Introduction to High-Yield Bond Covenants

Executive Summary

- Bond covenants are legally enforceable rules that borrowers and lenders agree upon at the time of a new bond issue. Covenants enumerate what issuers are required to do (affirmative covenants) and what they are prohibited from doing (negative covenants).
- High-yield covenants can protect a bondholder from detrimental actions by equity owners, preserve a bond's priority of claims, and accelerate a restructuring to preserve or distribute value to creditors.
- High-yield covenants can't justify an investment in a bad industry or company, give a bondholder meaningful control over management strategy or offset declining enterprise value.
- A proper understanding of a bond's protections is critical for a high-yield investor. Covenants are an important consideration and a key reason why active, rather than passive, management in the high-yield asset class can benefit investors.

In our January 2011 US High-Yield Investment Report, we wrote, "We believe that high-yield managers will differentiate themselves during 2011 through issuer selection." We expected that volatility would decline, performance disparities between rating and industry categories would be fairly muted, and issue selection would be the driving force that differentiated manager performance. Year-to-date (YTD) through June 6, 2011, the difference in total return among rating categories is down 39% and the difference in total return between industries is down 72%. Meanwhile, the difference in total return between the best and worst issuers is over 8,600 basis points (bps). These are market conditions in which investment management firms with strong credit teams can separate themselves from the pack.

Issue selection is a critical step in our investment process and includes many different aspects. One key factor in our process is a thorough review of an issue's covenant package. Though we never make a high-yield investment anticipating that an issuer will default, the reality is that defaults happen, and we need to consider how to protect our investments long before a problem becomes obvious. Identifying issues that are potential tender or call candidates is another reason covenant analysis is so critical. In this report, we will explain key bond covenants, analyze the covenant packages of several recent new bond issues, and demonstrate how Western Asset incorporates covenant analysis into its investment process.

Covenants Defined

Bond covenants are legally enforceable rules that borrowers and lenders agree upon at the time of a new bond issue. Covenants enumerate what issuers are *required to do* (affirmative covenants) and what they are *prohibited from doing* (negative covenants). The bond trustee (e.g., Bank of New York Mellon) is responsible for monitoring covenants and potentially taking action against the issuer in the case of a violation. In the event of a covenant violation, the bond's legal documents specify cure periods and remedies available to bondholders.

What Covenants Can and Can't Do

High-yield covenants can:

- Protect a bondholder from detrimental actions by equity owners
- Preserve a bond's priority of claims
- Accelerate a restructuring to preserve or distribute value to creditors

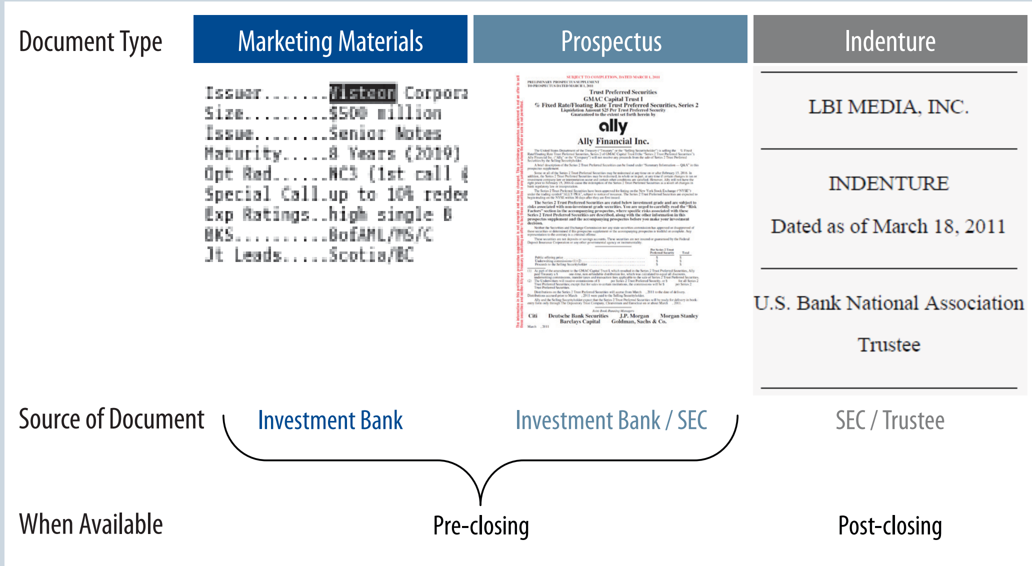
High-yield covenants can't:

- Justify an investment in a bad industry or company
- Give a bondholder meaningful control over management strategy
- Offset declining enterprise value

Sources of Covenant Information

An executed bond indenture is the binding legal document regarding bond covenants. However, the indenture is created *after* a new issue has been marketed, priced and sold. When purchasing a new issue, investors rely on marketing materials from Wall Street firms and a preliminary prospectus ("red herring") in analyzing the quality of a covenant package.

Exhibit 1
Sources of Covenant Information



Source: Western Asset

Structural Considerations

Before describing key covenants and their features, we introduce a number of key structural aspects of high-yield bonds that can impact the risk/reward characteristics of an individual investment.

Seniority

The first thing to note about the structure of a bond is its seniority, which will determine how a class of creditors will fare (i.e., their priority in receiving any recovery) in the event of a default.

A bond's priority can be altered by a number of factors, including:

- *Senior versus subordinated status*—The contractual priority is listed in an indenture.
- *"Opco" versus "holdco" issuance level*—Bonds issued at the operating company (opco) are closer to the assets and typically receive recoveries first.
- *Security / liens*—Much like a home mortgage, bondholders receive the benefit of the value of assets specifically supporting a bond issue.
- *Subsidiary guarantees*—A bond that has guarantees from the issuer's operating subsidiaries receives credit support from the subsidiaries as well as the parent.

Bonds with more senior claims (as defined by one of the factors above) historically have experienced higher recovery rates in the event of default. Certain covenants, including the Limitation on Indebtedness and Liens tests described below, further define one's place in the capital structure *and* protect it going forward.

Maintenance Versus Incurrence Tests

Maintenance and incurrence tests are two categories of covenants that require a borrower to adhere to certain financial metric limits. Maintenance tests, which are typically found in leveraged loans, require that a company *maintain* compliance with financial metrics in order to avoid defaulting on its debt. A common example of a maintenance test would be a 6.0x maximum debt-to-EBITDA leverage ratio, which if the company exceeded for any reason, would result in a technical default. This contrasts with incurrence tests, which are used in high-yield bond indentures and kick-in only when a company *incurs* additional debt or makes restricted payments to the detriment of bondholders. A company with a 6.0x debt/EBITDA leverage debt *incurrence* test would violate the covenant if the company actively added debt that caused it to exceed 6.0x leverage, but not if its EBITDA declined and caused its leverage to increase.

The Fine Print

A proper understanding of a bond's protections is critical for a high-yield investor. However, the dense and sometimes confusing nature of a bond indenture can make it complicated to understand. Many basic covenants, such as a leverage limit in the Limitation on Indebtedness test, contain written exceptions (also known as carve-outs) that can dilute their value to bondholders. An example of this would be a credit facilities carve-out that allows a company to make additional borrowings on its bank line, even when it would be in violation of its headline leverage or coverage-based Limitation on Indebtedness test.

Furthermore, the *Definitions* section in an indenture can allow a company more flexibility (at bondholders' expense) than an initial reading of a covenant would have suggested. The paragraph-long Limitation on Liens section in a bond indenture often has pages of Permitted Liens listed in the Definitions section that vastly increase the risk of structural subordination for bondholders.

Other Structural Considerations

Early redemption features can have a material impact on the total return of a bond, depending on a bond's call features. High-yield bonds typically have a non-call period during which a company's option to retire the issue is limited but not impossible. For example, most bonds contain a "make whole" call feature that allows the company to call bonds during the non-call period at a premium of US Treasuries (UST) plus 50 bps. Investors are typically very satisfied when a "make whole" call is made on a bond in their portfolios because the "make whole" price is typically well in excess of market prices. An equity clawback call is another matter. Equity clawbacks allow the issuer to refinance a certain amount of the outstanding bonds with proceeds from an equity offering, whether initial or follow-on offerings. A typical clawback would be for up to 35% of the outstanding bond issue at a price equal to par, plus the annual coupon. Investors are less enthusiastic about equity clawback calls, which tend to be at prices below where the market values the security. A recent and rather unfavorable development of issue structures has been the addition of a 10% annual call at 103 in some new issues.

Registration rights determine whether bondholders will benefit from US Securities and Exchange Commission (SEC)-mandated public filings and accompanying liquidity. This contrasts with less favorable "144A for life" status, which often implies lackluster financial reporting and weaker management interaction for investors.

Key Covenants Defined

1. Limitation on Indebtedness

The Limitation on Indebtedness covenant, which is also known as a debt incurrence or debt test, is one of the most common high-yield covenants. There is no standardized financial metric for the Limitation on Indebtedness test, but the two most frequently used ratios are leverage (debt/EBITDA) and interest coverage (EBITDA/interest expense). A Limitation on Indebtedness covenant restricts an issuer from incremental borrowing beyond a prescribed level. This covenant also typically includes carve-outs that permit additional debt above and beyond the base calculation, including credit facilities, the refinancing of existing debt and miscellaneous needs. This covenant may also contain subtests that limit secured debt, helping preserve a bond's place in the capital structure.

2. Limitation on Restricted Payments

The Limitation on Restricted Payments (RP) covenant limits cash outflows, dividends, acquisitions and investments by the company. This covenant helps protect asset coverage for bondholders and limits the power of equity holders. An RP "basket" from which the company is able to make restricted payments is typically calculated using either: a) 50% of net income, or b) 100% of EBITDA less 1.4x interest expense. Investments in restricted subsidiaries are typically not subject to RPs, allowing the company to invest in its core business without violating covenants. A properly written RP covenant starts with limited restricted-payment capacity at the date of a new bond issue, with capacity increasing over time as the company generates earnings. A tight RP test is frequently a catalyst for bonds to be tendered in acquisition/LBO situations.

3. Limitation on Liens

The Limitation on Liens covenant restricts a company's ability to secure future debt with company assets. This covenant protects a bond's place in the capital structure and can support recoveries in the event of default. A typical liens test permits a company's existing bank credit facility to be secured and may also include additional permitted liens capacity that could subordinate a new bond issue. The Limitation on Liens covenant is also typically the one meaningful covenant in investment-grade bonds. In investment-grade indentures, the liens covenant is typically referred to as a *negative pledge*, which requires that an unsecured bond issue is given security when new secured debt is placed on the balance sheet. Both a careful analysis and understanding of the definitions and carve-outs for the liens test are important, given the potential for unexpected, additional secured debt.

4. Limitation on Asset Sales

The Limitation on Asset Sales covenant prevents a company from selling assets out from under a bondholder without using the proceeds to either: a) reinvest in the business or b) offer to pay back bondholders at par (a "Net Proceeds Offer"). Asset sales are usually defined as a transaction of material size to the company; proceeds need to represent "fair market value" of the assets being sold and must be at least 75% cash. Companies typically have 365 days to reinvest proceeds of an asset sale—making a Net Proceeds Offer a lengthy process for bondholders. This covenant can sometimes be diluted when specific assets are exempted in the indenture from treatment under the Limitation on Asset Sales.

5. Change of Control

A Change of Control (CoC) covenant allows investors to *put* (sell) their bonds back to the company at 101% of par value when a specified event has changed the ownership/control of the company. The importance of this covenant typically depends on the trading prices of bonds, as well as the intentions of the new owners (such as pursuing an LBO versus an acquisition by an investment-grade company). Bond issuers have increasingly complicated this historically simple covenant by adding conditions, including carve-outs for "Permitted Holders" (current owners or logical acquirers). Some CoC covenants are triggered only by a rating decline, while others are not triggered if a public company acquires the high-yield firm. As a result, a close reading of an indenture's definition of CoC can be important.

6. Reports

The Reports covenant ensures the bondholder's access to financial information from the company. The Reports covenant is particularly important for holders of "144A" bonds that will not be registered by the SEC or required to file financials on the EDGAR system.

For 144A issuers, the Reports covenant will often require the filing of SEC-like financial reports. The Reports covenant also specifies the amount of time a company has to file its financial reports, typically set at 45 days after the end of a quarterly period and 90 days after the end of an annual period.

7. Mergers

The Mergers covenant prevents a company from merging with another company unless: a) the company is the surviving corporation out of the merger and continues to observe the indenture or b) the acquirer delivers a supplemental indenture to the Trustee expressly assuming the old bonds and terms of the old indenture. In addition, the combined company must not be in default and must be able to incur $1 of additional debt under the debt incurrence test. These requirements effectively prevent a company from avoiding its obligations to bondholders by selling out to another company.

8. Events of Default

The Events of Default covenant lists the conditions under which the company is in violation of the terms of its requirements. Events of Default can include bankruptcy of the company or its material subsidiaries, not paying principal or interest as scheduled, not filing financial statements on time, or a legal judgment against the company in excess of a certain amount. Events of Default typically have grace periods that allow the company an amount of time to cure the Event of Default, after which an actual default occurs and the bonds are immediately due. The typical grace period for missed timely payments of principal and interest is 30 days and 60–90 days for other covenants. Trustees are responsible for policing bond covenants and declaring Events of Default; however, a group representing more than 25% of bondholders can typically declare a default as well.

Other Covenants

In addition to the key high-yield covenants described above, there are many more which are used less frequently and may or may not be critical when considering an investment. These other covenants include:

- *Covenant Suspension/Fall-Away*—Companies with aspirations of investment-grade ratings may include this covenant, which suspends or removes most financial covenants when the company is rated investment-grade.
- *Amendment/Consent Solicitation*—Most indentures specify that an affirmative vote of greater than 50% of bondholders by value is sufficient to amend the indenture or waive an Event of Default.
- *Inter-creditor Agreement*—For secured bonds from a corporation that has another class of secured debt outstanding (e.g., first-lien bank loan and first-lien bond), the Inter-creditor Agreement section discusses the priority of payments in a default scenario. Note that secured bonds are typically at a disadvantage to bank loans in terms of collateral control and even priority of payment.

- *Anti-layering*—Second-lien secured bonds often have explicit or implicit (via incurrence/liens tests) anti-layering language that limits the ability of the company to place new debt in between the bonds and a standard first-lien bank facility or bond.
- *Limitation on Dividends of Restricted Subsidiaries*—This covenant prevents restricted subsidiaries from encumbering their assets and/or cash flows outside of the ways envisioned in the indenture in order to preserve value for the parent/issuer.
- *Designation of Unrestricted Subsidiaries*—Companies can "un-restrict" their subsidiaries by treating the transfer of the value of the subsidiary as a restricted payment, subject to the size of the basket.
- *Future Subsidiary Guarantees*—This covenant ensures that subsidiary guarantors are managed in the spirit of the original indenture, with new subsidiaries adding their guarantees to the indenture and sold/unrestricted subsidiaries dropping their guarantees.
- *Transactions With Affiliates*—This covenant prevents a company from transferring value into affiliated companies above a certain size unless the transaction is "arms length" or is counted as a restricted payment/permitted investment.

Case Studies: The Good, the Bad, and the Ugly

The following three case studies illustrate the potential benefits and risks that covenants can represent for high-yield bond investors.

Good Covenants

In November 2010, a high-yield document management services company brought an inaugural high-yield bond issue with a 10.5% coupon and a 2016 maturity.

Key Covenants:

- A conservative 4.5x maximum leverage Limitation on Indebtedness covenant that will limit the company's ability to issue much more additional debt, given its current leverage ratio of nearly 4.0x.
- Carve-outs to the Limitation on Indebtedness covenant were limited to approximately $105 million, with the credit facility carve-out reduced to only $50 million if leverage exceeds 4.5x.
- Permitted liens in the Limitation on Liens covenant were restricted to only credit facility borrowings and a $5 million miscellaneous carve-out, preventing the company from securing excessive amounts of future debt ahead of the unsecured notes.
- Restricted-payment capacity in the Limitation on Restricted Payments covenant shrinks by $15 million when leverage exceeds 3.0x.

In our view, this robust covenant package will protect bondholders in a downside scenario from a combination of excessive leverage, subordination from new secured debt, and depletion of asset coverage via restricted payments.

Bad Covenants

In March 2011, a high-yield auto supplier that had recently emerged from bankruptcy came to market with a $500 million senior note issue with a 6.75% coupon and a 2019 maturity. In addition to the cyclical nature of the auto industry and the company's historical financial problems, the new deal included a number of covenant features that were unattractive in our view.

Key Covenants:

- Subsidiary guarantees on only approximately 20% of the company's assets, making the new bonds effectively subordinate to any debt at subsidiaries representing the bulk of the company's value (see this paper's earlier section on seniority).
- Over $2 billion of additional secured debt is permitted under the Limitation on Liens covenant, which (if issued) could deeply subordinate the new unsecured bonds.
- The Limitation on Restricted Payments covenant would allow nearly $2 billion of dividends to shareholders under a permissive leverage-based limit and a $400 million miscellaneous carve-out.
- The bonds came with a bondholder-unfriendly eight-year maturity with a three-year call (8NC3) structure and an unusual 10% annual call at 103% of par.

Especially in the context of the company's 2009-2010 bankruptcy, we believe that this weak covenant package represented an excessive amount of risk for new bondholders and was not compensated for by an anemic 6.75% coupon (40 bps less than the high-yield market at the time).

Ugly Covenants

An investment-grade newspaper company was taken private in a leveraged buyout (LBO) in 2007. Its bond indenture contained a "negative pledge" (see this paper's earlier section on Limitation on Liens) that would typically prevent its formerly investment-grade notes from being subordinated behind secured debt. However, the indenture did not provide subsidiary guarantees, which then allowed the new owners of the newspaper company to add structurally senior bank debt at the subsidiary level, effectively deeply subordinating the formerly investment-grade bonds. Contrast the bondholder experience in this case with that of bondholders of an investment-grade Spanish-language television network that also LBO'd in 2007. Its bond indenture also contained a "negative pledge" clause. However, the television network bond indenture also contained subsidiary guarantees. As a result of this difference, the newspaper company's formerly investment-grade bonds traded as low as 2 cents on the dollar in 2009, while the Spanish-language television network's formerly investment-grade bonds were retired at 100 cents on the dollar.

A similar situation occurred for legacy investment-grade bonds of a large electric utility when the company was taken private in 2007. A "negative pledge" in the investment-grade bonds' indenture was written to include only "capital stock" (but not assets) of subsidiaries, which allowed the company to secure huge amounts of new debt at its subsidiaries. Furthermore, a lack of subsidiary guarantees in the investment-grade indenture allowed the company to place structurally senior guaranteed debt at the parent level as well. The poorly written fine print in the electric utility's legacy investment-grade bonds ultimately cost bondholders dearly, with some bonds trading as low as 50 cents on the dollar today.

A Comparison of Debt Asset Classes

Bond covenants are more prevalent in the high-yield market due to overall higher levels of debt and the greater chance of impairment for more levered companies. Exhibit 2 compares the typical structure and covenants of several corporate debt classes, including high-yield.

Covenants and the Investment Process

Covenants aren't the first or last step in analyzing a high-yield credit, but they are a key component of a bond's risk profile. A company's fundamentals, credit characteristics and valuation will often typically drive a high-yield investment, but covenants can alter a bond's risk profile

Exhibit 2

	Investment-Grade (IG)	Leveraged Loans (BL)	High-Yield (HY)
Security	Unsecured	1st lien	Typically unsecured
Subsidiary Guarantee	Typically no	Yes	Usually
Typical Maturities	5–30 years	7 years	5–10 years
Callable?	Non-callable	Callable at par	Callable at par plus ½ coupon
Financial Covenants	None	Maintenance	Incurrence
Other Covenants	Negative pledge only	RP, Liens, Asset Sales, Merger, etc.	RP, Liens, Asset Sales, Merger, etc
Public Filings	Yes	No	Only if "registered securities"

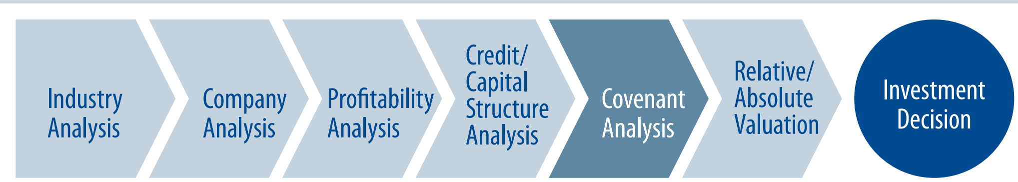
Source: Westerm Asset

significantly, potentially making it "uninvestable" or even particularly valuable.

Negotiating Covenants

Despite bankers' exhortations of new issues having "standard high-yield covenants," each deal is different, and the market will dictate the strength (or lack thereof) of a new issue's covenants. Often bankers, issuers and their respective lawyers will lead with "innovative" new covenants that give them flexibility at bondholders' expense. As a result, it is the bond investor's responsibility

Exhibit 3



Source: Westerm Asset

to push back on novel/weak covenants, with the strength of the market environment typically determining whether these efforts are successful.

Valuing Covenants

Ideally, a "standard" covenant package for a new issue would allow an investor to judge pricing based on credit and relative-value considerations. However, variations in covenant packages mean that sometimes standalone valuation has to be adjusted accordingly. Some weak covenant packages could make a new bond issue nearly uninvestable, while an attractive structure could actually lower an investor's perception of risk. Overall, barring a particularly atrocious set of covenants, high-yield investors will take covenant quality into consideration when setting their required return and position size for a new issue.

Conclusion

Covenants are an important input into the high-yield investment decision-making process and complement traditional fundamental credit and valuation analysis. Proper covenants can protect one's investment in a good company, and they can even generate incremental returns when covenants block desired corporate actions and when the bonds in question are tendered at a high price. Conversely, good covenants alone aren't enough to justify buying a high-yield bond deal. This is an important consideration and a key reason why active, rather than passive, management in the high-yield asset class can benefit investors. While investors should be cautious about investments in bonds that have aggressive covenants, larger high-yield managers such as Western Asset can have important input on the drafting of more favorable covenant language.