High Yield vs. Investment Grade Covenants Chart

A Lexis Practice Advisor® Practice Note by
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There are fundamental differences between the covenants of high yield and investment grade debt securities. While investment grade covenants tend to be less restrictive and more limited, high yield covenants are often much more onerous in large part because of the creditworthiness of the issuer. This checklist outlines key debt covenants and explains their differences. A covenant is a promise to take an action (an affirmative covenant) or to refrain from taking an action (a negative covenant). Negative covenants in bonds are typically based on incurrence tests. These covenants cannot be breached except by incurring or taking some affirmative action, such as incurring debt or a lien or making a restricted payment. On the other hand maintenance covenants must be maintained at all times or at regular intervals, such as maintaining a certain leverage ratio. Covenants in debt securities are almost always incurrence versus maintenance based.

For additional information on high yield covenants, see High-Yield vs. Investment-Grade Covenants, Market Trends 2016/17: High Yield Debt Offerings and Top 10 Practice Tips: High Yield Debt Offerings.

Covenants Explained

While each covenant package is distinct and should be tailored to an issuer's operations and industry, the key covenants are outlined in the chart below. Most of these covenants have built in exceptions, or baskets, capped at specific dollar amounts or percentages of certain financial figures (e.g. EBITDA or total assets), also called a grower, 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 often numerous and wide-ranging and are often highly negotiated.

Covenant	Definition
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 covenant regulates how much unsecured debt the issuer and its restricted subsidiaries (and in some cases, subsidiary guarantors) may incur.
Limitation on sale-and-leaseback	The sale and leaseback covenant limits transactions whereby an issuer sells a fixed asset to a bank or other institution and then rents it back.
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 bonds and ensuring that the 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 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 bonds from bondholders at a price equal to 101% of principal 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.

Covenants Compared

Covenant	High Yield	Investment Grade	Commentary
Limitation on Restricted Payments	✓		
Limitation on indebtedness	✓		Some investment grade deals contain a limitation on incurrence of debt by subsidiaries of the issuer.
Limitation on sale-and-leaseback		✓	In a high yield deal, the sale and leaseback limitation is typically a part of the debt covenant
Limitation on liens	✓	✓	Investment grade deals typically have a large general liens basket sized at a percentage of total assets, net tangible assets or EBITDA. In addition, some high yield deals have a provision by which, upon the bonds becoming investment grade, the liens covenant "flips" into this type of formulation.
Limitation on asset sales	✓		
Limitation on affiliate transactions	✓		
Reporting	✓		
Merger covenant	✓	✓	Investment grade deals typically do not have the FCCR requirement noted previously.
Future guarantors covenant	✓		

Change of control	✓	✓	Most investment grade deals have a double trigger change of control provision where no put is required at 101% unless a change of control occurs and there is a rating decline. Some very highly rated bonds do not have a change of control provision at all.

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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.

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