes due 2042

The Problem:

The Liens covenant does not apply to:

- loans, because of the defective definition of “Debt”: “notes, bonds, debentures or other similar evidences of indebtedness for money borrowed”

***The Credit*:**

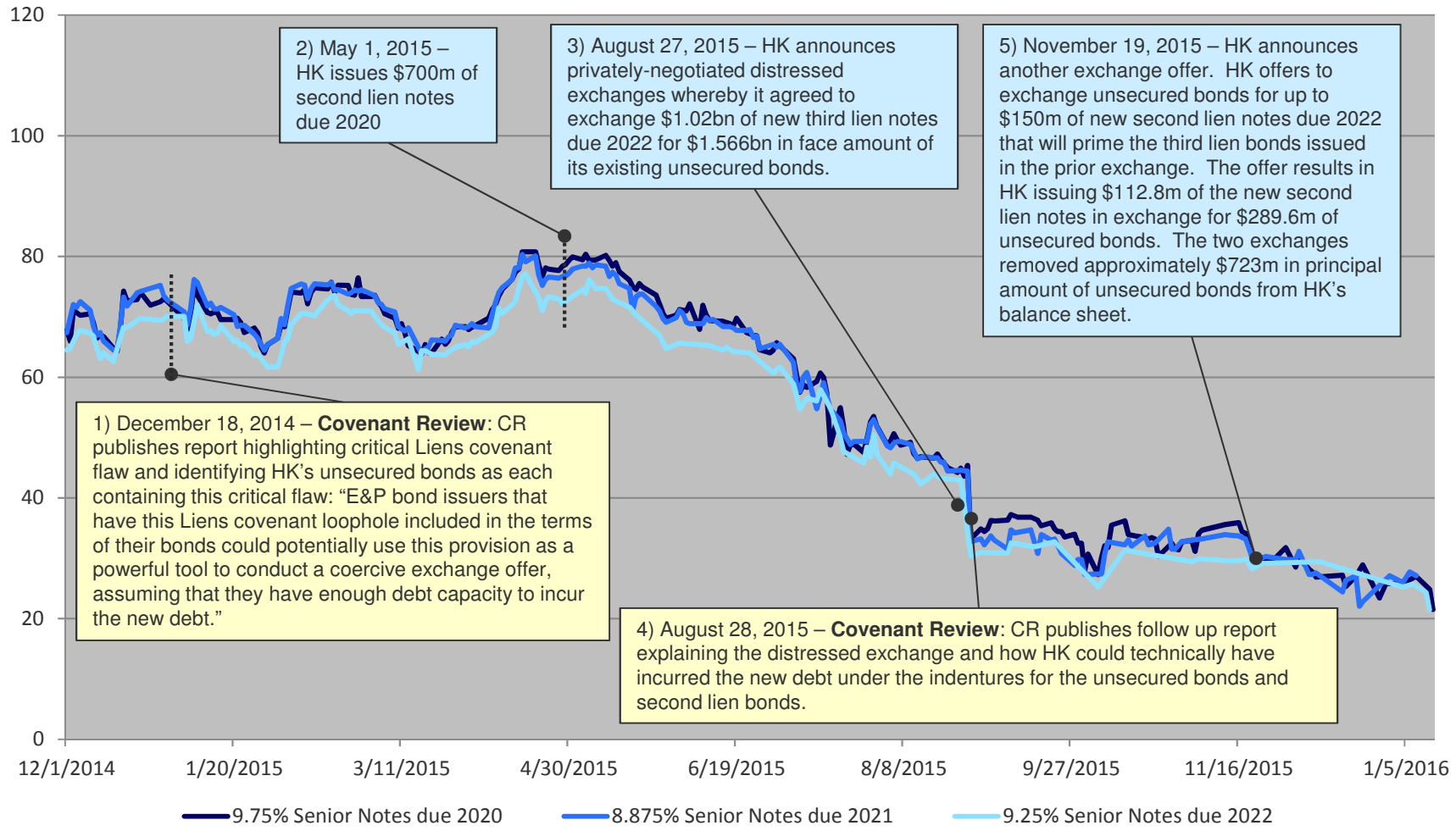
Analog Devices $400,000,000 5.3% Senior Notes due 2045

The Problem:

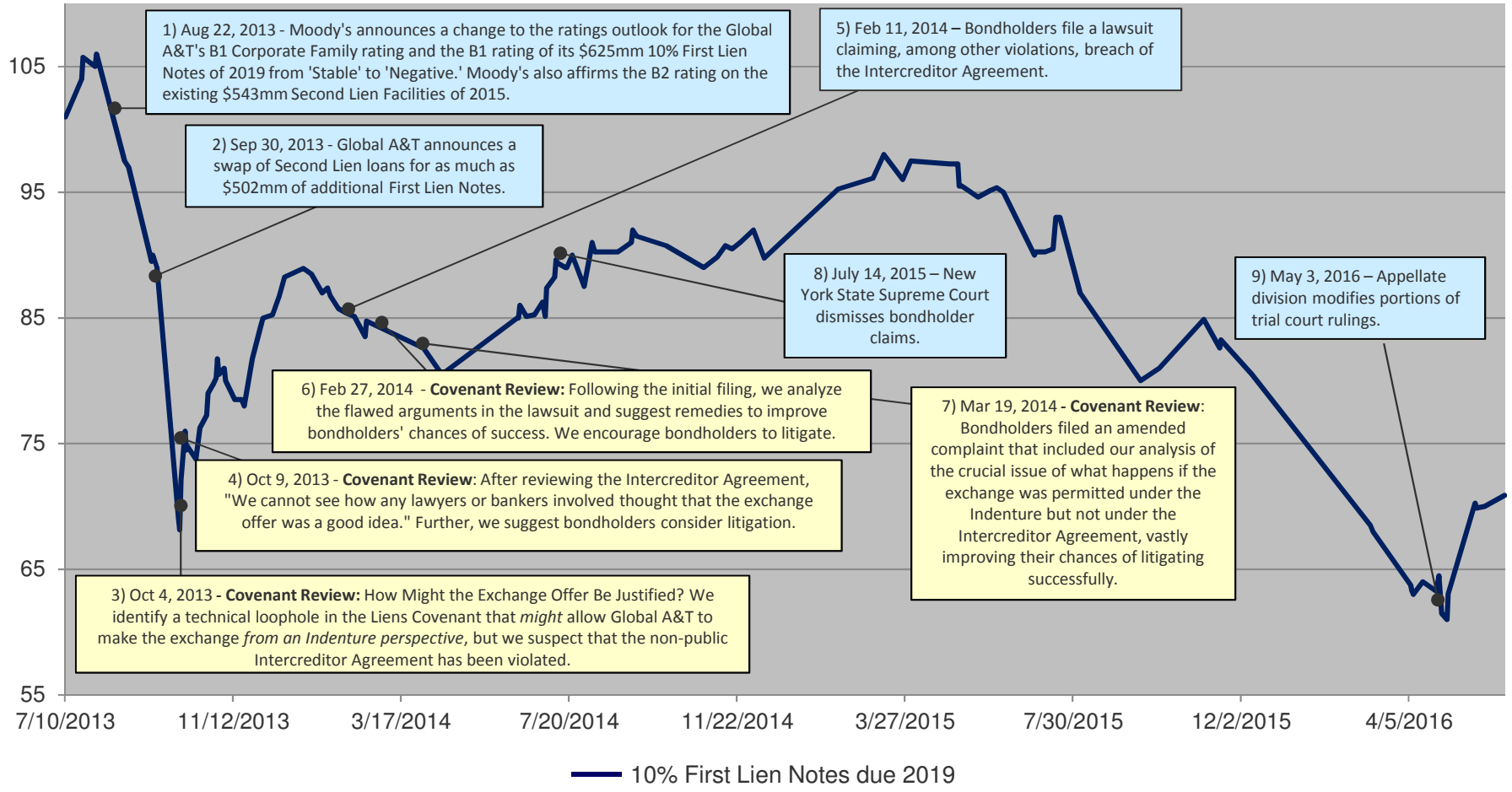
The Liens covenant is a sham:

- “We will not, nor will we permit any Subsidiary to, issue, incur, create, assume or guarantee …any debt for borrowed money…. secured by a mortgage…. upon any Principal Property”
- “Principal Property” means any single parcel of real property or any permanent improvement thereon…located in the United States…having a book value…in excess of 3% of our most recently calculated Consolidated Net Tangible Assets.
- Oops: “As of February 3, 2018, we did not have any Principal Properties.”

Halcón Resources: Distressed Exchanges



Global A&T: Add-on Chaos



Sale / Leaseback Covenant

What is a "Sale and Leaseback"?

- Duration?
- Intercompany?

Use of proceeds?

Recent debates

- Sprint
- Windstream

Restricted Payments Covenant

Purpose: Protect bondholders' interest in the assets of the company by limiting undesirable distributions and asset transfers such as:

- Dividends and equity purchases
- Retiring junior debt ahead of the bonds
- Investments in entities that are not Restricted Subsidiaries
- Guarantees of holding company debt

Restricted Payments Covenant

Basics:

- Company will typically be allowed to use up to 50% of "Consolidated Net Income" to make payments to those junior to the bondholders in the capital structure (i.e., junior bonds, preferred equity and common equity).
- Typical conditions to using 50% of Consolidated Net Income to make Restricted Payments: (1) no current default and (2) compliance with debt covenant ratio.
- Test is backward-looking – has the company "earned the right" to make payments to equity?

Restricted Payments Covenant

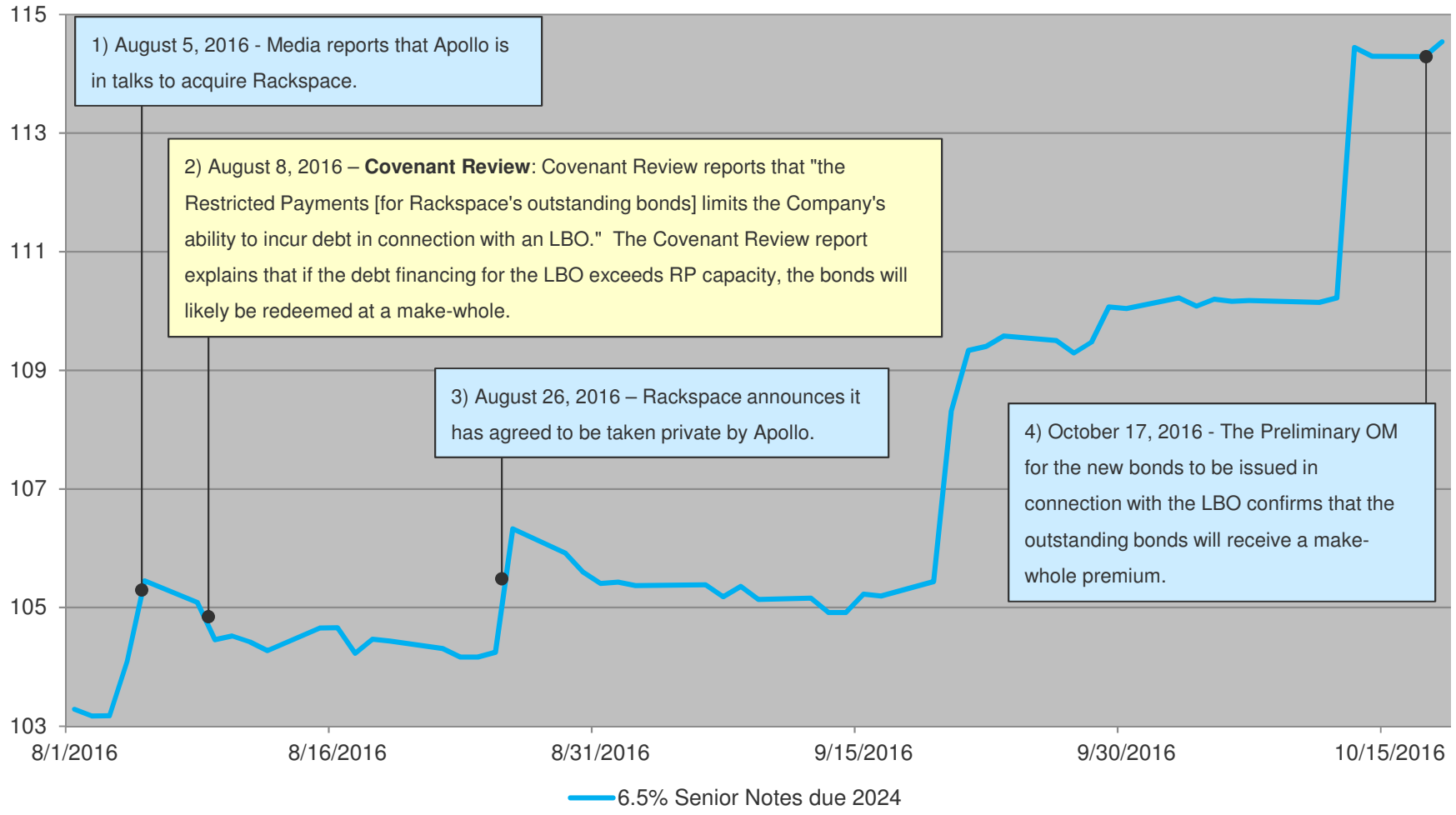
Common carveouts include:

- General Restricted Payment basket
- Joint venture investment carveout
- Unrestricted Subsidiary investment carveout
- Leverage test?
- Check Restricted Payments and Permitted Investments
- Beware J. Crew type risks

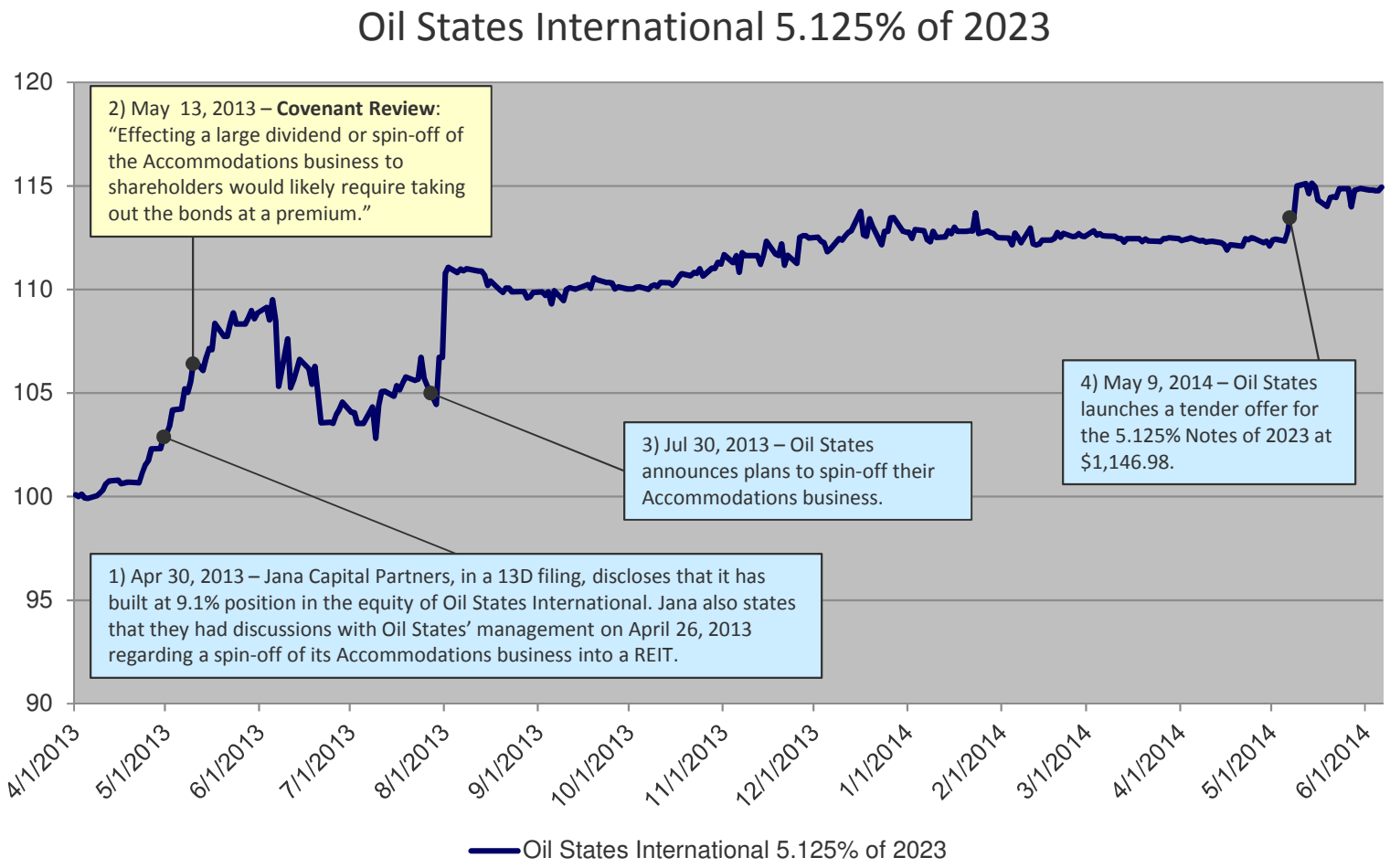
Questions:

- Can the company buy back / repay other bonds and loans?
- Are there “sneaky” dividend loopholes?

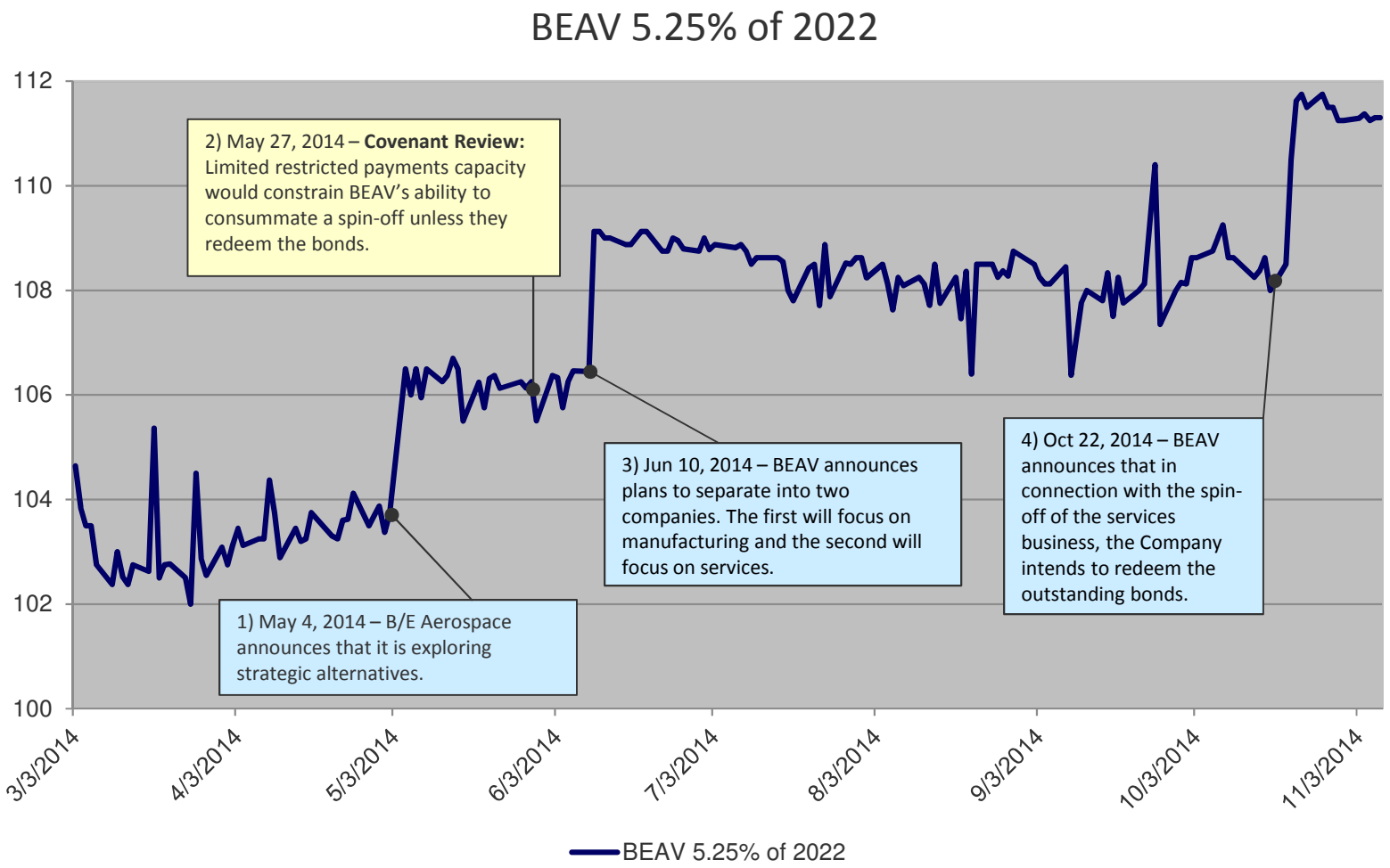
Rackspace: Make-Whole on LBO



Oil States Int'l: Make-Whole Conceded

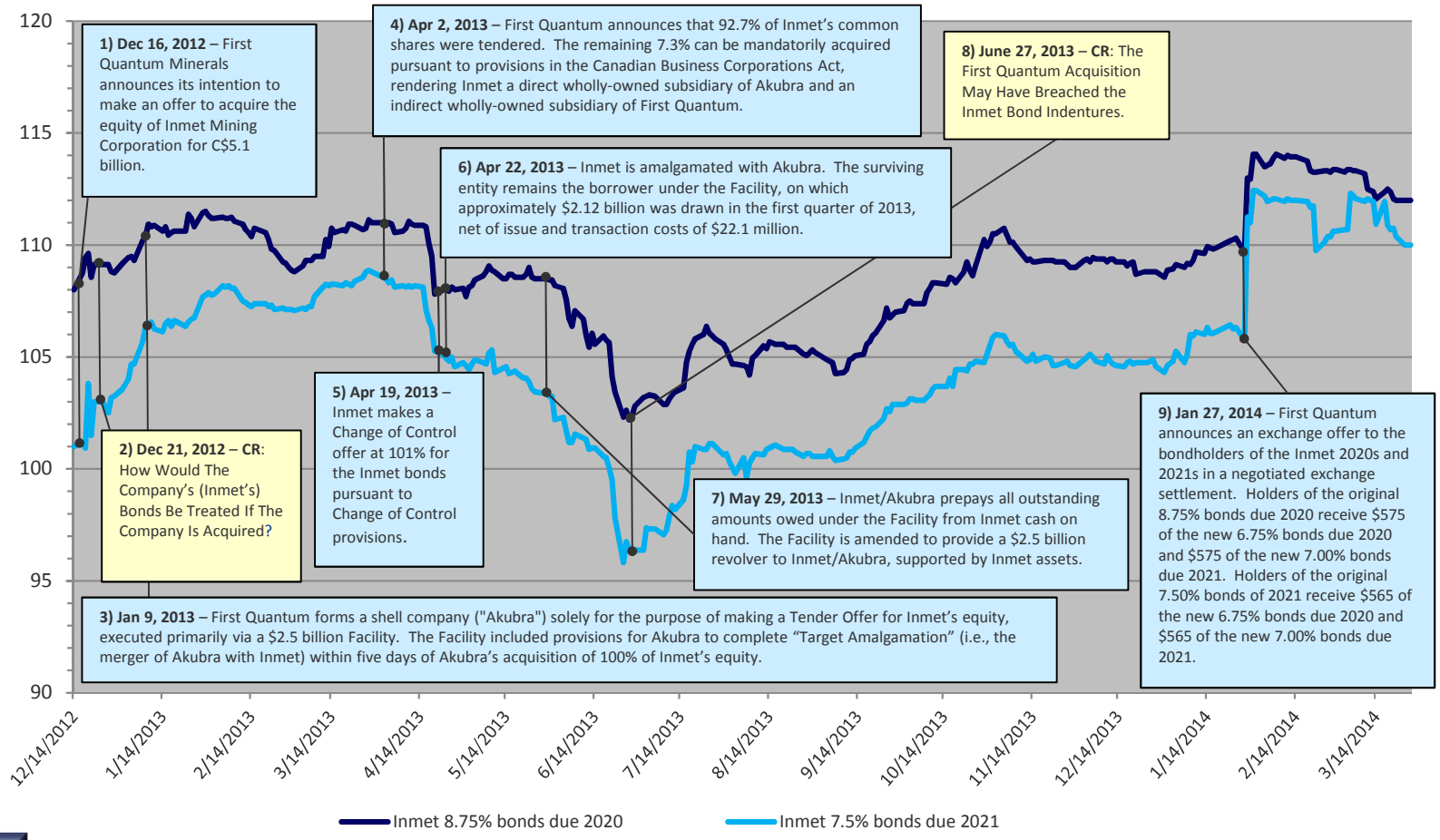


B/E Aerospace: Make-Whole on Spin-Off



First Quantum: Litigating to Win

First Quantum / Inmet Acquisition Timeline



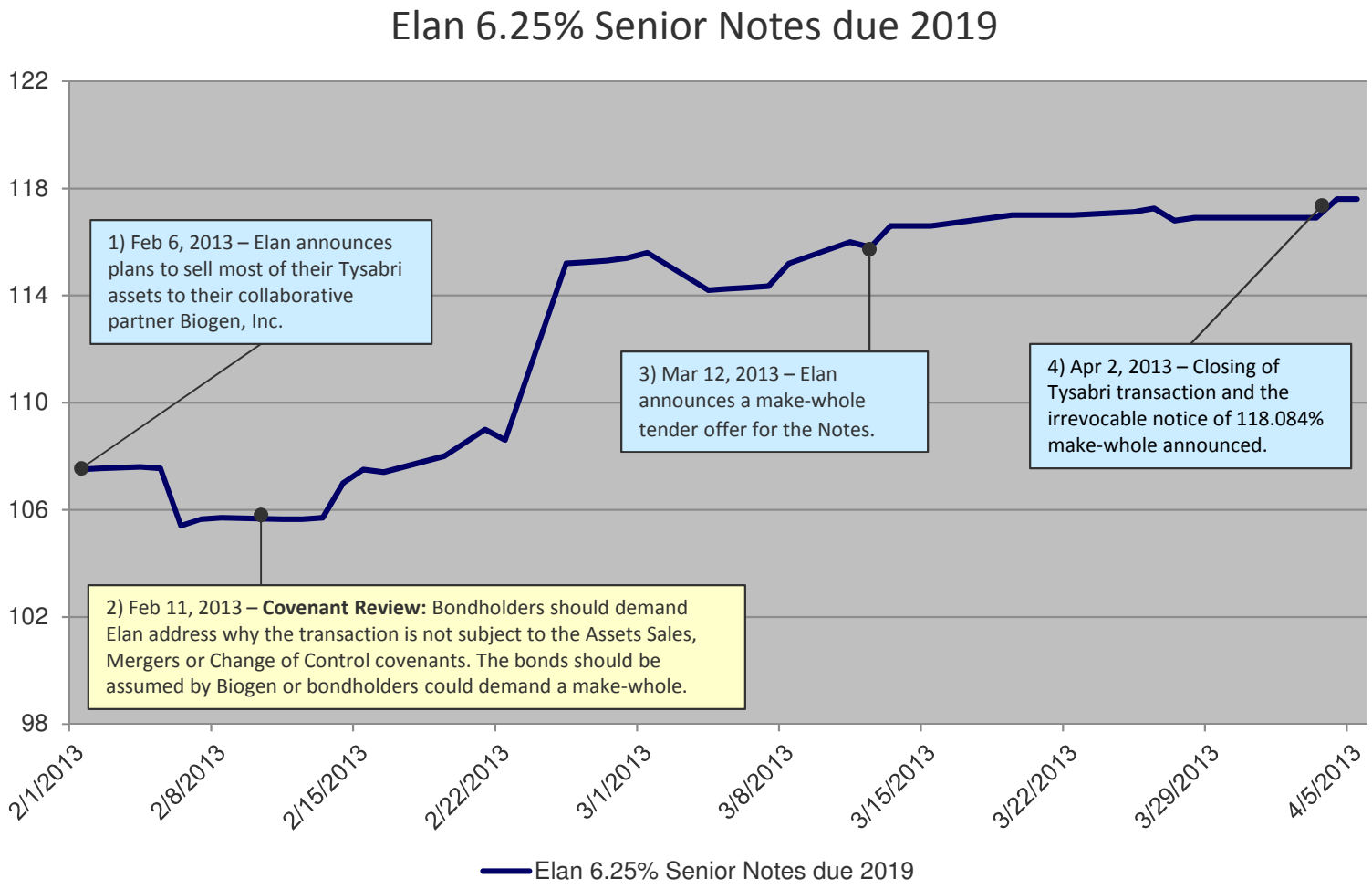
Mergers Covenant

Purpose: Make sure the bonds follow when the assets move

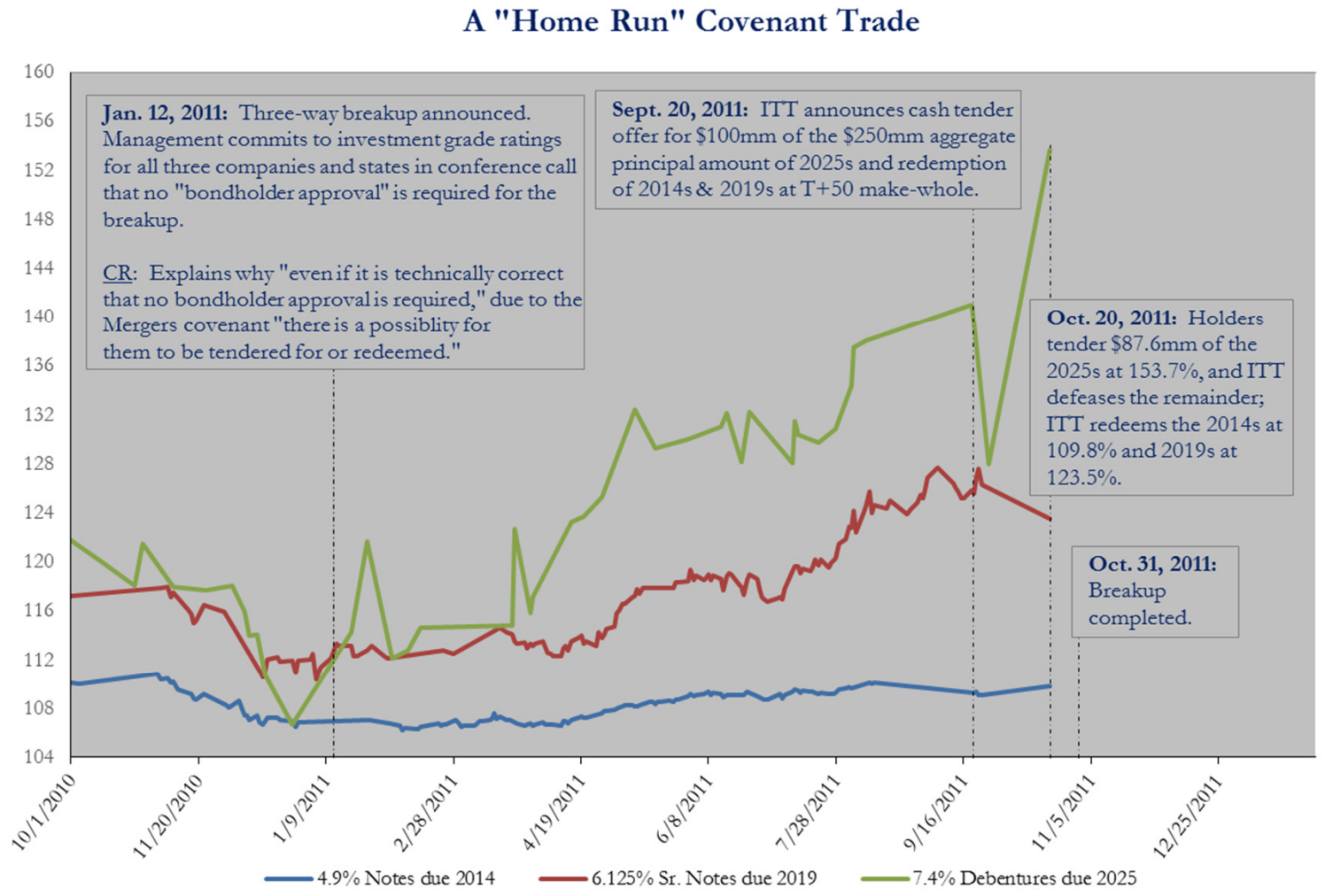
Basics:

- Applies to mergers where the Company transfers "all or substantially all" of the Company's consolidated assets
  - Erg…. What does "substantially all" assets mean…?
- High yield often has a leverage metric

Elan: Make-Whole on Asset Sale



ITT Breakup: Make-Whole on High Grade



A Glimpse at the Loan Market

These are not your Daddy's loans!

Credit Stats	Middle Market	Large Institutional
Average Adj. EBITDA of Issuers ($MM)	$42	$258
Average Tranche Size ($MM)	$179	$684
Net First Lien Leverage	4.27x	3.8x
Net Total Leverage	5.10x	4.9x
Data as of: 3/13/2018		

Financial Maintenance Covenant Stats LTM	Middle Market	Large Institutional
Percentage of Loans that are Cov-Lite	18%	83%
Percentage of Loans with Springing RC Covenant	18%	54%
Percentage of Maintenance Covenants that are First Lien Leverage Tests	19%	77%
Data as of: 3/13/2018		

EBITDA Adjustments LTM	Middle Market	Large Institutional
Percentage of Loans with Synergies / "Run Rate" Costs Savings Adjustment	80%	89%
Percentage of Loans with Uncapped Synergies / "Run Rate" Cost Savings Adjustment	13%	53%
Average Cap for Synergies / "Run Rate" Cost Savings Adjustment	20.99%	20.38%
Data as of: 3/13/2018		

Why Are Indentures So Complicated?

"Modern indentures have a low rating on the scale of popular reading … nobody loves an indenture... The corporate trust indenture is undoubtedly the most involved financial document that has been devised … and the accusation [is] commonplace that the lawyers are hoping to get paid by the word."

"It has been remarked that it was devoutly to be wished that some genius would arise to point the way to a reduction of the text of such [indentures]; but where the opportunity has been afforded to discuss the subject with such critics, they have been able to indicate little which upon full consideration they would be willing to omit."

Further Information

For general information and sample reports, email info@covenantreview.com.

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