Leveraged Finance Outlook: The Rise of Secured Bonds in M&A Deals

February 21, 2019

Early 2019 has seen a wave of issuances of secured bonds to finance large acquisitions. The likelihood of slower rate increases by the Fed has led to an uptick in investor demand for secured bonds while making the pricing on such bonds more attractive for issuers. While issuers in recent years generally preferred term loans to bonds, last month, Dun & Bradstreet, TransDigm and CommScope increased the size of their secured bond tranches in response to investor demand. This update reviews some key considerations when issuing secured bonds in lieu of term loans or unsecured bonds.

Debevoise & Plimpton

KEY CONSIDERATIONS

- **Call Protection**. The call schedule for recent secured bond offerings is generally the same as that for unsecured bonds. While it had been common to see secured bonds in which 10 percent of the bonds could be redeemed annually for the first three years (generally the no-call period) at a three percent premium, most secured bonds are now being issued without that feature.

- **Ability to incur secured debt**. The covenants in secured bond indentures are generally the same as those in unsecured bonds with a few key differences:

  - Secured bonds frequently permit debt to be secured by junior liens so long as the debt covenant permits such debt to be incurred.

  - In some cases, junior lien debt is excluded when calculating any consolidated secured leverage ratio for ratio debt incurrence under the applicable covenants.

  - Second lien secured bonds usually do not have the benefit of an anti-layering covenant restricting the incurrence of 1.5 lien debt.

- **Security and Intercreditor Arrangements**. Many of the recent secured bond issuances have been secured pari passu with the term loans. Even in this case, the collateral agent under the credit agreement debt usually controls the exercise of remedies. There is typically a standstill period, often 180 days, during which the secured notes collateral agent is prohibited from exercising remedies.

- **Incremental Issuances**. Like incremental term loans, additional secured bonds (whether fungible or not) may be issued under the same indenture so long as the indenture is drafted as an "open" indenture. Unlike term loans, no MFN provision applies to any such additional secured bonds.

- **Asset Sales**. Secured bond indentures require that if the assets sold constitute collateral, the proceeds can be used to prepay pari passu secured debt, and if the issuer chooses to prepay other pari passu secured debt, the issuer must prepay the secured bonds on a pro rata basis. At least one recent secured bond deal requires that if assets sold are collateral, the proceeds must be invested in collateral if reinvested.

- **Assignments**. Unlike term loans, issuers of secured bonds do not have consent rights over assignments or the benefit of any disqualified lender lists. Activist debt investors are more likely to have a position in secured bonds. We have seen more contentious disputes between borrowers and activists recently spurred in part by the activists' position in credit default swaps.

- **Registration Rights**. While registration rights have become fairly rare even in unsecured bond transactions, they are even rarer in secured bonds. Registered bonds have to comply with the Trust Indenture Act, which imposes a number of provisions specific to secured bonds that are costly to comply with. Registered secured bonds, for example, are required to deliver a collateral valuation opinion in the case of release of collateral. They are also subject to Rule 3-16 under Regulation S-X, which can require financial statements of affiliates whose pledged equity is valued at 20 percent or more of the principal amount of the secured bonds. As a result, very few issuers choose to register secured bonds.

SUMMING UP

Secured bonds are popular for a reason. Cautious investors in volatile markets and facing economic uncertainty prefer the downside protection afforded by being secured. Issuers, on the other hand, are willing to agree to provide call protection for the benefit of having fixed-rate debt with flexible covenants.

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Please do not hesitate to contact us with any questions.

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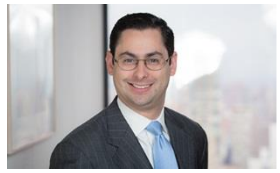

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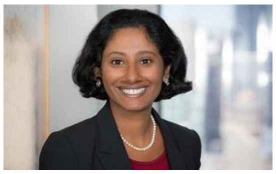

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