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## DebtXplained: 2010 Annual Review

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1. 2010 was a bumper year for EHY with over €44bn of issuance.
2. After fluctuations in April, in the last two quarters the market withstood a variety of macro financial pressures.
3. The strongest new market feature is the “senior secured” notes moniker.
4. From 2009, companies began issuing “senior” bonds through SPVs/holdcos.
5. These notes were therefore structurally subordinated to opco debt, which the market recognised.
6. The need to refinance loans with bonds has created new structural innovations.
7. Legal problems have prevented bonds being issued from the same companies as loans.
8. The value of the security therefore became a paramount issue for Noteholders.
9. Artificial measures were created to let “pari passu” loan holders control enforcement of security.
10. This could work well provided that the interests of bondholders and loan holders are aligned.
11. However, loan holders determine the value of the security potentially putting bondholders at risk.
12. Loan debt was also refinanced through bonds structured as a loan tranche.
13. This raised the question of disclosure and information arbitrage between bond and loan holders.
14. In 2011 the market must decide if it is happy to continue with the “senior-secured” precedents set since it re-opened in 2009.
15. There is evidence that some Noteholders want changes in areas such as disclosure and enforcement

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2010.... What a year!! It’s hard to believe twelve months have passed since I wrote a 2010 New Year blog as the inaugural entry for the new DebtXplained website. Without showing any great foresight I forecast 2010 as a “vintage year” (not defined!) and without any doubt it proved to be so in terms of total issuance (over euro 44 billion). Also noteworthy was the fact that no matter what happened in other financial markets across the globe, by the end of the year European high yield market just kept on going, open for business on the right terms, nailing the myth that it was an unreliable market.

First, I would like to thank all of you for your support and invaluable feedback during DebtXplained's first full year of operation. Your support and involvement in our progress has been instrumental in our success to date. We aim to further refine and improve our service in response to your needs and developments in the market. Watch this space for various changes coming to the website in early 2011 to facilitate use; we will appreciate your thoughts and comments.

There are numerous "trends" which come out of a year as active as 2010. However, as DXP is primarily concerned with structures and their implications, there is one word which springs to mind as the hallmark of the 2010 high yield bond issues and which forms the basis of my review: "senior". I wonder if any other word has been so generously used and in many cases inappropriately applied as in relation to notes issued in the 2010 European High Yield Markets? We have a proliferation of senior notes of all varieties- what does it all mean? Why is it a matter for concern? And is just being "senior" good enough?

### *"Senior"?*

High yield (as created in the 1980s) was a subordinated debt product. As such, the incurrence covenant package (developed at that time and still remaining broadly the same in concept some 30 years on) was designed to protect Noteholders through focus on certain key issues such as restrictions on leverage and payments to equity owners (the "restricted payments" provisions), ensuring no value leakage (transactions with affiliates), restrictions on asset sales and dealing with the allocation of proceeds and the like. As such these covenants were much less restrictive than the standard "maintenance" covenant package traditionally requested by senior loan lenders, which included extensive reporting, operational and financial covenants (and generally, for instance, enforced a deleveraging process over time).

The underlying concept was that not being "senior" debt meant that that a different level of protection was required. And not being senior tended to mean there was a substantial amount of debt that (either by contract, use of structure or a mixture of both) ranked ahead of the debt due under the notes. If the notes were issued by a vehicle company with no assets to speak of, the notes could legitimately be described as "senior" obligations of the issuer (though arguably this was misleading as the commercial reality was that the Noteholders would only receive funds after other more "senior" creditors had been paid.

As the high yield bond market re-emerged in Europe from 2009 onwards, a practice emerged of high yield (subordinated) notes (described as "senior") being issued by structurally subordinated SPV's. These SPVs had no assets other than the right to receive interest (and principal) on outstanding ("proceeds") loans. In these structures note proceeds were typically being passed into the "group" by way of proceeds loans. Credit support (generally by unsecured and second ranking guarantees) was often limited. Covenant protection (by way of a standard "incurrence" package) would be provided in relation to the "group".

Fundamental to payment priority rankings of note debt was the fact that a further deeper level of subordination was (and is) contained in these deals: generally both loan and bond debt is at the "holdco" position in the deal structure. As a result, all of this debt is

subordinated to all trade, unsecured and secured creditors of the operating companies. In reality therefore rather than being “senior” notes, they are actually super subordinated! In the DebtXplained market survey (summer 2010) there was general consensus that notes of this nature should not be described as “senior”.

Despite this consistent conflict between illusion and reality of “senior” ranked debt, the market grew to accept the contradiction. Over the course of a decade the term “senior” came to be viewed as a term of art rather than a precise description. No one had any illusions that while the note packaging was marked “senior”, what the packaging contained was not.... Pricing has, for the most part, reflected this.

The need to reconcile the significance of being “senior” vis-à-vis structural integrity was then triggered by the fact that following the financial crisis the loan market no longer had capacity to continue to supply the quantity of term debt required by many of Europe’s companies. It became clear that a new source of capital was required and in late 2009 leading bankers and lawyers crafted refinancing deals for companies such as Virgin Media and Smurfit Kappa to replace senior secured term debt with “senior” secured bonds. These early deals set some (perhaps unfortunate) precedents.

### *Senior Secured Notes*

*Simple concept: Replace maturing senior term debt with high yield bonds (senior of course!). As always the devil is in the detail. But as some say, better the devil you know....*

“Senior” term debt is considered to be debt ranking pari passu with other unsecured debt apart from that preferred by operation of law (taxes etc.). In many cases however it is not possible for the new notes (proceeds to be used to prepay existing term debt) to be issued by the existing borrowers (a simple “replace a senior loan by a senior bond”). “On loans” and guarantees might be used to attempt to replicate the prior loan structure but guarantees are subject to local law restrictions which may make this imperfect.

A further way of creating “parity” between existing term loans and new note issues is to grant to the new note issue the benefit of the same security as is held by the loans and agree that proceeds from enforcement will be distributed on a “pro rata” basis. Ultimately this has been the solution on all the senior secured bond structures.

While logical it does of course depend upon the security being effective: On an unsecured basis the term loan debt (which may in part be granted to operating companies or at least to companies senior in the structure to note issuers) is not likely to rank pari passu with new notes (it may well rank ahead). This means that it is only the security that protects the bondholder in the case of insolvency. This risk can be reversed however, for example on the Matalan unsecured senior note issue the notes and loans expressly rank pari passu on an unsecured basis and it is only the security granted to the loan holders that gives their loans priority. In 2010, this deal was an exception and was a total (rather than partial) refinancing.

A final variation on the “senior notes replace term debt” theme is where all (rather than part only) of the term debt is prepaid and replaced by notes. In these circumstances there will often be a revolving credit facility (secured in priority to notes) ranking ahead of the new

notes. These “super senior” RCF deals create a further twist to the existing note debt in respect of their respective rights as secured holders vis-à-vis other secured debt classes- this is the key element of the senior secured notes debate.

### *Precedent Structures*

While views may vary, some would argue that the Virgin refinancing set the standard for rights (or lack of) of Noteholders in senior secured notes deals. In that structure, loan holders had to consent to various changes required to allow for the note issue and agreed to do so on the basis that until such time as loans (as a percentage of combined loan/note) fell below 35% the ability to give instructions to enforce security would remain with the loan holders (thereafter voting would be pro rata to outstandings). In other words Noteholders, though entitled to share in security enforcement proceeds, had no rights in the process to determine the quantity of those proceeds. Perhaps surprisingly this has become (with variations to the relevant percentage) the standard for the majority of senior secured note deals in 2010.

In the meantime, the Expro transaction (the subject of my 2010 new year blog!) introduced another “standard” feature; namely the inclusion of a new tranche of debt in a bank facility where the proceeds were used to prepay other tranches. In these cases, the new tranche would originate from the proceeds of a high yield note issue. This structure brought to the forefront the issue of voting rights for lenders. The questions here became whether these rights should be granted to Noteholders as “lenders” and what should happen when incurrence and maintenance covenant packages sat side by side.

It also became increasingly clear that the structures were throwing up an information mismatch. Loan holders not only had access to more detailed financial information (through better reporting to the financial covenant package) but also comprehensive documentation (including the intercreditor agreement) which detailed enforcement control rights and which was not generally made available to potential Noteholders. Obvious issues of transparency emerged.

As the torrent of senior secured notes continued and intensified DebtXplained consistently pointed out the trends towards structural weaknesses of Noteholders position and the inability to carry out fully analysis in the absence of key documents.

### *At the end of 2010: Where did the market end up?*

The “loan” covenant package will always give loan holders an earlier default “trigger” which, coupled with shorter grace periods and a two thirds majority vote requirement for formal default, means loan holders will almost always be the creditor group driving any process towards acceleration/ insolvency/ enforcement/ restructuring. A pricing differential between the margin on the senior loans and the implied margin on senior bonds seems to have developed to compensate for this.

In senior loan/ bond deals such as Continental where loans and notes are issued by separate companies and rely on shared guarantees/ security each group relies on its own covenant package and enforcement voting follows the “minimum bank control” principle detailed

above. Cross default/ cross acceleration issues seem to have been dealt with on a case-by-case basis.

Voting in increasingly structured deals where note issue proceeds were in effect “converted” into loans and advanced to borrowers became difficult. One extreme was the Ziggo senior notes deal in which there was an express disenfranchisement of any right that might accrue to “converted loans”. Yet in deals such as UPC and Telenet note holders benefited from similar rights to loan holders. There is a broad spectrum here and no common standard has yet evolved.

Notwithstanding the disapproval of many investors (as evidenced by the DXP market survey summer 2010) as regards control of any enforcement process, the “minimum bank control” approach has become market standard (a big question is whether it will remain so in 2011). The percentages may have moved from deal to deal (though not by much!) but the concept remains intact. Indeed in a (small) number of deals the credit facilities expressly prevent the borrowers prepaying loan debt to below a level where loan holder control would be removed. As this “twist” emerged feelings of a non-level playing field were enhanced.

In a small number of deals the concept of loan holder control falling away after a given period should loan holders not have taken any action was introduced. While better to have than not; hardly a substitute for equal voting rights!

The rights of “super senior RCF” lenders do not seem to have generated the same passionate debate as other issues; as a passing comment I would say allowing such lenders to control an enforcement process would seem akin to allowing the tail to wag the dog!

### *And 2011?*

There are rumours that long term investors in high yield feel some of the issues outlined above need to be addressed other than on a case by case basis. An EHYA sponsored “intercreditor” initiative in 2010 failed to reach consensus. Investment banks feel a duty to obtain the best possible terms for their clients from a market hungry for paper. None of this leads one to think the issues will be resolved fast while as is well documented the requirement for “high yield” to replace maturing senior term debt will if anything increase in 2011, coupled with new corporate issuance and greater use of high yield in private equity deals.

It promises to be another busy (and complex) year. A happy, prosperous, active and profitable time to all!

Stephen Mostyn Williams - CEO DebtXplained: Your Eurobond Companion.

*P.s. DXP will be publishing a follow up papers focusing on some of the above concepts with reference to specific 2010 deals and welcomes questions and comments on any of the issues raised here: [info@DebtXplained.com](mailto:info@DebtXplained.com)*