PROTECTION FOR DEBT HOLDERS

CHARLES STEPHENS AND **JOHN THOMSON** OUTLINE HOW BOND INVESTORS AND LENDERS ARE REACTING TO THE CURRENT ENVIRONMENT.

Nasty surprises are a routine feature of the business of lending money or buying bonds. Recent history has given us various emerging markets crises, including those in 1997-98 affecting Asia and Russia, and more recently the Argentinian default. We have seen the unwinding of the dotcom boom and the disruption to markets following 11 September 2001. In addition, the stresses of the global economy have created their own difficulties and uncertainties, with 2001 being notably tough in most regions.

But what of the UK? Conditions here have been challenging, with certain manufacturing sectors hit particularly hard. With declining interest rates, strong consumer spending, and a less pronounced economic slowdown than on the continent, the UK economy can be characterised as 'resilient', but there have still been casualties.

In the past few months, we have seen dramatic changes to the credit standing of blue chip names such as Equitable Life, Marconi, Railtrack and Enron. And we have seen sharp ratings downgrades for companies such as British Airways, Invensys and Xerox. Bank lenders and fixed income portfolio managers are exposed to a cocktail of macroeconomic risks and specific corporate credit issues, which may include unpredictable political or legal risks.

So how do lenders and investors react to this challenging credit climate? Some of the reactions are forced on them by events, in the form of provisions and write-downs, larger workout teams and perhaps litigation. However, we are focusing here on the pre-emptive actions that debt holders are taking to manage or minimise potentially adverse exposures.

CREDIT CULTURE. The most basic protection available to lenders, of course, is to avoid problem credits at the outset. But that's easier said than done when unpredictability is inherent. And for relationship banks, there is particular pressure to support clients with their balance sheets in difficult times – albeit with the *quid pro quo* of additional business, as most of the bigger banks have now integrated their loan business into a broader product range.

With every recession and with every corporate credit scare, we see banks and investors going through the motions of 'learning the lessons' and reinforcing their credit disciplines – some might say, until the next bandwagon comes along. Nevertheless, lessons have been learned, and in the public financial markets, the structure of the underlying instrument – be it a syndicated loan or a bond – will generally dictate acceptability, or not, among debt providers. But, ultimately, a decision to provide financing should be underpinned by an analysis of the underlying credit.

The massive expansion of corporate bond issuance in Europe since the launch of the euro has at times outstripped the market's resources for in-depth credit analysis. Hence, the heavy reliance on credit ratings and a sometimes painful learning curve for European fixed income investors. In this area, euroland is still catching up with US practice, where buy-side credit analysts are a well-established feature of all the leading investment institutions, and with the sterling bond market, which has a longer history of corporate issuance.

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Who has responsibility for the structure of a debt transaction? Here, there is a divergence between the bank and bond markets. Lead banks which structure a loan need to make sure that the underlying credit is satisfactory and the structure reflects the various risks. They are strongly motivated to do so because they will typically keep a significant piece of the transaction on their own books until maturity. In addition to meeting their own internal credit committees' requirements they will need to satisfy market expectations in order to sell down their risk position, and therefore they will ensure they stay aware of the structural requirements of other bank participants.

By contrast, bond investors are not directly involved in the negotiation of terms and conditions. They are reliant on the lead manager(s) to do a conscientious job on their behalf, notwithstanding that the lead manager's underwriting risk may be

minimal – possibly just intra-day, for example, in an over-subscribed, book-built deal.

CONTRACTUAL PROTECTION. An important area of focus for lenders is the protection afforded to them by the provisions of their contract with the borrower – the loan agreement or bond terms and conditions. Specifically, at times of heightened credit awareness, we see particular attention paid to the various types of contractual covenants, for example, positive and negative undertakings, financial covenants and events of default.

Financial covenants tend to fall into three principal categories. First, those that seek to test debt service capacity, for example, interest cover and debt/earnings ratios. Second, the balance sheet tests, most commonly minimum net worth and gearing ratios (both net and gross). The third category comprises the more sector specific covenants, such as property transactions incorporating loan-to-value and rental income cover tests; retail or transport facilities including a fixed charge cover ratio; and project finance deals including, among others, loan life cover and debt service cover ratios.

From a borrower's perspective, the structure has to be one that affords it the ability to conduct its day-to-day business while, at the same time, providing contractual protection to its debt holders.

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The underlying *raison d'être* for any basket of financial covenants is to sound an early warning if a company begins to head towards problems. To that extent, reasoned debate needs to prevail when discussing what type and absolute level of covenants best support the underlying transaction.

Despite imposing a discipline on corporate borrowers, financial covenants are commonplace in the bank market, with many of the strongest corporate credits now agreeing to their inclusion within loan documentation.

The warning bell for lenders may be an examination of the applicability of certain contractual covenants, in the form of a waiver request or indeed a renegotiation of covenants. Although these may give rise to difficult situations, they are surely preferable to the stresses of a full-blown default.

Compared with loan markets, the bond markets in Europe were, until recently, skewed heavily towards AAA and AA rated issues, and predominantly uncovenanted, at least for investment grade, senior unsecured debt. However, with higher issuance volumes further down the credit scale, and the development of a European high-yield market, bond investors have had to become more covenant-literate, not least to ensure that they have the same protection as other groups of lenders. The cut-off point at which the bond market will accept uncovenanted deals is at present around BBB, though there are numerous exceptions and anomalies driven by industry sector and company specifics.

Covenants aside, the recognition of risk volatility can manifest itself in other ways. The surge of telecoms sector bond issuance in the past two years has been possible because the major borrowers in that industry recognised the need to give investors some protection against the risk of ratings downgrade. The Tecnost and Vodafone issues in 1999 and 2000 set the precedents for the sector in offering a step-up in the coupon rate in the event of a ratings downgrade. This formula, with a number of variations, has since become almost a pre-requisite for large scale bond issues by companies in that sector, and indeed has also been used subsequently by issuers in other industry sectors. While Vodafone has maintained its ratings in the single-A range, in other cases, the step-up has been triggered, and the fall in bond prices, which would otherwise have resulted, has been mitigated.

PORTFOLIO MANAGEMENT. Covenants, therefore, not only restrain companies from heading into default but also serve the purpose of protecting value for lenders and investors. Given the prospect of debt holdings being marked to market value, a significant change in a borrower's credit profile may flow directly through to a loss for investors. In the case of traded debt instruments, this effect can be almost instantaneous.

A notable learning experience for European investors arose in the case of Stagecoach, which in April 2000 suffered ratings downgrades on announcing the disposal of a subsidiary. At the time, Stagecoach had bonds outstanding in sterling, euros and dollars, but with different terms and conditions. The sterling bondholders were able to achieve early redemption of their bonds at a make-whole price, but there was no equivalent protection available to the euro or dollar holders, who saw a marked drop in the valuation of their bonds. Ever since, we have seen a clear demand from eurobond investors that their terms and conditions should, for each issuer, be on an equal basis with those achieved by investors in other markets.

Given that the transferability of loans does not – yet – match the speed of bonds, what can lending institutions do to manage their loan portfolios, apart from the obvious route of avoiding particular borrowers, sectors or countries?

Those with existing exposure now have the option in many cases to buy credit default swap protection, thereby achieving balance sheet management requirements without alerting clients to their concerns. The preferred choice may be the transfer of assets from one bank to another, as witnessed by the successful development of the secondary loans market, actively promoted by the Loan Market Association.

Ultimately, in debt restructuring situations, investors may need to negotiate directly with a borrower – sometimes in competition with other debt holders – to protect their interests.

OUTLOOK. Good market conditions provide borrowers with bargaining power in financial negotiations. Challenging conditions will undoubtedly produce a more conservative, credit-driven environment led by debt providers. Lending structures will be supported by meaningful contractual documentation that affords protection to the lenders and bondholders without restricting the ordinary business of the borrower or issuer.

Macroeconomic risks, corporate credit, and unpredictable political and legal issues require lending organisations to analyse each transaction fully and satisfy themselves that the structure gives them the proper protection. In a more challenging credit climate, those that take this process lightly do so at their peril.

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