Covenant Review

THE AUTHORITY ON BOND AND LOAN COVENANTS

HIGH YIELD BOND COVENANTS:

The Basics and Recent Trends

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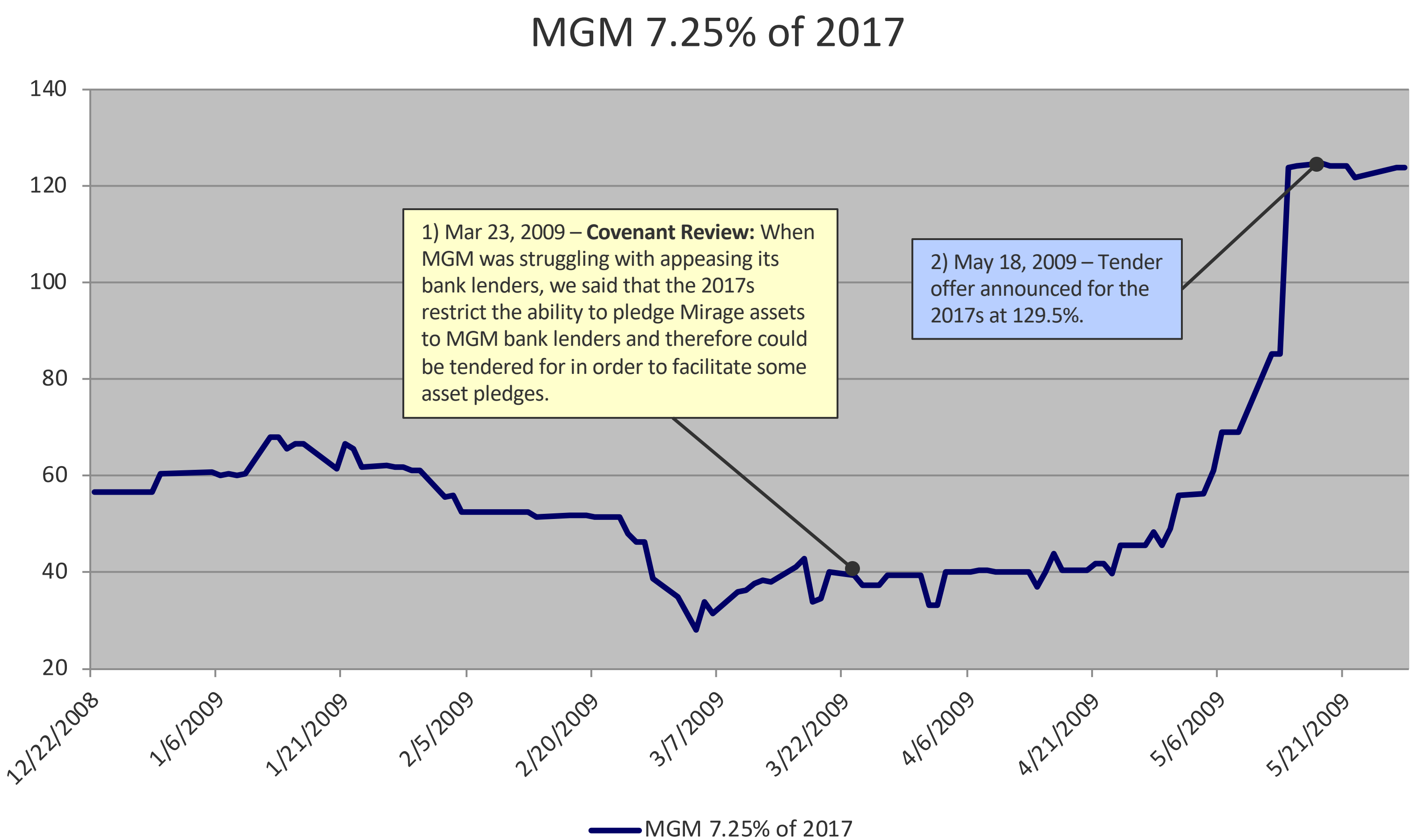
Why Are We Here?

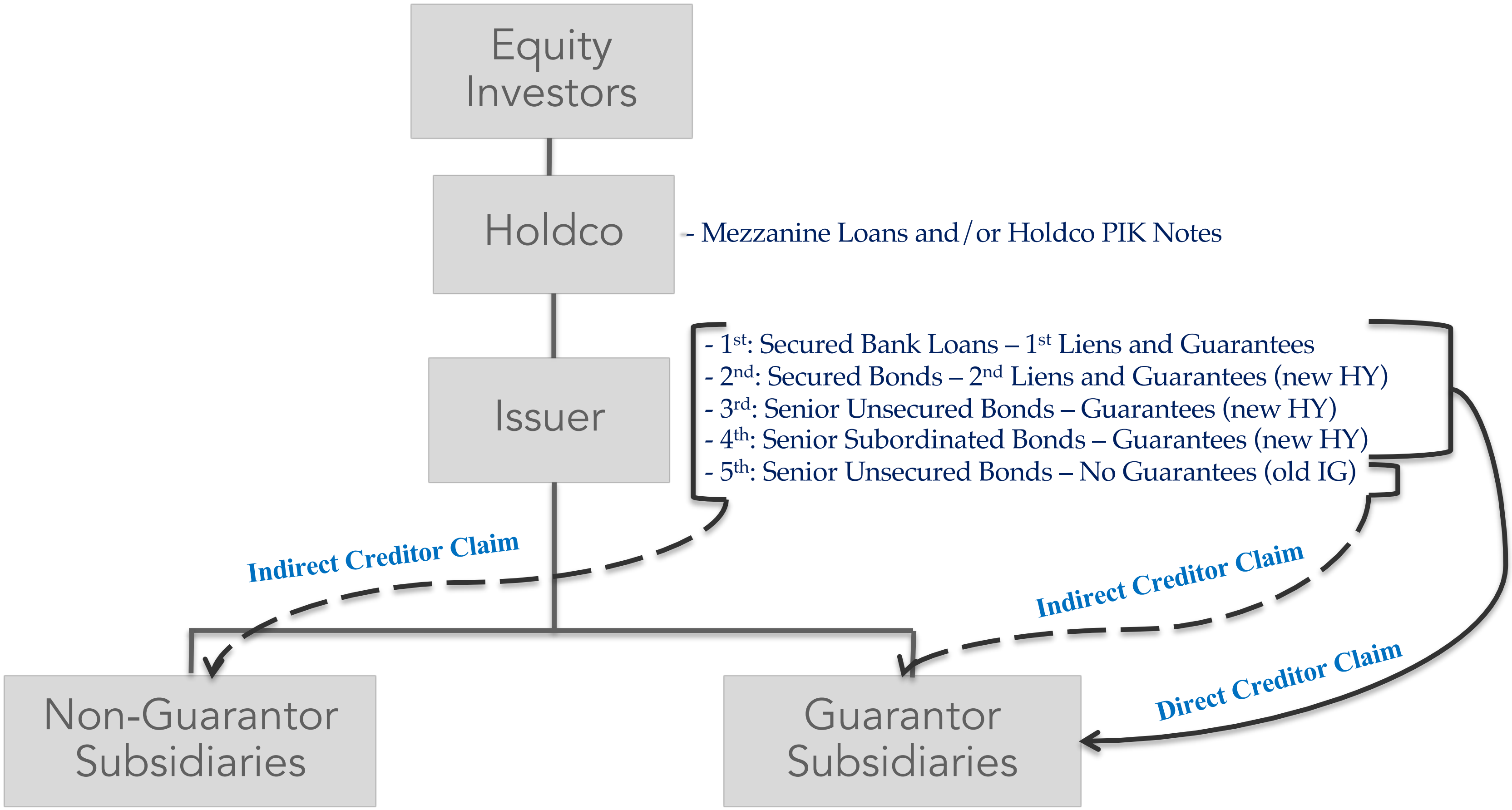
- Opportunity gap between how people “expect” covenants to work vs. “reality” of the language
- Covenants can and do vary among bonds from the same issuer
- The salesperson / analyst / banker does not understand how the covenants work
- Most analysts are not attorneys
- Covenant analysis is “underpublished” (and usually wrong)

Classic market inefficiency = You make money

MGM: Make-Whole on Refinancing



A Post-LBO Capital Structure



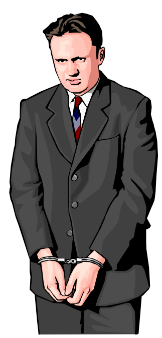
The Covenant System

Issuer / Borrower

- Primary obligor on the loans
- Must obey the covenants

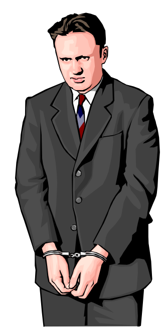
Guarantor(s)

- Secondary obligor on the loans
- Usually also a Restricted Subsidiary
- If a Restricted Subsidiary, must obey the covenants



Restricted Subsidiary

- May also be a guarantor
- Must obey the covenants



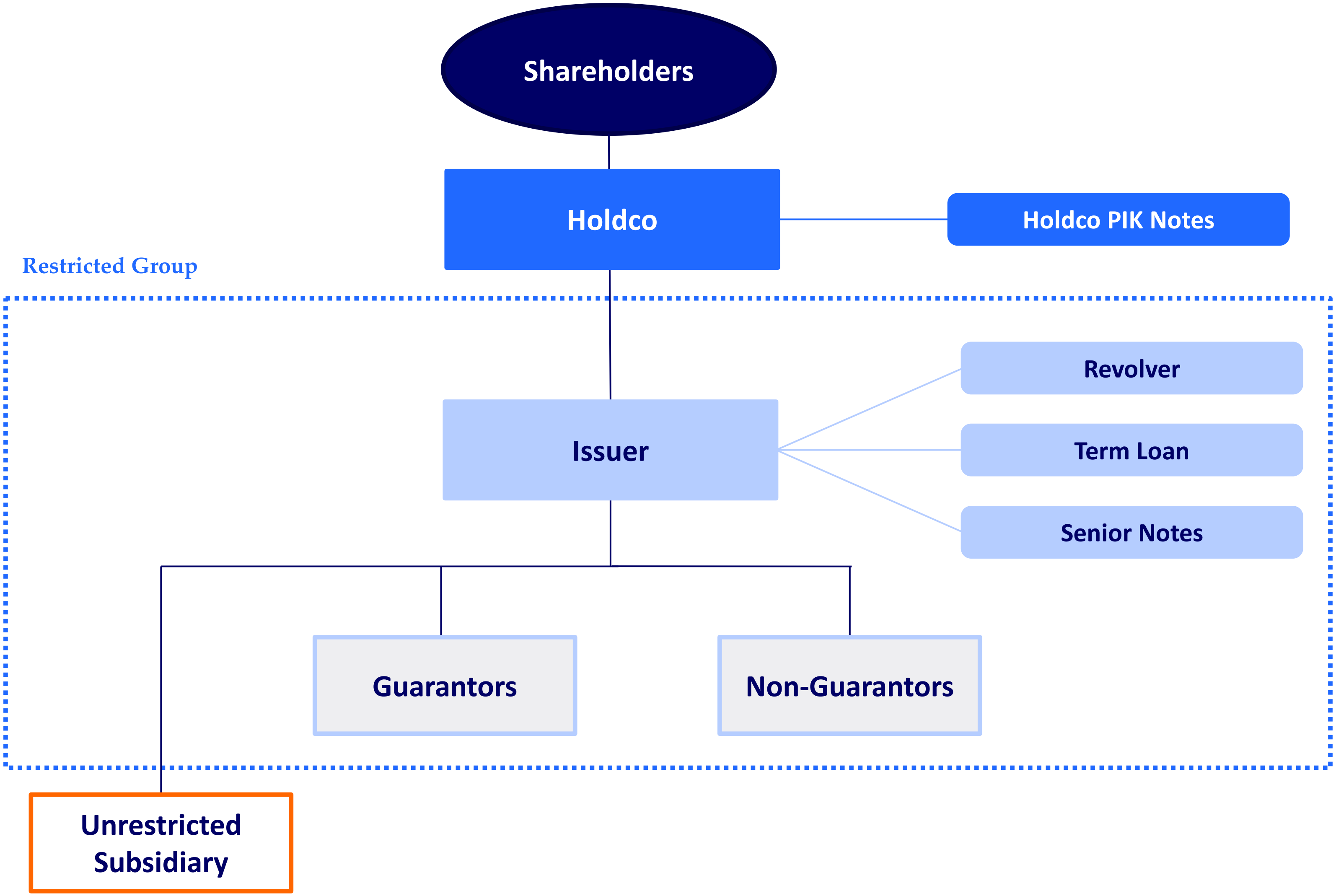
Unrestricted Subsidiary

- Not a guarantor
- Does not obey the covenants

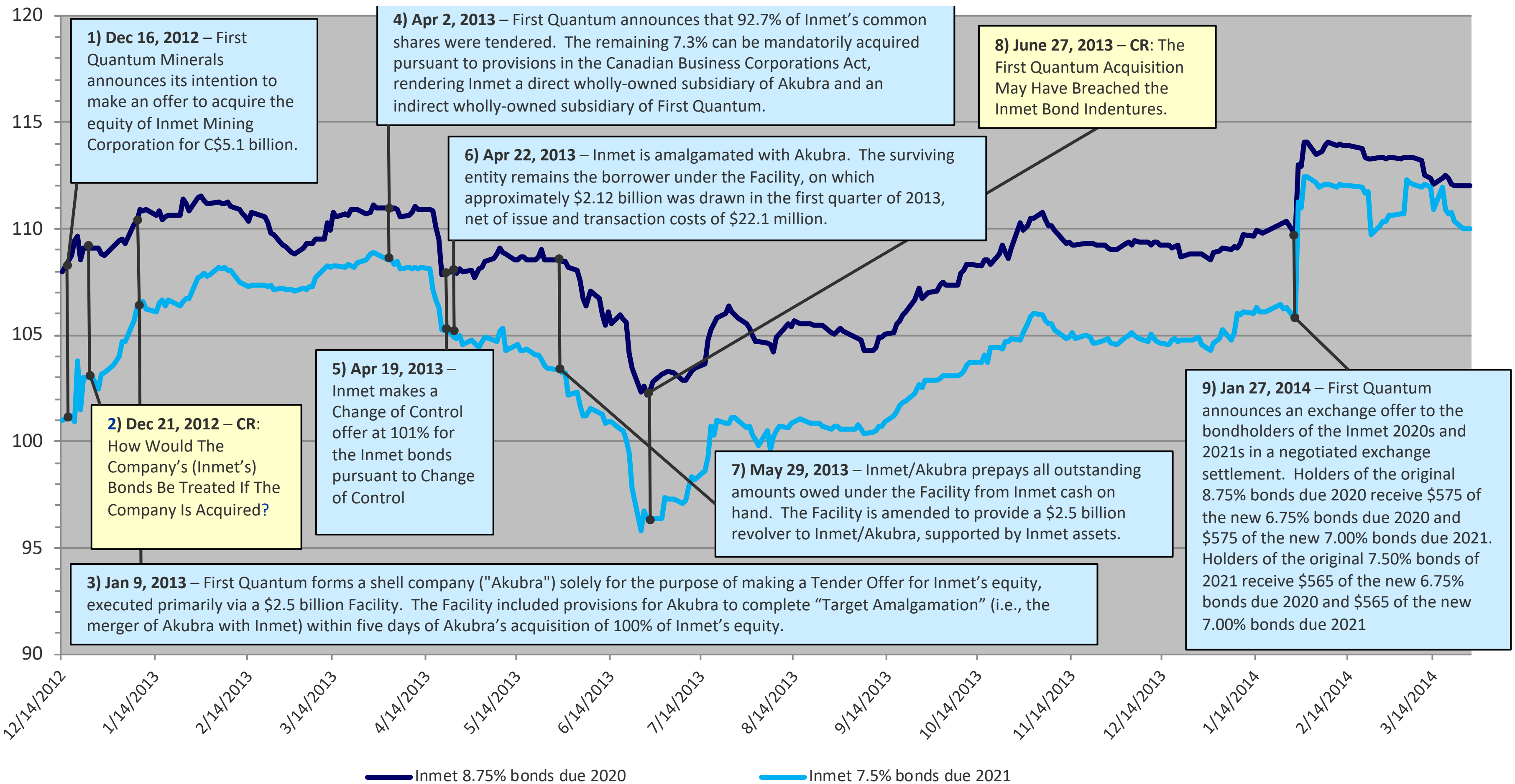
Restricted Payments Covenant

- **Purpose:** Protect bondholders' interest in the assets of the Company by limiting undesirable distributions and asset transfers such as:
  - Dividends on equity
  - Stock repurchases
  - Prepaying junior debt
  - Investments in entities that are not Restricted Subsidiaries
- The Restricted Payments covenant restricts the issuer from taking these actions "directly or indirectly"

Restricted Payments – Keeping Value in "The Box"



First Quantum: Litigating to Win



Restricted Payments: Basket Build

- **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) if:
    - Pro forma the issuer can incur $1 of Ratio debt (interest coverage / leverage); and
    - No default
  - Typically builds from the fiscal quarter beginning either before or after the issue date, but may be backdated to match other bonds of the issuer
  - Sometimes also includes a "starter" amount

Restricted Payments: Carveouts

- **Restricted Payments Carveouts include:**
  - **General Restricted Payment basket:**
    - Provides general capacity for restricted payments up to a specified amount
  - **Ratio-based carveout:**
    - It is becoming more common for a carveout to be included that permits any restricted payments subject to pro forma compliance with a leverage ratio test
    - These restricted payments should (but often don't) reduce basket build-up capacity
  - **Dividends of % of public offering proceeds:**
    - Allows annual dividends up to a specified percentage (usually 6%) of IPO proceeds received by the issuer
    - Sometimes allows for dividends up to the greater of a percentage of IPO proceeds and a percentage of market capitalization (which is more aggressive)

Restricted Payments: Carveouts

- **Restricted Payments Carveouts include (cont'd):**
  - **Excluded Contributions:**
    - Allows proceeds of equity offerings or capital contributions to be reserved for restricted payments
    - Permitted regardless of whether the issuer could incur $1 of ratio debt
    - Excluded Contributions will not build Restricted Payments basket capacity
  - **Distributions of unrestricted subsidiary stock or debt:**
    - Permits unrestricted subsidiaries to be spun off
    - Typically not allowed where the primary assets of the unrestricted subsidiary are cash / cash equivalents
  - **Repurchases management / employee equity**
    - Typically limited to a small annual cap
  - **Use new equity to repurchase old equity or to make a restricted investment**

Restricted Payments: Leverage-Based Carveout

- **Leverage ratio definition**
  - "**Consolidated Leverage Ratio**" means, as of any date of determination, the ratio of (x) Consolidated Leverage, net of cash and cash equivalents, at such date to (y) the aggregate amount of Consolidated EBITDA for the period of the four most recent fiscal quarters ending prior to the date of such determination for which internal consolidated financial statements of the Issuer are available….

- **Leverage based carveout**
  - (17) so long as no Default or Event of Default has occurred and is continuing (or would result therefrom), any Restricted Payment; provided that, on the date of any such Restricted Payment, the Consolidated Leverage Ratio for the Issuer and its Restricted Subsidiaries does not exceed 3.5 to 1.0 on a pro forma basis after giving effect thereto;

- **General Basket**
  - (11) so long as no Default or Event of Default has occurred and is continuing (or would result from), Restricted Payments in an aggregate amount outstanding at any time not to exceed the greater of $500 million;

Restricted Payments: Leverage-Based Carveout (Net vs Gross)

Values in $ millions	March 31, 2018					
	Actual		As Adjusted		As Further Adjusted	
	Amount	x Adj EBITDA	Amount	x Adj EBITDA	Amount	x Adj EBITDA
Cash	1,000		500		0	
Senior Secured Revolving Facility	-		-		-	
Senior Secured Term Loan	1,500		1,500		1,500	
Total Senior Secured Debt	**1,500**	**3.0x**	**1,500**	**3.0x**	**1,500**	**3.0x**
Total Net Senior Secured Debt	**500**	**1.0x**	**1,000**	**2.0x**	**1,500**	**3.0x**
Senior Notes due 2023	400		400		400	
Senior Notes due 2025	300		300		300	
Total Debt	**2,200**	**4.4x**	**2,200**	**4.4x**	**2,200**	**4.4x**
Total Net Debt	**1,200**	**2.4x**	**1,700**	**3.4x**	**2,200**	**4.4x**
Equity	1,500		1,500		1,500	
Total Capitalization	**3,700**	**7.4x**	**3,700**	**7.4x**	**3,700**	**7.4x**

LTM Adjusted EBITDA	**500**	**500**	**500**

Permitted Investment Carveouts

- **Permitted Investments Carveouts include baskets for investments in:**
    - Joint ventures
    - Unrestricted Subsidiaries
    - General investments
    - Other investments

Growing Concerns: Unrestricted Subs and the J. Crew Trapdoor

- Pushing frontiers on Unrestricted Subsidiaries
  - J. Crew: Dropped brands into an Unrestricted Subsidiary
  - Concerns over other issuers "pulling a J. Crew" and doing similar transactions
  - "Trapdoor" basket allowing for investments made by non-loan parties with proceeds of investments made in them by loan parties potentially converts such capacity to general-purpose capacity
  - Ultimately, any issuer's ability to do similar transactions rests upon investments capacity
  - This scenario illustrates why lack of leverage tests for use of builder baskets to make investments is problematic

Growing Concerns: Unrestricted Subs and the J. Crew Trapdoor

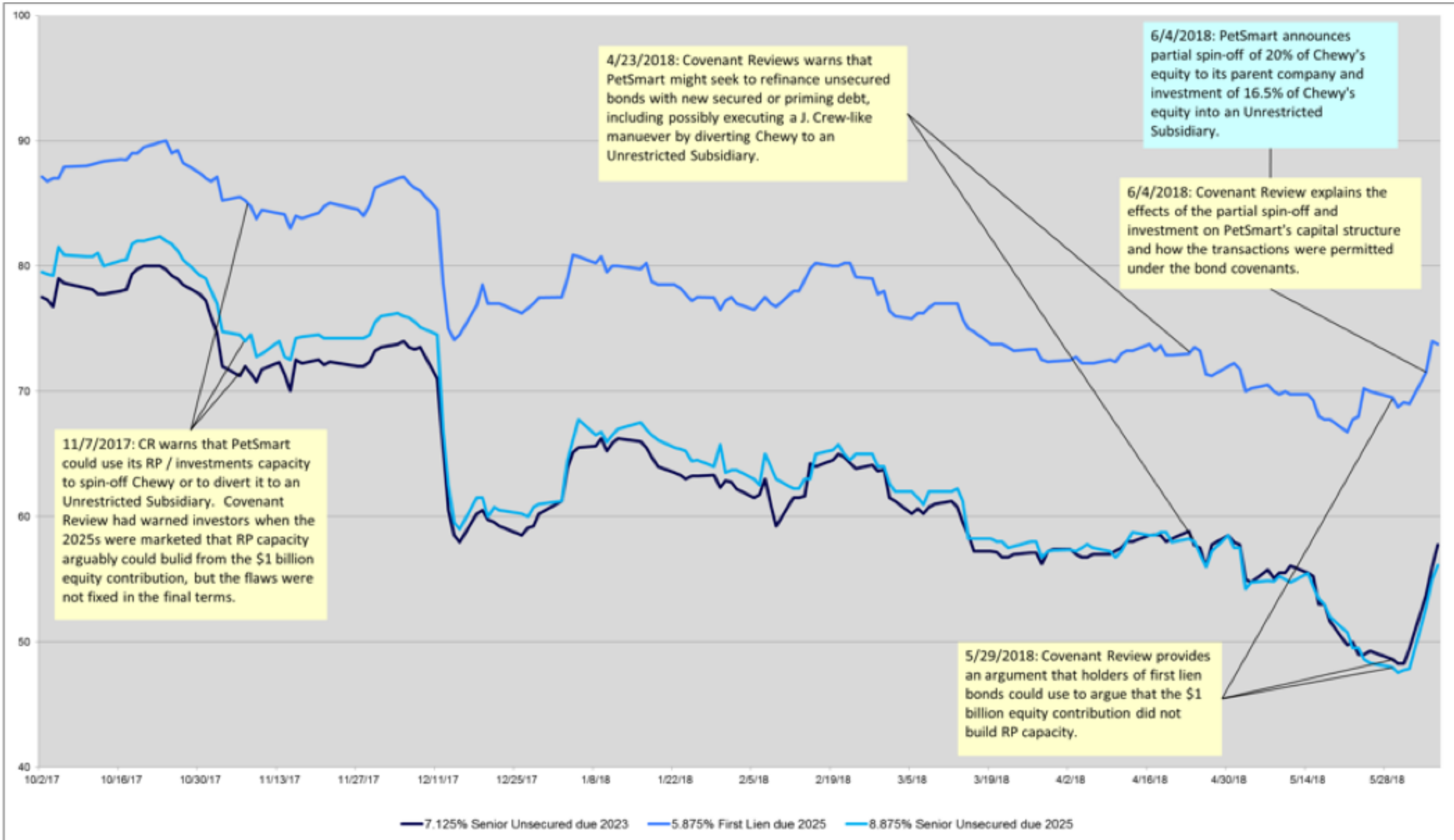
Covenant provisions are moving away from traditional rationale for investments in Unrestricted Subsidiaries and now often include multiple—sometimes duplicative—carveouts allowing substantial value to be diverted to Unrestricted Subsidiaries

For example, in addition to J. Crew trapdoor, TPG-backed RCN Grande's bonds include:

- $75 million / 25% of Consolidated EBITDA for investments in Unrestricted Subsidiaries
- $100 million / 35% of Consolidated EBITDA for investments in Similar Businesses
- $100 million / 35% of Consolidated EBITDA general Permitted Investments basket
- $62.5 million / 22.5% of Consolidated EBITDA general RP basket (in addition to $95 million / 32.5% of Consolidated EBITDA basket build starter amount)

Many sponsor deals also include an RP carveout for investments in Unrestricted Subsidiaries

PetSmart: Pushing Boundaries on Unrestricted Subs?



Covenant Review

Growing Concerns: Unrestricted Subs

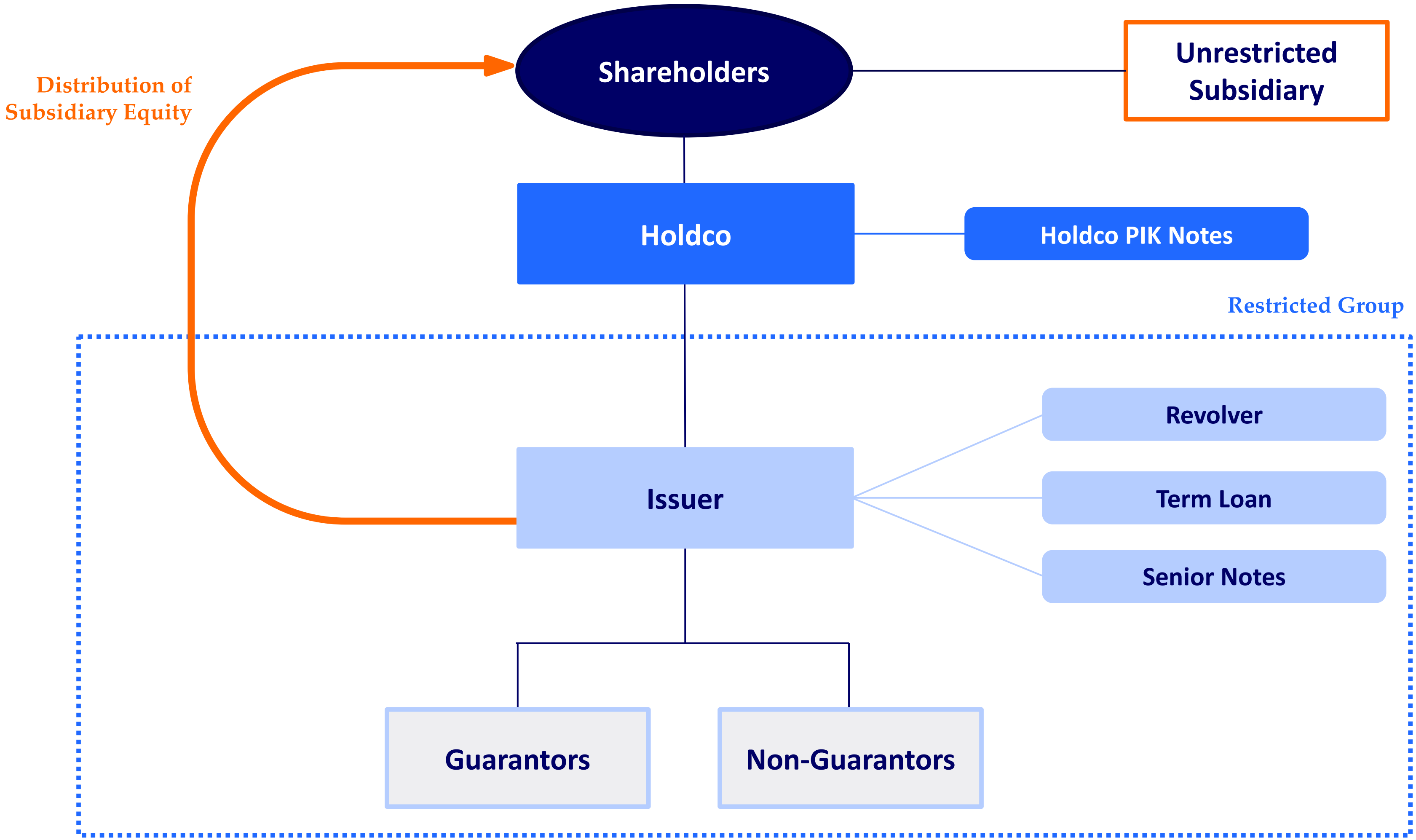
- Pushing frontiers on Unrestricted Subsidiaries
  - CCO: Using an Unrestricted Subsidiary to avoid the Asset Sales covenant of CCO bonds
  - CCO management: "But what I did hear was a question about the $900 million disposition basket under our credit agreement, that's accurate. We don't refresh what's outstanding under that basket but I think I can say that most of the asset sales that we've done have either been de minimis, and so they didn't count against that basket, *or it's been structured in such a way that it was an investment to an Unrestricted Subsidiary. And we like that technique, because the investment basket is refreshable. So, we can move assets into the Unrestricted Subsidiary. We have greater flexibility to get some proceeds. And we have a lot of value that we built up in Unrestricted Subsidiaries so we can pull cash or other assets back into the restricted group to refresh the investment basket."*

Growing Concerns: Unrestricted Sub Spin-Offs

"(15) the distribution, by dividend or otherwise, of shares of Capital Stock of, or Indebtedness owed to the Issuer or a Restricted Subsidiary by, Unrestricted Subsidiaries (other than Unrestricted Subsidiaries, the primary assets of which are cash and/or Cash Equivalents);"

Example is from PetSmart 5.875% Senior First Lien Notes due 2025

Growing Concerns: Unrestricted Sub Spin-Offs



Debt Covenant

- **Purpose:** Limit future debt incurrence to increase chances that the Company will be able to repay your debt

- **Basics:** Restrict incurrence of debt, disqualified stock, and restricted subsidiary preferred stock unless:
  - A ratio test is met, or
  - A "Permitted Debt" basket is granted

- **Two kinds of ratio tests:**
  - Fixed Charge Coverage Ratio (EBITDA: interest expense)
  - Leverage Ratio (debt: EBITDA)

- **EBITDA and covenant EBITDA are different!**

Debt Covenant

- **All debt covenants include a list of exceptions called "Permitted Debt"**
  - Permitted Debt is incurred after ratio debt, and can typically be incurred even if the ratio test cannot be satisfied

- **Permitted Debt carveouts include:**
  - **Credit facilities basket:**
    - Generally the largest and most important carveout
    - Allows for debt under credit facilities to be incurred and secured, typically ranking senior to the bonds
    - The definition of "Credit Facilities" is typically broadly drafted and includes any loans or bonds
    - Typically intended to provide capacity for the issuer's existing / new credit agreement, but it may have headroom that can be used for additional loans or bonds

Debt Covenant

- **Permitted Debt carveouts include (cont'd):**
  - **Existing debt basket:**
    - Debt covenant logically must permit any debt that already exists on the issue date
    - Typically permits all existing debt, other than the credit agreement
  - **Capital lease / purchase money debt**
    - Permits debt incurred in connection with acquiring assets or through capital leases
    - Typically 3-5% of assets
  - **Acquired debt:**
    - Permits debt of an acquired entity
    - Generally permitted if pro forma either the issuer can incur $1 of additional ratio debt or the fixed charge coverage ratio would not decrease
    - Often also permits acquisition financing debt

Debt Covenant

- **Permitted Debt carveouts include (cont'd):**
  - **Equity credit debt:**
    - Permits debt up to an amount of equity contributions after the issue date
  - **Non-guarantor / Foreign subsidiary debt:**
    - Typically a carveout for a specified amount of debt of non-guarantor restricted subsidiaries or foreign restricted subsidiaries is included
  - **General debt basket:**
    - Usually the last carveout in the list of Permitted Debt carveouts will be a general debt basket that allows some specified amount of additional debt for any purpose
  - **Other deal-specific carveouts**

Liens Covenant

- **Purpose:** Protect seniority position
  - Limit amount of debt that may be effectively senior to the bonds due to a lien on assets of the issuer and guarantors
  - Bondholders don't want the next senior note deal to be secured

- **Basics:** Two types of Liens covenants:
  - **Negative pledge**
    - Prohibits liens unless the bonds are equally and ratably secured, but also allows liens to be incurred under carveouts called "Permitted Liens"
  - **True liens**
    - Prohibits all liens except Permitted Liens

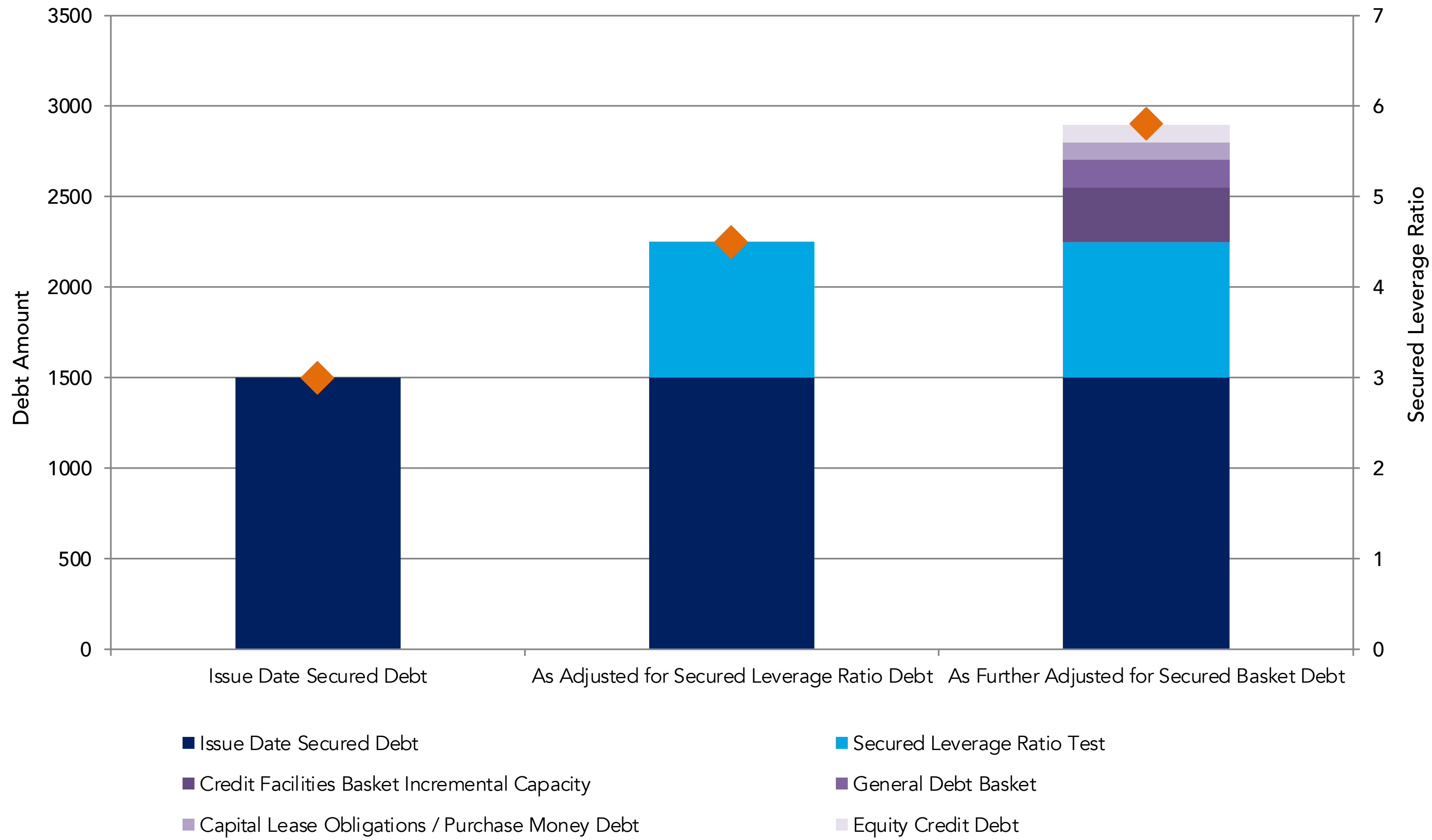
Liens Covenant

- **Permitted Liens carveouts include:**
  - **Credit facilities liens basket:**
    - Permits liens that secure debt incurred under the credit facilities debt basket
  - **Liens based on a secured leverage ratio:**
    - Permitted liens often permit additional liens based on pro forma compliance with a specified secured leverage ratio test
  - **General liens basket:**
    - Typically permits liens on any assets up to a specified cap
  - **Existing liens:**
    - Typically permits all liens existing on the issue date, other than the liens securing the credit agreement
  - **Acquired liens:**
    - Permits liens on acquired entities / assets existing at the time of acquisition; typically limited to liens that are not created in contemplation of the acquisition

Liens Covenant

- **Permitted Liens carveouts include (cont'd):**
  - **Liens on non-guarantor / foreign subsidiary assets:**
    - Permits liens on assets of non-guarantor restricted subsidiaries and/or foreign restricted subsidiaries securing debt of those entities
  - **Purchase money / capital lease liens:**
    - Permits liens securing permitted purchase money debt and capital lease obligations, limited to the assets financed
    - Often can only secure debt incurred under the purchase money debt / capital lease obligations debt basket
  - **Many miscellaneous exceptions for involuntary permitted liens**

The Secured Leverage Ratio is Not a Cap on Secured Debt



Designated Commitments

The "Secured Leverage Ratio" definition includes:

"To the extent Parent elects pursuant to an officers' certificate delivered to the Trustee ***to treat all or any portion of the commitment under any Indebtedness as being incurred prior to the actual incurrence thereof*** ***…*** the Issuer shall deem all or such portion of such commitment of such Indebtedness, as applicable, as having been incurred and to be outstanding for purposes of calculating the Secured Leverage Ratio for any period in which the Issuer makes any such election and for any subsequent period until such commitments or such Indebtedness, as applicable, are no longer outstanding."

Example is from Valeant 8.5% Senior Notes due 2027

Designated Commitments

Values in $ millions	March 31, 2017			March 31, 2018		
	Actual	As Adjusted	Covenant Pro Forma	Actual	As Adjusted	Covenant Pro Forma
Senior Secured Revolving Facility	-	-	1,000	200	850	1,000
Senior Secured Term Loans	1,500	1,500	1,500	1,500	1,500	1,500
Total Senior Secured Debt	**1,500**	**1,500**	**2,500**	**1,700**	**2,350**	**2,500**
Senior Notes	400	400	400	400	400	400
Total Debt	**1,900**	**1,900**	**2,900**	**2,100**	**2,750**	**2,900**
Equity	1,500			1,500		
Total Capitalization	**3,400**	**1,900**	**2,900**	**3,600**	**2,750**	**2,900**
LTM Adjusted EBITDA	**550**			**400**		

	At March 31, 2017	At March 31, 2018
Historical and pro forma leverage ratios:		
LTM secured leverage ratio	**2.7x**	**4.3x**
Pro forma LTM secured leverage ratio	**2.7x**	**5.9x**
Pro forma “Secured Leverage Ratio”	**4.5x**	**6.3x**

What do people say about Covenant Review?

"An independent and authoritative source of textual exegesis for the bond buyer."

James Grant, Publisher, Grant's Interest Rate Observer

"This is exactly the type of analysis [we are] interested in and seems more thorough and thoughtful than [other research]…. I mentioned that [provision] to the analyst and he shrugged. Now I realize that his shrug meant that he had no idea whether this was a problem rather than he was indifferent to this language in the covenant."

Portfolio manager, insurance company

"We really rely on your service [and] think your product's great…It's in everyone's interest to have you widely read."

In-house counsel, $5+ billion multi-strategy asset manager

"The commentary [is] sufficiently detailed to be meaningful, but not overbearingly so."

General counsel, $2+ billion credit fund manager, commenting on why his firm subscribed

"I know who you guys are. You're the ones who make things difficult for me every time I am working as issuer's counsel."

Law firm partner, meeting a Covenant Review analyst

Questions? Contact Covenant Review

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