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Bondholder Value & Covenants

An issue of the Dutch Commission on Bonds

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Foreword

The Dutch Commission on Bonds (DCB) welcomes the timely and necessary debate on the role of covenants in the structure and pricing of debt market instruments. Our Commission's main objective is to consider ways of promoting better standards in the European debt markets – among which credit markets – and eventually to make relevant recommendations to those market parties involved. This publication aims to provide a standard checklist for corporate debt investors, containing an overview of factors affecting bondholder value.

Bondholders are one of the firm's major stakeholders, not being the shareholders. Bondholder value can therefore be considered the complementary counterpart of shareholder value. Hence, decisions like buying back of shares, leveraging and expanding merger & acquisition activities may trigger the potential conflict of interest between the firm's debt and equity holders.

This publication wishes to focus on three main factors, considered to be crucial for corporate debt holders: disclosure of information, secondary market liquidity (after-market), and documentation. The latter is also referred to as covenants.

Covenants serve to discipline management. That is the key aspect where covenants are all about. They should control risk by imposing financial and strategic discipline on the management. The main question, though, is whether management is willing or able to cope with them. It is probably realistic to assume that no indenture covenant package will ever be perfectly watertight. Nevertheless, the higher the quality of such a covenant package, the better the protection should be for its bondholders.

Consequently, establishing minimum covenants for investment grade corporate issuers should offer investors protection in case of default (event risk). Through this publication on Bondholder Value & Covenants we hope to be of assistance to you as corporate debt investor in creating awareness to any potential pitfall and in making a proper judgement on corporate issues.

Bondholder Value & Covenants is a publication of the Sub-Committee Bondholder Value. Special thanks to Ron Bruggink from the Dutch State Treasury Agency for his contribution to the theoretical framework, Robert Manning from ABN Amro Bank for his technical assistance, and Peter Charles from Citigroup for his comments.

Amsterdam, November 2003
Drs. R.P.J.M. ter Horst RBA
Chairman Dutch Commission on Bonds (DCB)

Introduction

For the purpose of this paper we investigate the following aspect of Bondholder Value:

> *Which factors related to a bond issue **excluding price (i.e. spread) and credit quality (i.e. rating)** can be considered relevant for a bond's future performance.*

In **Chapter One** we describe the option-theoretical framework first developed by Merton, in which a corporate bond is analyzed as a combination of a bond without default risk and a short put option on the firm's assets. Using this framework we can explain why some factors (like covenants in a bond's documentation) not only intuitively protect bondholder's interests but also actually increase the current market value of the bondholder's claim.

This paper is designed to present a practical checklist for investors with an overview of factors affecting Bondholder Value. The factors can be divided into a couple of subgroups:

1 Information availability
2 Issuance process and after-market
3 Documentation and seniority

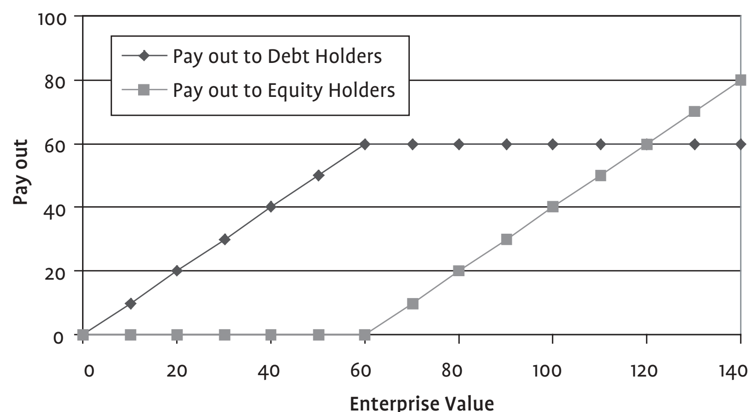
In **Chapter Two** we will focus on the first two factors. Because of the extensiveness and complexity of the factors relating to Documentation and seniority, we treat this subject separately in **Chapter Three**. Also an appendix is added to this chapter in which the most important legal issues are explained and illustrated with typical examples that we encounter in the bond market.

I Theoretical Framework

By definition the total value of a firm's assets as stated on its balance sheet equals the book value of its liabilities. The same equation holds using market values (MV), therefore:

MV assets = MV debt + MV equity

For simplicity we assume that there is only one class of debt (i.e. a zero coupon bond with a notional value of 60) and one class of equity. Then the payoff between debt and equity versus the value of the assets in case of a wind-up of the firm can be shown graphically as follows:



This graph illustrates the option-like nature of both debt and equity. The pay out to debt holders is capped at 60 and the pay out to the holders of equity equals the excess over 60. This pay out pattern can be replicated with different option structures using call or put options.

Using the long asset/short call definition in combination with the Black and Scholes (1973) option-pricing model[1], Merton (1974)[2] developed a generic[3] model to determine the market value of corporate debt. From this model an equation for the risk premium on corporate debt over the risk free rate (i.e. the spread) can be derived which shows, that the spread is an increasing function of:

i the business risk of the firm (measured by the volatility of the asset value)

ii the leverage ratio (measured as the notional value of debt discounted by the risk free rate divided by the market value of assets).

1 Black, F. & M. Scholes, 1973, The Pricing of Options and Corporate Liabilities, *Journal of Political Economy* 81, 637-654.

2 Merton, R.C., 1974, On the Pricing of Corporate Debt: The Risk Structure of Interest Rates, *Journal of Finance* 29, 449-470.

3 Merton imposes certain restrictions and simplifications but for the purpose of this analyses these are not viewed as material.

This framework clearly shows the potential conflict of interest between a firm's debt and equity holders. This "agency problem" is also illustrated in the following two examples.

I.1 Example 1: Investments and company risk profile

Assume that a company's management has the choice between a low-risk and a high-risk investment project. We further assume that the company is already substantially leveraged and that both projects are mutually exclusive. In case of a negative economic scenario (i.e. recession), with the low-risk project the company will just be able to service its debt whereas with the high-risk project it will default. In case of a positive economic scenario, the high-risk project will generate a return that is expected to be much higher than the return of the low-risk alternative. The expected pay-off of both projects in case of a 50% probability of either economic scenario is as follows:

Low-risk project

	Probability	Enterprise Value =	Value of Equity +	Value of Debt
Negative scenario	50%	100	0	100
Positive scenario	50%	200	100	100
Expected Value		150	50	100

High-risk project

	Probability	Enterprise Value =	Value of Equity +	Value of Debt
Negative scenario	50%	50	0	50
Positive scenario	50%	230	130	100
Expected Value		140	65	75

In this example the low-risk project has the highest ex ante expected return assuming an equal probability of either economic scenario. Because of the asymmetrical distribution of the returns, however, the high-risk alternative will provide a superior ex ante expected return for equity holders (65 versus 50). The opposite holds for debt holders; their expected pay off is clearly superior with the low-risk investment project (100 versus 75).
In option terms:

- The equity holder is long a call option on the excess value of the firm. This will enable him to profit from the higher volatility of the high-risk project whereas the *downside* is limited to its original investment (= option premium).
- The debt holder is short a call option on the excess value of the firms. Therefore, whereas the downside is the total value of its investment the *upside* is capped at the notional value of its claim (principal plus accrued interest).

I.2 Example 2: Leverage and pay-out policy

Instead of investing in a more or less risky project, a company may decide to buy back shares or pay an extra dividend to its shareholders. Either action will transfer value from the firm to its shareholders, which will be at the expense of debt holders. This is illustrated in the figure above by the line “Pay out to Debt Holders”. This line follows a pattern that is similar to the pay out of investing an amount of 60 and being short a put option with an exercise price of 60 (i.e. the notional value of the debt). Because the transfer to equity holders will bring the enterprise value closer to the exercise price, this will increase the value of the put option and therefore reduce the value of the debt holders investment.

I.3 Conclusion

Based on the analyses above there are a couple of straightforward ways bondholders can raise the current market value and protect the future value of their investment (apart from demanding a higher spread).

First they can demand more information from the company about the current market situation, its financial position and the strategy going forward. This way the investor can better assess the current and future value of the firm’s assets and therefore the asset volatility.

Secondly, by including covenants in the documentation, bond investors can limit the extra amount of risk a firm can take on and ensure that their interests are taken into account by the firm’s management. A trustee could obviously represent the investors in such negotiations. Covenants can restrict the company in its actions or demand the maintenance of certain ratios. In case of too strict or wrongly formulated covenants, ratio management can be a problem as what that does is increase the likelihood of (technical) default – in other words, it effectively moves the strike price of the put option further away from the bondholder.

Covenants become even more important if we also include bank debt in our analyses. Bank debt is often characterized by strong covenant protection relative to bondholders. In situations of distress this can result in a situation in which a bondholder’s claim is senior versus equity but de facto becomes subordinate to bank debt.

II Information availability and issue process

Our objective is to create a checklist, consisting of a set of factors related to a bond issue *excluding price (i.e. spread) and credit quality (i.e. rating)*, that are considered relevant for a bond’s future performance.

The factors are divided into a couple of subgroups:
- Information availability
- Issuance process and after-market
- Covenants and documentation

II.1 Information availability

The (potential) quality of the bondholders’ credit analyses strongly depends on the disclosed information.

Checklist

Factor	Variables
Information before launch	• company disclosure (accounting, reporting frequency)
	• availability of documentation (“red” & supplements)
	• summary of main clauses & comparison
Information after launch	• company updates to bondholders
	• updates of research by analysts

II.2 Issuance process and after-market

Even when the issuance process is handled “properly” from a bondholder perspective by the (co)leads, this obviously provides no guarantee for future performance. There are, however, a couple of factors related to the launch and after-market of an issue that impact the current and future value of the new bond.

Checklist

Factor	Variables
Issuance	• downward adjustment of spread(range)
	• upward adjustment of issue size (tap)
	• period between pricing and settlement
After Market	• bid-ask spread (market making commitment)
	• pricing sources (number and executable)
	• number of market makers

II.2.1 Issuance process

The introduction and official launch of a new issue is a complex and delicate process that is meant to make sure that the bonds are properly absorbed by the market. If the bonds find their way to the right investors at the right (i.e. market clearing) price, this is clearly in the interest of bondholders. But it also is in the interest of the issuer, as it supports its reputation and therefore its future access to the capital market. Important variables that are determined during the issue process are spread (range), issue size, the time period between pricing and settlement and finally the allocation of bonds to investors. We will briefly discuss the impact and interaction of these variables.

In case the initial spread-range at which an issue is marketed (i.e. the spread-talk) appears to be too tight, investor interest will be limited and the issue will fail to find enough demand from quality (mostly end-) investors. If the offered spread is too generous, the lender is not only overpaying but it will also attract a lot of interest from speculators going for "the quick buck". The main problem is to determine the "right" spread level as this is ultimately to be decided upon by a market that can be highly volatile and somewhat erratic. It requires a delicate process of setting an appropriate initial spread-range through (informal) inquiries with investors and controlled book building, thereby limiting the impact of speculative forces.

The lead or syndicate that manages the order book plays a crucial role in this process. Not only does it set the spread-range but it also provides the market with crucial information regarding the issue size and the way the book building is proceeding. If a deal is "hot" which implies that the (expected) size of the book is far bigger than the planned issue size, non-speculative accounts also start to inflate their orders. They assume that they will receive only a partial allocation and by doing so, they try to make sure getting all the bonds they want in their portfolios. Apart from cutting back allocations, it is not uncommon that the issue size is increased and/or the spread-range is being revised downwards. Measurements like these might seem perfectly right in solving the (short-term) allocation problem, but often it is not in the longer-term interest of bondholders. Once the "hype" is over it is not uncommon for the bonds to be poorly placed as they are bought by market participants with purely short term (speculative) interest and/or dumped in the market place by investors having received allocations that are too small given their minimum threshold.

Finally, the longer the period between the pricing of an issue and the final settlement, the easier it becomes for purely speculative accounts to get involved without needing to invest any cash. Similarly, in case of a negative view on the issue the pre settlement period provides an opportunity for taking a free short position as the bonds only need to be delivered (or lent in the repo-market at the applicable rate) starting at the settlement date.

II.2.2 After market

One of the key features that differentiate the (public) bond market from private placements is the availability of liquidity. This feature coupled with the increased focus on benchmarks by investors is an important driver behind the rapid growth of the corporate bond market being witnessed in Europe in the past five years. Liquidity is clearly in the interest of bondholders. Measures to determine liquidity are, for instance, bid-ask spread (commitments), the number of available price sources and the number of market makers. Highly rated, frequent issuers like supra-nationals and government agencies are highly dependent on providing ample liquidity to investors in order to secure the lowest possible funding costs. These issuers typically require those lead banks that not only properly manage the issuance process, but also make sure that the after-market is properly taken care of.

III Covenants and documentation

In March 2000 transportation company Stagecoach Group Plc announced the sale of an important business unit. The unit, Porterbrook, accounted for 38% of revenues. Bondholders of the GBP 175 million 7.625% 2007 saw the value of their investment increase by about 20% because the bond was called before maturity at par spread versus the UK gilt curve. Holders of the EUR 400 million 6% 2004 and the USD 500 million 8.625% 2009 bonds, however, suffered a mark-to-market loss of more than 15%. How could this happen?

The answer is that the GBP denominated bonds had a stronger indenture covenant package. The prospectus for the deal provided better protection for this particular event risk. Regarding the importance of covenants the following remarks:

- Investors have to take into account the quality of the indenture covenant package when they evaluate an investment opportunity.

- The purpose of indenture covenants is not to reduce the credit risk that results from adverse market conditions or investment decisions, but to protect bondholders from materially negative discretionary (management) action and to provide a level playing field for providers of different categories of senior debt finance.

- One of the main goals of the covenant package is to establish an investor relation between the company and the debt provider. Borrowers should be made aware of the importance of investor relations with respect to indenture covenants in bonds similar to what they have already been used to when they fund themselves through bank loans or private placements.

- The investor is not just a 'prospectus-taker'. By collaboration amongst ourselves or even by the market mechanism and dialogue with the syndication team(s) of leading banks, it is possible to ensure securities are issued which best suit our investment mandates. This may be a significant factor in our investment performance.

III.1 Understanding Covenants

Indenture covenants or covenants define with contractual precision the basis upon which credit agreements will remain outstanding. These are clauses within credit contracts that formalize agreements between the investor(s) and borrower regarding performance parameters. Covenants exist through the life of the bond or loan, although they can vary over time. They are legally enforceable contractual terms that can only be amended by mutual consent. This consent may be delegated to a Trustee or Agent and is often subject to prescribed creditor voting rights[4]. Because of the significant number of investors involved in a bond deal, it is extremely difficult to change covenants during the life of the bond. This may also be one of the reasons why bond covenants tend to be weaker and are often less restrictive than covenants in bank loans.

4 Brian Pearce, Greenwich Natwest, Global Credit Research, Covenants, Oktober 1, 1999.

To be really effective, covenants must be:
- *relevant* to the characteristics of both the issuer and the sector,
- *easy to understand, to use and to monitor*
- *effective at an early stage* so that investors can take timely, appropriate measures

Relevant characteristics refer to the fact that they should have a meaning. Covenants without direct meaning to the nature of the business and sector only reduce flexibility for the company and reduce willingness to negotiate. In addition, covenants should be clearly defined and measurable enabling active and appropriate monitoring. Even though no covenant package is watertight, the investor should ensure that it is as clear as possible, thereby leaving limiting room for interpretation.

Effectiveness is perhaps the most important characteristic. *Covenants control risk by imposing financial and strategic discipline on the management. They act as an early 'trip wire' of impending deterioration in creditworthiness.*

Since banks both negotiate bilaterally with the company (or multi-lateral at worst) and are better organized, they have stronger negotiation power. Also banks are easier to negotiate with outside the public forum and bank loans have more flexibility, as they generally are repayable at the option of the borrower at very short notice. As a result banks are generally able to negotiate better covenant protection against credit deterioration. A potential breach of a covenant is normally resolved by early negotiation with the banks, which often agree to waive or amend the covenant in return for amended terms, management action or an improved position in the capital structure. Unfortunately, bondholders lack such rights of action at this point. Strictly speaking, the vast majority of euro bond documentation do not cross-default to bank debt. Instead they are normally only triggered if the bank facility is actually accelerated. Unfortunately, in some cases, due to corporate structure and covenant wording, bonds may not default even then (see III.3 Pitfalls).

III.2 Why covenants?

III.2.1 Covenant protection in a historical perspective

"*Lenders and investors in corporate securities make decisions on the basis of the opinions of impartial third parties and their own views of the financial health of issuers. They are becoming increasingly disenchanted when these views of creditworthiness are changed by an unexpected and dramatic management decision. Today the difficult thing about debt rating is not evaluating business fundamentals. Rather, our greatest challenge comes in attempting to anticipate financial decisions that can have immediate and negative impact on credit quality*".

These lines come from an article written by Moody's in November 1984[5]. It shows that recent difficulty in coping with dramatic (potential) changes in the creditworthiness of corporate borrowers is not new. After such events, debt holders remain with a bond that is trading significantly below par and has little liquidity[6]. They may find out that they have been taking a risk that they were not aware of and for which they have not been adequately compensated. According to Moody's this happened frequently between 1984 and 1991. In that period 25% of all US debt was affected by special events. It was related to merger and acquisitions, recapitalizations, leveraged buyouts, litigation, unexpected incidents and accounting irregularities. In that period bondholders started to demand for indenture covenants to protect themselves. Dividend limitations and puts at par became common language in the prospectus. Moody's stated that although these protections had flaws and holes in them, it had a positive effect on bondholders' potential value loss. Since the late 1990s, however, only few investors ask for them. Therefore the quality of credit protection has been eroded. Meanwhile the focus on shareholder value has clearly been increasingly leaving bondholders in a riskier environment.

III.2.2 Focus on shareholder value

Example – In April 2000 Ford announced a share buyback program of 10 billion dollars, accompanied by a spin-off of the auto parts subsidiary and an acquisition of LandRover for 3 billion dollars. Moody's reacted by a downgrade of the long-term senior debt rating of one notch to A2.

The example above illustrates a phenomenon frequently experienced by bondholders since the middle of the 90's: the increased focus by companies on shareholder value. Increased global competition encouraged companies to increase their leverage, buy back shares and expand their merger and acquisition activities. In the theoretical introduction in Chapter 1 we have explained how these measures adversely impact the value of debt and therefore reduce bondholder value.

The European credit market has been developing rapidly both in terms of width and depth. At the same time general corporate credit quality has been deteriorating in the last few years and investors can no longer rely on stable credit fundamentals. Shareholder value often seems to prevail over bondholder value.

The lenders should realize that a renewed focus on debt protection measures is important and could preserve the desired risk profile that was present at the origination of the contract. The more developed covenant culture in the UK and to some extend in the US may be due to the fact that these markets have a longer history and that bond investors are more aware of the risks of the focus on shareholder value.

5 Harold Goldberg, 'Indenture Protection and Event Risk', Chairman of Moody's Corporate Rating Committee, November 1984.

6 High yield investors who are used to more stringent covenant packages may actually refuse to pick up fallen angels (downgraded companies from investment grade) because they do not have the required covenants.

III.2.3 What can covenants do for the lender?

In the theoretical framework of chapter I we outlined the possible conflict of interest between debt holders and equity holders. For a companies' management it may be difficult to establish both shareholder and bondholder confidence in the corporation at the same time; it may be hard if not impossible to deliver (preferably double-digit) profit growth to shareholders and at the same time deliver stability to the bond investor. This potential incompatibility is especially important if you consider that the bondholder is not enjoying the corporate governance means of power of the equity investor. There is no voting right, shareholder meeting or any other influence on the management. Consequently, indenture covenants play a crucial role in securing (investor) relations between management and bondholders.

Example – In the following case covenants substantially reduced damage to bondholders. TI Group primarily produces automotive parts. At a certain moment the stock price was under severe pressure. According to market rumors the management intended to sell off a substantial part of the business or take it private in a leveraged buy out. In this case, the nature off the business risk profile would dramatically have been changed. This is not consistent with the risk profile on which the company sold euro bonds a few months earlier. Despite this negative event the bonds never traded more than a few points below par because the indenture contained a put at par.

At the same time an investor should not count too much on covenants in other types of debt, mainly bank debt. In general, important clauses in the bank loan documentation do not "cross over" in the terms and conditions of public bonds (see III.3 Pitfalls). And even if they do cross over, although these covenants are often more restrictive, they are also more subject to change. During the maturity of the bond the bank loans may have come up for renewal several times and its covenants may be renegotiated and changed. Also there are provisions in the bank debt like a springing lien or higher coupon events that may actually worsen the position of bondholders.

The conclusion is that covenants are an important tool for bondholders to make sure that they can properly guard their interests versus both equity holders as well as other providers of debt. Also bondholders need to take responsibility for their own protection and cannot rely on bank debt covenants.

III.2.4 The role of lead managers and rating agencies

There are several reasons why bondholders are mostly less well protected than a bank:

- Bondholders are generally more fragmented and do not have a direct relation with the borrower. Management will be more averse to covenants in bond issues because they can not rely on the flexibility and good will of the bondholder. Also, when several issues incorporate different covenants or non-standard covenant packages, the debt portfolio may be more difficult to manage for the corporation. The flexibility concerns may be resolved with collective action clauses.

- Due to the fragmented body of bondholders, they lack negotiating power. Banks are very well organized and through a syndicate directly involved in the documentation process.
- Bond investors do not directly negotiate with the issuer. Instead the banks that lead the bond issue conduct the negotiations for the covenant package. There is no clear incentive to enhance the performance of the bonds in the longer run. The success of the issue is measured by its performance in the short term and the key priority is to sell the issue at a yield that satisfies the issuer. Perversely, if a bank also has a lending relation with the issue[7] it may be even advantageous to have bond covenants that leave enough leeway to improve its own position in times of stress. Covenants in bank loans or facilities that potentially adversely affect the position of bondholders should therefore be disclosed in order to avoid any such potential conflict of interest and to make sure that every (potential) investor holds the same information.
- Because market conditions can change rapidly the issuance process can often be characterized as a rush order. Once an issue is publicly announced it is already difficult to have a serious discussion about covenants because there is often a lack of time. Time becomes even more pressing once the book building has started. Nevertheless, the absence of a red herring should be unacceptable to investors and hence could make a deal uninvestable (undocumented investments should not be considered).
  In addition, the negotiation process can be cumbersome, especially if many parties are involved. It is easier to have a dialogue about covenants when a single lead is involved than when there is a syndicate of three or more banks. Also a more “stringent” stance of a bank towards covenants may be viewed negatively by the issuer in the selection of the leads for a new issue (“beauty contest”).[8] This often leaves the bondholder in the situation of “take it or leave it” with respect to documentation and therefore all negotiations focus on the pricing of the bonds rather than on actions that could make potential investors more comfortable with the credit.

There is a clear potential role for *lead managers* in this process. They can ensure that the documentation is made available at an early stage to the potential investor base and that the main content is properly communicated. Even though this may seem a time consuming and rather difficult job, the main clauses and definitions are mostly summarized under the Terms and Conditions. Like with any contract maybe “the devil is in the detail” but as we will explain later it is actually not that difficult to identify the most obvious potential pitfalls. Instead of starting the disclosure of covenants when an issue is about to be launched in the market place, it would be much more appropriate to make covenants an integral part of the pre-launch proprietary credit analyses.

Lead managers may argue that deal-related research is precluded from referring to the bond issue itself under compliance restrictions. However, this does not prevent the documentation and covenant overview being prepared sooner in order to be included in the information package.

Additionally also *rating agencies* can play an important role in this process. Next to their description and peer group comparison of business risk and financial ratios, they could enhance the usefulness of their analyses for investors by including a summary and quality assessment of the covenant package in their research. By providing both the original documentation and their assessment of the (relative) quality through their central database they can further improve on their service.

7 Because of relationship banking this is very often the case. The banks that provide low margin credit facilities often demand from the company to be granted other business as a sort of compensation.

8 Apparently, banks have lost transactions for suggesting that a “red herring” be provided in good time before pricing, when others have felt that investors could live without that.

III.2.5 Are borrower and lender on opposite sides?

Building a long-term relationship with bond investors has several advantages, not only for the lender (investor) but also for the borrower (issuer).

Firstly, it can imply relatively *easy access to the capital market* even in times of turmoil. A clear example in this context is Vodafone Group Plc. This company built up an excellent track record of rating stability and management credibility in the second half of the 90’s. Because of this track record it was able to access the bond market at relatively moderate spread levels even at times when the bond market was practically closed for telecom companies.

Secondly, a company can lower its borrowing costs because investors will demand less compensation if the perceived credit risk is lower because of management credibility and/or strong covenants.

Thirdly, by building up a relationship and reputation with bondholders, and by showing the willingness to “suit the action to the word” by putting intentions down in covenants, a company can prevent “erratic” pricing of its bonds in the secondary market because of investor panic. In times of distress, as we experienced in the second half of 2002, this is a phenomenon that is frequently observed. Companies with a track record of paying little attention to bondholder value and poor communication with bond investors can find its bonds “all over the place” during these periods.

Clearly, lender and borrower are on opposite sides when it comes to the pricing of a bond issue in terms of yield and spread levels. But a clear, balanced covenant package and the enhanced trust and confidence that goes with it can be beneficial for both sides by reducing agency costs. When it comes to securing capital market access there are some clear points to gain for the issuer, especially since this is also an aspect the rating agencies monitor closely. For the investor, a long-term relationship with the company means that it can make better and more rational investment decisions because of the superior information flow (directly from the source). Additionally, the investor will become less susceptible to event risk and market rumors.

III.3 Pitfalls

Unfortunately there are several methods for a company to avoid the disciplinary effect of covenants. The next few examples show how an indenture covenant can lose its value:

- The single most important pitfall is the specific clausing language. Lawyers write in complex wording. That is often not 100% clear to the investor. One could for example have different views on the quality of the language in the BT and FT offering circular of which we provide some quotes in the appendix. Another source of discussion is the

meaning of 'substantial'. If a covenant states that the investor has a put at par when the company sells off a substantial part of the business, it is important to define 'substantial' (for instance as a percentage of revenues). Finally, the investor should look out for different terms and conditions in bonds that are denominated in different currencies, like Sterling and Euro denominated debt. There are more than a few cases like Stagecoach Group Plc. in which the more experienced and less fragmented UK investor negotiated a stronger covenant package.

- Another important pitfall is the marking out of that part of the total debt that other vital clauses in the documentation like the negative pledge or the cross default apply to (i.e. *Relevant Debt)*. In many cases the definition of Relevant Debt is restricted to debt that is quoted or traded on an exchange. Other restrictions we find in the market are the exclusion of domestic bonds or debt with a maturity at issuance of less than a year. In general, bank debt together with private placements and project finance is excluded from the Relevant Debt definition. An additional consideration is whether the negative pledge also prevents the group giving of upstream/downstream guarantees to support bank or bond debt of the issuer, which could result in significant structural subordination.
- The value of a pari passu clause depends strongly on the definition of Relevant Debt and on the strength of the accompanying negative pledge clause. Being equal to other *unsecured* debt holders only has substance when there is a meaningful limit on the amount of assets that may be pledged.
- A *cross default* clause may seem to put a bondholder in the same position as the holders of the debt that it crosses into (for instance a private placement or bank debt). A company, though, can easily avert an event of default and circumvent the limitations this stricter documentation imposes by asking a waiver (in exchange for a price concession or by granting security) or by simply buying back this part of the total debt. The latter is what actually happened in the example of Stagecoach Group Plc that is described earlier.
  In this respect a so called *breach of covenants* clause can be viewed as stronger because it may become effective at an earlier stage of the process (i.e. after a breach of covenants rather than only after that breach has resulted in an acceleration). But it also does not forestall the `escape` of the debt buyback
- Notice the jurisdiction where the bond is issued. Liquidation regulation differs per country. This is especially important in the analyses of covered bonds or asset backed securities.
- Be careful on average interest coverage covenants. A three-year average does not preclude big swings in between these years that possibly have financial problems as a consequence. Also the effectiveness in term of timeliness may become an issue. When a company leverages up in a way that the current interest coverage is lowered to speculative grade levels, it will have a much less pronounced effect on the three-year average
- Be careful on static net worth terms. The company may grow and the old static net worth of the company may become obsolete in terms of preventing financial problems.
- Be informed about grace periods, minimum amount thresholds payable and the amount of debt holders required to declare a corporation into default. (Technically with most issues it is the Trustee who acts and declares default).

- Be aware of whether security is already granted to other debt holders and to what extend (% of assets the investor in the bond is also relying on).
- A special remark on utilities. Often these companies are (quasi) regulated and are looking to increase their return on equity while facing lower prices. Their stability of earnings and cash flows may open the door for complex restructuring. They might end up with a lot of debt, not owning the assets but leasing them off balance sheet from a dedicated asset vehicle.
- Structure – Is the issuing entity (often a finance company) remote from the assets? This boils down to the point of *structural subordination*, an issue that also enjoys a lot of attention from the rating agencies. What entities do the covenants apply to and does this achieve what the investor wanted? A negative pledge solely on a finance vehicle is of no use.

III.4 Checklist

Objective:

In the table below we present a checklist on the content of the prospectus and the structure of the issue. The objective of filling in this list is to enhance the transparency in the new issue market and to focus on the differences among the various outstanding issues.

Bondholder value checklist on prospectus

Covenants[9]	Seniority[10]	Relative value
• Pari passu	**Holding company debt:**	**Peer group debt:**
• Limitation on lien / Negative pledge	• **Size**	• **Covenants**
• Cross default / Cross acceleration	• **Covenants**	• **Seniority**
• Events of default		
• Limitation on debt	**Operating company debt:**	**Other sector debt:**
• Limitation payment	• **Size**	• **Covenants**
• Merger	• **Covenants**	• **Seniority**
• Sale and Lease-back		
• Restriction on asset disposals	**Bank debt:**	**Other issues:**
• Change of control	• **Size**	• **Covenants**
• Coupon step up	• **Covenants**	• **Seniority**
• Put at par		
• Spens clause		

9 What covenants are included in the prospectus.
10 What entity of the company becomes liable for the debt; what is the coverage of clausing. Is there any priority claim at operating level. What conditions do the banks have in their debt.

III.5 Conclusions

We would like to start with the not so gratifying but very realistic statement that no indenture covenant or covenant package is watertight. Obviously, it provides no protection against fraud. Also, if the management is determined to by pass a covenant package it will probably be able to do so! Nevertheless, the higher the quality of this covenant package, the more difficult it will be to accomplish.

- The main achievement of the covenant package is to establish an investor relation between the company and the debt provider. Although different due to the nature of the debt, for the issuer there are some clear advantages in establishing a relation with bond investors similar like the one with banks. It is also the responsibility of the investors to enforce this, maybe by organizing. Also rating agencies may play an important role in this by putting more emphasis on covenants and the relative strength of a covenant package in their analyses.
- Book building should be a controlled process that takes into account the time that investors need to do the homework as well as the interests of the borrower. Always ask for the documentation before you decide whether or not to participate (rather than trying to get hold of it once things appear to be going wrong) and try not to be forced to do the credit analysis in a too short period.
- Covenants can function as an early warning signal and place the lender sooner at the table to negotiate about the company's future in times of difficulty. That way the bondholder can actively participate in the decision making process and try to reduce the (chance on) a loss. We would advise not to wait for things to develop but to be aware of the clauses in the documentation that are applicable. If necessary, hiring legal expertise can pay off easily considering the potential loss.
- The mere sight of a 100+ page prospectus or pre-offering circular ("the Red") may deter you from any attempt to even take a closer look at the content. However, the main clauses and definitions are all presented under the Terms and Conditions. Once you become acquainted with the structure of the document and specific clausing language, understanding the main clauses will only take a few minutes. Also make sure who the issuing entity is and if there are any guarantee(s). Try to make an assessment of the quality of any guarantee(s) (unconditionally and irrevocably?) and make sure that covenants like the negative pledge also apply to the guarantor(s) and the group.
- The banks that lead an issue often provide you with their own credit research. Apart from this assessment of credit quality, ask the leading bank for a summary of the prospectus with a comparison among other deals. Let them state where you can find what kind of protection in the prospectus.
  Lead managers may argue that deal-related research is precluded from referring to the bond issue itself under compliance restrictions. There is, however, nothing stopping the documentation and covenant overview being prepared earlier so it can be discussed with investors.
- Ask the company or lead banks for regular (quarterly) updates on the financial situation of the company. Also demand from the leads that they keep-up the analyst coverage (and do not stop the coverage after the issue is launched) and update their credit analyses in the years after the launch of a deal as part of their after-market commitment.
- The lower the credit quality of an issuer, the more attention the covenant package deserves. Especially triple-B issuers that have only limited leeway before entering the speculative grade universe deserve close attention. In general, focus on (event) risk to be protected from like a take-over or leveraged buy out, debt financed acquisitions the sale of core business or assets.

The main goal is to make sure fundamental protection is properly worded, not to create triggers for collapse. Cross acceleration and negative pledge should pick-up bank debt, guarantees and private placements and cover all material group entities. Protection from materially negative discretionary action and significant shifts in credit quality plus compensation for a migrating risk profile within these defined parameters should be the goal together with a level playing field for providers of senior debt finance.

Appendix – List of possible covenants and explanation

Negative Pledge and limitation on lien

"So long as any of the bonds are outstanding the borrower and subsidiaries will not create or permit to subsist any mortgage, charge, lien or other encumbrance on its assets or revenues".

This is an example of a negative pledge. It puts a restriction on the grant by the borrower of security interests in favor of other (future) creditors unless the current debt holders benefit also. It is intended to limit the subordination of unsecured debt holders to secured debt holders. Standard exceptions are tax liens or worker's liens. A breach of this covenant can lead to default. However, it does not invalidate any security that is already created. Therefore the integrity of the management is important.

The 'limitation on lien' is a clause we often find in US law documents instead of a negative pledge. The next text is from the Worldcom offering circular[11]:

"Under the indenture, we may not, and we may not allow our restricted subsidiaries to, allow any lien on any of our property or assets (which includes capital stock), unless the lien secures your debt securities equally and ratably with, or prior to, any other indebtedness secured by such lien, subject to certain exceptions described below. The indenture excepts from this limitation secured debt which we or our restricted subsidiaries may issue, assume, guarantee or permit to exist up to 10% of the value of our total assets as shown on our most recent balance sheet at the time. This restriction will not apply to liens on property that exist when we acquire the property".

This standard text on the restriction on lien is interesting. Before this text there is an extensive list of liens defined like leases, assignments, pledges etc. Also, it makes clear to what extent securitization on assets and property is sustained. At least the investor knows to a certain extent what the management may or may not do.

Importantly it does not exclude bank debt from the definition. This is frequently achieved in euro bond documentation by restricting the clause to 'Relevant Indebtedness' that is specifically defined to exclude bank debt as mentioned earlier.

Pari Passu

*"The bonds are direct, unsecured, general and unconditional obligations of the borrower and rank pari passu amongst themselves and equally with all other **unsecured** obligations of the borrower".*

This is the standard companion of the negative pledge. The borrower promises not to subordinate your claim by preferring other creditors by the grant of security. By underscoring the word "unsecured" we want to highlight that it is supposed to work with a negative pledge and only works with a strong one. To be exact, the borrower only promises to not subordinate you to other creditors in your class of creditor and this is an important point not always recognized.

Limitation on indebtedness

This covenant limits debt to be incurred or guaranteed by the issuer or subsidiaries. A separate limit on subsidiary debt is meant to prevent the bondholder at holding level to become structural subordinated to debt at the subsidiary level. The subsidiaries are often defined as the principle operating subsidiaries. There are many different kinds of definition for this covenant. It can be a measure of gearing (debt to equity) or debt coverage (EBITDA interest coverage). Borrowing can be loans, overdraft, acceptance credit, hire purchase, leasing, preference shares and guarantee liabilities.

Sometimes there is an additional covenant limiting guarantees of parent debt by subsidiaries. This prevents parent debt with no guarantee to become subordinated to guaranteed debt.

An example for a limitation on indebtedness is the TI Group interest cover test:

"The issuer shall procure that, for so long as any bond is outstanding, as at the end of each of its financial years ending after the closing date, the ratio of the aggregate of profit before interest for its two financial years then ended to the aggregate of net borrowing costs for its two financial years then ended shall not be less than 3 to 1".

Limitation on payments

Here the payment of dividends or stock buy backs that would lead to a meaningful decapitalization is limited. This one only occurs in the lower end of the investment grade spectrum or below (cross over debt). For speculative grade debt the absence of this covenant may prevent it from being upgraded. During periods where the stock market is depressed, corporations have the incentive to buy back stock. This covenant can prevent that.

The covenant protects the integrity of the borrower from value leaking to outside the group. It captures dividends, loans, guarantees and investments. A post distribution pro-forma test provides better protection than a pre-distribution test.

Disposal restriction

"The borrower shall not sell, transfer, lease or otherwise dispose of all or a substantial part of its business or assets whether by one transaction or a series of transactions related or not".

The prime function is to restrict asset stripping whereby assets are transferred to a third party and thus resulting in an inter-company claim on tangible assets. It indirectly restricts the company's ability to change the nature of the business. It also restricts the ability to bypass the negative pledge covenant. An example is the above mentioned TI Group[12]. Here the bondholder has the option of redemption if during a certain period a restructuring event happens. The restructuring event is defined as;

11 WorldCom prospectus supplement to prospectus dated may 2001, JP Morgan and Salomon Smith Barney

12 TI Group offering circular, July 2000, Deutsche Bank and Salomon Smith Barney

"any person or persons acting in concert…become interested…in more than 50 per cent of the issued or allotted ordinary share capital of the issuer… or any member of the group sells, transfers, leases or otherwise disposes of, or is dispossessed by any means of, other than to a wholly owned subsidiary of the issuer or to the issuer,….where the turnover of such subsidiary or…is greater than 30 per cent of the turnover of the group…".

Change of control

This covenant can be triggered upon merger or acquisition. It expresses the exposure of the debt holders to become creditors of a significantly weakened organisation in terms of credit quality just like the former covenant. It protects the identity of the borrower and management. This clause can be of particular importance for a company that is susceptible to a possible leveraged buy-out (LBO). Often there is a put at par together with the event of a downgrade to speculative grade. The next example is from Sol Melia[13]. This family owned hotel chain is expanding aggressively. The bond investor runs the risk that the family does not want to let their stake dilute via equity issuance. Therefore the debt profile is deemed to deteriorate. After some negotiation the company finally agreed on adding this covenant to show bondholder commitment.

"We may also consolidate or merge with or into, or convey transfer, lease all or substantially all our properties or assets to any person; provided that:

1. *after giving effect to such transaction, no event of default (as defined in condition 13), and no event, which after notice of lapse of time, would become an event of default, shall have occurred and be continuing, and, in any case, only if such event is certified by the trustee to be materially prejudicial to the interest of the holders of the notes; and*
2. *the ratings assigned to these notes, after giving effect to such transaction, are not equal or lower than BB+ by S&P, when S&P make their first public announcement of the ratings for the notes following the consummation of the transaction."*

Cross Default and acceleration

The cross default clause is designed to benefit from covenants within other credit facilities. It places any lender on equal footing to other lenders in the event of default [not usually – usually only on an acceleration – using acceleration prevents having to organise bondholders for minor defaults but leaves bondholders exposed to banks or other debt 'cutting a deal' without them] of another credit agreement. A cross default covenant that comes into effect in case (financial and non-financial) covenants are breached is superior to a clause that triggers a default only when other indebtedness is actually accelerated.

Often there is a materiality threshold. That means that the covenant is only triggered above a certain amount payable. By the way, many covenants also have a grace period in place. That prevents the corporation from becoming in default due to a purely technical issue. In the TI Group offering circular of June 2000 are the events of default defined. A default is also a failure to pay or a breach of other obligations or the breach or of…

"any other present or future indebtedness for borrowed money of the issuer or any of its principal subsidiaries (other than indebtedness for borrowed money owed by a member of the group to another member of the group) becomes due and repayable prior to its stated maturity by reason of default…grace period…provided that the aggregate amount …£15,000,000…"

13 Sol Melia Europe B.V., Euro Medium Term Note Programme, December, 2000, Deutsche Bank

Coupon step-up

This has become a common covenant in the telecom sector. The sector captures a major technological and business risk for the near future. This uncertainty, which is what bondholders like least, is paid for with a higher coupon in case of a downgrade of either Moody's or S&P (or both). Sometimes when the risk is even higher a ratcheted language is more appropriate. This means an increasingly bigger step up the lower the rating (like in the Olivetti deals). The text below is from a KPN[14] deal in 2001.

"The Rate of Interest payable on the Notes will be subject to adjustment from time to time in the event of a Step Up Rating Change or Step Down Rating Change, as the case may be, (each as defined below).

From and including the first Interest Payment Date following the date of a Step Up Rating Change, if any, the rate of interest payable on the Notes shall, subject to any adjustment pursuant to a Step Down Rating Change, be increased by 0.375 per cent. per annum for each Rating Notch per Rating Agency by which either or both Rating Agencies have publicly announced a decrease in the rating of the Issuer's senior unsecured debt below Baa2, in the case of Moody's, or below BBB, in the case of S&P.

In the event of a subsequent further Step Up Rating Change, with effect from and including the first Interest Payment Date following the date of such Step Up Rating Change, the rate of interest payable on the Notes shall, subject as aforesaid, be further increased by 0.375 per cent. per annum for each Rating Notch per Rating Agency by which either or both Rating Agencies have publicly announced a decrease in the rating of the Issuer's senior unsecured debt further below Baa2, in the case of Moody's, or further below BBB, in the case of S&P".

Put at par

"If, at any time while any of the Notes remains outstanding, a put event occurs, then, unless at any time the issuer shall have given notice under condition 6 (ii) or condition 6 (iii) in each case expiring prior to the put date, the holder of each note will, upon the giving of a put event notice, have the option to require the successor to purchase such note on the put date at an amount equal to its principal amount together with interest accrued to, but excluding, the put date".

A put event shall occur if;

(a) *"the issuer, in any transaction or series of transactions, consolidates with or merges into any other person (other than a merger of a subsidiary into the issuer in which the issuer is a continuing corporation), or conveys, transfers or leases all or substantial all of its properties and assets to another person, except for the purpose of a reconstruction or an amalgamation the terms of which have been previously approved in writing by the trustee; and*

(b) *the rating assigned to the notes, after giving effect to any transaction referred to (a) above, is lower than Baa2, in the case of Moody's, and BBB, in the case of S&P, when Moody's and S&P make their first public confirmation of the ratings for the notes following the consummation of such transaction or transactions".*

14 KPN draft offering supplement, 2001

These fragments are from offering circular of British Telecommunications' (BT) issue[15] in February 2001. What is clear is that the put at par clause drastically limits the company's flexibility in a restructuring. There is an explicit rating trigger and the 'language' is clear. At the time telecommunication operators had difficulties in selling debt to the capital market. Because BT was the first, investors had to be convinced to buy the issue. By the way, for further reading one should ask the leading bank in the syndicate for a copy of the prospectus.

It should be noted that the triggering of a put event is unlikely to trigger the cross default clauses on other bonds.

Spens clause or make whole call

Under this clause the bondholder may call a category of bonds to make them whole on their investment at a significant premium, often close to the risk free rate. For the issuer the advantage is that it will not trigger the cross default clause. This is like a put at par but on a spread basis calculated using x basis point over the swap rate or government curve.

Consolidation, merger and sale of assets

"We or any principle subsidiary, without the consent of the registered holders of the notes, may consolidate with, or merge into, or convey, transfer or lease its assets substantially as an entirety to any corporation organised under the laws of the United States of America, any state thereof, or the district of Columbia, the Republic of France or any permitted jurisdiction; provided, except if we or another of our subsidiaries is the successor corporation, that (I) such merger, conveyance, transfer or lease occurs between our company and a principle subsidiary or between principle subsidiaries, or (ii) (a) the creditworthiness of the successor corporation is not materially weaker than our creditworthiness or the creditworthiness of the applicable subsidiary, as the case may be, immediately prior to such merger, consolidation, convergence, transfer or lease; (b) any successor corporation assumes our obligations under the notes, the registration right agreement and the indenture (including the obligation to pay additional amounts); (c) after giving effect to the transaction, no event that, after notice or lapse of time, would become an event of default, shall have occurred and be continuing; (d) the notes will be valid and binding obligations of the successor corporation entitling the holder thereof, as against the successor corporation, to all rights of holders of notes under the registration rights agreement, the indenture and the notes; and (e) certain other conditions are met (including payment of additional amounts, if any, resulting from such consolidation, merger, conveyance, transfer or lease of assets)".

These fragments come from the France Telecom[16] (FT) offering circular. The language is already a bit softer. First it only prohibits the company from doing these things without 'consent'. The ratings may not be 'materially weaker' and there may not be a default. I think that this covenant is a little weaker than the BT put event. The next fragment is from the Worldcom issue.

15 British Telecommunications prospectus supplement to prospectus dated July 2000, Merrill Lynch & Co, Morgan Stanley Dean Witter and Salomon Smith Barney

16 France Telecom preliminary offering circular, February 2001, BNP Paribas, Credit Suisse First Boston, Morgan Stanley Dean Witter and Salomon Smith Barney

"We may not consolidate or merge with or sell, lease or convey all or substantially all of our assets to, any other corporation unless (a) the surviving corporation (if it is not Worldcom) is a corporation organised and existing under the laws of the United States or one of the fifty United States and it expressly assumes (pursuant to a supplemental indenture) to pay the principal and any interest on your debt securities and to perform and observe all of the covenants and conditions under the indenture, and (b) immediately after such transactions, there is no default in the performance of any of our covenants or the conditions of the indenture. Upon any such consolidation, merger or sale, the successor corporation will succeed to and be substituted for us under the indenture".

This covenant looks weak compared with the BT put at par and the FT merger covenant. It does not give any protection against a restructuring or merger. The company issued its debt in a period just after announcing plans to split the company into two parts with a separate listing. One part would be a growth business and the other part would enclose the cash flow business. Although there was a promise that your debt will follow the cash flow business, it is not guaranteed in the prospectus. In this case, however, looking backward this turned out to be only one of the many things that were out of order...

VBA-Katernen

nr. 1 Winst per aandeel door H. Haarbosch en R.L. Boissevain (niet voorradig)

nr. 2 Vastrentende waarden; een inventarisatie van beleggersinformatie door J.J. ‘t Hart, J.P. Kleverlaan, P.P.F. van der Linden en J.C. van Roeel (niet voorradig)

nr. 3 Asset Liability Management bij pensioenfondsen door de Commissie Portfolio Management werkgroep Asset & Liability Management (niet voorradig)

nr. 4 Het Option Adjusted Spread Model door P.A. van Hoeken RBA, drs. J.C.M. Molenaar RBA, drs. C.L.J. Schoof RBA en R. van Wijk-Russchen RBA (niet voorradig)

nr. 5 Bond indices for the euro zone door drs. I.S.A. Ruis-Sijstermans RBA, drs. J.J. ‘t Hart en drs. J. de Wit RBA

nr. 6 Index Selectie in het Beleggingsproces door de Commissie Portfolio Management werkgroep Benchmarking

nr. 7 Goodwill in het licht van de economische benadering door de Accounting Commissie

nr. 8 VBA Perfomance Presentatie Standaarden 2003 The Dutch translation of GIPS door de VBA PPS commissie

nr. 9 High Yield Bond Indices
An issue of the Dutch Commission on Bonds

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