Credit & Restructuring Club 10/7 GBM

Intro to Debt

Agenda

1. Credit Intro
2. Covenants
3. Defaults
4. Debt Priority
5. Private Credit

Forms of Debt

Credit Facilities (Loans)

- Senior in capital structure
- Often secured
- Contract called *credit agreement*
- Interest usually floating
- Minimal pre-payment penalties

- Stronger covenant protections
- Often syndicated to "participant" investors
- Straightforward to renegotiate ("amend")
- Private agreements, pretty easily traded

Bonds/Notes

- Typically junior to loans
- Typically unsecured
- Contract called *indenture*
- Interest usually fixed
- Penalties/premiums if paid early.

- Weaker covenant protections
- Issued to dispersed investors

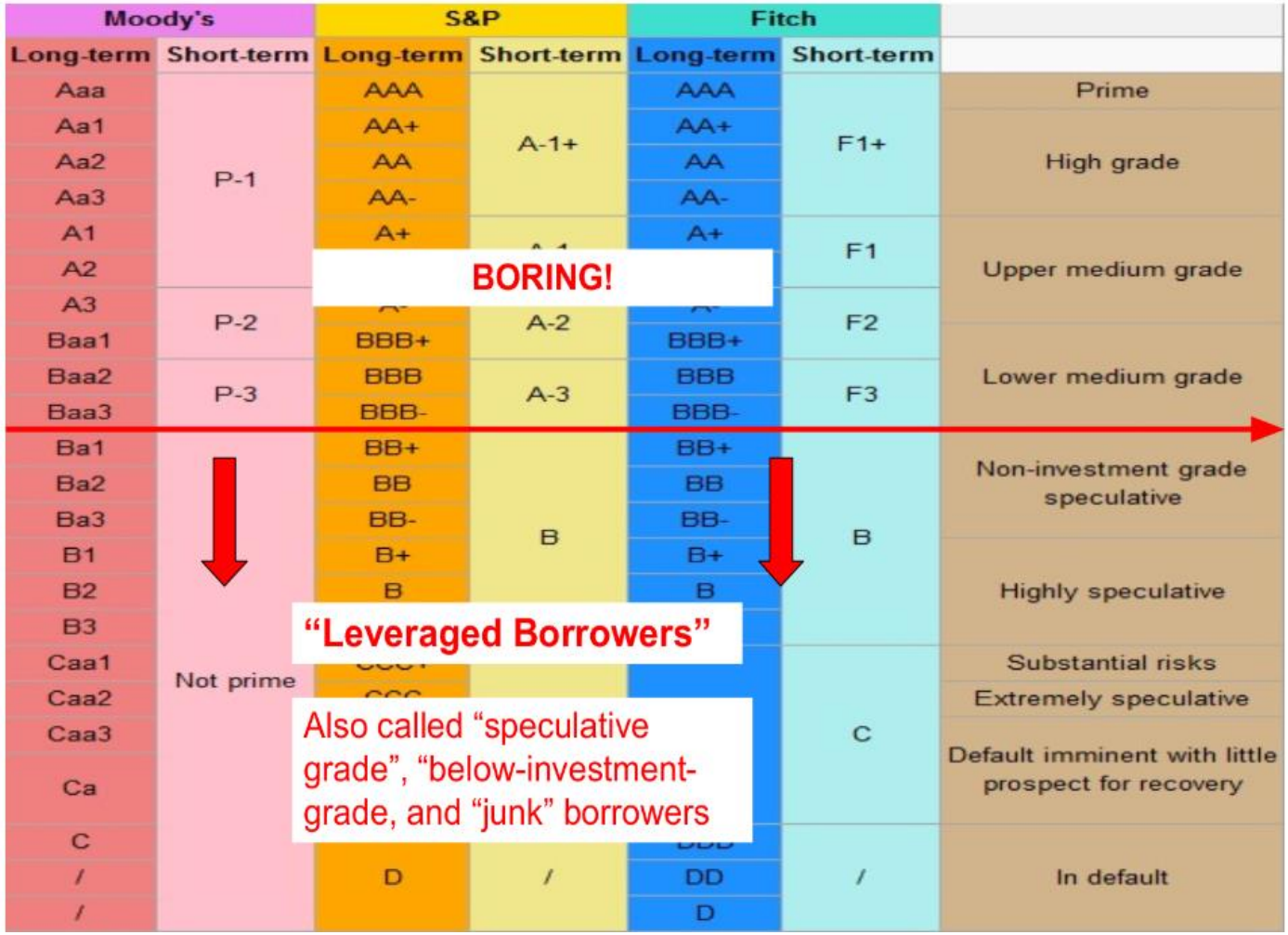
- Difficult to renegotiate

- Public securities, easily traded

Forms of Debt (continued)

Debt Type	Revolver	Term Loan A	Term Loan B	Senior Notes	Subordinated Notes	Mezzanine
Interest Rate:	Lowest	Low	Higher	Higher	Higher	Highest
Floating / Fixed?	Floating			Fixed		
Cash Pay?	Yes					Cash / PIK
Tenor:	3-5 years	4-6 years	4-8 years	7-10 years	8-10 years	8-12 years
Amortization:	None	Straight Line	Minimal	Bullet		
Prepayment?	Yes			No		
Investors:	Conservative Banks			HFs, Merchant Banks, Mezzanine Funds		
Seniority	Senior Secured			Senior Unsecured	Senior Subordinated	Equity
Secured?	Yes			Sometimes	No	
Call Protection?	No	Sometimes		Yes		
Covenants:	Maintenance			Incurrence		

Credit Ratings



After 1 and 5 years, firms rated Ba are 6.6 and 4.9 times as likely to default as firms rated Baa. In addition, credit risk increases substantially in economic downturns, with default rates doubling in recessions. For HY issuers, default rates in recessions prior to 2020 are ~10%, which is 4 times the rate in non-recession years.

Leveraged Finance

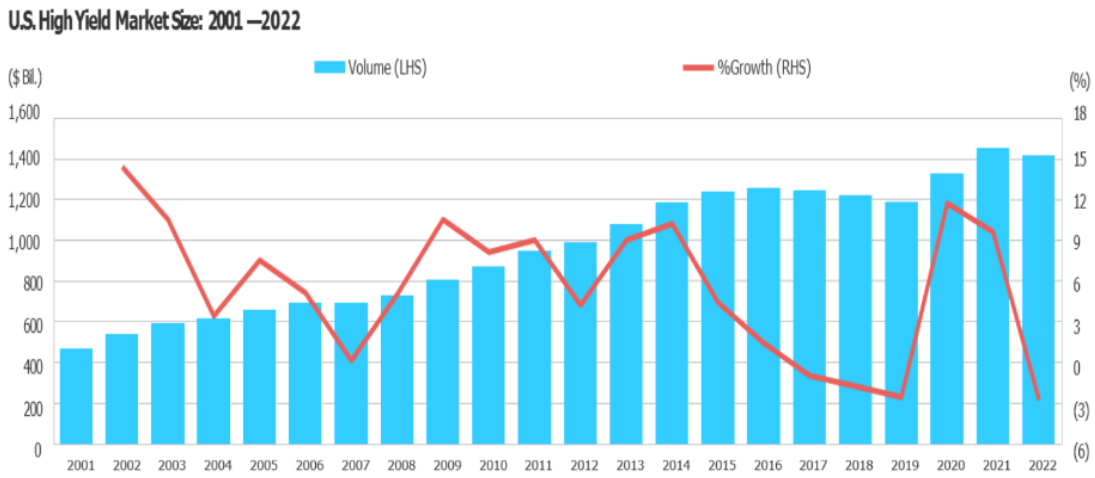
Leveraged finance: debt financing to large and relatively risky corporate borrowers.

- Restricted to large borrowers where the debt is typically too large for any single lender to provide all the funding.
- Leveraged borrowers have below-IG credit ratings.
- **Fallen angels:** firms that become "leveraged" due to credit rating downgrades

Levfin is distinguished from other credit markets because:

- Borrowers pose non-trivial default risk, amplifying issues around risk management, contract design, etc.
- A broad set of investors provide leveraged finance that have little relation to the borrower. This influences renegotiations and restructurings.

Firms become leveraged by using high levels of debt to fund operations or by experiencing operations declines that make previously moderate debt levels more at risk of default



US Leveraged Finance Outstanding
LL + HY = ~$2.9 Trillion

Debt Covenant Overview

- **Covenants restrict borrower to protect lenders**

AFFIRMATIVE COVENANTS

- What a borrower **must do**
- Affirmative covenants are not highly-contested and primarily specify what the borrower must routinely do (e.g., pay insurance, file quarterly financials)
- A breach of an affirmative covenant is a **technical default,** meaning creditors can accelerate the firm into bankruptcy, but it is their choice

NEGATIVE COVENANTS

- What a borrower **must not do**
- Negative covenants restrict what the firm can do (e.g., issue new debt or senior debt)
  - Help determine priority
  - Restrict payments to third parties to the detriment of the creditor
  - Prevent unsecured debt claims from being diluted by additional secured debt

FINANCIAL MAINTENANCE COVENANTS

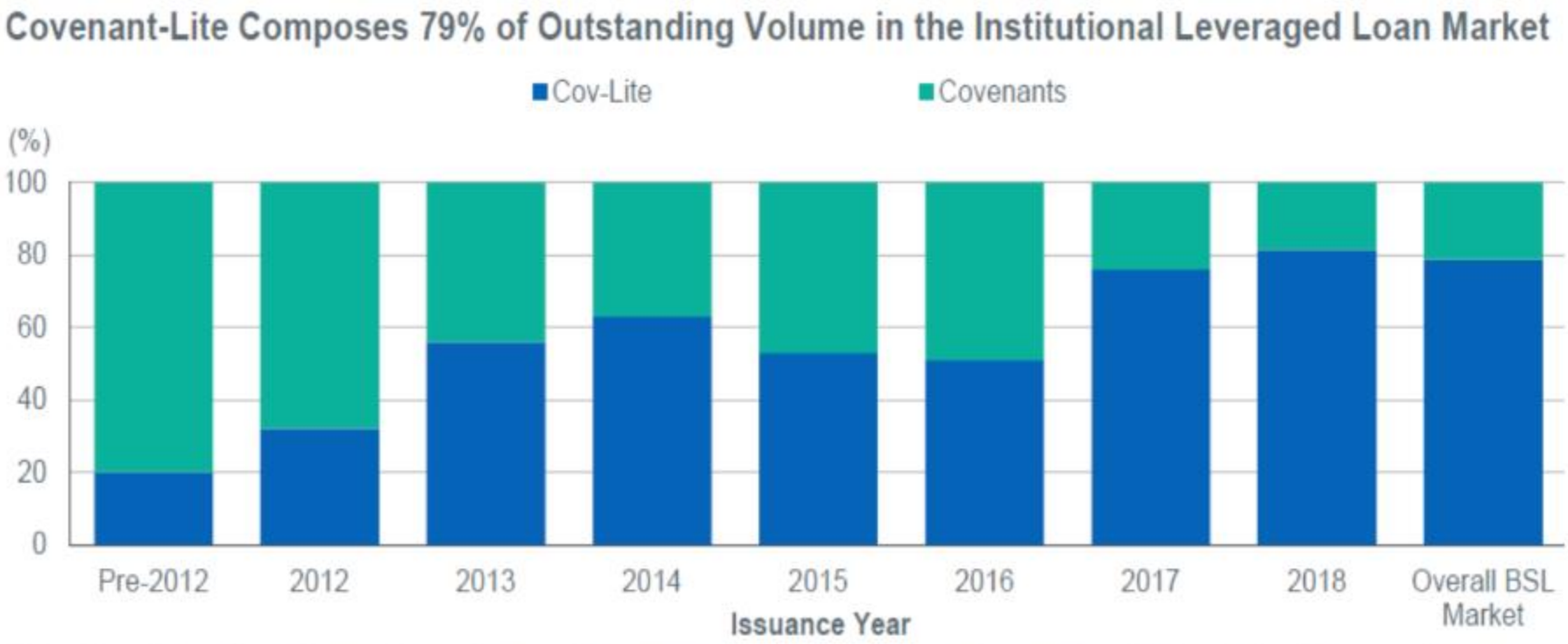
- Maintenance covenants are included in loan credit agreements
  - Come in the form of leverage and coverage ratios
    - **Leverage ratio:** Debt / EBITDA
    - **Coverage ratio:** EBITDA / int. expense
- Failure to comply results in a **default**
- **Purpose:** provide leveraged lenders with warning of underperformance which allows early action to be taken
  - In default, lenders can accelerate debt and exercise collateral remedies

FINANCIAL INCURRENCE COVENANTS

- Incurrence covenants are included in bond indentures (credit docs for bonds)
  - Same form as financial maintenance covenants
- Failure to comply results in restrictions on a firm's actions (e.g., can't issue more debt)
- **Purpose:** disallow issuance of more debt to capital structure

Covenant-Lite Lending

- **Covenant-lite contracts have no maintenance-based financial covenants**



BSL – Broadly syndicated loan. Note: Covenant-lite percentages shown. Years reflect outstanding institutional leveraged loan market profile at end of December. Overall BSL Market reflects the vintage of current loans outstanding and not total issuance. Covenant-lite is defined as deals that do not have maintenance covenants.
Source: Fitch Ratings, Refinitiv LPC, Bloomberg.

Covenant-Lite Lending

EFFECTS OF COV-LITE LENDING ERA

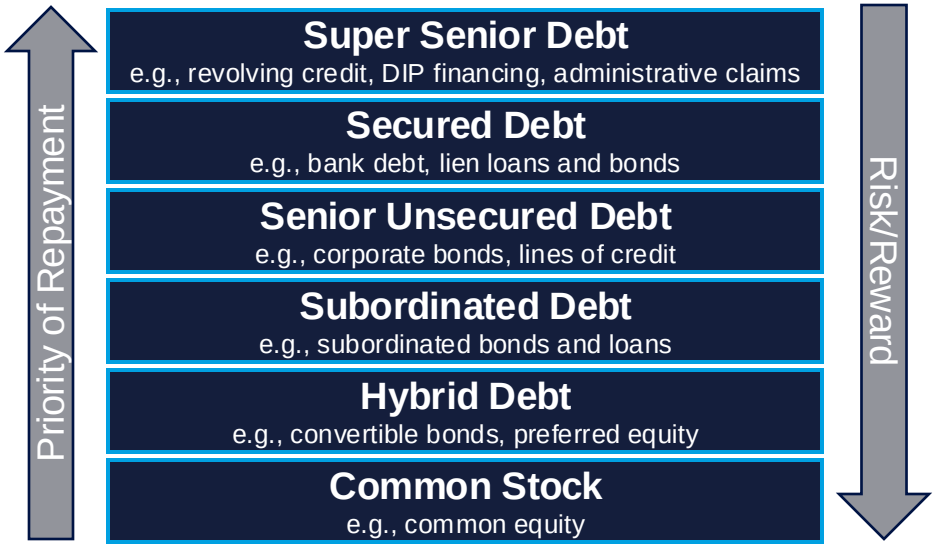
- Cov-lite loans lack financial maintenance tests, which makes their legal structure more similar to high-yield bonds, with incurrence style negative covenants.
- Cov-lite loans allow borrower to:
  - **Incur additional debt:** no maximum amount of debt, as long as firm meets incurrence leverage ratio post-issuance
  - **Incur additional secured debt:** firm may dilute original lenders' collateral liens if incurrence leverage ratio test is met
  - **Move collateral out of restricted group:** under some cov-lite loans, firm may move assets to unrestricted subsidiaries, which effectively renders original secured lenders' lien on those assets worthless
- Cov-lite loans grant borrower reduced risk of default, greater flexibility, and reduced risk of losing control, with little cons to cov-lite lending (except potentially more expensive debt).
- Cov-lite loans dilute lender protections, such as:
  - **Early warning of payment default:** no maintenance covenants, so less warning
  - **Avoiding unfavorable transactions:** borrower has more freedom to enter into transactions that are not beneficial to lenders
  - **Security interest in collateral:** borrower may dilute lien with additional debt issuance
  - **Priority over junior creditors:** under some cov-lite loans, a borrower can repay junior debt prior to a default, which can reduce liquidity available to pay off secured creditors
- Further weakening in credit agreement protections has allowed creative transactions, where firms utilize exceptions to negative covenant restrictions to complete transactions

Default

- **Remedies**

- Events of default are meaningless unless they are associated with remedies that lenders can act on
- Remedies available to lenders include:
  - Stop lending
  - Terminate commitments
  - **"Accelerate" payments**
  - Foreclose on collateral
  - Institute suit for past-due payments
  - Demand payment from guarantors
- **In the event of default (or anticipated default), lenders are *not required* to follow through on remedies**
  - **But important for staking out bargaining position.**

Debt Priority and Types of Subordination



Investments lower in the capital structure have better potential returns but carry more risk due to lower priority of repayment. This is particularly important in a restructuring context because there will almost always be **impaired** securities.

- Priority of payment of debt claims influenced primarily by four factors:
  1. Grants of collateral (security status)
  2. Contractual subordination
  3. Structural subordination
  4. Guarantees

Absolute Priority Rule: More senior claims **must** recover 100 cents on the dollar before any junior claims are eligible to receive any recovery

Debt Priority and Types of Subordination

- **1. Grants of collateral**

- Debt can be *secured* against specific assets of the firm through the granting of **collateral**.
  - Commonly secured assets: Real estate property and buildings, equipment, inventory, accounts receivable, and intellectual property including patents, brands, trademarks, copyrights, etc.
  - "ABL Loan" – revolver typically secured with inventory and/or receivables.
  - Can take security interests in "substantially all of the assets of a firm".
- Secured interest gives the debtholder right to seize or foreclose (sell) assets in case of default out of court.
  - In bankruptcy court, secured holders are "stayed" from foreclosure, but receive specific protections and first priority before all other claimants
- Foreclosure and bankruptcy rights give secured holders highest priority in capital structure.
  - Priority extends only up to the value of the smaller: (1) size of their claim and (2) the value of collateral.
- *Unsecured* creditors are due residual cash flows after secured holders are made whole.

Simple Waterfall Example

Market value of assets	Claim Amount	Distribution of Value: Low Case	Distribution of Value: High Case	Recovery Rates: Low Case	Recovery Rates: High Case
Distributable Value	---	$800	$1,600	$800	$1,600
Secured Debt					
Revolver	$400	$320	$400	80%	100%
Term Loan	$600	$480	$600	80%	100%
Available to lower claims	---	$0	$600	---	---
Unsecured Debt					
Senior Notes	$400	$0	$400	0%	100%
Available to lower claims	---	$0	$200	---	---
Sub. Notes	$400	$0	$200	0%	50%
Available to lower claims	---	$0	$0	---	---
Equity Interests	---	$0	$0	---	---

Important to identify fulcrum security

Fulcrum Security Overview

- **The fulcrum security is likely to get equity in the business**

FULCRUM SECURITY

- The fulcrum security is the first impaired security in a firm's capital structure
  - Most senior security that is impaired
  - In previous slide this would be secured debt (revolver/TL) under low case and sub notes under high case
- Important to identify as a credit investor because fulcrum security often gets much of the post-restructuring equity in the business
  - Introduces "loan-to-own" concept
  - Opportunistic credit investors will invest in a distressed firm's capital structure where they believe the fulcrum security will be, which allows them to own much of the equity after a restructuring
    - Does this by owning enough debt to influence restructuring process to favor an equity conversion
    - Allows quick acquisition process, typically at a large discount
    - Often done by PE firms or hedge funds with operational experience that believe they can turn the business around

Debt Priority and Types of Subordination

• 2. Contractual Subordination

- **Definition:** Contract or agreement in which one creditor group agrees to subordinate itself in priority to another creditor group.
- Two common forms:
  1. **Subordination clause in indenture.** One set of unsecured note/bondholders agrees to subordinate its cash flow claims to another set of investors.
  2. **Intercreditor agreement.** Agreement between two creditor groups that establishes that one group has priority in claims against borrower over the other creditor group.
     - *Common element when tranching secured debt into "1st lien" and "2nd lien" loans.*

Example Subordination Clause

REALOGY CORP. 13.375% SENIOR SUBORDINATED NOTES DUE 2018

Section 10.01. Agreement To Subordinate.

- The Issuer agrees, and each Holder by accepting a Note agrees, that **the payment of all Obligations owing in respect of the Notes is subordinated in right of payment**, to the extent and in the manner provided in this Article 10, **to the prior payment in full of all existing and future Senior Indebtedness of the Issuer** and that the subordination is for the benefit of and enforceable by the holders of such Senior Indebtedness. The Notes shall in all respects rank *pari passu* in right of payment with all existing and future Senior Subordinated Indebtedness of the Issuer, and will be senior in right of payment to all existing and future Subordinated Indebtedness of the Issuer; and only Indebtedness of the Issuer that is Senior Indebtedness shall rank senior to the Notes in accordance with the provisions set forth herein. All provisions of this Article 10 shall be subject to Section 10.12.

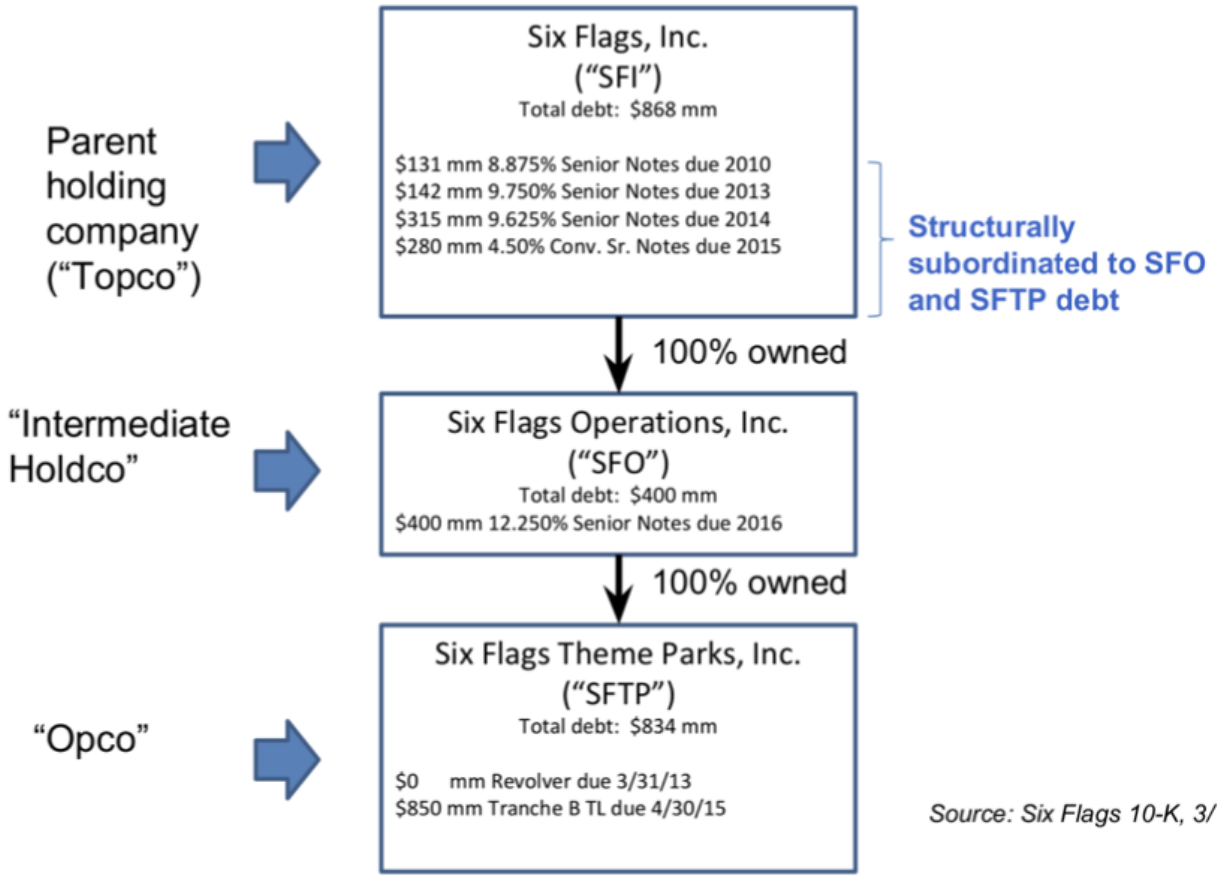
Debt Priority and Types of Subordination

- **3. Structural Subordination**

- In a complex organization with multiple separate entities, liabilities against a given entity are ***structurally* senior** to all claims against the entity created by other entities in the organization.
- Example: Loans to a subsidiary are senior to all claims, including secured claims, against the subsidiary by the parent.
- WHY?
  - Holdco creditors are subordinated to OpCos because OpCo has A/L on BS and HoldCo BS asset side as all equity from each OpCo
- Idea that each wholly or partially owned subsidiary is a separate corporation with its own boundaries of "separateness."
- Organizational structure matters!

Structural Subordination Example

Holdco-Opco Structure



Source: Six Flags 10-K, 3/

Different forms of guarantees

GUARANTEE OVERVIEW

- Guarantees make the obligations of the borrower become obligations of the guarantor in the event of default
- Guarantees can eliminate structural subordination by making (guaranteed) HoldCo debt pari passu with OpCo debt
- 3 types:
  - Upstream: subsidiary guarantees debt that is issued by the holding company
  - Downstream: holding company guarantees debt that is issued by a subsidiary
  - Cross-stream: subsidiary guarantees debt that is issued by another subsidiary

Debt Priority and Types of Subordination

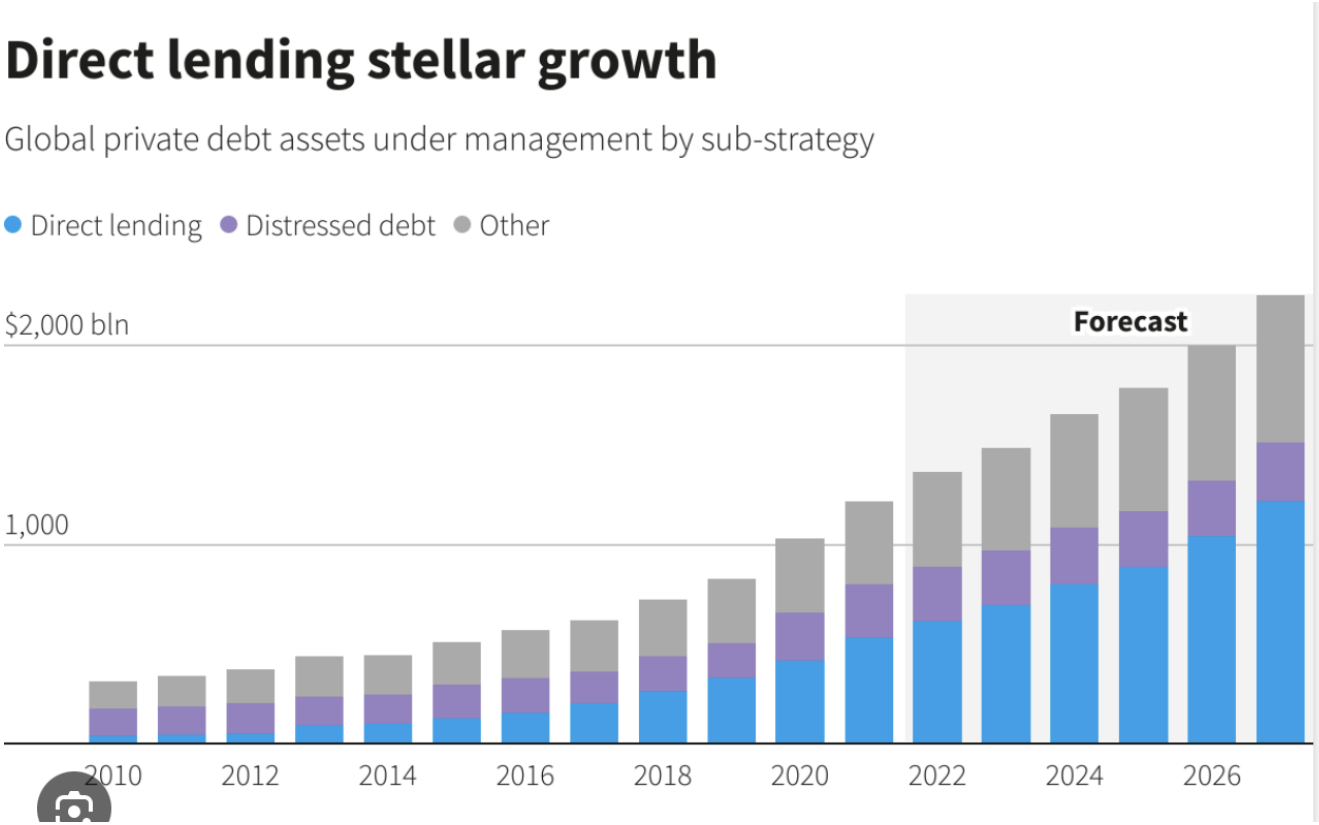
- **4. Temporal Subordination**

- Often overlooked, temporal subordination means *time*
- Example: 1L due 2028 is paid after 2L due 2026
- WHY?
  - 2L comes due first so company pays back in principal (all else equal)
- A business facing near-term bankruptcy will find a way to address its near term maturities, regardless of other protections

- How can lenders protect against this?
  - 1L in our above example can place a *springing maturity* in credit docs
  - Maturity of 1L springs in front of 2Ls if 2Ls are not refinanced or other leverage metrics are met

Private Credit Growth

- **Private credit is anticipated to only continue growing**



What is Private Credit

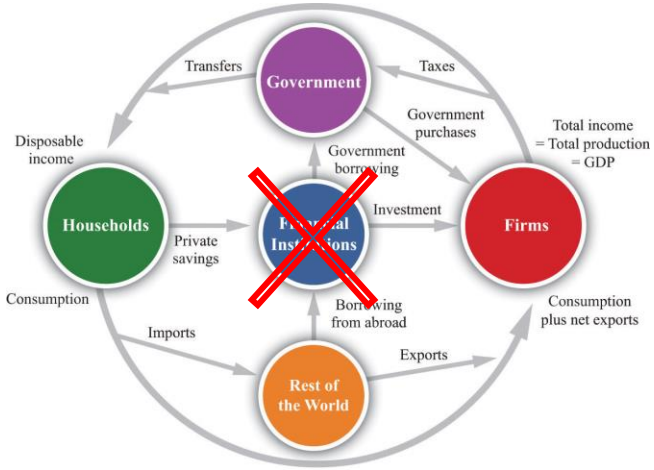
- **Private credit:** asset class built around non-bank lending to companies
  - Dominated by PE firms and specialty alternative investment firms
  - Structured as LP of business development company
  - Focus on middle-market borrowers, but company and loan sizes are growing
- Private credit Divided into 3 segments:
  1. **Direct lending**
     a) Predominantly LBO financing
     b) Loan sizes of ~$20m-2B
     c) Individual lenders or club deals
     d) Lenders hold and service loans
     e) Tighter covenants, richer pricing than syndicated market
  2. **Opportunistic credit**
     a) Bespoke financing to borrowers with unique needs
     b) Liability management
     c) Can include taking mezz or equity-like positions in combo with senior lending
  3. **Distressed investing**
     a) Buying/lending debt to distressed companies

What Is Private Credit?

Status Quo	Problem	Solution

- Households earn money in income
- Households place money in banks with short-term liquidity provisions
- Banks made illiquid investments (loans) in companies
- Banks have reserve requirements to cover potential liquidity events
- Banks hold debt until maturity and make gain on "interest rate spread" basis
- "Public Credit" where investment distributes loans off of balance sheet to CLOs

- Liquidity events (SVB etc.) shows mismatch in bank asset and liability liquidity
- Regulators hamper Investment Banks' ability to hold loans
- Principal-agent issue with LevFin teams underwriting debt before distribution



- Private Credit Funds will fill gap between demand for credit from markets and supply from banks alone
- Private Credit funds are raised with explicit investment horizons and investors can actively see "Where their money is"
- Private Credit funds can create tailored solutions and price in bespoke situations
- Private Credit funds underwrite their own holdings and have direct incentive

Opportunities in the Private Credit Market

1. **Refinancing the upcoming "maturity wall"** of leveraged loans and high-yield bonds issued around the same time, which are now approaching their repayment dates. We expect to see issuers increasingly turning to the private credit market for refinancing solutions.
2. **Investing in private equity sponsors**, who will continue to be the primary drivers of private credit consumption, given their significant capital available
3. Given the **marked increase in base rates over the last 18 months,** we expect companies to explore junior capital solutions to manage interest expenses and boost cash flow.
4. **Rescue-financing capital,** should the economy enter into a recession or high-default environment.

Why use PC: faster timetable, more bespoke terms, one set of lenders to deal with

Downside to borrowers: higher all-in cost

$400B of PC dry powder currently

Yield to Maturity Approximation Math

- **YTM math common credit and RX interview question**

- **YTM:** total return anticipated (IRR) on a bond if the bond is held till maturity
  - Because YTM is the bond's IRR, time to maturity affects it (more info in RXinterviews bond math guide)
- Total rate of return that will have been earned by a bond when it makes all interest payments and repays the original principal.
- In practice, calculated using financial calculator (Excel)
- Can approximate in a few ways:
  - Most simple: Current yield (coupon / market price) + average price appreciation ([par – market price] / # of years to maturity
    - Ex: bond trading at 80 cents and 10% coupon with five years to maturity
      - Current yield = 10 / 80 = 12.5%; average price appreciation (100 - 80) / 5 = 4%
      - Estimated YTM = 16.5%; actual YTM = 16.126%
  - More complex and accurate:

$$Approx\,YTM = \frac{C + \frac{F-P}{n}}{\frac{F+P}{2}}$$

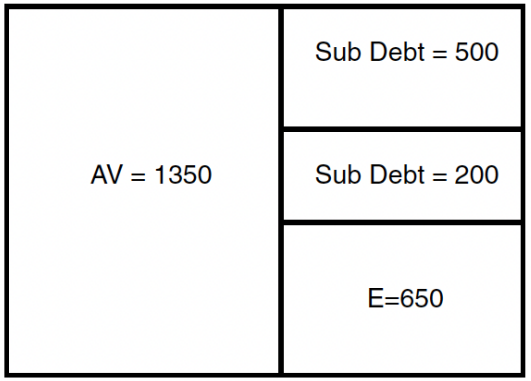
$C = Coupon/Interest\ Payment$
$F = Face\,Value$
$P = Price$
$n = years\,to\,maturity$

It's most important to understand that YTM comes from two components: interest and price appreciation

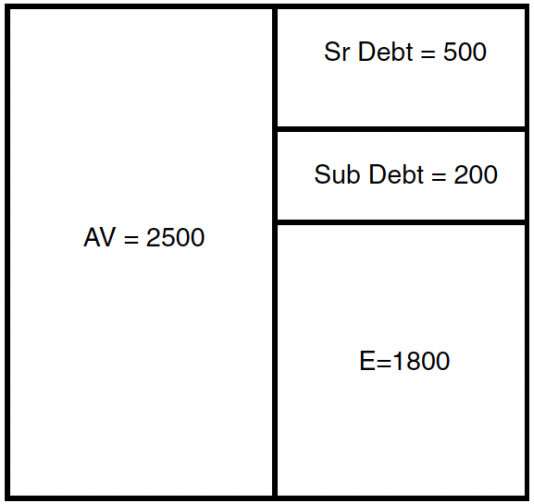
To Present if Time Allows

Simplified Cap Table (Healthy)

GAAP



MARKET



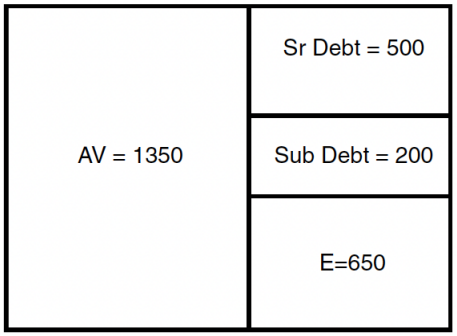
Cash	200	Senior Debt	500
Tangible Assets	970	Sub Debt	200
Goodwill	180	Equity	650
Total	1350		1350

	Amount	Price	Value
Senior Debt	500	100%	500
Sub Debt	200	100%	200
Equity	120	15.00	1800
Total			2500

Simplified Cap Table (Distressed)

- When the market value of debt declines, the pie has essentially shrunk, causing partial recoveries or even total loss (equity in this case)

GAAP



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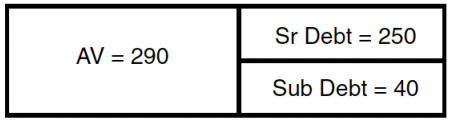
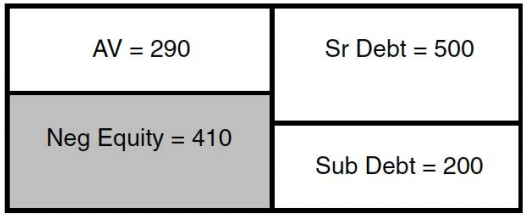
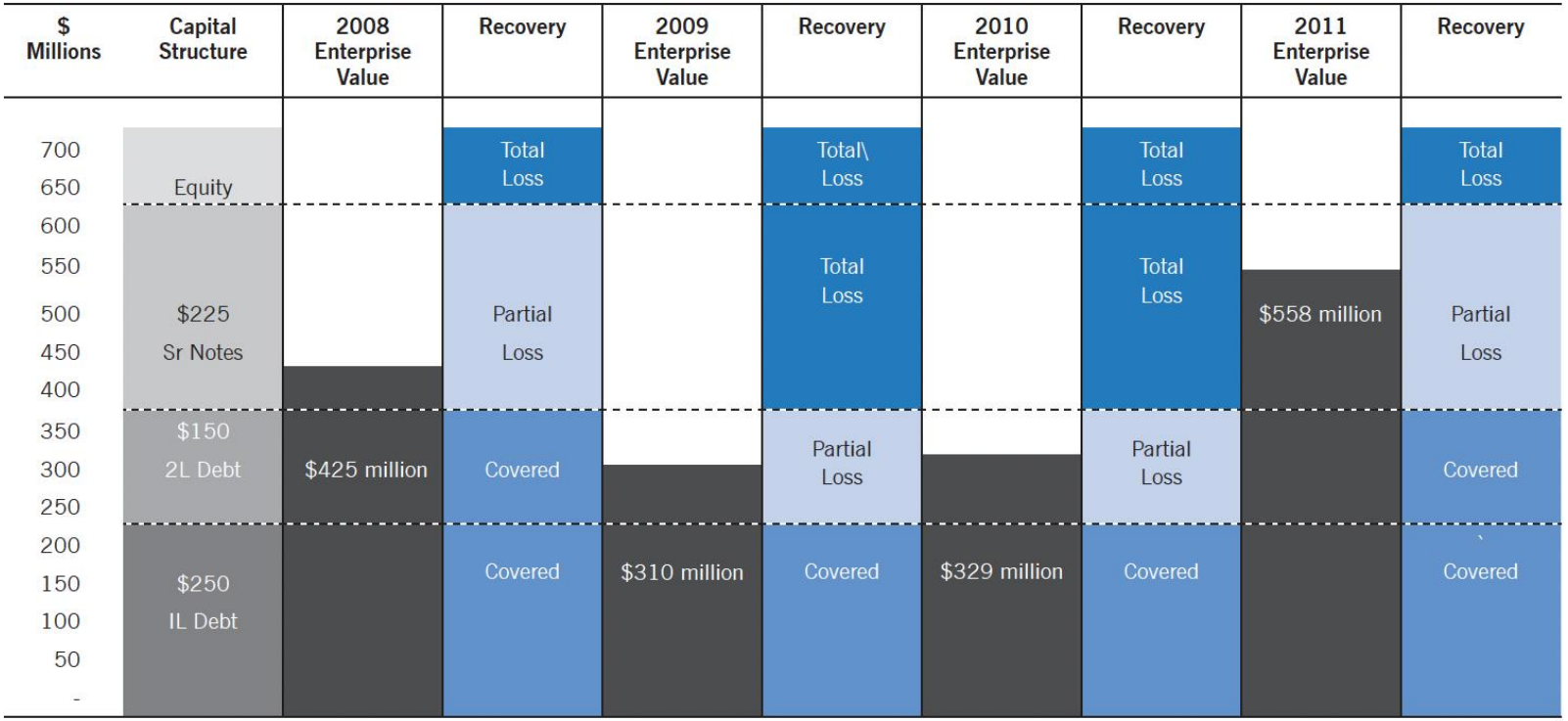


	Amount	Price	Value
Senior Debt	500	50%	250
Sub Debt	200	20%	40
Total			290



Assets	290	Liabilities	700
Net Equity	410	Equity	0
Total	700		700

Impact of Enterprise Value Fluctuation on Recovery



Fall 2024 Tentative Club Schedule

- **9/23:** Intro Meeting
- **9/30:** Accounting and Valuation Quick Overview
- **10/7:** Intro to Debt
- **10/17:** Blackstone Credit Guest Speakers (Resume Book Soon)
- **10/21:** Prof Smith RX 101
- **10/28:** Max Frumes (Caesars Palace Coup) Guest Speaker
- **11/4:** Recruiting Walkthrough
- **11/11:** Intro to Liability Management
- **11/19:** Evercore Guest Speaker
- **12/2:** Summer Analyst Experience Discussion