PROSPECT NEWS
Market Newsletters for Professionals

Reprint

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Upsized Fortescue megadeal, Seven Generations drive by; new 7G, existing Fortescue bonds climb
Energy XXI eyes third-lien bonds, asset sales to improve balance sheet

Proskauer junk study finds European HY market grows, increases use of more flexible deal provisions

By Paul Deckelman

New York, April 22 – High-yield bonds, as we know them today, originated decades ago in the United States but for a long time did not play a big part in the financing plans of most companies outside of the U.S.

That has all changed, however, with junk bonds taking an ever-increasing role in the non-U.S. debt markets, particularly in Europe, where traditionally, "the high-yield asset class was really never accepted as a mainstream product," at least not before the financial crisis that shook the fixed-income world nearly a decade ago, according to Frank J. Lopez, partner and co-head of the Global Capital Markets Group at **Proskauer Rose LLP**, one of the leading financial law firms active in the leveraged finance and high-yield markets.

On Wednesday, the New York-based firm released its fourth annual Global High Yield Bond Study, analyzing trends in junk market issuance, particularly from the standpoint of the kind of terms the deals carry. Those carefully crafted terms reflect the back-and-forth give-and-take between the issuing companies and, where applicable, their private-equity sponsors on the one hand, who look for maximum business flexibility with a minimum of cumbersome covenants, and, on the other hand, the lenders putting up the money that those companies are borrowing, who seek to maximize their oversight in order to minimize risk and protect their investment.

The study covered a database of 1,236 junk-bond deals completed in the U.S., Europe and the rest of the world between 2011 and 2014, dividing the market up by such categories as geography, deal size, industry of the borrower, ratings and whether or not the borrowing company has private equity sponsors, and then seeing whether there was any correlation between those various categories and the presence, or absence, of covenant provisions covering various corporate activities, including early redemption of bonds, changes of control and companies' use of earnings to pay dividends or distributions, among many other factors.

European junk issuance grows

Lopez said that with the financing crisis, junk issuance by European companies "filled the gap" that was created when more traditional funding sources such as bank debt were disrupted, and it has continued on, even after the crisis subsided, "and now we're seeing record issuance."

According to data compiled by *Prospect News* and cited in the Proskauer study, issuance by borrowers based outside of the U.S. and Canada – which are regarded as a single geographic region for the purposes of the study – accounted for a majority of the junk bonds issued in 2014, the first time that has ever happened.

U.S./Canada issuance fell to just 46% of the global total in 2014 from 53% in 2013 and from 64% in 2012.

Among the three regions into which the study divides the world outside of the U.S. and Canada, accounting for the other 54% of global junk issuance last year, Europe – which also includes issuance from the Middle East and Africa and thus officially is labeled EMEA – accounted for 30% of the global total in 2014, up from 29% in 2013 and 22% in 2012.

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Asia, which also includes Australia, made up 19% of global issuance last year, up from 14% in 2013 and 9% in 2012, while Latin America, which also includes the Caribbean, brought up the rear with 5% of the global issuance last year, versus 4% in 2013 and 5% in 2012.

New terms originate in Europe

Lopez also said that beyond the sheer rising numbers of European junk issuance and the region's increasing percentage of the global totals, "an evolution" is going on there.

Not only has high-yield become more accepted in an area where it had historically been looked upon as a U.S. import and, to a degree, had traditionally been minimized by the financial community, but looking at the deal terms and structures themselves coming out of Europe, Lopez continued, "We're now actually seeing terms that are starting in the European market and working their way over to the U.S."

That's a far cry from the way things always had been before. Heretofore, U.S. private equity sponsors such as KKR & Co. LP or Carlyle Group would push aggressively for better, more flexible terms on a bond deal for one of their companies – and usually would get them; Lopez said the study showed, among other things, that borrowing companies owned by private equity firms "generally speaking do get way better deals in the high-yield market, with everything else equal, whether it's by industry, rating or credit metrics" than stand-alone companies that don't have such sponsors.

Once that breakthrough had come, such new, more issuer-friendly terms "would get broadly into the U.S. market, and then it would find their way into the European market."

The fact that the reverse is happening in some cases shows "how evolved it's become," the Proskauer executive declared.

Change-of-control portability

Lopez said that "there are a couple of things that have started in Europe, but the one that's probably going to be the most important over the next three to five years is what they call change-of-control portability. It's really important to sponsors in particular, but to issuers in general."

Most high-yield bond indentures contain a change-of-control covenant that allows the bondholders to put their bonds back to the company at 101% in the event that the company is sold, merged or otherwise undergoes a strategic transaction resulting in a change of control. Lopez said that something that came up through the European high-yield market is the concept of "portability" – if the company stays within a certain leverage restriction contained in the indenture, and if there is no ratings decline, "then there won't be a change-of-control event under that definition of change of control, even though there *was* a change of control."

As a practical matter, he said, "Sponsor A could sell to sponsor B – but if you're still within the leverage ratio and there's not a downgrade, it sort of guts the change-of-control provision – which is a very nice new flexibility for sponsors and any owners that think they're going to try to sell the deal pretty early on after they do the issuance."

"So what we're now seeing in Europe is that a much higher percentage of European deals" have such a provision than in the U.S. or elsewhere."

While he said that "we're now seeing an incidence of it coming to the U.S., and it's increasing as well, the percentage is *way* higher in Europe."

In 2014 globally, 15% of the deals done had such portability built into them, versus 85% that did not.

About one-third of all of the European region deals had it, versus under 10% for the U.S. region deals (about 27% of the Asian region deals had portability, and the percentage is 10% for the Latin American issuers).

Other flexibility provisions

There were other areas as well where the indentures of European bond deals included more aggressive and issuer-friendly provisions.

For instance, junk bonds feature a non-call period for several years after the bonds are issued, during which the company cannot seek an early redemption of the bonds, which preserves potential returns for the bondholders but which prevents the issuing company or its equity sponsors from calling the bonds during that time, should it otherwise make economic sense to do so, unless they go through a terribly expensive make-whole call process.

Lopez said that starting around 2011 and 2012, some deals began including a provision allowing the issuer to annually call up to 10% of the bonds at 103% each year of the non-call period, "sort of a carve-out to the normal call schedule."

Although only a small percentage of bond deals have this relatively new wrinkle – about 7% globally in 2014, versus 93% that did not – breaking that small 7% slice of the pie chart down geographically, "the percentage of deals in Europe that have that

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flexibility is meaningfully higher than in the U.S."

Some 12.5% of the European total had such a provision, almost triple the 4.7% of U.S. deals – which was down from 6.3% in 2012 and 8.3% in 2013.

Lopez noted that the 103% redemption right did originate in the U.S., "but gained traction In EMEA."

He said that "we're sort of seeing that provision fade away in the U.S., but it's staying [in Europe]," where the 12.5% rate was roughly unchanged from 2012 and 2013.

The study showed that in some of the other deal-term areas, more of the European firms had opted for more aggressive structures giving the companies more leeway, versus their U.S. counterparts.

While an equity clawback provision allowing the company to redeem up to 35% of the bond issue for the first three years after the bonds are sold using proceeds from any initial public offering or other equity sale is a standard feature of most junk deals, some issuers have pushed for – and have gotten – the right to take out more than the usual 35% of the issue. In 2014, this accounted for 31% of all junk deals, with the other 69% holding to the more traditional 35% formula.

The study found that among the European issuers, 25.6% had the higher equity provision in 2013, which approximately doubled to 50% in 2014, while the U.S. percentage merely increased from about 15.5% in 2013 to 26.9% in 2014.

European issuers also appear to be making greater use of provisions that allow the companies to set up a basket permitting restricted payments of up to 6% – or even more – of the proceeds received from an IPO.

In 2014, about 65% of the European issuers had such a capacity, up from around 45% in 2012 and 62% in 2013, surpassing the U.S. issuers; only about 35% of the latter had such an ability in 2014, versus 35% in 2012 and 40% in 2013.

"So it's just interesting that [the European junk market] is evolving," Lopez said, "and even in some ways leading, as far as flexibility goes."