Windows of opportunity

Executive summary

- For businesses with access to the funds, debt buybacks can prove very cost-effective, with "fire-sale" prices sometimes as low as 15%. But controversial deals to buy back distressed debt have led to questions over whether they are legally effective, and the wording of agreements has been put under the spotlight.

"Could debt buybacks become the new thing?" asked the Financial Times last September, after several private equity-backed companies had made waves earlier in the year by buying back a chunk of their debt at a discount.

More recently, the paper has reported that distressed debt trading levels have risen sharply. Some bankers suggest that trading volumes have doubled or even tripled. As one business commentator noted: "Share buybacks were all the rage in the boom. Now debt buybacks are in vogue in the bust."

Certainly there has been a marked increase in the popularity of debt buybacks since the onset of the credit crunch. Provided that a company has access to liquidity, they offer a cost-effective means to reduce gearing levels.

As the purchase is made on the open market at a discount, the company can take advantage of general market concerns to reduce its debt responsibilities. So for indebted companies, the recent depressed trading levels in the loan market have helped establish buybacks as an attractive and relatively easy means to make a significant dent in their debt load, as some of it can be bought back at a discounted price.

As the FT summarised: "Typically, when a company becomes financially distressed, bondholders and bank debt holders start looking for opportunities to sell their debt claims before the situation deteriorates further. But the collapse in companies' debt values that followed the credit crisis has left many bonds and loans with market values well below their nominal worth."

These 'fire sale' prices have enabled Canary Wharf Group, for example, to buy back close to £120m of debt from bond holders for just £35.5m and reduce long term debt by £84m in April, when a bundle of outstanding mortgage-backed securities became available at an average of 30% of face value – although in some cases the price was as little as 15%. The securities, which are 30-year notes on Docklands office premises, were issued little more than two years ago so are not due to mature until 2037.

Across the Atlantic Ford doubled its planned debt buyback in March to $1bn to buy back $2.2bn of debt after investor interest surpassed expectations, although the offer represented only 47 cents to the dollar for bondholders.

Even the debt of apparently healthy companies has traded at anywhere between 70% and 90% of face value. Both Alliance Boots (which recently completed a debt buyback) and Debenhams (which in June announced a placing and open offer to raise £323m and cut its debt load of nearly £1bn), whose loans have been performing relatively well, were recently being quoted at about 70%.

BUYBACKS ARE BOOMING Until fairly recently, banks hesitated to unload their toxic assets – including the debt of failing or failed companies – fearing that crystallising their losses would alarm investors and trigger demands that they raise fresh capital.

But the burst of activity over the past few weeks shows that the market in distressed debt trading is picking up rapidly. Alliance Boots announced its buyback in May, revealing that it had taken the opportunity to buy back more than £400m of debt, thanks to the favourable trading price of its loans.

Executive chairman Stefano Pessina, who took the retailer private two years ago when the group was bought by US private equity firm Kohlberg Kravis Roberts, stated openly that it had been "opportunistic" in buying back debt at less than 70p in the pound.

"What happens generally is you can buy when there is a distressed fund, someone who needs the cash or is selling in a fire sale," he commented. "The prices look very attractive but at the end of the day we don't find many opportunities to buy."

Other buybacks announced in May included Bank of Ireland, whose shares jumped by 25% when it announced plans to boost its capital position to offer about €1.4bn for €3bn of debt trading at "significant discounts" and using the gain to bolster its Tier 1 capital.

THE CHANCE TO BUY BACK A CHUNK OF DEBT AT A HEAVY DISCOUNT IS ONE THAT HAS RECENTLY BEEN GRASPED BY SEVERAL COMPANIES, REPORTS **GRAHAM BUCK.**

Further afield, German chipmaker Infineon Technologies is buying up to €150m worth of convertible bonds and exchangeable notes at a discount of 25% or more to par value, Spanish telecoms group Jazztel purchased €140m of convertible bonds combined with a rights issue to collectively halve its debt to €119m, while Dutch brewer Heineken bought back loan notes at a heavy discount to face value.

Some buybacks have followed the company in question suffering a ratings downgrade from Standard & Poor's.

Swiss commodities firm Glencore International's debt rating was reduced by S&P to the lowest investment grade level of BBB- at the end of last year: it responded with a buyback in March.

The privately-held company does not grant interviews, but issued the following statement: "Given strong liquidity and credit spreads not reflecting Glencore's view of its underlying credit profile, Glencore has repurchased bonds in excess of US$100m equivalent of notional value across different maturities and will consider further purchases either in cash as done to date or via synthetic means."

Reports suggest that the company was able to repurchase the bonds at a substantial discount as they were trading in the region of 57% to 65% of face value.

Australian media group Fairfax followed its lead in May when a deteriorating advertising market led to an S&P downgrade from BBB- to BB+, which Fairfax reckoned would cost a further A$10m annually in interest payments on top of its existing A$1.8bn debt load.

But with its debt trading at around 85 cents in the dollar, it was able to purchase around A$200m of its own bonds for only A$170m and cut the load by A$30m.

PRIVATE EQUITY LEADS THE CHARGE Private equity-owned companies were among the first to go down the loan buyback route.

Danish telecoms group TDC led the way in February 2008 buying back €200m of loans at a discount. It was followed by PAI Partners, which bought back second lien debt connected with its acquisition of French group Lafarge's roofing business and Bridgepoint Capital, which acquired about 5% of the loan it used to buy clothing retailer Fat face.

The trend led to banks scrutinising the wording of loan agreements, which may contain covenant or other restrictions which inhibit a participation in the loan being transferred to the borrower or related entity. It also triggered a debate on whether loan buybacks by borrowers were legally effective as such. If a debt buyback by a borrower is instead characterised as a prepayment, the validity of the buyback may be open to challenge (as a pre-payment in breach of the contractual terms).

The controversy sparked by these deals, and the resulting friction between buyout firms and their bank lenders, led to an announcement by the Loan Market Association that "…the decision to permit debt buy-back or not on a specific transaction is primarily a commercial one, to be agreed between the borrower and the lenders. However… if debt buy-back is permitted, it should be conducted in such a way that it maintains one of the fundamental principles of syndicated lending, that the lenders be treated equally by the borrower. We believe mechanisms to do this can be achieved while, at the same time, giving flexibility to borrowers to redeem debt."

The LMA inserted some optional drafting into its recommended form of facility agreement for leveraged buyouts last September, to clarify whether, and on what basis, buybacks will be permitted, to be adapted according to the commercial agreement. These provisions are discussed in detail in the ACT 'Borrower's Guide to the LMA Agreement for Leveraged Transactions'.

Most loan documentation does not, however, contain such provisions and the implications of any loan buyback proposal will have to be considered against the relevant loan documentation.

Borrowers will also want to consider how best to structure the buyback from a tax perspective. The number of loan buybacks that have now been completed illustrates that the legal obstacles can be overcome, in many cases by effecting the buyback via another borrower group entity or a special purpose vehicle and/or by inviting lenders to participate in an auction process.

Standard & Poor's confirmed its thinking on the distressed debt trade in a report issued at the end of January:

"Entities in distress often restructure their obligations, offering less than the original promise. The alternative of a general default, in which the investor or counterparty stands to fare even worse, motivates (at least partially) their acceptance of such an offer. S&P treats … such offers analytically as equivalent to a default on the part of the issuer.

Therefore, upon completion of an exchange which we view as distressed, S&P rates the affected issues 'D', and the issuer credit rating is usually reduced to 'SD' (selective default), assuming the issuer continues to honour its other obligations. This is the case even though the investors, technically, may accept the offer voluntarily and no legal default occurs."

Debt buybacks are, understandably, less popular with debt investors who would far rather be repaid through formal channels at full value rather than the debt being repurchased in the market at a discount. But many have themselves been hard hit in the past couple of years. Battered hedge funds facing redemptions, or banks which have marked down their exposures and have given up hope of any prospect of early recovery, are often tempted to sell even at deeply discounted levels.

Stefano Pessina's admission that the Alliance Boots loan buyback was "opportunistic" underlines the fact that not all investors are seeking an exit, so companies have to take advantage as and when they can of conditions favourable to a buyback. If reports of green shoots in the economy prove to be justified, there may not be as many windows of opportunity in the future.

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