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Margin Bonds: Maximizing the Minority

Private equity firms are increasingly tapping into the global high yield market to finance their investments and investors have now been able to access high yield "margin bond" financing to acquire minority interests and fund joint venture investments. Such investments have historically been financed through margin loans or direct equity contributions, but now margin bonds may provide an innovative financing solution for investors seeking external finance for a minority acquisition in either a publicly listed or private company, as well as other types of investment.

To find out more about margin bonds – read on.

Why minority investments?

Reduced bank liquidity and an increasingly deep and liquid global high yield market has allowed private equity firms (PE firms), as well as other investors, to use margin bonds to finance minority acquisitions and joint venture (JV) investments in companies.

Minority investments can be particularly attractive to businesses that are owned by founding or family shareholders who are actively engaged in management and who are not ready to relinquish control. Such an investment can provide shareholders with a valuable source of capital, liquidity and diversification. It also allows them to leverage an investor's experience and potentially opens the business up for further growth and external investment.

While most PE firms, for example, prefer control investments, minority investments can be appealing as they allow the PE firm to benefit from the controlling shareholder(s) understanding of the business and sector it is in and provide a foot in the door before potentially acquiring a controlling stake in the future. In some instances it is a first step in a wider investment strategy. Additionally, if the business operates within a jurisdiction/industry that has foreign ownership restrictions, a minority stake may represent the only available option.

How have such minority investments typically been financed?

Traditionally such investments were either funded by a margin loan in the form of a "PIPE" (Private Investment in Public Equity) financing, if the shares of the company were publicly listed, or paid for in cash by the investor directly.

PIPE financing is a permanent fixture on the financing landscape and it has successfully helped many investors to purchase shares in publicly listed companies. PIPE financing is, however, limited to the acquisition of shareholdings in publicly listed companies typically with loan terms of two years or less and loan-to-value of the shares (LTV) thresholds ranging between 30% to 40%.

Key Facts

- Increased liquidity in the global high yield market is creating new opportunities in the bond market. PE firms and other investors are using margin bonds to finance minority and JV investments in lieu of traditional financing in the bank market.
- Margin bonds are an innovative development in the high yield market that could, over time, provide an attractive and flexible means of financing minority and other investments for PE firms and other investors.
- The "margin" element to the bond is there because, although the bond is secured against the shares acquired by the PE firm, the company itself is neither guaranteeing the bond nor providing the security.
- While margin loans represent an established financing instrument for investors to acquire publicly listed shares, the margin bond offers further potential to provide creative financing solutions for the acquisition of minority holdings in publicly listed and private companies or JV positions as well as giving the PE firm access to a broader range of investors.

A high yield option – margin bonds

An alternative to PIPE financing is the margin bond and it can be used to finance the purchase of minority stakes in either private or publicly listed companies or to fund JV investments. The "margin" element of the high yield bond refers to the fact that, although the bond is secured against the shares acquired by the investor, the company itself is not guaranteeing the bond nor providing any security. If the share price falls substantially in proportion to the principal amount of outstanding notes, this may trigger a breach of an LTV covenant.

With a structure that contains both high yield incurrence covenants and margin loan features, a margin bond is a significant development in the high yield capital markets.

An example of this instrument is the high yield bonds that were issued in October 2013 by Emma Delta (a consortium of investors lead by Emma Capital) to finance Emma Delta's acquisition of 33% of the Hellenic Football Prognostics Organisation S.A. (OPAP) from the Greek government. Emma Delta's margin bonds were successfully sold to both U.S. and non-U.S. investors.

Traditional PIPE financing – margin loans

Margin loans are an established financing instrument used by a range of investors from PE firms to hedge funds, pension funds and venture capitalists. The margin loan can be flexible and can facilitate a range of negotiated outcomes. The margin loan's security is constituted by shares held or acquired by the borrower and, where required, the shares of the borrower itself (see Exhibit A for further information).

While typically bearing interest at a floating rate and with bullet maturities of two years or less, margin loan value can vary in size and structure. Margin loans also contain a range of maintenance covenants which limit operational flexibility (i.e. limitation on ability to incur further debt, a negative pledge and limited restricted payments capacity). Most importantly, margin loans contain a LTV covenant whereby, if the value of the acquired shares drops below a specified threshold then the lender will make a margin call and the borrower must cure this breach. This is typically done through the borrower posting cash collateral or a pledge of further shares. If the LTV breach is not cured within a short grace period, the lender will enforce the margin loan's security.

The cornerstone of the margin loan is the LTV covenant but such a covenant also limits the scope of margin loan finance as it remains tied to publicly listed shares. Although there have been attempts in the market to arrange margin loans secured against assets other than publicly listed shares these have not caught on.

Margin bonds – overview and opportunity

A margin bond is an innovative alternative to a margin loan. Unlike a margin loan where the lenders are largely financial institutions, margin bond's may be sold to a range of investors around the world who regularly buy high yield securities.

High yield investors considering a bond investment, will primarily focus on cash flows and the risk of value leakage outside of the credit. Beyond these considerations, high yield investors typically allow the credit to operate flexibly. An investor should be able to use a margin bond to finance the acquisition of a minority stake or a JV investment provided the investors can reassure bondholders that there is sufficient cash to service the margin bond's interest payments; that there will be sufficient cash to pay principal on the bond at maturity; and that the high yield investors will be able to enforce the security quickly should the bond be accelerated.

The Margin Bond Alternative

- An instrument to finance minority acquisitions in publicly listed and private companies or a JV investment
- A broad high yield investor base
- A range of packaging options:
  - Rule 144A and/or Regulation S offering
  - Direct private placement
  - Private high yield loan
- A range of potential structuring options to balance investor certainty against operational flexibility
- A flexible incurrence-based covenant package
- Typically longer tenors than margin loans

While the basic structure of margin bonds and loans are similar (see Exhibits A and B), there are a number of features that distinguish margin bonds.

A margin bond can be structured to provide financing to an investor who is acquiring a minority stake in either a private or a publicly listed company. While Emma Delta's margin bonds financed the purchase of publicly listed shares (and thus utilized a LTV covenant), through the negotiation of a shareholders' agreement (as well as other potential safeguards) between the majority shareholder(s) and the investor, a margin bond could finance the acquisition of privately-owned shares and should be marketable without a LTV covenant – see the following section for further discussion.

In addition, while a margin loan's terms are typically two years or less, a margin bond has the potential to be significantly longer. Emma Delta's margin bonds, for example, had a tenor of four years, other high yield investments have tenors of several more years. The difference is primarily due to different types of investors. Margin lenders primarily focus on the equity value of the shares that are acquired, and anything longer than two years is difficult to predict. However, high yield investors focus on protecting the value of their investment and on receiving high yielding coupon payments in sufficient amount in order to gain sufficient return from their investment.

Where a margin loan has a restrictive covenant package at the company level, a margin bond's incurrence-based covenants provide a flexible alternative for the investor and the company. The investor can use a looser covenant package that facilitates easier day to day running of the business and greater potential for growth. The covenants are only tested when a significant action is to be taken (i.e. an incurrence of debt, a dividend payment or an asset sale) and provides increasing flexibility the better the business performs. High yield incurrence covenants are particularly attractive for businesses looking at growth opportunities and provide an opportunity for a minority investment to be financed by a margin bond without overly burdening the investor or the company.

Margin bonds – structuring considerations

Margin bonds can provide for and facilitate creative corporate arrangements between the parties, including the ability to purchase both public and private shares.

When structuring a margin bond the key considerations may include the following:

Service of bond interest payments – dividend capacity

Ensuring that the company will have sufficient dividend capacity throughout the life of the margin bond to service the bond's interest payments is critical. This will require diligence in terms of local law, historical and anticipated dividend performance, as well as, the company's current plans and its industry. In the context of a private minority acquisition, arrangements will likely need to be entered into in a shareholders' agreement in order to ensure sufficient dividends are paid on the acquired shares owned by the investor. In an acquisition of publicly-listed shares, additional comfort may be given by having the investor prefund a year's worth of initial bond interest payments into a secured escrow account.

Ability to impose covenants on the company

As noted above, bondholders will look for assurances that there is sufficient cash to service bond interest payments when due and to pay principal on maturity and that significant value will remain within the company. Therefore, they will seek comfort that covenants can be imposed on the company. In the context of a private acquisition, the investor may, as part of the terms of its investment, require the company to sign-up to a covenant agreement in order to align the company to the covenants under the margin bond. In the case of publicly-listed shares or where covenants cannot be formally imposed on the company, an alternative is to couple meaningful corporate governance protections with a put option for the bondholders. In this situation, if the investor cannot procure the company's compliance with a covenant, bondholders have the option to put their bonds back to the issuer at par or with a small premium.

Shareholders' agreement

A shareholders' agreement between the investor and the majority shareholder(s) will, in private acquisitions, be important to provide comfort to the bondholders regarding the investor's rights, control and influence on the company post-acquisition.

The scope for negotiation will be highly contextual depending on the nature of the investor, the size of the investment and the company's bargaining position. However, there are likely to be a number of key issues or reserved matters, that will require the investor's consent in order to ensure the company's compliance with the margin bond's covenants. Such reserved matters could be provided for in the form of director or shareholder veto rights or weighted voting rights. These reserved matters would likely cover the ability for the company to: incur debt; make restricted payments; enter into major transactions (including asset sales, affiliate transactions and mergers or consolidations); make changes to its business; issue further shares; make amendments to senior management, the board or sub-committees thereof; and amend the shareholders' agreement itself.

Governance rights – board representation

A further consideration is whether the investor is able to obtain board representation through its shareholding. While this is likely to depend on the size of the investment and the relationship between the investor and the other shareholders, significant board representation would be expected in any meaningful private investment, as it will provide further comfort to bondholders when assessing the investor's ability to control or influence the direction of the company. In the context of publicly-listed shares, significant board appointment rights will be an important feature in what is likely to be an investment made without a shareholders' or covenant agreement.

Other considerations

When structuring a minority investment with a margin bond, it will be important for the investor and its advisors to think actively about its investment and to provide appropriate flexibility to the company and the bond issuer. For example, if the investment was made with a view to the company engaging in a future IPO, consideration should be given as to whether the margin bond is able to receive early repayments from the proceeds.

If the minority investment represents the first step towards acquiring a controlling stake in the company, consideration should be given to structuring the margin bond so that it can facilitate a larger financing. For example, where the margin bond could be repaid early using proceeds from larger more traditional financing or, alternatively, allowing the margin bond to be tapped and potentially pushed down to the company as part of the final step to a controlling ownership interest. Using the margin bond so that it could facilitate the purchase of a controlling stake would require the covenant package to be flexible to allow the consolidation of control by the investor.

A flexible financing alternative

Although their development will take time, it is clear that margin bonds have significant potential to provide high yield financing solutions for investors to finance minority acquisitions of publicly listed or private shares or funding JV investments.

Joint Venture Financing: An Alternative High Yield Structure

Where an investor and an established company have entered into a JV that is to be externally financed, but the JV cannot itself access high yield financing on suitable terms, an alternative financing structure is for the company to directly issue the high yield bond and on-loan the proceeds to the JV. Key points to consider:

- Intercompany loan arrangements between the company and the JV:
  - Sharing of baskets/carve-outs in the bond covenant package
  - Ability for the JV to utilize the company's debt ratio capacity under the bond
  - Alignment of bond redemption and intercompany loan prepayment provisions
  - Coordination of pricing and payment terms (i.e. interest rate, maturity, payment dates, etc.)
  - Events of default mechanics and thresholds
  - Currency exchange considerations (i.e. if the JV utilizes bond proceeds in a different currency)
  - Corresponding indemnities (including extent thereof) for any breach of bond terms by the JV
- Nature and extent of guarantee/security package contributed from the existing business and/or the JV
- Ranking of the debt
- OM disclosure, company is the credit balance between the company and the JV
- Responsibility for transaction and on-going costs

Exhibit A: Margin Loan Structure

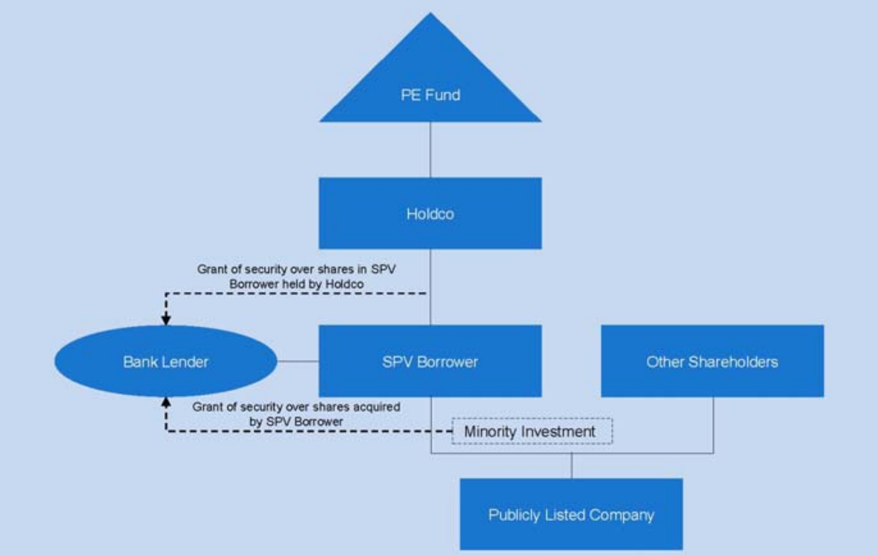
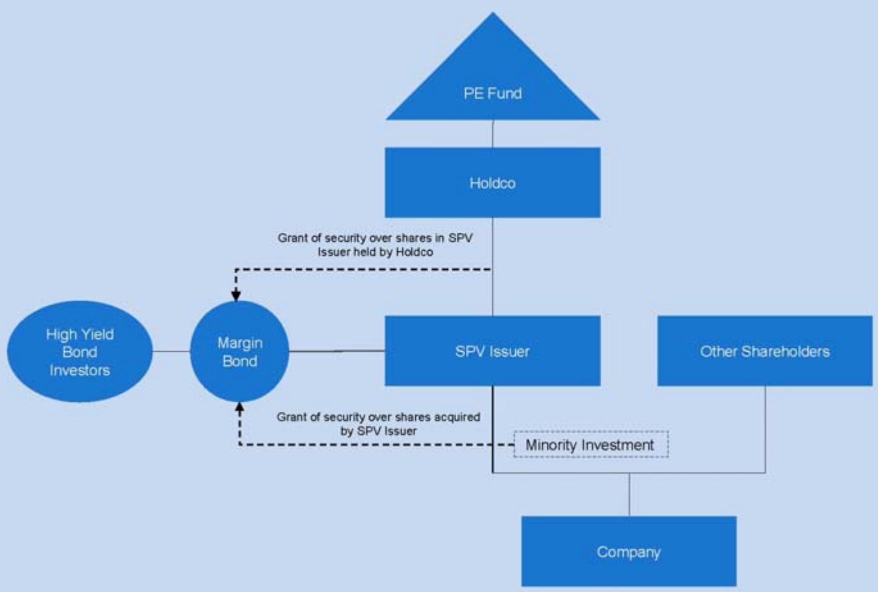


Exhibit B: Margin Bond Structure



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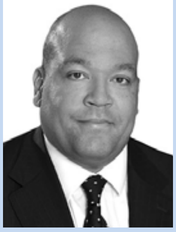

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