Market Trends 2018/19: High Yield Debt Offerings

A Lexis Practice Advisor® Practice Note by David Azarkh and Sunny Cheong, Simpson Thacher & Bartlett LLP

David Azarkh
Simpson Thacher & Bartlett LLP

This article discusses the market trends for high yield debt offerings in 2018, including notable transactions, deal structure and process, deal terms, disclosure trends, and industry insights, and provides a market outlook for 2019. After a strong and steady 2017, volatility returned to the U.S. high yield market, particularly in the second half of 2018. 2018 started strong with $64.3 billion of high yield issuances in the first quarter but turned negative as the year progressed, with issuances effectively halting in the fourth quarter. High yield volume decreased significantly from $284.2 billion in 2017 to $173.0 billion in 2018. Overall, 2018 saw the lightest annual issuance volume since 2009.

The U.S. high yield market faced a number of macroeconomic and geopolitical challenges in 2018, including, in particular, four rate hikes, the unpredictable policies (and tweets) of the Trump administration, heightened trade tensions between the United States and China, tensions in North Korea, uncertainties around Brexit (the impending departure of the United Kingdom from the European Union), Italy's acrimonious budget negotiations with the European Commission, and commodity price instability. Such challenges culminated in the fourth quarter with an underwhelming third quarter earnings season, declining oil prices, softer global growth, and another rate hike in December. December 2019 was the first month with no new high yield issuances since 2008. The government shutdown also affected the last two months of 2018 and had a significant impact on January 2019.

Market stays cautiously optimistic for 2019 as positive credit fundamentals, such as strong corporate revenue and cash flows and default rates near all-time lows, remain and provide a healthy general economic backdrop for high yield issuers. The quality of new issues has improved and there has also been lower new-issue supply. In addition, issuers have started shifting products from the term loan market back to the high yield market as high yield bonds have become a more attractive instrument to investors. The first quarter of 2019 has already shown signs of improvement, with $67.2 billion in high yield issuances.

The high yield market will, however, continue to grapple with several headwinds that negatively impacted 2018, such as escalating global trade tensions, in particular with China, the risk of protectionist policy, continued uncertainties around Brexit, ongoing equity volatility, and widening credit spreads.

Notable Transactions

The year 2018 included a variety of noteworthy high yield transactions, from challenging acquisition financings and mega-sized debut issuances. Some of these deals are listed below.

WeWork

In April 2018, WeWork Companies Inc. completed a debut offering of $702 million aggregate principal amount of 7.875% Senior Notes due 2025, the proceeds of which were used for general corporate purposes, including in connection with the company's expansion into domestic and international markets and additional product and service offerings.

Nationstar

In June 2018, Nationstar Mortgage Holdings Inc. issued two series of notes: (1) $950 million aggregate principal amount of 8.125% Senior Notes due 2023 and (2) $750 million aggregate principal amount of 9.125% Senior Notes due 2026, the proceeds of which were used to finance the company's merger with WMIH Corp., including the refinancing of outstanding debt.

Refinitiv

In September 2018, Refinitiv US Holdings Inc. issued four series of notes: (1) $1.25 billion aggregate principal amount of 6.250% Senior First Lien Notes due 2026, (2) €860 million aggregate principal amount of 4.500% Senior First Lien Notes due 2026, (3) $1.575 billion 8.250% Senior Notes due 2026, and (4) €365 million aggregate principal amount of 6.875% Senior Notes due 2026. The proceeds of each issuance were used to finance the acquisition of substantially all of the financial and risk business of Thomson Reuters Corporation by King (Cayman) Holdings Ltd., controlled by certain investment funds affiliated with The Blackstone Group L.P.

Envision Healthcare Corporation

In September 2018, Envision Healthcare Corporation issued $1.225 billion aggregate principal amount of 8.75% Senior Notes due 2026, the proceeds of which were used to finance the acquisition of the company by entities affiliated with Kohlberg Kravis Roberts & Co. L.P.

Fortescue

In March 2018, FMG Resources (August 2006) Pty Ltd, an Australian corporation and a direct wholly owned subsidiary of Fortescue Metals Group Ltd, issued $500 million aggregate principal amount of 5.125% Senior Notes due 2023. The proceeds were used to redeem a portion of the company's outstanding 9.75% Senior Secured Notes due 2022 for which the company conducted a tender offer.

Deal Structure and Process

High Yield Offering Process

The timeline of a typical high yield offering has remained relatively unchanged. An offering is launched by the distribution of what is called the "red" (i.e., the preliminary offering memorandum or prospectus) to investors, which is typically accompanied by a press release announcing the transaction. For debut issuers or a significant transaction, the issuer may then go on the road following launch to meet with investors while the banks are building the book of potential allocations to investor accounts and determining deal pricing. The bankers work with the issuer to determine the length of the roadshow. A formal roadshow can be as short as three days and as long as two weeks depending on the nature of the transaction. Investors may provide feedback through the bankers to the issuer that affects the terms of the particular security, including requesting particular changes to the proposed covenant package. The banks will instruct investor accounts that books close by a certain time on the final day of the roadshow, which is the deadline for submitting an order in the bonds. Once books close, the bankers will schedule a pricing call later that day with the issuer in which the bankers and the issuer will agree to the terms of the deal (i.e., the coupon, issue price, maturity, call schedule, and the like).

After the pricing call, a pricing term sheet is sent to investors to confirm sales and the issuer and underwriters / initial purchasers sign the underwriting agreement / purchase agreement, pursuant to which the underwriters / initial purchasers agree to purchase the securities from the issuer. Once a securities transaction is priced, the securities begin trading. As part of the pricing terms, the parties will also schedule a closing date, which is typically the second business day following the date of pricing (commonly known as a T+2 basis), and the securities offering will close on that date. A secured transaction may close on a T+5 basis and certain deals may close on a T+7 or T+10 basis to accommodate an acquisition, tender offer, or bond refinancing.

Extensive roadshows are less common in today's market. For a repeat high yield issuer, launch and pricing are often accelerated to a single day, referred to as a drive by offering. The offering launches before the market opens, followed by a single or several investor calls and pricing later that afternoon. If the market is familiar with the issuer, there is often no need to have a formal roadshow to meet with accounts and, as a result, the process is accelerated.

Over the last few years, issuers seeking to execute high yield bond offerings, particularly in the European Union, have increasingly used non-deal roadshows through which issuers meet with potential investors to introduce their business and financial profile without providing any material nonpublic information or announcing the intention to execute a particular transaction. After completing such meetings, issuers determine whether or not to proceed with an offering. If they go forward with a transaction, they tend to follow the traditional offering structure described above, subject to any applicable marketing regulations in non-U.S. jurisdictions. Non-deal roadshows are helpful to issuers as they reduce the risk of a failed deal. However, there are many hoops to jump through for both issuers and bankers, including determining the information permitted to be provided at the meetings, when the meetings are held in relation to a formal deal launch, the role of bankers at the meetings, who may attend the meetings, whether the information needs to be broadly disseminated, and so on.

Deal Terms

High Yield Covenant Packages

Before proceeding to discuss some of the most common covenants and how high yield bonds are generally issued, a few words are in order on the purpose of high yield covenants and how they are structured to function from a big picture perspective.

A Delicate Balance Made to Last

High yield covenants typically seek to strike a delicate balance that requires the collaboration among the various parties involved. On the one hand, the covenants are designed to provide protection for high yield investors against an issuer being able to overextend itself or unwisely use its cash. On the other hand, the covenants must provide flexibility for the issuer to operate its business and grow over the life of the bonds. In other words, the covenants protect the investors' ability to be paid principal and interest on the bonds while preserving the issuer's ability to run its business without undue restrictions.

High yield covenants are designed to last for the entire maturity of the bonds, which is typically 7 to 10 years (more 5-year bonds are being issued in a rising interest rate environment). High yield covenants are generally difficult to amend, and so are often more flexible than covenants contained in traditional credit agreements. Unlike bank loans held by a relatively small number of lenders, high yield bonds are typically widely held and high yield investors traditionally do not expect to be approached for consent to amend any of the terms of the bonds, except in special circumstances. In addition, unlike an administrative agent under a typical credit agreement, the trustee under a high yield indenture is not expected to closely monitor or be in frequent contact with an issuer. Amending a high yield indenture requires a formal consent solicitation process that follows an established market practice. If that consent solicitation is coupled with a tender offer for the bonds, the tender offer must also follow the federal securities laws and the specific rules of the Securities and Exchange Commission (SEC) that govern tender offers.

Restricted vs. Unrestricted Subsidiaries

The high yield covenant package is designed to regulate the ability of the issuer and its restricted subsidiaries to service its debt and run its business. Every subsidiary of an issuer is deemed to be a restricted subsidiary. The only way in which an issuer can have an unrestricted subsidiary is to designate it as such. Most issuers of high yield bonds have subsidiaries that provide upstream guarantees. Remember that all subsidiary guarantors are restricted subsidiaries but, for reasons that vary depending on the issuer's capital structure, not all restricted subsidiaries are guarantors. For example, subsidiaries utilized in connection with securitization facilities are frequently restricted subsidiaries but not guarantors. High yield covenants are typically very flexible in permitting all kinds of transactions between the issuer and its restricted subsidiaries or among the restricted subsidiaries, which is different from typical credit agreements that often provide flexibility only between the borrower and the loan parties (i.e., guarantors) or among the loan parties. Unrestricted subsidiaries are outside of the reach of the high yield covenants, but designating a subsidiary as unrestricted has the following effects:

- The issuer generally is prohibited from counting that subsidiary's net income when it calculates consolidated net income unless the issuer actually receives cash from the unrestricted subsidiary.
- Most interactions between the issuer and its restricted subsidiaries, on the one hand, and an unrestricted subsidiary, on the other hand, must be treated as if they were transactions with an unrelated third party and comply with all the covenants.

Because of these limitations, issuers rarely designate subsidiaries as unrestricted, although they may do so (e.g., to consummate a project finance transaction where that subsidiary cannot be subject to the high yield covenants).

Incurrence vs. Maintenance

High yield covenants are incurrence-based tests rather than maintenance tests. In other words, high yield covenants are typically tested only when an issuer or a restricted subsidiary actually wants to do something, like pay a dividend, incur debt, or grant a lien. Most high yield covenants do not require an issuer to meet quarterly maintenance covenants.

Typical High Yield Covenants

While each high yield covenant package is distinct, the main covenants are as follows:

- **Limitation on restricted payments (i.e., the RP covenant).** The RP covenant regulates the amount of cash and other assets that may flow out of the issuer and its restricted subsidiaries. It typically limits cash dividends, the redemption or repurchase of the issuer's capital stock, the redemption or repurchase of subordinated debt obligations, and restricted investments.
- **Limitation on indebtedness.** The debt covenants regulate how much unsecured debt the issuer and its restricted subsidiaries may incur.
- **Limitation on liens.** The lien covenant regulates how much secured debt the issuer and its restricted subsidiaries

may incur. It protects the investors' position in the capital structure by regulating the incurrence of secured debt that may be effectively senior to or pari passu to the high yield bonds and ensuring that the high yield bonds will have a senior priority lien on collateral that secures any junior debt.

- **Limitation on asset sales.** The asset sale covenant establishes guidelines that must be followed in any asset sale and, subject to certain exceptions, permits the issuer or its restricted subsidiaries to use the proceeds either to prepay certain debt or reinvest in the business. If the proceeds are not used pursuant to the guidelines, the issuer will be required to offer to repurchase the high yield bonds from bondholders at par.
- **Limitation on affiliate transactions.** This covenant limits the issuer's and its restricted subsidiaries' ability to enter into transactions with affiliates unless those transactions are on terms no less favorable than would be available for similar transactions with unrelated third parties.
- **Reporting.** The reporting covenant governs the information the issuer must provide to its investors in order to support trading in the securities and to monitor the performance of the issuer. The covenant can vary significantly from issuer to issuer depending on, among other things, whether the issuer is a public or a private company.
- **Merger covenant.** This covenant is principally designed to prevent a business combination in which the surviving obligor of the bonds is not financially healthy, as typically measured by whether the fixed charge coverage ratio (FCCR) of the issuer and its restricted subsidiaries following the transaction would be equal to or greater than the FCCR of the issuer and its subsidiaries prior to the transaction.
- **Future guarantors covenant.** This covenant is designed to make sure that if a subsidiary of the issuer is guaranteeing other debt, the bondholders also receive the benefit of such guarantee.
- **Change of control.** This covenant requires that the issuer purchase the high yield bonds from bondholders at a price equal to 101% if a change of control occurs. A change of control is typically defined to occur when (1) a person or group obtains ownership of 50% or more of the voting stock of the issuer, (2) a merger or consolidation transaction occurs in which the equity holders of the issuer before the transaction do not represent the majority of equity holders of the surviving entity, (3) the issuer sells all or substantially all of its assets, or (4) the issuer adopts a plan of liquidation.

Most of these covenants have built in exceptions capped at specific dollar amounts, commonly known as baskets, and other exceptions providing the issuer with the flexibility that it needs to operate its business and grow over the life of the bonds. Such exceptions are vast and are often highly negotiated.

High Yield Deal Terms in 2018 — A Look Back

High yield trends and covenant changes during a particular year (whether loosening or tightening) depend on the market backdrop at the particular time of issuing the bonds and the particular industry. In addition, the credit rating of the issuer and other factors, such as the existence of a sponsor, new issuer strategies, and investor familiarity with the issuer, always make a difference in the outcome of the overall covenant package. During the course of 2018, a general theme, in line with a challenging high yield market, was investors seeking more investor-protective changes to the covenant package, such as their push back on the change of control covenant described below. Nonetheless, on the whole, high yield covenants in 2018 did not change meaningfully from 2017.

Change of Control

The change of control covenant continues to be a focal point for investors, especially when it comes to two aspects. First, many definitions of change of control do not contain what is known as the merger prong. That prong provides that, among other things, a change of control includes a merger or consolidation in which the equity holders of the issuer before the transaction do not represent a majority of the equity ownership of the surviving entity. This is typically the prong regulating parent to parent public company mergers. The rationale for excluding it is that the equity ownership in a public company is so diverse that no one would really control the surviving entity. A number of investors in 2018 high yield deals continued to request to include this prong for their protection, whether or not the issuer is public.

The second item that investors have pushed back on is the double trigger change of control concept. This concept has always existed in investment grade bond offerings and has crept into the high yield world. During 2018, high yield investors continued to object to this concept. In a double trigger change of control provision, a put or obligation to repurchase the bonds is triggered only if there is both a change of control and a ratings downgrade from one or more rating agencies within a specified period following the announcement of the change of control. While this provision is still extremely common in investment grade bond offerings and offerings with cross-over hybrid covenant packages, it has received significant pushback in typical high yield packages.

Disclosure Trends

Continued Scrutiny of Non-GAAP Measures

High yield issuers have long supplemented U.S. generally accepted accounting principles (GAAP) with non-GAAP financial measures, in particular Earnings Before Interest Taxes Depreciation and Amortization (EBITDA) and EBITDA adjusted to exclude certain nonrecurring items (Adjusted EBITDA). Non-GAAP financial measures provide additional information tailored to the particular issuer's business and/or industry in order to help investors better measure issuer performance and evaluate ability to service indebtedness. Regulation G (17 C.F.R. § 244.100–102) and Item 10(e) (17 C.F.R. § 229.10) of Regulation S-K set forth the SEC's core framework for the use of non-GAAP financial measures in SEC filings. Principally, the rules require that whenever an issuer publicly discloses material information that includes a non-GAAP financial measure, the issuer must accompany that non-GAAP financial measure with a presentation of the most directly comparable GAAP financial measure and a reconciliation between the non-GAAP measure disclosed and the most comparable GAAP financial measure. The rules seek to bridge the gap for investors by requiring issuers to disclose the adjustments they are making to GAAP financial measures.

Issuers with SEC-registered securities have noticed a substantial uptick in the number of SEC comments focusing on the use of non-GAAP financial measures and related disclosures, based in part on guidance issued by the SEC in May 2016. The SEC 2016 guidance mainly seeks to reinforce prior guidance and not impose new requirements. The SEC updated guidance posted on April 4, 2018, available at https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm. Consistent with prior years, the SEC is expected to continue to focus on and scrutinize non-GAAP financial measures throughout 2019. The SEC is expected to particularly scrutinize unusual adjustments and non-GAAP measures used in connection with business combination transactions, which will also impact high yield bonds issued under Rule 144A in an unregistered context because such issuances tend to track most SEC guidance.

Industry Insights

Consistent with prior years, issuers' abilities to negotiate covenant packages were to a degree impacted by the overall performance of their respective industries. For example, high yield issuers in the oil and gas space, in light of relatively higher default rates compared with other industries, were at times forced to accept tighter covenant packages than issuers of comparable credits in other industries. Issuers in the financial services and technology, media, and telecommunications spaces, on the other hand, were more likely to achieve favorable terms and greater covenant flexibility. But while an issuer's industry certainly plays a role in the outcome of a covenant package, it is only one piece of the larger puzzle. Over the years, it has become apparent that private equity backed issuers generally achieve more favorable covenant packages than their industry peers. Other factors, such as the credit rating of the issuer, new issuer strategies, and investor familiarity with the issuer, consistently factor in the outcome of the overall covenant package as well.

Market Outlook

High Yield in 2019 – A Look Ahead

The trends in high yield bond issuances change based on the state of the market. When the market is hot and demand for high yield paper is great, issuers and sponsors endeavor to push the envelope in terms of covenant packages. As a result, there tends to be more flexibility in issuer favorable covenants, most frequently expanding the debt, lien, and restricted payment covenants. When the market cools off and demand dissipates, issuers are often forced to accept tighter covenant packages in order to execute transactions. Volatility is likely to remain present throughout 2019 as the macroeconomic and geopolitical concerns that negatively impacted 2018 continue to plague the high yield market. However, strong economic fundamentals, a more dovish Fed and low new issue supply should help stabilize the high yield market, which has already begun to recover in the first quarter of 2019. Some of the trends that may impact the high yield market in 2019 include the following:

- **What will Trump do next?** Trump succeeded in cutting taxes, but his ability to solidify and execute the rest of his agenda, in particular with respect to deregulation and reducing spending, remains to be seen. In addition, uncertainty around the direction of the Trump administration's plans with respect to global trade, immigration, and foreign policy could add to an increasingly cautious, if not already concerned, market environment. Nonetheless, while the market waits to see if positive changes in the corporate and economic environments are actually achieved, there is optimism for growth in the high yield markets during 2019 given the strong economic backdrop.

- **The Fed, interest rates, and inflation.** Fed raised the Federal Funds Rate four times in 2018 following three increases in 2017. Even with increased clarity on the Fed's policy going forward, uncertainly as to the timing and degree of interest rate hikes may create patches of headwind in the high yield markets. To some observers, these increases have signaled confidence in continued growth in the U.S. economy. The Fed's hikes, together with the possibility of a rising inflation environment due to high employment and wage growth, could lead to a corporate debt environment that makes corporate borrowing (including through high yield) more expensive and less attractive for issuers in the near term. The January 2019 comments by the Fed's chairman, Jerome H. Powell, seem to indicate that the Fed was not planning to raise interest rates any time soon.
- **Volatility.** Since the recession in 2008, there has been a great amount of volatility in the high yield market. 2018 has been fraught with geopolitical and macroeconomic uncertainly. The threat of global trade wars, inflation, political turmoil in Italy, the ongoing Greek crisis, Brexit, and the wider European recovery, to name a few, have created a roller coaster market environment. All along, yields on U.S. Treasuries have continued on a steady rise. As the Trump administration navigates the turmoil (some of which is its own making), its policies and deals with other nations going forward promise to have significant impacts on the global economy, in particular in emerging economies, that could further exacerbate the 2018 volatility in the high yield markets. Uncertainly around the Trump administration's approach with respect to a number of areas, notably foreign policy, including tensions with North Korea and Iran; recurring threats of tariffs and a global trade war (in particular, the escalating tensions with China); and the ever-increasing deficit, may cause the cost of high yield debt to increase significantly for issuers. These macroeconomic and geopolitical considerations loom large in the background.
- **The M&A market.** Economic indicators also point to a potentially strong year for mergers and acquisitions (M&A) in 2019, which could lead to an increase in new high yield volume as a source of funding. Observers expect a solid year given the favorable regulatory environment under the Trump administration and potential cash-positive impacts of tax reform. The expectation is also that sponsors will factor more in M&A activity than in recent years given the substantial capital available to do so. Whether strategics and sponsors go to the high yield markets as a source of financing in connection with LBO transactions remains to be seen.
- **Will refinancing drive the market?** A challenging high yield market in 2018 sidelined many high-yield issuers from accessing capital markets, and refinancing risk remains elevated, with hundreds of billions of corporate bonds set to mature in the next few years. Issuers with near term maturities will seek to refinance their debt, introducing supply to the high yield market. However, increased refinancing risk also means increased risk of higher default rates, which, coupled with market volatility and increased recession fears, may exacerbate challenges high yield issuers may face in 2019.
- **The threat of global recession.** While the majority sentiment on the U.S. economy remains bullish as 2019 begins, certain economists maintain that there is the possibility of a recession. Whether the early dips in the market in 2019 signal that the United States is entering a recession, or whether it will in the next 12 to 18 months or on a longer timeframe, is not known. Furthermore, if there is a recession, it is uncertain as to what the extent or duration will be. As the answers to these questions firm up, the 2019 high yield market will respond.

As of the date of this article, there are promising signs for 2019 with the pipeline continuing to fill out, but the year remains ripe with uncertainty. Despite volatility, the high yield market has proven to be resilient and survive the highest of the highs and the lowest of the lows, and in 2019, it will hopefully be resilient once again.

David Azarkh, Partner, Simpson Thacher & Bartlett LLP

David Azarkh is a Partner in Simpson Thacher's New York office and a member of the Firm's Corporate Department. David's primary area of concentration is capital markets, an area in which the Firm has a preeminent U.S. and international presence.

David regularly represents underwriters, corporate clients and private equity sponsors in securities offerings ranging from high yield and investment grade debt offerings, leveraged buyouts, initial public offerings and other capital markets transactions. He also assists companies with compliance, reporting and establishing corporate governance programs.

In 2016, David served as a Contributing Editor of the inaugural edition of "Getting the Deal Through: High-Yield Debt." The publication provides advice and insight into the global high yield market, with chapters covering a range of international jurisdictions. David co-authored the opening segment titled "Global Overview," and the "United States" chapter discussing recent activity in the high yield market.