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# The rise of portability in European high yield bonds: Have bond, will travel

High yield bonds have become increasingly attractive to sponsors in financings and, most importantly, refinancings. Sustained liquidity and growing investor demand, coupled with the reduced availability of new M&A credits, has driven the inclusion of flexible "portability" features into European high yield bond terms. In the US this has also resulted in increasingly flexible tenors, shorter call periods and larger equity claws. To find out more about these developments and how they may be used in new deals to enhance a private equity sponsor's options – read on.

### *What is portability and why does it matter?*

Traditionally high yield bonds have contained a change of control feature which can make selling an issuer prior to the date that its bonds are callable more difficult, namely:

(a) on a change of control the issuer is obliged to offer to repurchase the bonds (bondholders are not required to accept); and

(b) in such circumstances the issuer has to pay a redemption premium typically of 1% of the face value of the bonds.

For an issuer that expects to be sold in the foreseeable future, high yield debt can be a less attractive proposition.

Portability enables the issuer to have the change of control offer requirement waived on certain conditions. The test may vary from deal to deal, but a common formulation includes achieving an agreed leverage ratio. That ratio may often decrease over a 12 to 24 month period post issuance of the bond.

This relaxation of the strict terms of the change of control offer obviously has advantages for those seeking to realise the value of their investment in the issuer on its sale.

### *When did portability emerge?*

Portability first emerged in the European market during spring 2010 with the debut issuance of Ziggo, a Cinven and Warburg Pincus portfolio company. Because Ziggo was a TMT credit and there was an expectation that it would be an attractive asset for one or more key industry players, the sponsors were eager to maximize asset and investment value by ensuring the company could be sold quickly and easily – hence the inclusion of a portability feature. Exhibit 1 provides an overview of the Ziggo portability formulation as well as a

## Key Facts:

- Portability refers to a feature in a high yield bond that provides for an exception to the change of control covenant allowing, under certain circumstances, the equity of the issuer to be sold without requiring a change of control offer to be made.
- A liquid European high yield market has allowed sponsor portfolio companies to increasingly incorporate portability features into high yield bonds.
- Since the introduction of limited portability in 2010, it has evolved into high yield bonds that are fully portable (i.e., the issuer can be sold multiple times) until maturity.
- There have been equivalent developments in the US market with sponsor portfolio companies increasingly issuing bonds with more flexible tenors, shorter call periods and larger equity claws.
- These developments are likely to become more prominent with sponsors using an attractive financing option while retaining flexibility to sell the business.

history of the portability feature in Europe.

The successful execution of the Ziggo refinancing illustrated the European market's acceptance of a portable high yield refinancing subject only to an objective leverage test, as opposed to a ratings trigger (as seen in investment grade transactions). The leverage test is preferable to a ratings trigger, whereby a credit rating downgrade test is applied, because it adds certainty to a transaction by, among other things, eliminating the vagaries of a third party (i.e. a ratings agency).

## What call rights are usually included in high yield bonds?

Typically high yield bonds are subject to a call schedule whereby they are:

- Subject to a make-whole (i.e., an issuer has to pay the net present value of the bonds at their first call, including all interest payments to the first call date to make investors whole).
- Otherwise non-call for half of the bond's life (e.g., an 8 year bond would be non-callable for 4 years).
- Historically, the call schedule typically started at par plus 50% of coupon, declining rateably to par in the year prior to maturity (e.g. an 8 year bond with an 8% coupon would be callable at 104% in year 4, 102% in year 5, etc.).

There are also certain other "Call" rights which can be of advantage to the issuer:

First, an "equity claw" which allows the issuer to redeem its bonds with the proceeds of a *bona fide* equity offering for a period after closing at a fixed price. The equity claw has also been extended from the proceeds of public equity offerings to the proceeds of private equity offerings, for example under Rule 144A and Regulation S of the US Securities Act.

Secondly, the new super senior RCF and bond structures which have no amortising debt often include an additional redemption feature allowing optional amortisation. Specifically this allows for an amortisation (at the issuer's discretion) of up to 10% of the bond per year in the first three years of a bond at a price of 103%.

## Is portability developing fast?

Yes. From its inception in Spring 2010, portability has developed from a single use exception into a more flexible tool that may be used more than once. In addition, the time for which it is available has been extended and the conditions that apply have been both varied and expanded.

Exhibit 1 illustrates the development of portability in Europe and shows the formulations that are currently used.

## Where do we stand now?

The wave of high yield issuances in the first four months of 2013 act as a benchmark for the current approach to portability. The high yield issuance by UK healthcare group Voyage Care is a leading example. The portability feature provides flexibility for the business to be sold more than once to any buyer over the life of the bond without triggering a change of control offer. This is, however, subject to a condition (the company's leverage must remain below the specified leverage ratio) and a cost (the covenants provide for a reduction in the debt basket and restricted payment exceptions upon an initial change of control event), but provides significant potential flexibility.

## Are there trends in the US market which may affect the market in Europe?

Recent US market trends include:

– greater flexibility around the tenor of bonds;
– reduction in the time during which bonds are "call

## How they compare:

**European Market**
- Portability
- 10% at 103%

**US Market**
- More flexible tenors
- Shorter call periods
- Equity claw

protected"; and

– an increase in the size of the equity claw.

As in Europe, the US market has experienced a strong push for refinancings, particularly by sponsor portfolio companies. Many of these transactions were structured as dividend recaps while others were pure dividend deals (often executed through the issuance of payment-in-kind ("PIK") notes). The focus on tenor, calls and equity claws reflect the same desire for flexibility to sell portfolio companies in the future.

There have been an increasing number of deals in the US market that feature bonds with non-traditional tenors. Typically, these are PIK notes which have been structured around the current maturity profile of the issuer's existing notes, usually maturing six months after those existing notes. As a result, their tenors tend to be shorter than has traditionally been the case - around five years or less.

The average length of time between a bond's issuance and the first date that the issuer can call the bonds has reduced in the US, with a significant number of eight year bonds being non-callable for the first three years and 10 year bonds being non-callable for the first four years.

The US market is also seeing bonds with extremely short call periods of six months or one year. Examples of this can be seen in the last wave of PIK bond deals such as:

– the issuances by Apollo's portfolio company Taminco and Interactive Data via Igloo Holdings, each with a five year non-call 12 month PIK note, and

– the PIK note issued by Michael Foods of a 5.5 year non-call 18 month bond.

Such short call periods allow these bonds to function as a bridge to an IPO or a business sale whilst allowing for sponsors to take cash out today. This development is also beginning to feature in the European market, for example, the recent non-call 12 month €225 million PIK note issuance by Kloeckner Pentaplast.

At the same time, the size of equity claws have been increasing with some high yield bonds in the US market featuring 100% equity claws. For example, the Taminco PIK Note with an equity claw of 100% at 102% -again, making these instruments as bridges to IPOs.

## *Are there concerns about portability?*

It remains to be seen how prevalent these developments become, but in Europe some investors are concerned that portability could result in a change in management, strategy or the business direction of a company for which bondholders have only limited rights. And in the US, investors have expressed concern that as more bonds get called earlier they are left with the choice either to reinvest the proceeds in increasingly lower yielding bonds or going deeper into high yield territory in order to achieve the same returns.

It seems clear that portability is a growing trend in European sponsor transactions, especially for better non-investment grade credits and existing private equity portfolio companies that require refinancing. In particular, with financers increasingly pitching loan-to-bond refinancings, portability will significantly increase the attractiveness of high yield bonds to sponsors.

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## Exhibit 1: Portability's Evolution

| Issuer | Portability Feature |
|---|---|
| **Ziggo**<br>April 2010 | A Change of Control Offer is not triggered *provided* that the Consolidated Leverage Ratio is *less* than:<br>(a) 5.0 to 1.0 **prior to the first year** of the issue date; and<br>(b) 4.5 to 1.0 thereafter.<br>The portability feature can only be used **once.** |
| **Sunrise**<br>October 2010 | A Change of Control Offer is not triggered *provided* that the Consolidated Leverage Ratio is *less* than:<br>(a) 3.5 to 1.0 **prior to the first year** of the issue date; and<br>(b) 3.0 to 1.0 thereafter.<br>The portability feature can only be used **once.** |
| **Odeon**<br>May 2011 | **Specified third parties** can obtain control of the business without triggering a Change of Control Offer *provided*:<br>(a) The transaction is consummated **within 183 days** of the issue date; and<br>(b) total debt remains below £475 million. |
| **Orange**<br>January 2012 &<br>April 2013 | A third party can obtain control of the business without triggering a Change of Control Offer *provided* that the Consolidated Leverage Ratio is *less* than:<br>(a) 4.25 to 1.0 if the business is acquired by CVC or Sunrise; and<br>(b) 2.75 to 1.0 if the business is acquired by any other person.<br>The portability feature can only be used **once**. |
| **Cabot Group**<br>September 2012 | A Change of Control Offer is not triggered *provided* that Net Debt does not exceed an amount equal to 50% of the estimated remaining collections **prior to the 18 month anniversary** of the issue date.<br>The portability feature can only be used **once.** |
| **Voyage Care**<br>January 2013 | A Change of Control Offer is not triggered *provided* that the Consolidated Leverage Ratio is *less* than:<br>(a) 5.85 to 1.0 **prior to the 18 month anniversary** of the issue date; and<br>(b) 5.0 to 1.0 thereafter. |
| **Infinis**<br>January 2013 | A Change of Control Offer is not triggered *provided* that the Consolidated Leverage Ratio is *less* than:<br>(a) 4.0 to 1.0 **prior to the first year** of the issue date; and<br>(b) 3.5 to 1.0 thereafter.<br>The portability feature can only be used **once.** |
| **Arrow Global**<br>January 2013 | A Change of Control Offer is not triggered *provided* that Loan to Value remains equal to or below 0.5 **prior to the 24 month anniversary** of the Issue Date. |
| **DFS**<br>February 2013 | A Change of Control Offer is not triggered *provided* that the Consolidated Leverage Ratio is *less* than:<br>(a) 3.5 to 1.0 **prior to the first year** of the issue date; and<br>(b) 3.0 to 1.0 thereafter.<br>The portability feature can only be used **once.** |
| **Takko Fashion**<br>March 2013 | A Change of Control Offer is not triggered *provided* that the Consolidated Leverage Ratio is *less* than 3.75 to 1.0.<br>The portability feature can only be used **once.** |
| **Elior**<br>April 2013 | A Change of Control Offer is not triggered *provided* that the Consolidated Leverage Ratio is *less* than:<br>(a) 5.0 to 1.0 **prior to the 18 month anniversary** of the issue date; and<br>(b) 4.75 to 1.0 thereafter.<br>The portability feature can only be used **once.** |

## Exhibit 1: Portability's Evolution (continued)

| Issuer | Portability Feature |
|---|---|
| **RPG**<br>April 2013 | **Prior to the 24 month anniversary** of the issue date, a Change of Control Offer is not triggered *provided* that:<br>(a) The Loan to Value ratio remains below 0.437 to 1.00; and<br>(b) the acquirer is (i) not subject to U.S. sanctions (OFAC or Dept. of State) or any EU or EU member state equivalent sanction or (ii) not located in a country that is subject to sanctions by OFAC, the EU or any EU member state. |
| **Médi-Partenaires**<br>April 2013 | A Change of Control Offer is not triggered *provided* that the Consolidated Leverage Ratio is *less* than:<br>(a) 4.75 to 1.0 **prior to the 18 month anniversary** of the issue date; and<br>(b) 4.25 to 1.0 thereafter. |
| **New Look**<br>April 2013 | A Change of Control Offer is not triggered *provided* that the Consolidated Leverage Ratio is *less* than:<br>(a) 5.5 to 1.0 **prior to the 18 month anniversary** of the issue date; and<br>(b) 5.0 to 1.0 thereafter.<br>The portability feature can only be used **once.** |
| **Brighthouse**<br>April 2013 | A Change of Control Offer is not triggered *provided* that the Consolidated Leverage Ratio is *less* than:<br>(a) 4.0 to 1.0 **prior to the first year** of the issue date; and<br>(b) 3.5 to 1.0 **on or after the first year** of the issue date and **prior to the second year** of the issue date.<br>The portability feature can only be used **once.** |
| **Eircom**<br>May 2013 | A Change of Control Offer is not triggered *provided* that the Consolidated Leverage Ratio is *less* than:<br>(a) 4.5 to 1.0 **prior to the 18 month anniversary** of the issue date; and<br>(b) 4.0 to 1.0 thereafter.<br>The portability feature can only be used **once.** |
| **Ista**<br>May 2013 | A Change of Control Offer is not triggered *provided* that the Consolidated Leverage Ratio is *less* than 6.00 to 1.0.<br>The portability feature can only be used **once.** |