Leveraged Finance
Europe
Special Report

Senior Secured Bond Issuance: Buys Time, but may not Solve the Problem of Leverage

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Related Research

- *European Leveraged Credit Review: Pause for Recovery (October 2009)*
- *Approach to Rating Covenant-Light Loans and CLOs (September 2007)*

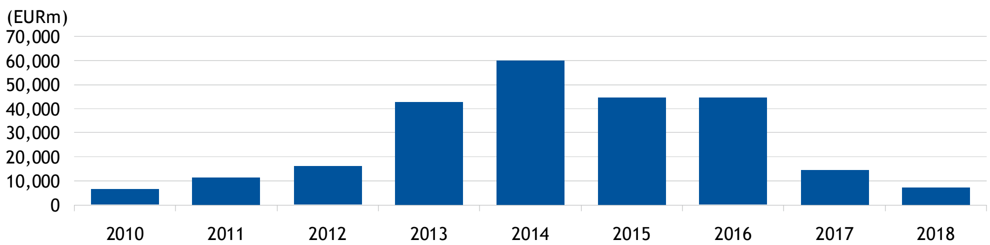
Recent Senior Secured Bond Issuance to Relieve the Pressure from Senior Secured Loans

Are senior secured bonds the answer to the refinancing cliff faced by Europe's several hundred billion euro leveraged credit market? With traditional senior secured bank lenders and collateralised loan obligation (CLO) managers constrained by legacy exposures, deleveraging pressures, stricter lending criteria, and funding issues, the latest trend towards senior secured bond issuance by companies such as Smurfit Kappa Group plc ('BB'/Stable), Virgin Media Inc ('BB-'/Positive), Seat Pagine Gialle S.p.A., Groupe Novasep, Manchester United Ltd and Unity Media Gmbh (among others) represents a potential long-term funding alternative towards a more diversified investor base — as well as a credit market of last resort for those borrowers in need of covenant headroom and maturity extension.

While the initial wave of senior secured high-yield refinancings was concentrated on formerly investment-grade "fallen angels" and legacy high-yield borrowers familiar to the European high-yield investor base, they also mostly represent borrowers with proven business models through the worst of the recession, and corresponding legacy capital structures capable of assuming fixed-rate bonds. Moreover, not all European leveraged borrowers have been willing — or able — to accept the higher pricing and pre-payment restrictions inherent in longer-term fixed-rate bonds.

Even though issuance activity has been brisk since the initial deals that re-opened the European high-yield market in 2009, the current senior secured bond market represents only a small portion of the potential volumes over the next several years. Specifically, Fitch Ratings' shadow-rated, principally private-equity-owned, leveraged credit portfolio has approximately 300 legacy European leveraged borrowers with leverage multiples of 5x to 7x operating cash flow on average, and over EUR300bn in looming maturities in the form of bullet loan tranches due for repayment in 2013-2014 — and, for some, mounting amortisation pressure through 2010-2012 (see *Chart 1*).

Wall of Refinancing Risk in 2013-14
Fitch rated saggregated cheduled debt amortisation



Note: Excluding C/CC rated credits as a coercive debt exchange or default situation is expected in the near term or seems inevitable
Source: Fitch

During the boom years of 2006 and 2007, the level of market liquidity produced rapid rises in acquisition and debt multiples, and lenders were happy to accept refinancing risk in relation to the source of their ultimate debt repayment. Senior secured bonds may address some of this refinancing risk by terming out maturities and diversifying the investor base. However, as noted in Fitch's special report "European Leveraged Credit Review: Pause for Recovery", published on 21 October 2009, the issuance of senior secured bonds buys time but does not reduce the overall leverage of the issuing companies.

Indeed, while near-term refinancing risk diminishes with the maturity extension, the new bonds may lead to deteriorating interest coverage metrics given the replacement of peak-of-the-cycle floating-rate senior loans priced at LIBOR+250bp-350bp with fixed-rate senior secured bonds yielding between 7% and 11% — depending on the credit rating profile (from high 'BB' to single 'B').

A Need for Breathing Space

Following the financial crisis of 2007-09, traditional senior loan lenders remain constrained by legacy exposures, stricter underwriting criteria, and a preference for defensive and proven business models. The resulting primary senior loan market has therefore limited senior leverage to between 3x and 4x operating cash flow, well below the senior debt multiple averages on current legacy deals — as well as requiring a greater degree of debt amortisation as opposed to bullet maturities.

In the absence of other one-off deleveraging events such as an equity injection from current sponsors or an IPO, asset sales, or strategic investments, legacy borrowers which do not qualify for primary loan market refinancing may have no other choice than to attempt refinancing via senior secured bonds.

In contrast to the improving — yet limited — risk appetite and volume constraints prevailing in the primary senior secured loan market, the primary senior secured bond market has demonstrated a willingness to provide up to 6x leverage, depending on the sector, and can accommodate much larger volumes. By allowing highly-leveraged issuers to extend and retain their debt burden with no amortisation, senior secured bonds postpone — but do not in themselves solve — the underlying issue of leverage that will eventually need to be tackled.

Additional Complexity, with some Subordinated Debt Maturing before New Bonds

Senior secured bond issuers have been able to layer new bonds into existing debt structures that accommodate both legacy senior and subordinated debt instruments. Senior secured bondholders for Virgin Media, Smurfit Kappa and Seat Pagine Gialle have even accepted that subordinated instruments will mature ahead of them.

Going forward, Fitch cautions that senior secured bond investors may be more wary of such temporal subordination. Legacy senior secured loans in more highly-leveraged capital structures may only be eligible for senior secured bond refinancing once the subordinated debt has been refinanced, or even restructured or exchanged for equity, as highlighted in recent press reports concerning UK gaming group Gala Coral Group Ltd.

Senior Secured Bonds: an Alternative not available to Everyone

Fitch anticipates that, in the near-term, only leveraged borrowers with accommodative capital structures or legacy debt structures comprising only senior secured, will attempt senior secured bond refinancing. Otherwise, borrowers will have to wait — either for further operational cash flow deleveraging on total debt towards the levels of the primary senior secured bond market, or towards primary senior and subordinated loan market levels, such that secondary/tertiary buyouts are facilitated — as in the recent case of UK retailer Pets-at-Home Ltd.

Alternatively, private equity sponsors will continue to pursue cash flow deleveraging in light of the economic recovery, and hope for risk appetite to improve further in equity and credit markets such that they have greater options to achieve exits via IPOs, strategic sales, or to refinance in more benign primary credit markets — all while remaining compliant on legacy senior and subordinated terms and conditions.

Ratings Impact of Senior Secured Bonds

Although the benefits to the issuer in terms of longer-dated maturities and reduced short- or medium-term refinancing risk may be clear, there are a number of other factors which Fitch takes into account when assessing the impact of both the IDR and instrument rating (on the basis of Recovery Rating, or 'RR') of such a refinancing, which high-yield bond investors should consider.

Lower Short-Term Refinancing Risk against Higher Interest Costs

Firstly, the agency will determine whether the overall quantum of debt is increasing, or whether a straightforward refinancing is taking place. Furthermore, the degree to which the new issuance relieves refinancing risk or amortisation pressure may be positive for the issuer's credit profile, but this must be compared with the likely increase in interest costs which will result compared with cheaper floating-rate debt (with EURIBOR/LIBOR currently at historical lows) — albeit the price of such floating-rate debt would be expected to rise along with base rates, to the extent it remains unhedged.

Fitch estimates that senior secured debt in the agency's portfolio of European leveraged loan ratings has a weighted average price of 2.7% over base rates - compared with an average 8.4% coupon for senior secured bonds issued since the second half of 2009. The net benefit to an individual issuer's credit profile could be measured by comparing the degree of refinancing risk (via credit metrics such as net debt/EBITDA, or funds from operation (FFO) leverage) at the new refinancing point with that under the pre-refinancing profile. If they are similar, then the company has bought time, but at the expense of free cash flow (FCF) generation.

The higher absolute cost of debt for senior secured bonds also means that unless they are faced with significant short-term amortisation pressure, those borrowers with the most limited FCF (typically in the low 'B' range or 'CCC') might be unlikely to benefit in the short-term from such issuance, and in fact issuance to date has largely been concentrated with issuers rated in the mid-to-low 'BB' and mid-to-high 'B' range.

Defining Pari-Passu

Other important considerations for investors relate to the specific terms of such senior secured bonds, and whether they are truly comparable with senior secured loans in terms of security and ranking, particularly for those issuers where loans and bonds co-exist in the revised capital structure. Key differentiating terms between senior secured loans and bonds might include claims of pari-passu status, the specifics of the security package granted, acceleration rights, voting control over security enforcement, and any release mechanism of security in case of default.

Because of the non-standard, ad hoc negotiated nature of most European loan and bond documentation, each issue and its rating impact must be reviewed on a case-by-case basis. However, unless the security package is significantly different — or there is a ranking provision in the inter-creditor document — the agency is unlikely to assign differentiated RRs or instrument ratings to senior secured bonds than for senior secured loans in the same capital structure. This is largely because it is difficult to reflect such differentiation in terms via Fitch's RRs, which represent a range of expected recoveries in bands of up to 20% (eg 'RR2' refers to expected recoveries in the range of 71%-90%).

Impact of Covenants on Recovery

In cases where senior secured bonds have replaced senior secured loans in their entirety, Fitch will also consider the resulting covenant package — as bonds typically contain only incurrence-based financial covenants, rather than maintenance covenants tested on a quarterly basis, which leads to the analogy of senior secured bonds in the capital structure as little more than fixed-rate covenant-light loans.

Fitch's report *"Approach to Rating Covenant-Light Loans and CLOs"* (dated 28 September 2007) outlines the agency's approach to assessing recoveries for issuers which have an (incurrence-based) covenant-light structure. In summary, a lack of quarterly covenant tests could result in a delay by management in tackling the issues faced by the issuer in a distress scenario, and this may have a negative impact on the recovery available to lenders.