Lead Article – High Yield Bonds 02
Market Comment: 04
People Moves 08
Nicholas Scott Profile 10

Lead Article
High Yield Bonds

Drew Salvest and John Taylor
Partners – Mayer Brown LLP, London

One of the more significant developments in the wake of the global financial crisis has been the emergence of a strong market for high yield bond issuance in Europe.

One of the more significant developments in the wake of the global financial crisis has been the emergence of a strong market for high yield bond issuance in Europe.

Although such bonds have been a staple of corporate fund raising in the US for over twenty years it is only relatively recently that they have become widely accepted as a financing tool for European corporates

Background to the High Yield Market

Originally high yield bonds developed in the US as bonds issued by companies with a low credit rating but which compensated investors for their higher risk by carrying a higher coupon and a far more comprehensive covenant package than would be typical for investment grade bonds.

Although there have been various attempts to forge a European high yield market dating back as far back as the nineties, it is only in the last three years that the market has seen exponential growth.

Investor Appeal

The drivers for the recent expansion of the market have been varied but there are certain recurrent themes. Primarily the low interest rate environment that followed the global financial crisis has seen investors seeking higher returns on their investment. This has in turn caused spreads to tighten but spreads over treasury benchmarks have not yet reached the lows seen against treasuries in pre –crisis years. At the same time default rates for high yield bonds have remained relatively low, further enhancing the attractiveness of such bonds.

Borrower Appeal

From a borrower point of view the issuance of high yield bonds as an alternative to traditional bank financing also has attractions. Whereas in Europe corporates have historically tended to look mainly to banks for their financing needs, there has been an increasing shift towards borrowers tapping the bond market. Although investment grade borrowers in Europe have long used Medium Term Note programmes for their funding requirements, heightened investor demand means that lower graded mid-sized corporates are now increasingly able to access the bond market through the issuance of high yield bonds. Indeed while the high yield market has expanded over the last year, issuance of investment grade bonds in Europe has contracted during the same period.
This trend is partially explained by a contraction of liquidity in the bank funding market and a reluctance on the part of banks to fund the kind of leveraged loans that they would have entered into pre-crisis. This problem was exacerbated by the fact that leveraged loans were frequently bundled up and placed in the CLO market, one which has largely dried up. Accordingly, borrowers have been forced to tap the bond market in order to secure an acceptable cost of funds. However, the covenant package typical of high yield issuance has also proven attractive to certain borrowers in that the covenants tend to be triggered by "incurrence" rather than the "maintenance" covenants usually seen in classic bank deals.

Thus the covenants are only tripped by a specific action by the issuer, such as taking on more debt, rather than being applied on an ongoing periodic basis. There is thus less risk of an issuer triggering an involuntary default. Because of this many borrowers when refinancing existing bank debt have turned to the high yield market because of the less onerous nature of the covenant package. In a separate but contrasting development other issuers who do not have a public rating have used bond covenant packages adapted from their existing loan documentation in order to avoid having to comply with two differing sets of covenants.

cont'd page 03

High Yield Bonds cont'd

Investor Concerns

The high levels of supply combined with greater investor demand have forced down yields dramatically. Despite this, certain groups of investors have been increasingly concerned that the market is not sufficiently transparent, while also pointing to erosion of standard covenant packages. Typically high yield bonds form part of a wider financing picture and may sit with pari passu senior or super senior bank debt. However the terms of intercreditor agreements or senior financing facilities are not typically available to bondholders.

This has caused for investors to call for greater transparency putting them on a level playing filed with bank lenders. Similarly although covenant packages have not changed significantly in the wake of the global financial crisis, the burgeoning supply of bonds has meant that some investors have detected a loosening of some covenants particularly with regard to "change of control provisions". Whereas previously a change of control had always triggered an absolute put right, certain deals have followed investment grade precedent in requiring that the change of control actually has to trigger a ratings down grade.

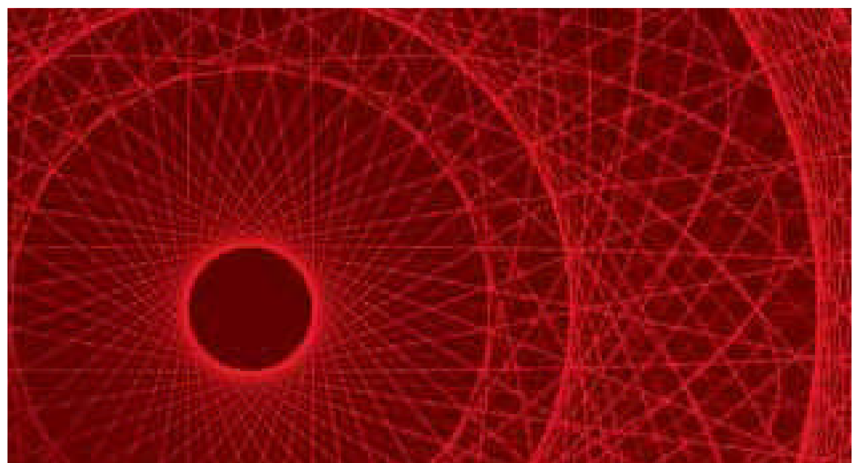
The legal market for High Yield

Historically a US law governed product and still sold into the US, instructions on high yield issuance have been largely the preserve of a small group of US firms, although increasingly UK law firms have started to acquire a high yield capability.

Because the covenant package differs both from the LMA style seen in loan documentation and from the relatively light covenants seen in classic Eurobonds a different skill set is required that can address the nuances of the high yield style covenants.
In addition a high yield bond is usually part of a broader financing picture, which may contain senior or super senior bank debt sharing a security package with the high yield debt. Accordingly such transactions require an understanding of the interaction of the various levels of the borrower's financing and related intercreditor issues. In addition, upstream guarantees and the security package may extend across several different jurisdictions requiring the involvement of firms which are used to routinely structuring complex cross border transactions.

Finally, as the deals are still usually sold into the US through private placements an understanding of US securities law issues and a familiarity with US style disclosure standards is vital to the smooth running of the transaction. Because of the increasing acceptance of the high yield bond issuance as a mainstream financing tool for European corporates, it will be interesting to see whether the legal market for issuer's and in particular underwriters' counsel will remain so heavily concentrated. In particular it has yet to be seen whether UK firms with a US capability will be viewed as acceptable alternative to their US counterparts in the London market.

At present despite record issuance volumes, high yield is still not viewed as a commoditised product and recovery rates for law firms remain high. Perhaps the entrance of new players into the legal high yield market may trigger a downward trend on recovery rates as competition increases.



Whereas previously a change of control had always triggered an absolute put right, certain deals have followed investment grade precedent in requiring that the change of control actually has to trigger a ratings down grade.