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HIGH YIELD BONDS, CLOS AND DEBT CAPITAL MARKETS – SOURCES OF ALTERNATIVE FUNDING, OPPORTUNITY AND LIQUIDITY FOR PRIVATE EQUITY SPONSORS

STRUCTURED FINANCE AND DEBT CAPITAL MARKETS

Bank lending is returning to the leveraged finance market, but its absence has allowed other potential sources of funding to gain momentum. This note looks at developments during 2013 in the high yield bond, CLO/CDO and debt capital markets, in their role as potential sources of finance and opportunity for private equity sponsors as well as their role in aiding the return of liquidity to the market.

HIGH YIELD

The market for European high yield has been the focus of a great deal of comment over the last 12 to 18 months. Total issuance for 2013 was the highest on record and, despite the uncertainty around the US government shutdown and the Federal Reserve "taper", supply continued to hold up - at least in part driven by investors' sustained search for yield. The majority of issuance has been targeted at refinancing pre-crisis era LBOs, replacing the capacity constrained bank debt market in the process, but a significant proportion has filled the void in acquisition debt for new transactions and provided funding for general corporate purposes. That replacement of bank financing has also come at the expense of mezzanine and second lien lenders whose position in the capital structure is increasingly supplanted by high yield.

With European high yield seemingly set to continue its expansion as an alternative funding source, we set out below some of the features of the current market.

Deal size and rating

Historically, one of the main limiting factors in accessing the high yield bond (HYB) market has been the minimum issuance size required in order to get a deal away. That minimum issuance size has been driven by the perceived decrease in liquidity represented by a small deal size together with (and driven by) traditional HYB investors' desire for big individual tickets. However, that deal size requirement has fallen and deals can now be achieved at €100 – 150m in total issuance amount (and in some cases even lower). That shrinking of the minimum deal size has helped to open up the HYB market as a funding source for smaller and medium sized companies who would otherwise have had to rely on bank debt.

In addition to the decrease in deal size, the average credit rating attached to issuances has fallen. Whereas previously investors were happier with ratings in the BB range, a sizeable proportion of issuers with ratings in the B range (and, to a limited extent, in the CCC range) are managing to access the market. Again, that has helped to lower the barriers to entry in the HYB market for smaller and medium sized companies with either insufficient historic data or generally lower credit quality.

Non-call

HYBs incorporate a period during which the offering cannot be prepaid (or optionally redeemed) by the issuer without attracting a prepayment premium. Those periods have traditionally been set at three years for HYBs with a seven year maturity and five years for HYBs with a 10 year maturity. During those non-call periods the issuer can elect to optionally redeem but must pay a premium (expressed as a percentage of the face value of the HYB) which decreases from the date of issuance to the end of the non-call period – 104/103/102/101.

Recent issuances have seen those non-call periods either shorten or other features being incorporated such as the ability to redeem up to 10 per cent of an issuance in each of the first three years at 103 per cent of face value or the premium payable on redemption being reduced.

"Equity claw"

An additional relaxation in the context of optional redemption has been the increase in the amount of equity issuance proceeds that can be applied in redemption of HYBs. Whereas the market norm has generally been for up to 35 per cent of the proceeds of new equity to be capable of application in optional redemption, some recent deals have seen that figure increase to 40 per cent. A premium is payable upon any such equity-funded optional redemption but that increased option size represents additional flexibility for the issuer in being able to manage its capital structure.

Change of control/portability

As with bank debt, HYBs generally incorporate protection for bondholders in the event that the sponsor seeks to exit its investment. Typically, HYB investors have been able to require redemption of their bonds at a price equal to 101 per cent of the face value of the HYB upon a change of control of the issuer and/or its group or the sale of all or substantially all of the assets of the issuer's group.

Increasingly, HYBs are including a "portability" feature whereby the change of control provision is effectively waived if certain conditions are met. Those conditions generally include a pro forma leverage test and a portability window limited to the first 18 months of the issuance. Some deals have also seen the multiple use of the portability feature.

This new feature is an important concession by the HYB market which allows HYBs to cater better for private equity's typical investment profile and for speculative sales of successful investments to be made without incurring a costly redemption premium.

Covenant erosion

Perhaps unsurprisingly, the increased appetite for HYBs has seen a relaxation of covenant packages, by way of increased baskets, additions to EBITDA add-backs (used in the context of restricted payments to sponsors and permitted debt incurrence) and greater flexibility in securing other debt over HYB asset security.

Future

Whilst the HYB markets are likely to remain volatile, reflecting macroeconomic concerns, there remains significant appetite for the HYB product and issuers will continue to bring deals to market (both for refinancing purposes and acquisition financing). The extended market closures apparent in 2011 and 2012 were not repeated to the same extent in 2013.

CLOS

In addition to the surge in HYB issuance volume, collateralised loan and debt obligations (CLOs and CDOs) made a significant, albeit limited, return to the funding market in 2013. CLOs and CDOs represented an important source of secondary market liquidity for leveraged loan transactions in the years prior to the credit crisis and the absence of new vehicles, combined with the expiry of reinvestment periods for legacy structures, has, to a significant extent, hampered the availability of credit for leveraged deals.

A number of new deals were brought to market in 2013 with a total issuance size of €7.4bn. Those deals have incorporated new features designed to tackle the perception that the pre-crisis CLO/CDO model was insufficiently robust in its protection of investors as well as to provide increased flexibility for managers of the structures. Those features include:

- refinancing and re-pricing options, as well as clean-up call options;
- restrictions on investment in certain asset classes, countries and maturities;
- greater flexibility in terms of curing and avoiding breaches of over-collateralisation tests;
- restrictions on note cancellations (particularly in the context of those over-collateralisation tests); and
- parameters for dealing with amends and extends.

In addition to the above, some CDOs have sought to include a larger investment limit for investments in HYBs. That desire to increase the investment limit has been prompted by the absence of supply of new leveraged loans (in no small part due to the availability of HYBs to meet corporate funding needs) and the need to diversify the asset class. That lack of supply of leveraged loans has also held back the issuance of new CLOs/CDOs, particularly given the need for new vehicles to have sourced a greater percentage of assets prior to issuance of the CLO/CDO (i.e. being more fully "ramped up" before launch). However, the recent enactment of the Volcker Rule in the US, which has the effect of restricting investment in CDOs that contain bond buckets, appears likely to reverse the trend for increasing CDO investment in HYBs.

It has also been necessary for those structuring new CLOs/CDOs to address European regulatory requirements introduced post-crisis (notably the "skin-in-the-game" requirements of Article 122a of the CRD (as amended) and in their recast form under CRD IV). Those requirements have limited the potential pool of managers of new CLOs/CDOs to those with sufficient balance sheet capacity to hold the required "skin-in-the-game" and who also hold the relevant authorisations under MiFID. (For further details see our earlier briefing "CRD IV and CLOs - Revised risk retention requirements: Back to the drawing board?")

The lack of supply of new leveraged loans combined with the additional complexity of satisfying European regulation could well hinder the issuance of new CLOs/CDOs in Europe for some time to come.

ALTERNATIVE CAPITAL

Continuing the theme of placing less reliance on the bank market for funding, an increased emphasis has been placed on encouraging a debt capital markets alternative for small and medium sized companies in recent years. Whilst attempts to develop a private placement market in the UK were made prior to the credit crisis, the abundance of bank funding at that time made it difficult to gain any real support for a new funding source. Since the onset of the crisis, greater emphasis has been placed upon disintermediation (as can be seen from the increase in HYB issuance volume and the reinvigoration of the CLO market), including the emergence of alternative lenders and a new effort to develop a private placement model.

The examples of both the German Mittelstand funding model, where public bonds have been issued in sizes significantly smaller than in the HYB market, as well as the US private placement market, have prompted market participants to explore the possibility of developing a similar market in the UK.

The advent of the London Stock Exchange's Order book for Retail Bonds (ORB) at the beginning of 2010 prompted a number of corporates to take advantage of the public debt capital markets. However, issuance has generally been limited to household names and/or entities with an investment grade rating and so is not as diversified as either the German Mittelstand or the US debt capital markets.

There have been a number of recent discussions in relation to the promotion of a debt capital markets alternative for UK companies that do not meet the criteria for either the HYB market or the investment grade (and/or retail) debt capital markets in the UK. That alternative would seek to combine elements of the public markets of the German Mittelstand and the private placement market of the US in order to create a product for small and medium sized companies to issue debt securities without reliance on bank funding. With pressure on bank balance sheets likely to continue for the foreseeable future, we continue to discuss the potential for a capital markets alternative for small and medium sized companies, together with other non-bank alternatives, with our clients.

Macfarlanes has a dedicated structured finance and debt capital markets practice with experience in all of the areas discussed above.

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