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Description of typical covenants

High yield corporate bonds often have a number of covenants attached that may be invoked under various circumstances. In the following, we describe a number of these covenants. Some of these descriptions will also include examples of calculations relating to bonds covered by Jyske Markets. In this document we look into the following covenants/provisions:

- **Make Whole**
- **Equity Claw-Back**
- **Change of control**
- **Restricted payments**
- **Limitation on debt incurrence**
- **Sale of assets**
- **Restriction on mergers**
- **Negative pledge / Limitation on liens**
- **Limitation on sale / lease-back**

Make Whole

A Make-Whole provision allows the issuer of a bond to evade the original call structure by defining a premium above the market value that is offered to bondholders for allowing the borrower to pay off debt early in full or in part. In principle, it is a call, but typically at a relatively high price.

The payment to the bondholder in the event of a Make-Whole call consists of two components:

- the net present value of the earliest call price, which is defined in the prospect, and
- the net present value of all coupon payments that would have been paid in the period until the first possible call date. The net present value is calculated on the basis of an interest rate typically 50 bp above a pre-defined reference rate (typically the German government bond yield in the case of European issues).

Hence a Make-Whole payment includes a premium compared to the par value; therefore the company pays compensation to investors. This is paid to investors as compensation for allowing the issuer to repay the debt early.

Due to the high premium payable to investors - if the Make-Whole provision is invoked by the company - such provisions are typically only invoked if a business experiences a major capital injection, for instance in the event of an IPO, share issue or significant sales of assets, enabling the company to repay fairly expensive debt.

Below we give an example of how the total payment to the bondholder is calculated in the event that a Make-Whole provision is invoked. The example is based on the 11.75% Wind bond with maturity in 2017. This bond has a Make-Whole provision, entitling the company to buy back the debt before the first call date, which is 15 July 2013, at a premium 50 bp above the German government bond of which time to maturity is closest to the next call date.

The calculations are based on the transaction being carried out on 11 September 2009 with a yield identical to the German government bond (DBR 3.75% 4/7 2013) of 1.991%, which means a discount rate of 2.491%. The semi-annual coupon on the bond is 5.875 and can be called on 15 July 2013 at the price of 105.875. The sequence of payments as well as the discounted amounts is shown in the table below[1]:

	Date	Amount	Number of days	Net present value
Coupon	15-01-2010	5.940	124	5.890
	15-07-2010	5.875	304	5.754
	15-01-2011	5.875	484	5.684
	15-07-2011	5.875	664	5.614
	15-01-2012	5.875	844	5.546
	15-07-2012	5.875	1024	5.478
	15-01-2013	5.875	1204	5.411
	15-07-2013	5.875	1384	5.345
Principal	15-07-2013	105.875	1384	96.319
Total value (price)				**141.041**

Equity Claw-Back

An equity claw-back provision allows a bond issuer to refinance a fixed part of the outstanding debt by issuing new shares and apply the proceeds from this issue to buy back issued bonds. The maximum proportion that the issuer can buy back will typically amount to about 35% - 40%, and there are no minimum limits to the amount of bonds that can be bought back

Any buy-back due to an equity claw back provision will take place at a predefined price, typically at price 100 plus one year's coupon. The period during which such a provision can be invoked is predefined in the prospectus and a typical period would run from the issue date of the bonds to about a year before the first actual call date.

This type of buy-back is voluntary for the issuer, while the investors will not have any possibility of influencing the outcome; this is to be justified by the fairly high premium.

For instance, the 11.75% Wind bond, maturing in 2017, comes with an equity claw-back provision that entitles the company to buy back, until 15 July 2012, up to 35% of the bonds issued at the price of 111.75.

As mentioned under "make-whole", the Wind bond also comes with a make-whole provision entitling the company to buy back all bonds at the price of 141.041.

If we imagine that Wind is to be listed on the stock exchange and wishes to buy back all bonds on 11 September 2009, 35% would be bought back at the price of 111.75 due to the equity claw-back provision, while the rest would be bought back at the price of 141.04 according to the make-whole provision. Hence the payment to investors would be the weighted average of these two prices, namely 130.79.

Also the TDC bond, 8.25%, maturing in 2016, comes with both an equity claw-back and a make-whole provision. However, at this point in time the equity claw-back provision has expired, and therefore, if TDC should wish to buy back all the outstanding bonds, the company would be forced to do this at the price that can be calculated on the basis of the make-whole provision, which on the

[1] Inclusive of accrued interest.

basis of the date 11 September 2009 will come to 117.685[2]. If the buy-back had taken place before the expiration of the equity claw-back provision, 40% could have been bought back at the price of 108.25.

Change of control

The purpose of a change-of-control covenant is to protect bond holders from situations where a change in the company's ownership may deteriorate the credit quality. Generally the covenant will give the bondholders the opportunity to sell the bond back to the issuer at a fixed price of 101 in the event of a change in ownership.

By definition we have a change-of-control situation when a third party gains ownership of 50% or more of the total number of shares. However, there are certain exceptions that prevent this covenant from being invoked even though in actual fact a change of ownership is taking place. The covenant may name a number of "permitted holders", i.e. certain persons or companies that are allowed to gain control of the company without the change-of-control covenant being invoked.

Also, change-of-control covenants may be linked to the company's credit rating. Particularly in Europe, prospectuses often include a provision according to which a change-of-control covenant can only be triggered if the company's credit rating is downgraded in connection with or immediately after a change in ownership.

In principle, a change-of-control covenant is a special case of a poison put. Poison puts may be constructed in many ways and contain a number of covenants that entitle bondholders to redeem their bonds under various conditions. Such conditions will often relate to leveraged buyouts or hostile takeovers, for which reason the change-of-control covenant is the poison put most often used.

Restricted payments

A restricted-payments covenant limits the issuer's right to make certain types of payments and may comprise cash as well as assets or shares to shareholders as well as buy-backs of subordinated debt, buy-back of shares or payment of dividends.

The purpose of a restricted-payments covenant is to protect the bondholders against the company owners withdrawing money or assets from the company and hence deteriorate its ability to continue to make the payments on the bonds.

The company is, however, allowed to make certain, pre-approved payments of which the total amount is limited by a certain formula. For instance, the total amount at disposal could be defined as 50% of the net income plus various additions for certain payments, such as dividends or special payments that may be necessary. This amount for payments will be accumulated on an ongoing basis so that the funds that are not used will be rolled over to the next period.

Limitation on debt incurrence

The purpose of a limitation-on-debt-incurrence covenant is to limit the total claim on the company and hence prevent the company from taking up further debt unless the cash flow is sufficient to service the entire debt. Hence the interests of the existing bondholders are put above those of potential creditors.

[2] Inclusive of accrued interest.

Typically a specific “test” has been defined that is to be passed before the company is allowed to take up further debt. Such tests typically involve the requirement of a minimum interest coverage ratio or a maximum debt/equity ratio.

The interest coverage ratio is typically calculated as EBITDA / interest expenses[3], and the requirement may be that this ratio remains at minimum 2.5x. The maximum debt/equity ratio is typically calculated as total debt / EBITDA, and in this connection the requirement could be that this ratio may not exceed 6.5x.

However, certain exceptions may be defined that enable the company to take up debt even though the requirements of the debt test are not met. If acquisitions are part of the future strategy, there may be an exception that allows the company to take up debt for this purpose irrespective of the current status.

In the same way as the debt of the issuing company is limited, this covenant will often also apply to subsidiaries (limitation of subsidiary debt). This limitation of subsidiary debt is identical to that applying to the parent company and often the limitations pertaining to the parent company as well as subsidiaries are included in one covenant.

Sale of assets

This covenant limits the issuer’s possibility of selling assets from the company and hence reduces the security that bondholders have in the company in the event of bankruptcy.

Such a covenant may be split into two, where the one specifically prohibits the sale of assets that are placed as security for the bondholders, while the other part prohibits the company to sell other assets at prices below fair market value. There may be a requirement that the profit from a sale must be at least 70% of the fair market value. Also, there may be a requirement that a certain proportion of the payment is to be received in cash, typically 75%.

The main purpose of this type of covenant is to prevent that due to extensive sales of assets a company becomes a "shell” with very few assts of value to creditors in the event the company becomes subject to bankruptcy proceedings.

Moreover, it may be required that a certain percentage of the profit from the sale of assets is applied to repay senior debt.

Restriction on mergers

A restriction-on-mergers covenant limits the issuing company’s possibility of merging with other businesses and to transfer all or large parts of the assets to another party. This protects bondholders against a weakening of the issuer’s credit profile due to a merger, for instance.

Typically this covenant will prohibit mergers unless a number of requirements are met. Typical requirements are:

- the issuing company must be the surviving entity after the merger, or the surviving entity must be domiciled in the same country and assume the debt under the same circumstances;
- the merger must not result in bankruptcy;

[3] If allowed by the conditions in the prospectus, the company may, for instance with acquisitions apply a pro forma calculation of the various coverage ratios (for instance in the event the acquired company's EBITDA is fully used).

- The net value of the surviving entity must be higher than or equal to the original value of the issuing company; and
- the pro forma gross profit ratio of the total enterprise must meet a predefined minimum ratio.

Negative pledge / Limitation on liens

A negative-pledge covenant prevents the issuer at some later time to take up new debt by placing assets as security if as a result of this the security enjoyed by the original bondholders is deteriorated. Hence such a covenant will guarantee that at no time new creditors will have a stronger claim to the assets than that of the original bondholders.

A limitation-on-liens covenant works in the same way as a negative-pledge covenant as it guarantees that the issuer provides the same security to the bondholders even though at some later time additional debt is taken up.

However, there are typically certain exceptions in such covenants that are necessary for being able to carry out the daily operations of the business such as mortgage deeds on buildings, temporary financing of dealers, etc.

Limitation on sale / lease-back

Such a covenant limits the company's possibility of selling assets and then leasing back the same assets from the buyer. Such a transaction will reduce the assets of the company and at the same time the lease contract will increase the total debt, and this will effectively reduce the credit quality of the business and weaken the position of the bondholders in the event of bankruptcy. These types of transactions are often carried out by firms that have liquidity problems.

A covenant designed to protect the bondholders against such situations may involve a requirement that the profit from the sale of assets be applied to the purchase of new assets or to the reduction of debt. Another way of doing this may be to have a covenant stipulating that sale / leaseback must be limited to less than 10% of the total share capital.

Various covenants

In addition to the covenants mentioned above, a number of various financial covenants may be linked to bonds. Such covenants consist typically of requirements of the business' earnings or expenses in the form of specific ratios that must be met as in the case of debt-incurrence covenants, for instance. If such financial covenants are not complied with by the business, the bondholders will typically be entitled to redeem the bonds at par.

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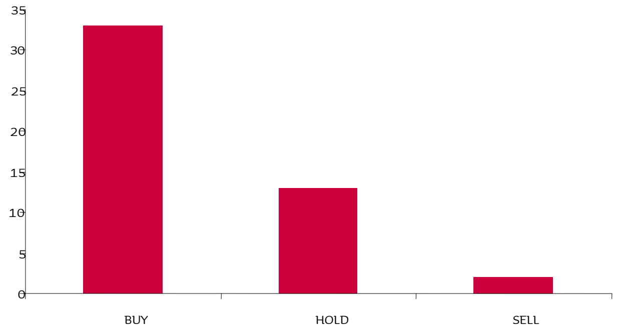
Jyske Bank's corporate bond recommendations – current breakdown

Breakdown of recommendations, corporate bonds (number)



Source: Jyske Bank

Financial models
Jyske Bank uses mainly Credit Edge from Moody's.

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Update of the research report
The planned update of the report will be prepared immediately upon the release of the company's financial statements.

See the front page for the initial date of publication of the report.
All prices stated are the latest trading prices at the time of the release of the research report, unless otherwise stated.

Recommendation concepts
Our recommendations are based on market developments and an assessment of the expected return. A positive recommendation (BUY) is based on expectations that investment in the corporate bond will generate a return above that of the general credit market. On the other hand, a negative recommendation (SELL) implies that we expect investment in the corporate bond to generate a return below that of the general credit market.

The future and historical returns estimated in the research report are stated as returns before costs since returns after costs depend on a number of factors relating to individual customer relations, custodian charges, volume of trade as well as market-, currency- and product-specific factors.