



European High Yield Bond Trend Paper (First Quarter 2010)

1. Post “Credit Crunch” an atmosphere of caution and restraint prevail in debt market.
2. A tendency to overlook compromised investor interests plagues the non-investment grade euro bond sector.
3. Three general trends emerge with consistency:
 - (i) Defining note debt as senior but effectively subordinating it to interests of other senior creditors;
 - (ii) Absence of noteholder control over collateral; and
 - (iii) Increasingly conservative disclosure in offering documents.
4. There has been a recent wave of deals containing lender-biased terms that may compromise the position of noteholders.
5. Noteholders are particularly vulnerable in an enforcement scenario.
6. Recourse by multiple senior creditors to all collateral available to noteholders is increasingly becoming the norm.
7. Increasing vulnerability of noteholders is compounded by the tendency to give non-note debt an exclusive say in respect of directing security.
8. As structures become more complex, noteholders rights are becoming increasingly diluted.
9. Deal complexity means noteholders may be unaware of the structural and contractual risks they face in these circular arrangements.
10. It appears that a hunger for paper (and a lack of time?) has replaced much needed scrutiny.
11. The fundamental problem with a lack of comprehensive disclosure is that investors may be unaware of loss of control over priority standing and recourse to security.
12. There is a conspicuous absence of rated deals.
13. Current trends combined with a lack of note ratings leaves note investors in a vulnerable position.

The question on the collective conscience of the debt market is whether lessons have been learned from the latest liquidity crises. The term “credit crunch” has become so commonly used that it has been included in the most recent edition of the Oxford English Dictionary. Credit Crunch is defined as: “a severe shortage of money or credit”. Following the recent market turmoil, European financial sectors have become characterized by an atmosphere of restraint and caution. This brief paper explores some of the trends, patterns and moods that have emerged within the Eurobond market in response to these new economic conditions.

Are Noteholders becoming overlooked?

Prior to the credit crunch appetite for debt soared. One particular innovation to the demand for easy loans was the use of a particular feature of the high yield market (incurrence testing), which replaced an obligation on borrowers to comply with financial ratios (maintenance testing). These loans became known as covenant-lite loans. Hindsight taught that such loans proved dangerous for investors due to a lack of protection.

Although the credit crunch halted these loans in their tracks; a tendency to overlook investor interests has continued in the bond market. A consequence of this is that noteholders often stand in the same vulnerable position as loan investors once did.

This is because ***senior notes have started to resemble covenant-lite loans in terms of contractual risk exposure and the associated uncertainty that this entails.***

Three General Trends Emerge:

Three general trends in recent deal structures are clear:

(i) A tendency to designate note debt as senior without practical mechanisms to enforce priority; (ii) An absence of noteholder control over collateral with direction of the security trustee in the hands of loan/hedge or other new secured creditors; and

(iii) Vague (if not absent) disclosure in offering materials where noteholder interests are concerned.

The combination of these features has led to the 2010 first financial quarter of the European bond market being synonymous with one thing – note holder vulnerability.

Noteholders as Silent First Lien Creditors:

A common feature of many recent debt issues is a sharing of collateral between multiple senior secured parties. In addition, certain other potentially negative features characterize more recent debt issues. This has resulted in a wave of deals containing lender -biased terms that may compromise the position of noteholders in an enforcement scenario.

While the shared collateral is not an issue where obligations are being met, shortfalls could mean that the noteholder is effectively holding unrepresented interests in an enforcement scenario. Deceptively defined, in practice: ***Noteholders are often silent first lien creditors effectively ranking second*** (See: *UCPB, InterXion, Seat, Kerling, Rexel, Man Utd, C&W*).

Since 2009, DXP has highlighted a recent phenomenon of deals describing notes as “senior” and then including features that erode any practical relevance of such priority. In most recent instances where note debt is described as “senior”, it is ranked equally with existing senior facilities and other hedging lenders. To further confuse priority, these noteholders not only share collateral with many other senior secured interests (*Seat, UCPB, InterXion, Man Utd, C&W*), they are often entirely subordinated in the event of

default. ***In many cases the interests of these “senior” noteholders are only paid out after other secured interests are discharged.***

It is fairly standard for noteholders to share certain collateral with existing loan facility and hedging lenders. However, recourse by multiple senior creditors to all collateral available to noteholders is increasingly becoming the norm. Given the tendency to subordinate noteholder recourse in favour of other senior secured parties, ***shared collateral may result in noteholders being left without a claim to anything.***

Lending Atmosphere of Caution & Restraint

Recently there have been numerous adjustments to deal structures reflecting a more cautious and restrained lender mentality. Many new or revised features focus on a reduction of risk and easier access to security for facility lenders. Such features take the form of tighter maintenance covenants giving loan lenders an earlier default than noteholders. Noteworthy is the inclusion in a recent deal of an unusually early default trigger in favour of the senior facility lender (*Seat*).

Conversely, ***noteholders seem to be faced with a reduced flexibility and diminished access to security.*** This can be seen in the common presence these days of lengthy standstill periods and limited redemption options. In recent issues standstill restrictions can last up to 179 days (*C&W*). During this period noteholders relinquish rights in respect of directing the security trustee and control of the collateral is left to other senior secured creditors via the security trustee.

The vulnerability of noteholders is further compounded in these shared security structures by the ***tendency to give non-note debt exclusive control in respect of directing security.*** This is exacerbated by mechanisms, which in the same transactions often allow

the release of guarantees (*InterXion*) and valuable pieces of collateral (*Man Utd*) without noteholder consent. Without a voice to instruct the trustee or say in the release of security, noteholders appear to be passive investors in relation to other senior creditors.

In the context of priority rankings, there seems to be very little practical upside for noteholders these days. ***In theory, the pricing of note debt presumes some advantage to being ranked as senior. In practice, these note holders are arguably not realising any benefit from their rightful claim to priority.***

Lender Bias and Noteholder Subordination

Detailed intercreditor arrangements intended to establish the relative security rankings of competing senior creditors are often misleading. ***Close inspection of these arrangements reveals loan lender bias and de facto noteholder subordination*** (*Kerling*). In almost all recent deals, Noteholders rank pari-passu with other senior secured parties (*Man Utd, UCPB, InterXion, Kerling, Seat, C&W*). Although this is not a new phenomenon, ***as structures become more complex, noteholders rights are becoming increasingly diluted.***

The general health of the debt markets determines the consequence for noteholders of shared priorities: In a payment priority scenario it is rarely relevant where “senior” notes rank. When markets are strong and deals are performing, there will be sufficient income to pay all parties. However, where senior creditors are given a “super priority” and deals are not generating enough revenue streams, ***shortfalls will be borne by noteholders while priority lenders may still get paid.*** One might ask if a small layer of super senior RCF should actually have control over a default scenario when the bulk of debt is supplied by noteholders?

Such other priority creditors often include note guarantors, pre-existing debt

interests such as floating rate notes and other creditors under a variety of financing facilities. In addition, the tendency for lien covenants to allow future debt to be added to the security package with all secured interests sharing equally in the collateral is not uncommon. While this gives flexibility to the Issuer, it creates further uncertainty and compromised priority for note investors (*Expro, C&W*).

Complex Deals: Conflicts of Interest?

The most common purpose these days of a note issue is for debt refinancing (*Seat, C&W, Sable, Rexel, Kerling*). ***In recent transactions it is not uncommon to see complex structures that involve noteholders effectively financing an spv (Expro, UCPB), which becomes lender under existing loan arrangements.*** The noteholders may get a vote in respect of the finance facility (*UCPB*). However, deal complexity means noteholders may be unaware of the structural and contractual risks they face in these circular arrangements.

Perhaps ***the presumption of regulators and subscribers is that the pricing of the notes takes account of these additional risks. The more likely scenario is that investors will remain blissfully unaware.***

Certain refinancing transactions are more sophisticated than others (*Expro, Kerling*). However, certain key features are apparent in most of these deals such as reliance upon subsidiary operating revenue or new loans to meet note payment obligations. Another type of ***circular deal landscape is emerging where the subsidiaries being relied upon to generate income for payments are acting as guarantors for the very same obligations.***

The interconnected nature of party obligations and shared security gives rise to an increasing risk of conflicts of interest. Unfortunately, the speed with which these deals are being structured and sold means that note debt investors are vulnerable prey.

Some banks structure bond deals while also retaining major loan positions; no conflict there then.

These patterns of potential conflict are not only becoming typical but acceptable to regulatory authorities and investors alike: ***A mood of complacency has replaced much needed scrutiny.***

Hidden Details in Intercreditor Terms...

Most deal structures offer Noteholders a perceived measure of balance and flexibility. However, compromising details are often hidden in the Intercreditor Terms. For example, optional redemption rights are often restricted by a standard 4-year non-call period. Benefit to noteholders has been further curtailed in a recent deal (*Seat*) where Noteholders are disqualified from sharing in prepayment of indebtedness except upon a Change of Control.

Somewhat ironically, ***a change of control seems to be the only circumstance that gives the noteholder any control these days.*** The presence of anti-layering covenants in certain recent issues (*Sable, UCPB*) prohibiting debt incurrence unless subordinate to noteholders provides a measure of balance but it seems unlikely that this is enough of a remedy. It is not clear what advantage these options provide as prepayment often redeems at par.

Issuer's are also retaining the control to reduce their own leverage by ensuring redemption rights are in place where equity streams render note debt undesirable. For example, two recent deals (*Kerling, InterXion*) allow the Issuer to redeem up to 35% of note debt in various circumstances (rather than the traditional IPO only). These trends show a general shift away from risk and reward towards a model premised upon a general appetite for control and flexibility. Whether deal structures will be able to achieve these aims is yet to be seen.

Covenant Packages Favour Lenders...

Loan lenders are getting better covenant packages that noteholders. **Permitted indebtedness ratios make it fairly easy for loan borrowers to take on additional debt and other obligations that will rank equally with the noteholders.** The result is that not only are noteholders competing with existing lenders but an indeterminate amount of future debt (*Man Utd*) may also have priority. Loan lender facility terms typically contain covenants allowing for early default triggers in favour of the lender. By comparison, **late default and acceleration triggers to benefit noteholders are becoming the norm.** In many cases, investors in note debt would have to read the fine print not only of the offering documents but also of the increasingly complex intercreditor arrangements for the imbalance to be revealed.

Traditional security packages and credit support have been replaced with Issuer dependence upon subsidiary revenue streams (*InterXion*) and unconditional guarantees (*C&W, UCPB, Rexel, Sable*). **Interdependence between Issuer and investor is highlighted in recent deals (UCPB) where issuances are used to finance loans which are in turn are relied upon to pay noteholders.** In these circular deal structures noteholders indirectly become lenders and may even get a vote with respect to lending terms under the facility (*UCPB*).

Tendency Towards Conservative Disclosure

The general mood of restraint can be seen in a sustained tendency towards conservative disclosure. This trend is contrary

to current market wisdom, which promotes transparency.

However, **a review of recent deals shows a pattern of disclosure that is confusing at best and at worst is misleading.** Whether or not noteholders are concerned about cross-defaults (*InterXion, UCPB*), cross-accelerations (*InterXion, Invitel*) or other default triggers is not the only significant issue here. **The fundamental problem with a lack of comprehensive reporting is that investors lose control over their investments.** This in turn can compromise the integrity of the debt markets as a whole. It begs the question: how can we improve stability if the fundamental tenants of the “new economy” are already being provocatively breached?

Where Have all the Ratings Gone?

A final fundamental change can be seen in the debt space: The conspicuous absence of traditional note ratings from the trio of standard rating agencies. This may be due to a general scepticism about the benefit or credibility of such ratings or to reluctance given the expense and time rated note issues entail. **In the light of the recent trend towards neglecting noteholders interests, the absence of ratings assumes a more sinister guise; and confirms that all parties investing in the debt space are more vulnerable today than ever before.**

Tammy Cadsby
Senior Reviewer, DebtXplained
info@debtexplained.com
+44 - 207 - 100 - 9777

We have noted various market weaknesses and resulting note investor vulnerability. This points towards an obvious need for improved market awareness and structural clarity. Market parties would also benefit from easy access to details of current offerings. DebtXplained offers an invaluable tool to compare deals with ease and to navigate complicated debt market waters with simplicity. Subscription to the DebtXplained service permits ease of understanding and the ultimate advantage to investors – the opportunity for painless, straightforward market scrutiny.

www.debtexplained.com