Market Trends 2019/20: High Yield Debt Offerings

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This practice note discusses the market trends for high yield debt offerings in 2019 and early 2020, including notable transactions, deal structure and process, deal terms, disclosure trends, and industry insights and an outlook for the remainder of 2020. After a volatile 2018 led to the lightest high yield annual issuance volume since 2009 (including zero issuance in December 2018), high yield activity roared back in 2019 with $272 billion of annual issuance volume, up 57% from the prior year.

For additional information on high yield debt offerings, see Top 10 Practice Tips: High Yield Debt Offerings, High Yield Indentures: Typical Covenants, Financial Definitions in High-Yield Indentures, Corporate Debt Securities in U.S. Capital Markets, and High Yield vs. Investment Grade Covenants Chart. For other market trends articles covering various capital markets and corporate governance topics, see Market Trends.

In 2019, the U.S. high yield market continued to face a number of macroeconomic and geopolitical challenges from 2018, most notably the continued trade tensions between the United States and China as well as the sense of an impending global economic slowdown after a historic bull run. But following four rate hikes in 2018, the Federal Reserve changed course significantly in 2019, cutting rates three times in an effort to ease policy and in doing so providing a favorable technical backdrop for the high yield market. The federal easing policy shift was coupled with a flood of investor money into perceived lower risk corporate bond investments. The result was that by July 2019 it was reported that approximately $13 trillion of fixed-income assets had negative yields. All the while, high yield issuers were maintaining strong credit fundamentals and low default rates. This backdrop created a significant refinancing opportunity for many high yield issuers, with a reported near 50% of high yield bonds trading above their next call price as of September 2019. Spreads tightened across all credits and issuers of new debt showed preference for secured bonds instead of term loans. The result was a robust year in the high yield market.

The good trends of 2019 continued into January and February of 2020 until COVID-19 brought the world to a collective halt by March of 2020. For an overview of practical guidance on COVID-19 covering various practice areas, including capital markets, see Coronavirus (COVID-19) Resource Kit. Issuers of all qualities and sizes have suffered varying fates depending on their respective abilities to operate within the confines of shelter-in-place rules and social distancing measures. Not surprisingly, default rates have been on the rise and restructurings have become common place. But with many issuers (even formerly investment grade issuers) needing cash to bridge their capital structures to better times, the high yield market remained robust throughout the first quarter and into the second quarter of 2020. Short-term, secured issuances have been particularly popular instruments across industries. Uncertainty surrounds the reopened world and what that means for businesses, particularly in spaces that rely on people coming into close contact with each other such as travel, retail, and recreation. Companies such as Carnival Cruise Lines, Cinemark, and AMC Entertainment have issued short-dated, secured high yield paper to maintain operating liquidity during the crisis. The high yield market has met the needs of many challenged issuers during this time and will likely continue to provide a significant source of capital to issuers as they evaluate their capital requirements throughout this extremely challenging period.

Notable Transactions

The year 2019 included a variety of noteworthy high yield transactions, from complex refinancing transactions to challenging secured debut issuances. Some of these deals are listed below.

Mineral Resources

In April 2018, Mineral Resources Limited, an Australian mining services and mining company, completed a debut offering of $700 million aggregate principal amount of 8.125% Senior Notes due 2027, the proceeds of which were used to repay existing indebtedness and for general corporate purposes.

Endo Pharmaceutical

In April 2019, Endo Pharmaceutical, an Ireland-domiciled, global specialty pharmaceutical company, issued $1.5 billion aggregate principal amount of 7.5% Senior Secured Notes due 2027. The proceeds of the offering were used to fund the concurrent tender offers for aggregate consideration of up to $1.5 billion for certain series of Endo International's outstanding senior unsecured notes and related consent solicitations.

Kosmos

In April 2019, Kosmos Energy Ltd, a full-cycle deepwater independent oil and gas exploration and production company focused along the Atlantic Margin, completed an offering of $650 million of 7.125% Senior Notes due 2026. Kosmos used a portion of the net proceeds from the offering to redeem all of its outstanding 7.875% Senior Secured Notes due 2021 and the remaining net proceeds to repay a portion of the outstanding indebtedness under its revolving credit facility.

Fortescue

In September 2019, FMG Resources (August 2006) Pty Ltd, an Australian corporation and a direct wholly owned subsidiary of Fortescue Metals Group Ltd., completed a $600 million offering of 4.5% Senior Notes due 2027. The net proceeds from the offering were used to repay a portion of Fortescue's syndicated term loan.

Infrabuild

In October 2019, InfraBuild Australia Pty Ltd, a vertically integrated steel manufacturing, recycling, processing, and distributing company based in Australia, completed its debut offering of $325 million of 12% Senior Secured Notes due 2024. The net proceeds from the offering were used to refinance existing indebtedness and for general corporate purposes.

GFL Environmental

In December 2019, GFL Environmental Inc., Canadian environmental services company, issued $500 million aggregate principal amount of 5.125% Senior Secured Notes due 2026 and $275 million in aggregate principal amount of 7% Senior Notes due 2026. GFL used the proceeds to fund certain acquisitions, to repay outstanding borrowings under its revolving credit facility, and for general corporate purposes.

Deal Structure and Process

High Yield Offering Process

The timeline of a typical high yield offering has remained relatively unchanged. An offering is launched by the distribution of what is called the "red" (i.e., the preliminary offering memorandum or prospectus) to investors, which is typically accompanied by a press release announcing the transaction. For debut issuers or a significant transaction, the issuer may then go on the road following launch to meet with investors while the banks are building the book of potential allocations to investor accounts and determining deal pricing. The bankers work with the issuer to determine the length of the roadshow. A formal roadshow can be as short as three days and as long as two weeks depending on the nature of the transaction. Investors may provide feedback through the bankers to the issuer that affects the terms of the particular security, including requesting particular changes to the proposed covenant package. The banks will instruct investor accounts that books close by a certain time on the final day of the roadshow, which is the deadline for submitting an order in the bonds. Once books close, the bankers will schedule a pricing call later that day with the issuer in which the bankers and the issuer will agree to the terms of the deal (i.e., the coupon, the issue price, the maturity, the call schedule, and the like).

After the pricing call, a pricing term sheet is sent to investors to confirm sales and the issuer and underwriters / initial purchasers sign the underwriting agreement / purchase agreement, pursuant to which the underwriters / initial purchasers agree to purchase the securities from the issuer. Once a securities transaction is priced, the securities begin trading. As part of the pricing terms, the parties will also schedule a closing date, which is typically the second business day following the date of pricing (commonly known as a T+2 basis), and the securities offering will close on that date. A secured transaction may close on a T+5 basis and certain deals may close on a T+7 or T+10 basis to accommodate an acquisition, tender offer, or bond refinancing.

Extensive roadshows are less common in today's market. For a repeat high yield issuer, launch and pricing are often accelerated to a single day, referred to as a drive by offering. The offering launches before the market opens, followed by a single or several investor calls and pricing later that afternoon. If the market is familiar with the issuer, there is often no need to have a formal roadshow to meet with accounts and, as a result, the process is accelerated.

Over the last few years, issuers seeking to execute high yield bond offerings have increasingly used non-deal roadshows through which issuers meet with potential investors to introduce their business and financial profile without providing any material nonpublic information or announcing the intention to execute a particular transaction. After completing such meetings, issuers determine whether or not to proceed with an offering. If they go forward with a transaction, they tend to follow the traditional offering structure described above, subject to any applicable marketing regulations in non-U.S. jurisdictions. Non-deal roadshows are helpful to issuers as they reduce the risk of a failed deal. However, there are many hoops to jump through for both issuers and bankers, including determining the information permitted to be provided at the meetings, when the meetings are held in relation to a formal deal launch, the role of bankers at the meetings, who may attend the meetings, whether the information needs to be broadly disseminated, and so on. We have observed this trend continue throughout 2019 and into 2020, particularly in the context of challenging financings during the COVID-19 crisis.

Deal Terms

High Yield Covenant Packages

Before proceeding to discuss some of the most common covenants and how high yield bonds are generally issued, a few words are in order on the purpose of high yield covenants and how they are structured to function from a big picture perspective.

A Delicate Balance Made to Last

High yield covenants typically seek to strike a delicate balance that requires the collaboration among the various parties involved. On the one hand, the covenants are designed to provide protection for high yield investors against an issuer being able to overextend itself or unwisely use its cash. On the other hand, the covenants must provide flexibility for the issuer to operate its business and grow over the life of the bonds. In other words, the covenants protect the investors' ability to be paid principal and interest on the bonds while preserving the issuer's ability to run its business without undue restrictions.

High yield covenants are designed to last for the entire maturity of the bonds, which is typically 7 to 10 years (more 5-year bonds are being issued in a rising interest rate environment). High yield covenants are generally difficult to amend, and so are often more flexible than covenants contained in traditional credit agreements. Unlike bank loans held by a relatively small number of lenders, high yield bonds are typically widely held, and high yield investors traditionally do not expect to be approached for consent to amend any of the terms of the bonds, except in special circumstances. In addition, unlike an administrative agent under a typical credit agreement, the trustee under a high yield indenture is not expected to closely monitor or be in frequent contact with an issuer. Amending a high yield indenture requires a formal consent solicitation process that follows an established market practice. If that consent solicitation is coupled with a tender offer for the bonds, the tender offer must also follow the federal securities laws and the specific rules of the Securities and Exchange Commission (SEC) that govern tender offers.

Restricted vs. Unrestricted Subsidiaries

The high yield covenant package is designed to regulate the ability of the issuer and its restricted subsidiaries to service its debt and run its business. Every subsidiary of an issuer is deemed to be a restricted subsidiary. The only way in which an issuer can have an unrestricted subsidiary is to designate it as such. Most issuers of high yield bonds have subsidiaries that provide upstream guarantees. Remember that all subsidiary guarantors are restricted subsidiaries but, for reasons that vary depending on the issuer's capital structure, not all restricted subsidiaries are guarantors. For example, subsidiaries utilized in connection with securitization facilities are frequently restricted subsidiaries but not guarantors. High yield covenants are typically very flexible in permitting all kinds of transactions between the issuer and its restricted subsidiaries or among the restricted subsidiaries, which is different from typical credit agreements that often provide flexibility only between the borrower and the loan parties (i.e., guarantors) or among the loan parties. Unrestricted subsidiaries are outside of the reach of the high yield covenants, but designating a subsidiary as unrestricted has the following effects:

- The issuer generally is prohibited from counting that subsidiary's net income when it calculates consolidated net income unless the issuer actually receives cash from the unrestricted subsidiary.
- Most interactions between the issuer and its restricted subsidiaries, on the one hand, and an unrestricted subsidiary, on the other hand, must be treated as if they were transactions with an unrelated third party and comply with all the covenants.

Because of these limitations, issuers rarely designate subsidiaries as unrestricted, although they may do so (e.g., to consummate a project finance transaction where that subsidiary cannot be subject to the high yield covenants).

Incurrence vs. Maintenance

High yield covenants are incurrence-based tests rather than maintenance tests. In other words, high yield covenants are typically tested only when an issuer or a restricted subsidiary actually wants to do something, like pay a dividend, incur debt, or grant a lien. Most high yield covenants do not require an issuer to meet quarterly maintenance covenants.

Typical High Yield Covenants

While each high yield covenant package is distinct, the main covenants are as follows:

- **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 the cash dividends, the redemption or repurchase of the issuer's capital stock, the redemption or repurchase of subordinated debt obligations, and the restricted investments.
- **Limitation on indebtedness.** The debt covenants regulate how much unsecured debt the issuer and its restricted subsidiaries may incur.
- **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 high yield bonds and ensuring that the high yield 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 high yield 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 high yield bonds from bondholders at a price equal to 101% 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.

Most of these covenants have built-in exceptions capped at specific dollar amounts, commonly known as baskets, 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 vast and are often highly negotiated.

High Yield Deal Terms in 2019 – A Look Back

High yield trends and covenant changes during a particular year (whether loosening or tightening) depend on the market backdrop at the particular time of issuing the bonds and the particular industry. In addition, the credit rating of the issuer and other factors, such as the existence of a sponsor, new issuer strategies, and investor familiarity with the issuer, always make a difference in the outcome of the overall covenant package. During the course of 2019, a general theme, as money flooded into the high yield funds, was investors being more willing to accept slightly less favorable terms in covenant packages, and in the case of refinancings, accepting many such packages with modest issuer improvements from the packages that were being refinancing. Nonetheless, on the whole, high yield covenants in 2019 did not change meaningfully from 2018.

Change of Control

The change of control covenant continues to be a focal point for investors, especially when it comes to two aspects. First, many definitions of change of control do not contain what is known as the merger prong. That prong provides that, among other things, a change of control includes a merger or consolidation in which the equity holders of the issuer before the transaction do not represent a majority of the equity ownership of the surviving entity. This is typically the prong regulating parent to parent public company mergers. The rationale for excluding it is that the equity ownership in a public company is so diverse that no one would really control the surviving entity. A number of investors in 2019 high yield deals continued to request to include this prong for their protection, whether or not the issuer is public.

The second item that investors have pushed back on is the double trigger change of control concept. This concept has always existed in investment grade bond offerings and has crept into the high yield world. During 2019, high yield investors continued to object to this concept. In a double trigger change of control provision, a put or obligation to repurchase the bonds is triggered only if there is both a change of control and a ratings downgrade from one or more rating agencies within a specified period following the announcement of the change of control. While this provision is still extremely common in investment grade bond offerings and offerings with crossover hybrid covenant packages, it has received significant pushback in typical high yield packages.

Disclosure Trends

Continued Scrutiny of Non-GAAP Measures

High yield issuers have long supplemented U.S. generally accepted accounting principles (GAAP) with non-GAAP financial measures, in particular Earnings Before Interest Taxes Depreciation and Amortization (EBITDA) and EBITDA adjusted to exclude certain nonrecurring items (Adjusted EBITDA). Non-GAAP financial measures provide additional information tailored to the particular issuer's business and/or industry in order to help investors better measure issuer performance and evaluate ability to service indebtedness. Regulation G (17 C.F.R. §§ 244.100–244.102) and Item 10(e) (17 C.F.R. § 229.10) of Regulation S-K set forth the SEC's core framework for the use of non-GAAP financial measures in SEC filings. Principally, the rules require that whenever an issuer publicly discloses material information that includes a non-GAAP financial measure, the issuer must accompany that non-GAAP financial measure with a presentation of the most directly comparable GAAP financial measure and a reconciliation between the non-GAAP measure disclosed and the most comparable GAAP financial measure. The rules seek to bridge the gap for investors by requiring issuers to disclose the adjustments they are making to GAAP financial measures.

Issuers with SEC-registered securities have noticed a substantial uptick in the number of SEC comments focusing on the use of non-GAAP financial measures and related disclosures, based in part on guidance issued by the SEC in May 2016. The SEC 2016 guidance mainly seeks to reinforce prior guidance and not impose new requirements. The SEC updated guidance posted on April 4, 2018, available here. Consistent with prior years, the SEC continued to focus on and scrutinize non-GAAP financial measures throughout 2019. The SEC is expected to particularly scrutinize unusual adjustments and non-GAAP measures used in connection with business combination transactions, which will also impact high yield bonds issued under Rule 144A in an unregistered context because such issuances tend to track most SEC guidance. In 2020 and beyond, we will also watch closely as to whether issuers seek to make adjustments to account for unusual costs and periods of lost revenue during and in the wake of the COVID-19 pandemic and the SEC's reaction to any such adjustments.

Industry Insights

Consistent with prior years, issuers' abilities to negotiate covenant packages in 2019 were to a degree impacted by the overall performance of their respective industries. For example, high yield issuers in the oil and gas space, in light of relatively higher default rates compared with other industries, were at times forced to accept tighter covenant packages than issuers of comparable credits in other industries. Issuers in the financial services and technology, media, and telecommunications spaces, on the other hand, were more likely to achieve favorable terms and greater covenant flexibility. But while an issuer's industry certainly plays a role in the outcome of a covenant package, it is only one piece of the larger puzzle. Over the years, it has become apparent that private equity backed issuers generally achieve more favorable covenant packages than their industry peers. Other factors, such as the credit rating of the issuer, new issuer strategies, and investor familiarity with the issuer, consistently play a role in the outcome of the overall covenant package as well.

Market Outlook

High Yield in 2020 – A Look Ahead

The trends in high yield bond issuances change based on the state of the market. When the market is hot and demand for high yield paper is great, issuers and sponsors endeavor to push the envelope in terms of covenant packages. As a result, there tends to be more flexibility in issuer favorable covenants, most frequently expanding the debt, lien, and restricted payment covenants. When the market cools off and demand dissipates, issuers are often forced to accept tighter covenant packages in order to execute transactions. In 2020, the market has shifted dramatically from issuer friendly to a "rescue financing" environment. The desperate need for cash by many issuers to continue to fund operations has given investors considerable leverage to dictate deal terms. Some of the trends and factors that we are observing impact the high yield market in 2020 include the following:

- **The COVID-19 global recession.** To state the obvious, the economic impact of the global COVID-19 pandemic has been drastic. Business operations across many different industries have been sidelined entirely, some seeing multi-month periods without revenues, leading to devastating drops in liquidity and the implementation of cost saving measures, including, unfortunately, significant headcount reductions. The urgent need for cash has resulted in many complicated secured high yield rescue financing transactions as issuers seek to fortify their balance sheets. While there are some signs of hope, the economic reopening, including the threat of a second wave of COVID-19 outbreaks, remains very uncertain. This dynamic leads to a number of plausible outcomes for the high yield market, including the continued need for secured financing if economic instability continues, or perhaps even a late 2020 / early 2021 spate of refinancing transactions if economic conditions improve and issuers seek to swap out expensive short-term rescue debt.

- **The Fed response.** As the COVID-19 crisis set in, the Fed has utilized seemingly every tool available to help the economy and the markets, including cutting the federal funds rate to a range of 0% to 0.25%, executing a "quantitative easing" type strategy by committing to purchase an open-ended amount of treasury and mortgaged-back securities, expanding its repo program, lending to banks at discounted overnight rates, and loosening regulatory capital requirements. These actions have created a corporate debt environment that makes corporate borrowing (particularly through high yield) an attractive option for short-term financing. As the economy begins to reopen, it does not appear that the Fed is planning to raise interest rates or otherwise limit its initiatives any time soon.

- **The 2020 elections.** We head into the 2020 election with tremendous uncertainty around outcome and a growing divide between the economic policies of the incumbent Donald Trump and the Democratic nominee Joe Biden. Additional uncertainty abounds with respect to the direction of the Trump administration's plans on global trade, immigration, and foreign policy coming out of the COVID-19 crisis, any of which seem to change at a tweet's notice. At the same time, following the defeat of Bernie Sanders in the primaries, the Biden platform appears to be shifting increasingly toward the new Democratic paradigm of significant economic, social, and environmental reform. At the moment, neither candidate appears to be focused on or concerned with addressing the ever-increasing federal spending deficit, particularly in the wake of significant federal spending to buoy the economy during the COVID-19 pandemic. The 2020 elections—presidential and congressional—will no doubt have significant ramifications on the economic backdrop and fiscal policy.

- **Other ongoing geopolitical uncertainty.** Even while the impacts of COVID-19 continue to run roughshod over the global economy, 2020 remains fraught with other geopolitical and macroeconomic uncertainty. The threat of global trade wars, inflation, political and economic turmoil in European and emerging economies, and recovery efforts from the impacts of the pandemic, to name a few, will persist in a fragile recovering market environment.

- **What all of this means for the issuers of 2020 high yield debt to date.** The urgent need for cash as a result of the COVID-19 pandemic has, not surprisingly, shifted the tide of leverage dramatically in favor of investors. To date, we have observed substantially tighter covenant packages in new issuances, particularly for distressed issuers. Many of these distressed issuances have included outright prohibitions on additional indebtedness or restricted payments until the issuers achieve certain time or leveraged base financial metrics. Issuers have also accepted additional investor protections such as the make-whole event of default provision, which requires issuers to pay investors a full make-whole or call premium upon an event of default, as opposed to just accelerated principal and interest. In addition, collateral packages and terms have remained a principal focus of investors with appetite for investing in distressed names. Issuers have also explored a variety of liability management transactions, notably uptier exchange offers utilized to exchange near term maturities into longer dated instruments that benefit from collateral or higher priority in the capital structure.

- **Will refinancing boom when the market recovers?** As economic conditions improve and distressed issuers are able to have greater visibility and control over their liquidity prospects and requirements, we expect that many issuers of distressed debt packages (especially with shorter dated maturities) will seek to refinance into less expensive and onerous instruments. In addition, substantial maturity walls exist, with hundreds of billions of corporate bonds set to mature in the next few years. When the dust settles from the COVID-19 pandemic, we do expect to see significant refinancing activity in the years to come.

As of June 2020, there are some promising signs for 2020 economic recovery as the reopening begins and job recovery takes hold. The high yield market has nonetheless remained a robust source of capital for many issuers dealing with exceedingly challenging circumstances throughout the response to and recovery from the COVID-19 pandemic.

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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.