

Swiss Cheese and High Yield Covenants

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What do Swiss cheese and high yield covenants¹ have in common? A lot of holes!

Unfortunately for investors, the covenants are not supposed to have holes. They are meant to preserve a lender's claim value. In this note, we wanted to hash out why covenants are important and why should investors care about them.

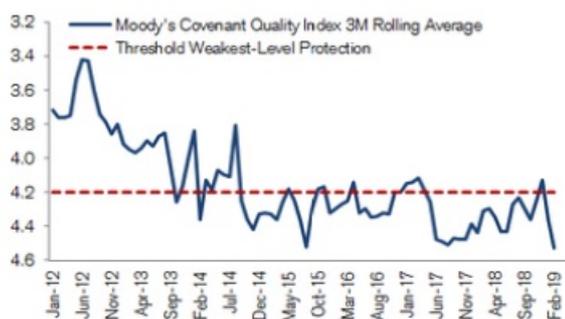
Why should you care about covenants?

The looser covenant structures that we see today will likely have two major consequences for investors. They will create "zombie" companies as management teams and sponsors utilize every flexibility under covenant terms to extend the lifespan of a company at a time of financial stress. This, in turn, will result in lower recovery rates than what investors have experienced historically. High yield spreads will widen to anticipate these credit events while the reported default rate may remain low. Many investors focus on the default rate to assess the health of the high yield market, therefore some caution will be warranted before reaching an investment view. Be careful about judging a book by its cover.

Covenant quality continues to deteriorate.

QE and the subsequent reach for yield have been a strong tailwind for the High Yield Market. Investors in their quest to acquire "higher" yield, have traded off covenant protections. Moody's Covenant Quality Index (see Chart 1) is at all time weak levels - ie less protective covenants. The trend of watered down covenants is not just applicable to the US HY market; European and Emerging HY Markets also exhibit the same trends. In our view, the seeds for lower bond holder recovery and more price volatility at the next credit cycle have been sown.

Chart: 1 Covenant quality at all time lows



Source: Credit Suisse, Moody's

High Yield covenants explained

There are five key covenants that we believe a typical high yield bond investor will care about:

Limitation on incurrence of additional debt - this restricts an issuer from incremental borrowing beyond a certain level. Higher levels of debt may impact potential recoveries for note holders should the issuer becomes unable to service its debt and file for bankruptcy.

Limitation on restricted payments - this limits dividends, buybacks, subordinated debt repayments, acquisitions and investments by the company to junior classes to help protect asset coverage for bondholders.

Limitation on liens - this restricts a company's ability to secure future debt with company assets.

Limitation on asset sales – this 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.

Change of Control – this 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. In essence, the bondholders get a chance to revisit their investment underwriting on the back of a transformational event that may increase credit risk.

For the purposes of this note, we will predominantly focus on the limitation of debt and restricted payments clauses that have been chipped away and highlight some of the creative proposals we have seen in the market. We would note that some of these propositions have received notable investor pushback and, as a result, been modified. However, it highlights the importance of digging deep when conducting due diligence on individual securities.

How the debt incurrence test became Swiss cheese

Debt incurrence test is typically based on net debt or interest coverage ratio. **We have seen various versions of this test which may increase the probability of capital loss to a bond investor due to allowance of higher leverage.** These proposals include:

- Debt that is calculated on net debt basis and ignores certain debt when calculating compliance. This simply understates debt liabilities of a company.
- Debt incurrence test that is driven off of adjusted EBITDA² calculation that can have additional addbacks that can equate up to ~30% of EBITDA for one-time costs and run rate cost synergies.
- Secured debt capacity that can exclude some secured debt, thus increasing the maximum amount permitted. We have seen more generous carve-outs where there are numerous baskets that can be tapped for incremental secured debt such that it can increase secured debt allowed nearly 2X.

Restricted payments melted in a Fondue pot

Another covenant that is critical for bond holder value preservation is the **limitation on restricted payments (RP) test**, which regulates the amount of cash or assets that can be taken away from the bondholder collateral pool. The RP calculation has been historically derived from a formula that builds available reserves (called a basket). This basket comprises 50% of cumulative consolidated net income plus other items such as proceeds from equity sales or capital contributions, which the issuer can tap into if it meets certain credit metrics. In simplistic terms, the issuer gets access to a variable basket that grows or decreases simultaneously with its profitability. As the company generates profits, it earns the flexibility to reward its shareholders along with the creditors.

Now, let's visit some of the new versions of the language that have been proposed.

- Ability to make unlimited payments as long as leverage remains below a certain threshold irrespective of the available amount in the basket. In fact, per Covenant Review, a research firm that is solely focused on covenant analysis, two thirds of the recent deals in the last 12 months feature this language, which in an extreme case allows a company to increase its adjusted EBITDA on any given quarter to lower its leverage metric and take unlimited amounts of cash out of the collateral pool. Recall that EBITDA is not a GAAP³ figure, therefore it is prone to A LOT of adjustments and subjectivity. In fact, as mentioned before, documents may allow for additional addbacks that can equate up to ~30% of EBITDA.
- Ability to use the capacity built up at any time without any standard financial ratio or coverage test, as long as the company is not in default. In a very specific case, there was even the proposal to make a dividend payment EVEN if there is an event of default.
- Ability to make a payment using asset sale proceeds regardless of the size of the available amount in the basket. Think of a case where a company owns two coffee shops and the owner sells one. Typically, there are provisions where it would require the proceeds to be directed towards debt payments, so the creditors are in no worse position. Under this language, the owner sells half of the stores and takes all the proceeds to pay himself a nice bonus, leaving the creditors with half of the collateral.
- “Builder baskets” that build off of an adjusted EBITDA rather than net income. Again, EBITDA is a non-GAAP figure, which allows subjectivity to creep in. Net income, in contrast, is a cleaner figure and factors in important cash expense items such as interest expense and taxes.
- Baskets that are not reduced by the amount of the restricted payment made or alternatively start with an amount that can be anywhere from \$500 million to in excess of \$1 billion on day one before the company earns a \$1 of net income. It's like having a bottomless checking account that does not decrease the amount available to the borrower by the withdrawal amount (I would personally love to have that if any banks are offering it to consumers). In our view, a company should earn the ability to take cash away from the lenders by executing on its business plan, not be entitled to it.

The devil is in the details.

Sponsor led deals generally tend to have more of the aggressive terms and are featured prominently in high yield benchmarks and thus in ETFs that follow them. As explained above, looser covenant terms, in an extreme case, may allow the sponsor to strip assets from the bondholders at times of financial distress, notably impacting bond recoveries. The challenge for an investor is that Sponsor led companies generally feature companies with the largest stacks of debt and hence occupy a greater percentage of high yield benchmarks.

We don't ignore the cash flow statement in our credit analysis.

Unlike equities, bondholders have limited upside but share similar downside risk should a company's performance worsen. As the credit cycle nears its end, it is critical to assess each issuer's creditworthiness on cash flow metrics along with covenant strength. Covenants can protect bondholders and preserve claims' value but can't justify an investment in a bad company. We believe that focusing on business quality, stability and cash flow can be additive to traditional EBITDA metrics-based credit analysis.

My grandmother used to say that every household should have an accountant, lawyer and a doctor. Perhaps the same can be said of the high yield market. You need an accountant to understand the EBITDA adjustments, a lawyer to navigate the covenants and a doctor to help you keep your sanity.

¹ Covenant: A bond covenant is a legally binding term of agreement between a bond issuer and a bondholder. Bond covenants are designed to protect the interests of both parties. Negative or restrictive covenants forbid the issuer from undertaking certain activities; positive or affirmative covenants require the issuer to meet specific requirements.

² EBITDA: EBITDA, or earnings before interest, taxes, depreciation and amortization, is a measure of a company's overall financial performance and is used as an alternative to simple earnings or net income in some circumstances.

³ GAAP: Generally accepted accounting principles (GAAP) refer to a common set of accepted accounting principles, standards, and procedures that companies and their accountants must follow when they compile their financial statements.

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