
DebtResearch: Change of Control: Erosion of Standard Noteholder Protections

We at DXP have noticed in recent deals what appears to be an evolution in what is considered “market standard” in change of control provisions that could signal an erosion of a high yield Noteholder’s protection in the event of a change of control. We partnered with our friends at Covenant Review to get a sense of how these changes compare to similar developments in the US market. We have concluded that on the basis of recent deals, there is the risk of a serious erosion of standard Noteholder protections due to various creative formulations of the change of control (CoC) covenant employed in deal structures to serve the interests of sponsors and issuers. While these do not wholly fail to accommodate certain Noteholder interests, the increasing presence of non-standard features creates the risk that they, rather than the standard protective CoC provision, will become what is considered “market”.

The Purpose of Standard CoC Provisions

Traditionally, the CoC provision in a high yield bond was designed to require an issuer to give each Noteholder the right to elect whether to stick with the credit or put its notes back to the issuer upon the occurrence of certain fundamental corporate events. These events almost always include:

- i. Beneficial ownership of a majority (or greater than 35% post-IPO) of the voting stock of the issuer by a Person (who is not included in the definition of permitted holder);
- ii. A sale of all or substantially all of the assets of the group to a Person (who is not included in the definition of permitted holder);
- iii. Sweeping changes in the board of directors over a two-year period; and
- iv. Certain insolvency events.

Whilst we have noticed that some deals omit one or both of the latter two categories, the majority of deals in Europe include all four, and require the issuer to make a change of control offer upon the occurrence of one of the events.

The CoC put is essential in the context of a Noteholder’s investment. When an investor makes its initial investment decision, he or she does so on the basis of all of the information included in the offering memorandum, including the disclosure regarding principal shareholders and the strategic plans for the company. Should the identity of those shareholders change such that another group has effective control of the business plan, Noteholders want assurance that they can revisit their investment decision and the option to exit if they are not comfortable with the new ownership.

Ziggo: The First Major Change

The first recent deal in Europe to alter these rights was Ziggo’s bond issue launched in May 2010. The Change of Control definition included the standard triggers of the 101% put requirement listed above, but also allowed the company to avoid making a change of control offer if it could declare it a “Specified Change of Control Event”. A Specified Change of Control is defined as the occurrence of any event that would otherwise constitute a Change of Control (except for the insolvency trigger), provided that immediately before and after the event (on a pro forma basis), Ziggo’s Consolidated Leverage Ratio would be less than 5x (if the event occurred within a year of the Issue Date) or 4.5x (for events occurring thereafter). Ziggo can only make this election once in the life of the bonds.

The provision raised some eyebrows, but the syndicate had no trouble selling notes issued by a solid Dutch cable company, marking the first acceptance by the European market of this kind of provision. However, we can recall from dialogue with our buy-side subscribers their expression of surprise at the omission of public mention of the provision at the roadshow. The concern at the lack of a push back by the buy-side in support of their standard rights may also have contributed to the formation of the informal buy-side group, which has recently been in dialogue with various syndicates about greater transparency and disclosure for Noteholders. So while the provision was included and the bonds were sold, this was not without effect.

You Don't Know What You've Got Till it's Gone?

We have again spoken to Noteholders for the purpose of this note about their perspective on these CoC “get out of jail free” cards. The general feeling was that these terms are factored into a total investment decision and a choice is made on a deal-by-deal basis whether their presence is significant enough, in combination with other factors, to make the deal undesirable to buy. While this is logical, it seems to miss a key point: the establishment of a new market standard that, eventually, may not make its way into pricing determinations.

At present, Noteholders are in a position whereby the minority of deals manifest these new, unfavourable provisions. Therefore, Noteholders currently *do* have a choice about whether to buy a deal with one of these provisions or to defer and buy another deal, which includes the standard market protections. Ultimately the decision to forego the deal is a vote against the provision itself, such that future deals may omit the provision in the interest of getting the deal away.

However, as we have recently seen with the special optional redemption provision of 10% @ 103 during the non-call period, what once was a feature included in a small number of deals can very easily become the market standard. When we published our note on this special optional redemption provision in March it appeared only sporadically. Now it is seen far more frequently, illustrating the danger of erosion in standard Noteholder protections. The increased appearance of novel CoC provisions could mark the inception of a similar trend – and the potential for the creation of a new CoC market standard. The difference between the 10% @ 103 call feature and the Change of Control provision is that the latter has a greater potential to negatively impact bond prices in the secondary market after the occurrence of a CoC event. If Noteholders cannot rely on the ability to sell at a specified price (and at a small premium), they will be completely exposed to the risk of this downward pressure on secondary market prices.

Recent CoC Innovation

In the past few weeks, five deals (six if Linn Energy is included) came to market with non-standard Change of Control provisions. We remarked on all of these in our reports and published a special note on the Odeon provisions, which were particularly elaborate. We briefly summarize the provisions below.

In Page Jaunes, launched on 6 May, the Change of Control covenant specifies that where no ratings downgrade results from the change of control event in question at the time of the transaction or within 90 days thereafter, and no default or event of default has occurred or is continuing or would occur as a result thereof, the Issuer will not have any obligation to launch a change of control offer. Refresco and Linn Energy, launched on the same day, follow the same construct implemented in a slightly different way. Polsat, a deal from two weeks ago, is the earliest example of this CoC formulation. See the reports for Page Jaunes, Refresco, Linn Energy and Polsat here: <http://www.debtexplained.com/Reports>

A few days later, on 9 May, Odeon launched its deal, which contained an entirely novel formulation of the change of control provision, one that seemed designed to facilitate an acquisition of the Company within 183 days of issuance of

the bond without triggering the CoC provisions so long as the deal met specific requirements related to leverage and identity of the buyer. See our note for a more fulsome description of the provisions: http://www.debtexplained.com/pdf/articles/_1252011154017623.pdf

Just yesterday Gala Coral was launched with CoC provisions reminiscent of the Ziggo formulation. In Gala, the CoC provisions will be disappplied in connection with a sale meeting certain specifications, including the ability to comply with a specified leverage ratio but unlike Ziggo, this “Permitted Sale” carve out is not expressly limited in the number of times it may be used. For a more complete summary of the provisions, see the report here: <http://www.debtexplained.com/deal.aspx?id=214>

The Implications of Erosion in the CoC Market Standard Protections

In four deals (Polsat, Pages Jaunes, Refresco and Linn), the CoC formulations appear to be incorporating looser standards typically seen in investment grade deals, similar to the trend seen in the US high yield market for some time (see below). We view these CoC provisions as the least hostile to Noteholder interests, as the link to ratings downgrades is protective of investment value. The ratings agencies will analyze a whole range of factors in evaluating the change in ownership on the future of the business, a fact that should give Noteholders some comfort.

In Odeon, however, the abnormal CoC seems to have been designed to permit the note refinancing to act as pre-acquisition financing should the company be sold. The CoC waiver included a specific time period, type of acquiring company and leverage ratio applicable to a transaction that would escape the application of the CoC provisions. The deal terms communicated to Noteholders that they could rely on the current leverage of the company (and their current level in the capital structure) to remain the same and the transaction to take place within around six months, which may have given Noteholders greater confidence in investing in a credit without traditional CoC protections. The Odeon CoC formulation gives some protection to Noteholders while also facilitating the interests of sponsors.

The same cannot be said for Ziggo or Gala Coral, as the only requirement for disapplication of the CoC provisions is the ability of the group to meet a maximum leverage ratio (pro forma for the transaction), a get out of jail free card that the issuer can call on at any time during the life of the bond.

Emerging CoC Trends in the United States Market

In the US, emerging trends around the Change of Control covenant make it increasingly dangerous to assume how the provision will work. First, as referenced above, some issuers are trying to incorporate some of the looser standards of investment grade Change of Control covenants. For example, the new Chrysler Group bonds would require a ratings downgrade before offering the 101% put. The new U.S. Foodservice bonds would allow the issuer to become a subsidiary of a publicly listed company without triggering a put, which is a surprisingly common (but little appreciated) loophole in American investment grade bonds.

Second, the market is seeing exceptions for “Permitted Holders” that not only include the current management and stockholders, but all kind of future possible affiliates, co-investors, and “groups.” A notable example was Exco Resources, where the company sold \$750 million of new bonds and then mere weeks later the CEO proposed a management buyout where Ares, Oaktree, and T. Boone Pickens would be able to come in to buy the vast majority of the shares to take the company private, and yet escape the Change of Control by forming a “group” where the CEO would have shared voting control.

Third, some issuers are bringing to market an apparent mergers trigger, which would make an investor think they could get a put if their issuer merges with another company. However, this mergers trigger can be cleverly drafted as just being a repetition of the standard trigger for a third party owning a majority of the voting stock. This approach

was deployed in the Emergency Medical Services offering and almost looks like a cynical attempt to make investors think that they have a normal Change of Control definition with a mergers trigger, but it is not really there. More commonly, the mergers trigger is missing altogether, such as for the recent CoreLogic and NRG Energy offerings.

Fourth, we are seeing a “close-out” provision where once 90% of holders accept the 101% put, the rest of the holders can also be forced to accept the put, as in the Goodrich Petroleum, Oasis Petroleum, and SM Energy offerings.

Finally, the US market is occasionally seeing some brazen provisions similar to Ziggo and Odeon, ones that almost seem to sneer the issuer’s understanding of the covenant and making it feel like a seller’s market. Perhaps the most offensive covenant has been in IASIS Healthcare. IASIS will be allowed a “free” Change of Control as long as the company’s leverage ratio would not go past 5.75x, allowing the business to be flipped to another private equity firm without triggering the 101% put.

(US examples are kindly provided courtesy of Covenant Review, a New York company that analyzes US bond covenants. Contact Adam Cohen, acohen@covenantreview.com / +1-212-716-5781)

Conclusion

As can be seen from the foregoing, CoC provisions seem to moving towards (or are currently in) a state of flux. In the context of acquisition financing the loan markets developed the concept of "staple finance" where a financing package in effect was "stapled" to the asset for sale and would be made available to any buyer. The clear implication was that the identity of the ultimate owner was not a major factor in the financing decision. It can be argued that if, as in Odeon, the terms of the notes are robust and protect the noteholders then a "portable" CoC is not unreasonable. What seems clear is that certainty as to a market "standard" is currently a thing of the past. DXP will continue to review changes as they occur.

Comments and questions welcome as always: sabrina@debtexplained.com / +44 207 100 9777