Comm 4722 Notes

Nini Smith Corporate Finance Chapter Reading:

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.

Levfin markets include syndicated leveraged loans and high-yield bonds.

- Sometimes limit syndicated LL market to institutional TLs (funding primarily nonbank).
- Non-institutional (i.e., bank) TLs (non-ITL) LLs are revolvers and fully amortizing TLs.

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.

The optimal capital structure views the choice of debt as a tradeoff between the tax benefits of interest expense and rising service costs as default risk grows.

- More cash-flow-stable firms can support larger debt loads.

Firms that become leveraged due to performance deterioration are **fallen angels**.

Leveraged finance has larger default risk:

- 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.

In addition to the risk of default, leveraged finance investors must also worry about the recovery in the event of default. This is determined by the debt's priority in the capital structure.

- Leveraged loans, particularly ITLs, are nearly always senior debt that is secured by collateral. Bonds are frequently unsecured.
- For TLs, average recovery is >75%; unsecured bonds recovery only 35% on average.

High-yield bonds: subset of corporate bonds issued by firms with a rating below investment grade. Borrowers are large; usually larger than those issuing LLs because of the additional costs to issue bonds.

- Typically offer little amortization, no ownership stake, and rank ahead of equity.
- Investment banks bring the bonds to market and are responsible for attracting investors.
  - Underwritten by banks then issued to investors.
- Banks sometimes purchase the entire deal before reselling to investors but most deals are marketed on a best-effort basis, meaning the underwriter (investment bank) does not guarantee any terms of the deal. Underwriters receive a fee for marketing the bond.
- **Bond issuance is regulated by the SEC**, however, high-yield bonds are typically issued as private placements to avoid costs associated with registering a security.
- HY bonds have **higher coupon** payments, **shorter maturities**, and other contractual differences with IG bonds. The bonds are **usually fixed rate** and **not callable for at least some portion of the bond's life**. The bonds include a broad set of covenants that restrict borrowers.
  - Fewer covenants than leveraged loans.
- Penalties if paid early.
- Difficult to negotiate.
- Traded OTC but more liquid than loans.
- Overseen by indenture trustee.

Leveraged loans: relatively risky and syndicated to multiple lenders. Underwritten by a single or small set of arrangers who intermediate between the borrower and investors. Borrowers are usually large.

- Unlike bonds, loans designate a single administrative agent lender to handle payments and monitor the borrower's compliance.
- Growth in LLs has been fueled by institutional investor-funded TLs (ITLs).
- ITL LLs are most similar to bonds because they are funded at origination and paid off at maturity. Unlike bonds, these are **usually floating rates and are secured**.
  - Note: secured is distinct from unsecured due to the **security interest** in the assets of the company; this means if they default you can seize (foreclose) those assets or take over without court involvement. **Unsecured lenders can't do this without suing** through the courts.
- Minimal prepayment penalties.
- More covenant protection than bonds.
- Straightforward to renegotiate (amend).
- LLs are **private financings** that aren't SEC-regulated, but the development of a secondary OTC loan market has increased liquidity and grown the asset class.

BONDS vs. LOANS

Credit Facilities (Loans)	Bonds/Notes
• Senior in capital structure	• Typically junior to loans
• Often secured	• Typically unsecured
• Contract called *credit agreement*	• Contract called *indenture*
• Interest usually floating	• Interest usually fixed
• Minimal pre-payment penalties	• Penalties/premiums if paid earl
• Stronger covenant protections	• Weaker covenant protections
• Often syndicated to "participant" investors	• Issued to dispersed investors
• Straightforward to renegotiate ("amend")	• Difficult to renegotiate
• Private agreements, pretty easily traded	• Public securities, easily traded

Bonds:

- Issuance initiated and underwritten by large commercial or IB
- Securities sold through public issuance (SEC-registered) or private placement (144A Offerings)
- Public indenture governed by Trust Indenture Act of 1939, which requires unaminity in major voting changes
- Issuance represented by indenture trustee, not an involved role, compared to admin. agent on credit agreement
- Difficult to renegotiate out of court relative to credit agreements because no central registry of holders (e.g., through loan assignment), so you have to go track down holders for voting out of court.
- Covenants are always incurrence based and relatively lax compared to credit agreements
  - Rarely the driving force behind a default

Bond covenants:

- Restrictions on raising new debt
  - Debt and lien incurrence restrictions often tied to leverage or interest coverage
  - **Negative pledge clause** - no incurring new liens without making bond investors pari passu to new secured debt
- Restrictions on acquisitions and divestitures
  - Put provisions: allows debtholders to put (sell) bonds back at par or premium when there is a change of control (CoC put)
  - Restrictions on asset sales (less onerous than credit agreements)
- Restricted payments
  - Limitiations on div and cash distributions (less onerous than credit agreements)

Indenture - Callability/Redemption:

- Standard bonds can be redeemed or called after a certain date with a call premium

decreasing as maturity nears
    - Before call period is No Call (NC)
- Make whole provision: allows issuer to redeem bonds earlier than call date but must pay applicable premium (discounted value of remaining interest payments plus principal discounted at a low discount rate)

Class 1 and 2 Notes:
Financial distress: in danger of or has defaulted on a fixed obligation.
Insolvency: market value of assets < book value of debt.

RX needs to fix right (L+E) and left (value deteriorating assets) sides of the business.

Chapter 11

- **Advantages:** automatic stay, cram-down, DIP (more detail in Onenote), rejection/assumption, sale of assets free of liens.
    - Note: post-petition borrowings are characterized as administrative claims and have priority over prepetition unsecured liabilities.
- **Disadvantages:** expensive, additional laws and regulations, and involvement of the court.

Speculative grade borrowers raise debt (leveraged finance) in these markets:

1. Leveraged loans,
2. High-yield bonds,
3. Private credit.

These markets have attractive features:

1. Largest source of external financing to risky companies,
2. Most likely to become financially distressed
3. Key to financing the restructuring of distressed firms.

~$1.7T of LL and $1.4T of HY bond financing outstanding and $1.5T of PC AUM ($400B is dry powder).

- Implies $188B of default/year at a 4% default rate (attractive for RX).

Moody's		S&P		Fitch		
Long-term	Short-term	Long-term	Short-term	Long-term	Short-term	
Aaa	P-1	AAA	A-1+	AAA	F1+	Prime
Aa1		AA+		AA+		High grade
Aa2		AA		AA		
Aa3						
A1					F1	Upper medium grade
A2						
A3	P-2				F2	
Baa1		BBB+		BBB+		Lower medium grade
Baa2	P-3	BBB	A-3	BBB	F3	
Baa3		BBB-		BBB-		
Ba1	Not prime	BB+	B	BB+		Non-investment grade speculative
Ba2		BB		BB		
Ba3		BB-		BB-		
B1		B+		B+		Highly speculative
B2		B		B		
B3						
Caa1					C	Substantial risks
Caa2						Extremely speculative
Caa3						Default imminent with little prospect for recovery
Ca						
C					/	In default
/						
/				D		

BORING!

"Leveraged Borrowers"

Also called "speculative grade", "below-investment- grade, and "junk" borrowers

- Default probabilities are not linear on the credit ratings scale - they jump from BBB to BB (i.e., IG to HY)

Private credit uses an LP or BDC structure to collect capital from LPs and invest that capital through non-syndicated loans to generate a return.

- Dominated by PE and specialty alternative investment firms.
- Focused on middle-market borrowers, but company and loan sizes are growing.
- Low liquidity: typically not rated or traded.
- **Why use PC:** faster timetable, more bespoke terms, one set of lenders to deal with
- **Downside to borrowers:** higher all-in cost
- $400B of dry powder currently.

Spreads are compressing in LLs due to an increased supply of investors while PC yields have held up (current 12% yield).

Fed dot plot implies 2.5-3.0% long-term inflation rate. Bullish expectations for large near-term cuts may be too positive as the economy is not so weak that it needs to cut largely.

- Company cost of capitals are going to remain high.

Interest coverage ratios are low relative to the average (attractive for RX).

Class 3 Notes:

If you have Net Debt/EBITDA multiple and know the company's EV/EBITDA, you know what equity cushion the debt has. (4.8x leverage for 10x EBITDA company has 5.2x equity cushion).

Leveraged loans involve the arranger (1-3 banks) syndicating the loan across investors while an agent (usually one of the arranging banks) acts as an intermediary.

- Following origination, pieces of the loan are sold as assignments or participations.

CLOs buy only TLs and only from syndicated borrowers. Almost all these loans are leveraged.

- Asset side is the loans invested in; liabilities side is the tranches from AAA to equity.
- Tranches are rated by agencies.
- CLOs own a large portion (70%) of leveraged loans.

Nini Smith Corporate Finance Chapter Reading 2:

Credit agreements, indentures, and other credit documents

Investors look through credit docs to look for exceptions and mistakes to exploit to move value away from existing creditors.

The reason credit documents are so much more complex than just "pay interest and principal" is because borrowers have incentives to behave opportunistically once they receive the principal by engaging in risky behavior or behavior that reduces the value of the lender's claim.

- Under circumstances in which lenders (1) find it costly to pursue remedies to collect the principal and interest when a borrower defaults, or are otherwise unable to recover, and (2) cannot effectively cover the risks of opportunistic defaults in the loan price, lenders and borrowers agree to restrictions that mitigate shareholder-debtholder conflict.
- Shareholder-debtholder conflicts are likely to occur via dividend payments, dilution or subordination of the claims, asset substitution, underinvestment in projects that benefit only debtholders.
- Covenants must protect investors while also providing ample flexibility for management to operate.

Sections of credit agreements:

I.	Definitions	VI.	Negative Covenants
II.	Credits (or Commitments)	VII.	Financial Covenants
III.	Representations and Warranties	VIII.	Events of Default
IV.	Conditions Precedent to Lending	IX.	Agents
V.	Affirmative Covenants	X.	Miscellaneous

Definitions: provides definitions for all capitalized terms in the agreement. This includes important terms, such as what the interest rate is, the spread, the benchmark itself. Also includes how EBITDA is defined.

Credits: describes the loans for which the credit agreement is written. Includes type of debt, how payments are made, how to extend loan amounts and maturity. Also includes instructions on optional prepayments and whether those require premiums. Includes mandatory sweep prepayments.

Representations and Warranties: in this section the borrower attests (warrants) to be true a series of statements (the representations) about its standing as a borrower. These representations typically include general statements about the borrower's legal structure, its authority to enter into the loan agreement, and an understanding of the enforceability of the loan agreement as a

legally binding contract. **If the lender later finds out that the borrower misrepresented in this sedition, this constitutes a default.**

Conditions Precedent to Lending: lists a set of conditions that must be satisfied before the loan transaction can go through, as well as conditions that must be met on a continuing basis for additional lending to occur.

Affirmative Covenants: the actions a borrower must take to remain in compliance under the credit agreement. Actions include providing up-to-date financial statements to lenders, meeting all insurance obligations, maintaining in good standing all properties of the business, and remaining in legal compliance.

- **Affirmative covenants can help reduce potentially costly incentive conflicts by pushing the borrower to protect the underlying asset value even when the borrower may not have an incentive to protect the assets on its own (e.g., debt overhang).**

Negative Covenants: actions the borrower must refrain from to remain in compliance under the credit agreement. These covenants "limit managerial behavior." A typical negative covenants section in a leveraged loan agreement will include restrictions on:

- Investment decisions, capital structure decisions, and dividend decisions.

Negative covenants often include **exceptions** (aka exclusions, carveouts, or baskets) to the restriction that weaken the impact of the restriction.

- Exceptions in negative covenants allowed J. Crew to move brand assets away from secured lenders in 2016. This allowed it to refinance unsecured bonds and avoid bankruptcy, at the expense of the secured debt.
- Petsmart did this to transfer 36.5% of its ownership of Chewy from existing lenders.

Financial Covenants: pre-specified financial performance benchmarks that a borrower must maintain to remain in compliance under the credit agreement. Most commonly, debt/EBITDA and EBITDA/(fixed charges).

- These alert lenders of a borrower's decline in financial performance prior to a payment default, giving an opportunity for lenders to step in and work with the borrower.
- Financial covenants have declined since the early 2000s. So has the proportion of firms vioolating a covenant. Today, ITLs often have no financial covenants (cov-lite).

Events of Default: specifies events under the credit agreement that constitute a default, including failures to pay interest and principal payments, violations of covenants, misrepresentaitons in Reps & Warranties, and any actions by the borrower to file for bankruptcy or liquidate the firm. This will also include a cross-default provision, where if the borrower

defaults on other debt, it is also in default on the debt under the current agreement. Each default will have a period in which it can be cured.

- Also often will list the potential remedies available to a lender once an event of default has been recognized. The set of remedies include the cessation of all lending, termination of any lending commitments, a demand for immediate repayment (acceleration), of all principal and accrued interest, and the pursuit of repayment through litigation.
- As long as a borrower is in default, any individual lender can refuse to extend new credit. Conversely, actions such as accelerating repayment or terminating commitments requires the lending group to act as a single entity and needs >50% vote typically.

Agents: covers the responsibilities of the administrative agent.

Miscellaneous: many parts are of little concern to finance professionals, but the "Waivers and Amendments" section is important because it constrains the renegotiation process by outlining the rules for modifying or waiving the provisions of the credit agreement.

- Changes to a credit agreement are often proposed by the borrower and must be approved by lenders through voting. Lenders vote collectively unless the amendment affects only a single tranche.
- "Sacred rights" provisions require the consent of all lenders. These include the size of the loan commitment, required payment dates, and the interest rate and fees paid by the borrower. Collateral release is also a sacred right.
    - Unanimous consent is required to change these.
    - Transactions, such as Serta, have seen borrowers gain the required lender consent to subordinate an existing lien, which subordinates the minority of creditors who do not participate in the amendment.
- **Assignment section:** This subsection includes the legal details around assignment to a new lender, such as a minimum assignment amount and fee to administrative agent. This also includes specifications on who may become a lender.
    - The general rule is the borrower and administrative agent must provide legal consent to allowe a lender to assign a loan to a new lender.
    - **Disqualified lender list** is also included here. Typically includes those who would benefit from private information, such as competitors and lenders with ulterior motives. This section also precludes borrowers from repurchasing their loans on the secondary market by listing them as a DQ lender. This prevents the borrower from unfairly favoring any lender to the detriment of others.