A guide to structural protections
for institutional investors in credit
June 2015

M&G INVESTMENTS
In recent years, pension schemes and other institutions have sought to de-risk their portfolios. For many, that will mean an increase in their allocation to credit.

These investors are therefore likely to benefit from a range of terms and conditions within the asset documentation that are designed to manage the risk of the investment and improve recoveries should the debtor become distressed.

These structural protections can be loosely divided into three categories: seniority, an advantageous position relative to other investors; security, a priority claim on specific assets such as real estate in the event of default; and covenants, obligations to maintain certain credit metrics or restrictions on incurring further indebtedness.

Individually, in combination or collectively, structural protections work to counterbalance the downside risk associated with investing in a bond or loan.

Every debt instrument employs a unique combination of these protections so it is near-impossible to make generalisations about their use or importance. What is possible, however, is to highlight common areas of value to investors in different public and private debt asset classes.

At M&G, we have a wide range of public and private credit portfolio management and analysis teams, and a dedicated team of restructuring professionals with deep experience of analysing and negotiating these structural protections and then using them to maximise returns for our investors during debt workout situations.

This guide aggregates the views of these investment professionals to explain why structural protections are important and how they can help institutions with active allocations to credit achieve their goals.

We hope you find it useful.
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Investing with a safety net: an introduction to structural protections

Pension schemes and other institutional investors face a wide range of investment options to help them overcome the challenges they face. Much focus is rightly placed upon the results that each option can achieve.

However, selecting the right investment should always include significant focus on how it will perform when something – or everything – goes wrong. This is an especially important decision in fixed income, where the amount that could be lost is almost always higher than the total possible gains.

One way to make decisions easier is to choose investments that incorporate a safety net of contractual features that can help to protect and preserve investors’ capital if they do not perform as expected.

In fixed income, these features include concepts such as seniority, security and covenants that are collectively known as structural protections. In essence, they are steps credit investors can take to manage the risk that a debtor will become distressed and to increase their recoveries if there is a default.

A useful way to think of structural protections is as a series of dials that lenders and borrowers alike can adjust and fine-tune to manage their investment risk.

Seniority provides priority repayment to one creditor over others, while security allows investors rights over certain of the borrower’s assets should the latter not meet its repayment obligations. Covenants are binding commitments that set parameters for acceptable financial performance on the part of the borrower over the entire life of the investment.

Structural protections become subject to trade-offs between investors and the companies they invest in. One is that the more creditworthy the borrower, the less contractual protection they are willing to give up to their lenders and correspondingly, investors in entities with the lowest probability of default are far less likely to require pledges of security.

Generally, the better-developed and more liquid a debt market, the lighter the structural protection on the debt security. If investors can exit whenever they feel uncomfortable they can be more relaxed about a borrower’s behaviour and so accept a lower level of seniority or fewer covenants.

Public bonds, for instance, are relatively standardised debt securities with a well-developed secondary market and near negligible historic default rates. As a result, they are often unsecured, particularly those of the most creditworthy issuers, and their covenants are usually only restrictive, to limit aggressive behaviours like incurring a large quantum of debt that is senior to the bonds or has greater security.

In contrast, leveraged loans and private placements, which are signed privately between a borrower and a group of lenders and have fewer secondary trading opportunities, are generally either the company’s most senior debt or have a claim over its assets, and bear maintenance covenants that monitor a range of ratios and behaviours.

The table opposite illustrates the typical structural protections that an investor might expect in different credit instruments and asset classes.
<table>
<thead>
<tr>
<th>Asset</th>
<th>Description</th>
<th>Percentage of market that is secured</th>
<th>Strong covenant package?</th>
<th>Liquidity</th>
<th>Credit rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Developed market government bonds</td>
<td>Senior</td>
<td>0%</td>
<td>✗</td>
<td>High</td>
<td>AAA to AA</td>
</tr>
<tr>
<td>Investment grade public bonds</td>
<td>Senior / junior</td>
<td>Less than 10%</td>
<td>✗</td>
<td>High</td>
<td>AAA to BBB-</td>
</tr>
<tr>
<td>High yield public bonds</td>
<td>Senior / junior</td>
<td>25%</td>
<td>✗</td>
<td>Medium / high</td>
<td>BB+ and below</td>
</tr>
<tr>
<td>Investment grade asset-backed securities</td>
<td>Senior / junior</td>
<td>100%</td>
<td>✗</td>
<td>High</td>
<td>AAA to BBB-</td>
</tr>
<tr>
<td>Sub-investment grade asset-backed securities</td>
<td>Junior</td>
<td>100%</td>
<td>✗</td>
<td>Medium / low</td>
<td>BB+ and below</td>
</tr>
<tr>
<td>Senior leveraged loans</td>
<td>Senior</td>
<td>100%</td>
<td>✓</td>
<td>Medium</td>
<td>BB+ and below</td>
</tr>
<tr>
<td>Covenant-lite leveraged loans</td>
<td>Senior</td>
<td>100%</td>
<td>✗</td>
<td>Medium</td>
<td>BB+ and below</td>
</tr>
<tr>
<td>Direct corporate lending</td>
<td>Senior</td>
<td>100%</td>
<td>✓</td>
<td>Low</td>
<td>BBB-B</td>
</tr>
<tr>
<td>Leasing agreements</td>
<td>Senior</td>
<td>100%</td>
<td>✓</td>
<td>Low</td>
<td>A to BB+</td>
</tr>
<tr>
<td>Private placements</td>
<td>Senior</td>
<td>20%</td>
<td>✓</td>
<td>Low</td>
<td>AA to BBB-</td>
</tr>
<tr>
<td>Social housing loans</td>
<td>Senior</td>
<td>100%</td>
<td>✓</td>
<td>Low</td>
<td>AA+ to BBB</td>
</tr>
<tr>
<td>Regulatory capital trades</td>
<td>Junior</td>
<td>100%</td>
<td>✗</td>
<td>Low</td>
<td>BB+ and below</td>
</tr>
<tr>
<td>Long lease property</td>
<td>Senior</td>
<td>100%*</td>
<td>✗</td>
<td>Medium</td>
<td>AA to BBB</td>
</tr>
<tr>
<td>Income strips</td>
<td>Senior</td>
<td>100%</td>
<td>✗</td>
<td>Medium</td>
<td>AA to BBB</td>
</tr>
<tr>
<td>Senior real estate debt</td>
<td>Senior</td>
<td>100%</td>
<td>✓</td>
<td>Low</td>
<td>AA to BBB</td>
</tr>
<tr>
<td>Junior real estate debt</td>
<td>Junior</td>
<td>100%</td>
<td>✓</td>
<td>Low</td>
<td>BB+ and below</td>
</tr>
<tr>
<td>Senior private infrastructure debt</td>
<td>Senior</td>
<td>100%</td>
<td>✓</td>
<td>Low</td>
<td>A to BBB-</td>
</tr>
<tr>
<td>Junior private infrastructure debt</td>
<td>Junior</td>
<td>100%</td>
<td>✓</td>
<td>Low</td>
<td>BB+ and below</td>
</tr>
</tbody>
</table>

*In long lease property transactions the investor also owns the property. Source: M&G, illustrative.
Seniority: knowing where you stand

The position occupied by a creditor in a borrower’s capital structure is of paramount importance. In some cases, especially investment grade corporate bonds, seniority is the only structural protection available.

Seniority enables the investor to insulate or distance themselves from losses, when a borrower in difficulty has only enough cash to honour some, but not all of its commitments. It means a preferential position relative to junior or subordinated debt, which is in turn senior to equity.

How seniority shapes a company’s capital structure

This example illustrates how debt and equity instruments might rank in a company’s capital structure. Every borrower will use a different combination of senior and junior debt. For companies with no secured debt at all the senior unsecured debt is ranked highest in priority of repayment.

This means that the interest and principal on senior securities must be repaid before payments can be made to creditors further down the capital structure. Seniority also applies to the repayment of outstanding debt in the case of a default, bankruptcy or debt restructuring.

Senior and subordinated lending first became popular in corporate bond markets during the 1980s, although the concept had existed for many years previously. The first ever public subordinated bond was issued in 1936, by the General Finance Corporation, a US sales finance company. Before even that, it was also common for commercial banks to require existing creditors to subordinate their claims as a precondition of lending.

In today’s market, the expectation that senior lenders will be repaid first becomes extremely important when organisations have large amounts of junior debt that matures earlier than senior debt. In such circumstances any borrower would be expected to ensure that senior lenders would not be materially disadvantaged by such a repayment. As a result, junior tranches of debt are typically given longer maturities than more senior levels, to ensure that the borrower always has the resources to repay the senior debt before the junior.

Source: M&G, illustrative.
However, seniority is a relative term. It does not necessarily mean a place at the very top of the tree. A great number of instruments are referred to as ‘senior’ by borrowers in their marketing documents, but detailed analysis of the instrument and issuer is required to understand the true validity of that label.

In bonds issued by banks and other financial institutions, which represent some 35%* of the global investable corporate bond universe, depositors rank above senior bondholders or lenders. In addition, such borrowers also tend to have different types of senior lenders (senior secured, secured and senior unsecured, among other possibilities) all occupying different positions.

Any investor hoping to position themselves as favourably as possible must understand not only the seniority of that position but how much other debt is already outstanding at more senior levels in the structure. To further complicate matters, borrowers can issue debt at any future stage that subordinates their current senior lenders unless their existing debt agreements forbid it. Lenders may require documentary protections to ensure that their relative seniority is not eroded during the life of the debt.

One tool at investors’ disposal to support the seniority of an investment is to seek a position of parity with other creditors, known as ranking *pari passu* (Latin for “on equal footing”). In certain areas of private debt a *pari passu* position alongside senior creditors – usually bank lenders – can give vital protection against losses for investors when securities are held to maturity, as in the case of private placements.

Investors in public bonds must also consider the seniority of their position relative to other issuing entities within the same credit. European utilities provide a classic example: a firm’s holding company, its operating company and its finance company can in theory all offer ‘seniority’ to lenders but with materially different risks, since one entity may be the holder of all the business’ assets while another has none. In the latter case, credit investors may opt to seek higher returns and quantifiable losses in ‘riskier’ positions further down an issuer’s capital structure.

In the absence of detailed and expert analysis, an assertion of seniority never comes with absolute certainty. It is only when the specifics of a particular investment are examined in detail that any assessment of the value offered by the protections can be made. For the credit investor with the skills and experience to assess exactly where they sit relative to other lenders, seniority becomes an essential yardstick for measuring relative value – and therefore generating attractive returns from the credit.

*Source: Barclays*
Seniority in action: investors in private placements are protected by a negative pledge

Private placements are unlisted, typically investment grade debt securities sold privately to investors. They are predominantly senior unsecured liabilities and borrowers usually have no secured debt in their capital structures. To protect investors’ seniority and so claim over assets and cash, agreements include a negative pledge. Template documentation created by the Loan Market Association describes this clause as follows:

- No Obligor shall (and the Company shall ensure that no other member of the Group will) create or permit to subsist any Security over any of its assets.

- No Obligor shall (and the Company shall ensure that no other member of the Group will):
  - sell, transfer or otherwise dispose of any of its assets on terms whereby they are or may be leased to or re-acquired by an Obligor [or any other member of the Group];
  - sell, transfer or otherwise dispose of any of its receivables on recourse terms;
  - enter into any arrangement under which money or the benefit of a bank or other account may be applied, set-off or made subject to a combination of accounts; or
  - enter into any other preferential arrangement having a similar effect,
  - in circumstances where the arrangement or transaction is entered into primarily as a method of raising Financial Indebtedness or of financing the acquisition of an asset.

Source: Term facility agreement for use in Pan-European Private Placements, Loan Market Association. The Loan Market Association ("LMA") consents to the publication of the above extracts from the LMA Facility Agreement for use in private placement transactions (the “Document”) in hard copy and for information purposes only. The LMA does not consent to the use, reproduction, transmission, publication or distribution of all, or any part of, the Document for any other purpose, in any other manner or by any other person and expressly reserves all other rights. The LMA assumes no responsibility for any use to which the Document, or any extract from it, may be put. The views and opinions expressed are the views of the author and do not necessarily represent those of the LMA. Furthermore, the LMA cannot accept any responsibility or liability for any error or omission. © 2015 Loan Market Association. All rights reserved.
Secured lending pledges a borrower’s assets, known as collateral, against the value of a loan to reduce the risk.

The history of lending against collateral is as old as finance itself. Around 5,000 years ago, in what is now the Middle East, it was possible for a person to pledge their liberty as collateral for a loan. Default would mean a lifetime of slavery.

Things have moved on considerably since then and securing a loan with assets is primarily designed to give lenders greater confidence in recovering the value of their investment. Secured lenders are in effect the most preferred creditors in a company’s capital structure, having first call on a particular pool of assets ahead of even the most senior unsecured lenders. As a result, they often receive the highest ‘recovery rate’ if a borrower defaults.

Security mostly brings advantages to investors but there are circumstances in which it may be less necessary or justified. In general, the riskier the borrower, the more likely lenders will want to invest on a secured basis, so lower-risk companies such as large multinationals with low leverage and diversified, stable earnings can have entirely unsecured debt structures.

For this reason, most of the debt issued in the investment grade corporate bond and private placement markets (both of which supply debt finance to larger, creditworthy companies) is unsecured, whereas investors lending to companies with higher leverage and operating in riskier sectors typically insist upon security.

In certain areas of private debt, security is a means of protection given the long-term, illiquid nature of the investments. No-one can predict 30 years into the future, so additional protections are required when making loans for that length of time. Long-dated bilateral loans to social housing providers are one example, where the debt is secured against a pool of houses.

Many different assets can be used as collateral, including real estate, equipment, vehicles and intangible items such as software or trademarks. Lenders can be offered different security packages by buying into a specific claim or lien over the collateral. For instance, a company may have borrowing secured by a first lien and then further borrowing in exchange for a second lien claim. The first-lien secured creditors recover their claims first and often receive a higher recovery than the second lien lenders.

From a borrower’s perspective, pledging security can have advantages and disadvantages. While it can allow the borrowing entity to pay a lower rate of interest than on equivalent unsecured debt, offering security can reduce the borrower’s control over those assets. For example, if a pool of equipment is pledged, the company may be unable to replace or upgrade it without obtaining lenders’ permission, which might be a costly process.
Signalling is another reason borrowers may wish to opt for unsecured debt. Equity investors often view an ability to raise unsecured debt as an indication of robust financial strength as it demonstrates that lenders are confident in the company’s ability to repay. Experienced debt investors will avoid needlessly constricting a business when structuring a secured loan.

The rate of recovery from a security package will depend on a number of factors, including the nature of the asset, the current market for it, as well as the legal and practical steps involved in seizing and selling those assets.

Security over fixed (hard) assets such as real estate will generally deliver higher recoveries than security over intangible assets. However, there may be problems with gaining control of the asset. For example, hard assets such as ships or freight trains may seem like ideal collateral, but their mobility may make them hard to track down should lenders seek to claim them. Further challenges can be added by complicated legal enforcement procedures in some jurisdictions or a debtor who chooses to oppose the enforcement procedures.

The bottom line for any debt investor is that secured lenders will always have a recognisable claim over assets and this can help to improve their recovery value in a worst-case scenario.

**Location, location, location**

As the search for yield and diversification drives investors to expand the geographical horizons of their portfolios, knowledge and experience of the legal frameworks of different jurisdictions become crucially important. The laws governing the credit and security arrangements have a direct impact on how effectively lenders can enforce their claims over security and so obtain repayment by seizing the collateral after a default.

However, the relevant legal frameworks differ widely from country to country. In western Europe, the UK is considered a very clear and creditor-friendly jurisdiction but in other markets, enforcement of creditors’ claims can be difficult and lengthy. In France, resolving a bankruptcy process takes an average of 1.9 years compared with one year in the UK, according to World Bank data for 2014. France’s parliament is now debating proposals to overhaul the country’s insolvency regime to streamline the process.

The chart overleaf assigns a rating to each western European legal jurisdiction based on how reliably creditors are likely to be able to enforce their claims in practice.
Types of collateral

Collateral often comprises property, machinery, stock or cash – but it can also take other forms. In the cable industry for example companies have lent against valuable fibre-optic infrastructure. Elsewhere, a paper company pledged several thousand hectares of forestry against its bonds. While we have seen a company include chickens on its balance sheet, it stopped short of using them as collateral, although that would have been entirely possible.

‘Intangible’ assets offered as security include software, trademarks or patents. Security can also be made on a pool of assets that move in and out of the company, such as a pool of receivables (unsettled transactions or obligations owed to the company by debtors or customers). When security is granted over a pool of assets whose composition changes continually it is commonly referred to as a ‘floating charge’ (as opposed to a ‘fixed charge’ which is typically security over a defined and unchanging set of assets).
To secure or not to secure: is security always important?

In theory, a secured form of lending should be more attractive to investors than a similar investment that is unsecured. In practice, well-resourced investors can employ structural protections in place of an explicit security package. Here are two real-life examples.

A property backstop for Genesis Housing Association investors

Long lease property transactions involve purchasing real estate and leasing it to a tenant for a term of around 30 years. The investor receives a stream of rental payments that increase either in line with inflation or by a fixed percentage over time, providing cashflows similar to that of an inflation-linked corporate bond. However, by also owning the property, the investor can gain a comparatively higher level of security than on instruments such as an unsecured corporate bond.

In 2014, M&G conducted a sale and operating leaseback deal with Genesis Housing Association, one of the UK’s largest social housing providers. M&G acquired the Stratford Halo development near London’s Olympic Park for £125 million and leased it back to Genesis for 35 years on a fully repairing and insuring basis, with rental income rising every year in line with inflation (between zero and five per cent).

The table below contains M&G’s prospective returns on the ownership of the development under various property growth scenarios, as well as the yield to maturity on Genesis’s outstanding unsecured corporate bond with a similar maturity. The returns assume a constant inflation rate of 3% per annum on the sale and leaseback, a lack of default in either case and that both investments are held to maturity.

<table>
<thead>
<tr>
<th>Forecast IRR (per annum)</th>
<th>Property value remains unchanged at lease expiry</th>
<th>Property value increases in line with inflation</th>
<th>Property value falls to £0 at lease expiry</th>
</tr>
</thead>
<tbody>
<tr>
<td>**Genesis property sale and leaseback (35 years)**1</td>
<td>6.0%</td>
<td>8.4%</td>
<td>5.0%</td>
</tr>
<tr>
<td><strong>Genesis Finance II 6.604% 2039 corporate bond</strong></td>
<td>4.8%</td>
<td>4.8%</td>
<td>4.8%</td>
</tr>
</tbody>
</table>

Source: M&G. Data from the inception of the investment, February 2013.
Sample for illustrative purposes only. Forecasts and projections represent assumptions and expectations in light of currently available information. The actual performance may differ from those projected. 1Assumes constant inflation at 3% p.a
The index-linked cashflows on the long lease investment ensure that even in the scenario where the property is worthless at the end of the lease term, the investment will have returned more through its lease payments than could be achieved from owning the corporate bond.

Investing in property leases through deals of this nature is open to fewer investors and as these investments are not highly liquid they require lenders to take a long-term view. For those prepared to give up liquidity and commit for a considerable time horizon, the high quality cashflows and value accretion offer significant benefits.

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**An unsecured loan gives Workspace more room**

In 2013, M&G provided a £45 million, ten-year direct loan to Workspace Group, a UK-based provider of premises to approximately 4,000 small and medium-sized companies.

Workspace had previously borrowed on a secured basis with its properties as collateral, but this arrangement required the company to obtain consent from lenders when it wanted to refurbish or sell any of the buildings that were pledged as security – decisions aimed at supporting and enhancing its business. The process was time-consuming, resource-intensive and restrictive.

Instead, Workspace negotiated with M&G and other lenders to refinance all its debt on an exclusively unsecured basis, putting all lenders on an equal footing. The new debt package totalled £353 million and diversified the company’s sources of funding to include short-term bank facilities, longer-term institutional loans and a private placement. It has both decreased Workspace’s reliance on bank debt and given it greater flexibility to manage its properties.

It is unusual for a company with property assets to issue unsecured debt and investors were keen to include documentary protections to safeguard the investment. These included senior status and maintenance covenants. Creditors were also comfortable with the credit quality of the borrower and the health of its business, so anticipated a low risk of default.
Security in action

Issuers can offer creditors a comprehensive security package, particularly if the entity has experienced financial difficulties in the past.

This illustrative example lists some of the assets that investors might be granted a claim over:

- All of the issuer’s share capital;
- All the issuer’s bank accounts as well as bank accounts held by its subsidiaries;
- The mortgages associated with the issuer’s property and properties of its subsidiaries;
- Some or all of the issuer’s intellectual property rights;
- Outstanding receivables of the issuer, its subsidiaries and intragroup receivables;
- The equipment and machinery owned by the issuer’s main operating companies;
- All inventory in circulation in the issuer’s main operating companies. This can include raw materials, manufactured items, technical inputs and parts but is not limited to those;
- The issuer or its operating subsidiaries’ movable assets, and any rights of those entities;
- Contracts or agreements with third parties and other business arrangements.

Alternatively, security can be extremely sparing. Bonds may simply offer investors a claim over financial assets such as:

- A first-ranking claim over the shares of the group’s main operating entity; and / or
- A first-ranking claim over preferred equity certificates (an equity-like instrument) issued by the group’s main operating entity.

Source: M&G, Illustrative
Covenants count

Fixed income investors, particularly those in less liquid areas of credit, have long appreciated the essential role of covenants in protecting the value of an investment. These clauses monitor borrowers’ behaviour and flash up early warning signals of deterioration in creditworthiness. Importantly, they can enable lenders to intervene in the borrower’s business to preserve its value and so improve their repayment.

As with all structural protections, covenant packages differ widely between debt asset classes. For private investments such as direct corporate loans or private placements they are critical and investors often negotiate them as they originate a deal. Leveraged loan investors typically prefer issues with a strong covenant package and, even in liquid assets such as corporate bonds, covenants are considered necessary to curb extreme behaviour by the borrower.

While covenants do not alone create a rationale for investing, they are a factor in investment decision-making. Although an excellent covenant package is not sufficient to turn a bad investment into a good one, poor covenants can change an ostensibly good investment into an unattractive one.

“Covenants give enormous comfort to investors who have few opportunities to sell out”

Financial covenants fall into two main camps: maintenance and restrictive, commonly called “incurrence” covenants.

Maintenance covenants are tests of financial performance the borrower must pass, normally at the end of every three or six months. The most common are of a borrower’s leverage (the ratio of outstanding debt to earnings) and coverage (earnings divided by interest expense or fixed charges). In certain circumstances, the ratios can be set to step up or down over time in expectation that the borrower’s business will grow, it will repay debt, or both. Where a lender has few opportunities to sell out of an investment, the checks and controls provided by maintenance covenants can give enormous comfort.

If a business grows much faster than expected then maintenance covenants cease to be restrictive, but if performance falls short, it may not be able to stay within the specified bounds. Borrowers can ask lenders to agree to reset the covenants at a less constrictive level, but as the pressure could indicate that a company is becoming too weak to service the debt it owes, lenders have the right to refuse.

Maintenance covenants are of greatest importance to investors when a test is failed, which is known as a breach. Should this happen, investors have a number of rights including the ability to demand immediate full repayment, known as accelerating the debt. This extreme option is rarely chosen, though, as rather than force a repayment at a point of weakness creditors usually seek to support the business and enhance their ability to manage its risk.
Creditors typically agree a waiver of the breach or relaxation of covenant levels in exchange for increased oversight by the lenders and potentially increasing the loan’s interest rate to reflect the higher credit risk of the borrower. Borrowers may also have to make concessions to lenders such as paying fees to gain consent for a waiver or posting collateral against its debt.

**Incurrence covenants** are so named because the chief limit they impose is on incurring more debt. It is critical that lenders keep a limit on how indebted a borrower can become, especially if the new debt could rank senior to their claim. Typically the borrower must prove that after raising new debt its financial ratios would remain below a prescribed level.

Incurrence tests can be applied to many other situations in which cash or value could leak from a business, but since they are only tested for a specific event, these tests are far less onerous than maintenance covenants on a day-to-day basis.

Covenants are valuable for lenders but can be unwelcome constraints on a borrower. Each covenant package is unique and negotiated at the outset of the investment based on the borrower’s credit strength, forecast performance and current market conditions. Obviously the actual performance of the business can be very different from what is initially anticipated, so setting covenants requires care and expertise to provide sufficient protection for lenders while not putting the borrower under undue pressure.

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**Maintenance covenants in action: a typical credit facility**

Maintenance covenants vary enormously for different issuers and securities. Companies with very low leverage at the time of investment may have one fixed ratio to comply with, while leveraged borrowers may be set ratios that step down over time.

A high yield-rated company may sign a revolving credit facility that requires the issuer to comply with a maximum net leverage ratio tested quarterly. Such calculations are usually described as ‘the ratio of consolidated total net debt at each quarter end to consolidated adjusted EBITDA for the 12 months ending on that quarter end’. These levels are typically set to step down each year to ensure the company deleverages over time, for instance as follows:

<table>
<thead>
<tr>
<th>Financial year ending 31 December</th>
<th>2011</th>
<th>6.50:1</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>6.25:1</td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td>6.00:1</td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td>5.75:1</td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td>5.50:1</td>
<td></td>
</tr>
<tr>
<td>2016</td>
<td>5.25:1</td>
<td></td>
</tr>
</tbody>
</table>

Source: M&G, Illustrative
Some types of debt also include repayment covenants, which govern compensation in the event that the borrower elects to repay the debt early. These are not always to the benefit of lenders.

A common covenant in public bond indentures is a call schedule, which sets a future date and price at which the issuer may repurchase the bond prior to maturity. The first call on a fixed rate bond is usually halfway through its lifetime at a price of 100 plus half of the bond’s coupon, giving issuers the option to refinance a bond at a lower rate if market conditions are favourable – and limiting the returns that the investor would generate over the full life of the bond.

However, this is not always the case. Some asset classes such as private placements and direct corporate lending routinely contain compensations for lenders should the borrower wish to repay early. These can range from prepayment fees of 1-4% in direct lending to a full ‘make-whole’ in private placements, where the lender is compensated in full for coupon payments that are missed due to the early repayment.

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**Schools for the Scottish Borders: structural protections vital for infrastructure investors**

Infrastructure investments typically incorporate solid structural protection covering seniority, security and covenants. The sector is stable with robust cashflow characteristics, reflecting the essentiality of assets, high barriers to entry and exit or regulation. In some cases such as a Private Finance Initiative (PFI) project, repayment of debt relies solely upon a contract with the project’s public sector counterparty. The long-term nature of these contracts, or the infrastructure assets themselves, can facilitate financing with a maturity of 30 years or more, so lenders usually require comprehensive security and covenant packages.

The documentary protections and strong cashflows support typically high recovery rates on project finance loans in the event of a default. Data collated by Moody’s on more than 5,000 project finance deals globally between 1983 and 2013 indicated that average recoveries were 80%, but the most likely recovery was 100% – lenders were repaid in full in 138 of 212 defaults covered by the study.

M&G has been active in private infrastructure debt since the 1990s and in January 2007 provided approximately £70 million of long-dated index-linked debt to build and maintain three secondary schools for the Scottish Borders Council. M&G originated and structured the investment directly with the borrower (the project company) and the public sector counterparty, incorporating senior status, security over the project company’s assets and maintenance covenants to monitor the ongoing performance of the business. The schools’ construction was completed in 2009 and they are now operational.
Ineos: a favourable reaction by the chemicals giant

Switzerland-based petrochemicals group Ineos signed a term loan in November 2006 with a 275 basis point margin over Libor. However, by late 2008 the impact of the financial crisis had severely damaged its profitability and by January 2009 the major rating agencies had downgraded the company to CCC, in anticipation of a default. Ineos breached its maintenance covenants and the loan traded at 40% of par.

After several months of negotiation between Ineos and its lenders, the lending syndicate agreed in July 2009 to amend the covenant test levels upwards in exchange for a near-doubling of the margin on the term loan to 475 basis points (bps) over Libor and the addition of a floor to the margin of 125bps.

The margin uplift reflected Ineos’ elevated credit risk, but at the same time, the covenant amendment showed that lenders viewed the company’s stressed situation as likely caused by temporary external factors rather than a permanent collapse of the business. By December 2009, the term loan was trading at above 80 and during 2010, Ineos’ credit rating was upgraded to B-, before further upgrades to BB- in 2012.

The presence of maintenance covenants ensured that Ineos’ lenders – and so by implication their clients – received additional compensation for the spike in risk during this period. The company’s bond investors, in contrast, were not able to benefit from this protection and enhanced economics.

Source: M&G, MarkIT Partners. Line is Term Loan B to Sept 2009 (MarkIT Partners) and then aggregate value of Opco cash pay, Holdco cash pay, Holdco PIK and equity (M&G)
In the worst case scenario...

Structural protections become extremely valuable to debt investors when borrowers get into difficulty. This is because when a borrower’s performance takes a turn for the worse, the amount of debt it has to service and repay can become a strain.

At this point, investors in liquid securities may consider selling. Such a decision is informed by current market pricing, prevailing market liquidity, a bond investor’s relationship with and confidence in a borrower’s management team and the broader performance of the sector in which the borrower sits – among a host of other factors.

Investors with the benefit of covenants are empowered to engage with a company as soon as headroom tightens or a test level is breached.

Of course, a well-resourced fixed income investor may stick with a firm and may even lend more, to benefit from capital growth. In the case of comparatively illiquid investments, sticking is usually the only option and lenders will negotiate with a company to achieve the best possible outcome.

Investors with the benefit of strong covenant protection are empowered to engage with a company as soon as headroom tightens or a test level is breached. If difficulties are temporary, for example a recession or a spike in input costs, lenders may agree to adjust covenant test levels upwards to give the company more flexibility, in exchange for fees and an increase in the interest rate paid on its loan.

If the challenges pose an existential threat, such as competitive disruption or a structural decline in demand, lenders are likely to work closely with management, perhaps to implement a new strategy or require the company to strengthen its balance sheet with an equity injection or asset disposal.

Should such steps fail to turn a business around, the deterioration may become too extreme and the borrower’s outstanding debt too high to bear. These situations are typically described as ‘stressed’ or ‘distressed’, depending on their severity. If the business is unable to pay the interest or repay the debt, it may be forced into a default. However, this is rarely the end of the story.

When it becomes clear that a company will be unable to fully repay the debt, lenders begin to assess the likely recovery value that each level of seniority and security may receive. Since the underlying company is frequently healthy once the debt burden is removed, this process does not always aim to liquidate the company but to drastically cut down the amount it owes: a debt restructuring.

A debt default is rarely the end of the story.

Lenders typically also have to engage with one another. Although lenders at different levels of seniority and security have different, competing interests, all parties must agree a division of the assets. Senior lenders to a company whose debt is higher than the total value of its assets may expect to receive up to 100% repayment at the expense of more junior lenders, who would be entirely wiped out. However, it is more common for lenders to seek a consensual solution in which every stakeholder recovers something.
Recovery can sometimes mean a cash repayment but, more often than not, the borrower does not have sufficient cash to do this. Here, lenders agree to convert their proportion of the company’s debt, which essentially represents their claim over the assets, into equity to give them ownership of the company.

Strong covenants are vital tools for hammering out such agreements. The ability to be part of conversations on the outcome of distressed companies is key to maximising recoveries.

**Dometic: major recovery from mini fridges**

In early 2009, the credit crisis prompted an unprecedented trading downturn for Dometic, a Sweden-based specialist in mini-refrigeration. M&G and other senior lenders formed a steering committee to negotiate with the company and its owners and reached agreement on a restructuring proposal. A valuation of Dometic indicated that the company’s value did not cover the outstanding amount of its senior loans, leaving senior lenders facing a partial loss and the junior lenders’ claims worthless. The eventual restructuring wrote down the junior debt in full and senior loans by 22%, but senior lenders also received around 70% of Dometic’s equity.

Guided by M&G’s work-out team, the senior lenders converted a quarter of the pre-restructuring debt into a ‘payment-in-kind’ note (which does not require interest to be paid in cash) and provided a short-term super-senior loan. Given Dometic’s dominant market position, lenders were well positioned to benefit from a cyclical upturn in the business.

After a period of stronger performance anticipated by both M&G’s own analysis and the business review conducted as part of the restructuring, Dometic was sold to Nordic private equity firm EQT in 2011. This resulted in a full repayment of the original senior lenders and, thanks to the ownership of the equity, an ultimate recovery value significantly in excess of the original par value of the debt.

Risk on the rise? The weakening of structural protection

The strength and nature of structural protections ebb and flow as the credit cycle turns and as the balance of demand and supply shifts in favour of either borrowers or investors. Companies typically seek to increase their flexibility by lightening the protection they grant investors, particularly when demand for debt is abundant; the opposite occurs when investors can be more choosy.

"Today a typical leveraged loan has two or three maintenance covenants, down from four a decade ago"

Changing standards of structural protection can make investors uneasy about being exposed to higher risk, but can create opportunities for active fund managers able to secure alternative assurances or select investments carefully. It is vital that all participants in credit markets are vigilant in their oversight of deal documentation to ensure they are fully aware of the exact terms being offered.

In Europe, several credit asset classes are experiencing a weakening of structural protection in some form – although not at all in many newer areas of private debt, where bilateral negotiations of structural protections start early in the investment process.

Change is partly prompted by the rapid growth of bond markets and migration of new trends from the larger, better developed US market. Strong demand for higher yielding debt and greater liquidity in public bond and loan markets have also made investors increasingly prepared to accept fewer structural protections, despite the implied higher risk.

In public credit, the trend towards lighter restrictions is apparent in the area of call protection, which is being shortened or even removed from some indentures, allowing companies to repay bonds sooner after they are issued and avoid paying costly make-whole premiums to investors.

Bondholders are also increasingly asked to accept a portable capital clause, which takes effect if the business is sold and allows all its outstanding debt to be transferred to the new owner. In contrast, standard agreements provide for creditors to request repayment at a price of 101 when ownership changes to protect their investment against unwelcome or aggressive takeovers.

Private debt asset classes in Europe such as leveraged loans continue to benefit from relatively high levels of structural protection but are not completely immune to the trend. The number of maintenance covenants on a typical European leveraged loan declined to two or three in 2014 from an average of four a decade ago, according to LCD Capital IQ.

Maintenance covenants on a typical leveraged loan are shrinking

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Source: LCD Capital IQ, M&G, 31 December 2014
A breed of loan known as covenant-lite has emerged that bears only incurrence tests and no maintenance covenants at all. Covenant-lite loans are now widely accepted in the US, representing 71% of all US leveraged lending in 2014 according to Standard & Poor’s, as greater transparency and liquidity in that market mean investors have less need to rely on covenant protection. However, ‘cov-lite’ leveraged lending is taking only its first tentative steps in Europe. Local markets remain far more private and opaque and demand and supply have been evenly balanced to date, so these loans represent only a small proportion of issuance and are usually comprised of only a few large deals.

Nonetheless, active credit investors in Europe are careful to ensure they have alternative mechanisms to structural protection through which they can take ‘action’ on an investment should it underperform. The most important of these is selecting investments that offer sufficient secondary market liquidity to enable investors to trade out of a position should the company fail to perform as anticipated. As a consequence, borrowers with greatest liquidity in their loans are more likely to be able to access covenant-lite facilities. The most creditworthy issuers, for which lenders can more willingly accept lighter oversight, are also more likely to issue them.

Change to structural protections can sometimes offer credit investors a valuable insight into the intentions of an issuer or its owner. A portable capital clause can suggest that an issuer is likely up for sale, for instance, while a clause to allow a company to buy back some bonds after an initial public offering could imply it is considering a stock listing.

Whatever the exact terms, an active credit investor armed with detailed knowledge and experience of the benefits on offer, and what must be given up to obtain them, will always be well placed to assess relative value and find opportunities that offer compelling downside protection for the return.
Bond: a tradeable debt instrument through which an entity borrows money for a fixed period and pays the lender interest at regular intervals. The entire sum (known as the principal) is repaid at the end of the contract (maturity). A bond can either be listed on an exchange and so public or unlisted and so private; a private placement is an example of an unlisted private bond.

Bond indenture: a legally binding contract that forms the main part of the agreement between public bond issuer (borrower) and investor (lender).

Capital structure: the blend of debt and equity with which a borrower arranges its finances.

Collateral: the assets pledged by a borrower to a lender as security against borrowing.

Covenant: a limit on a borrower’s ability to behave in a way that is not in the interests of lenders (see also Maintenance covenant, Incurrence covenant).

Covenant-lite (also known as ‘cov-lite’): a leveraged loan structured so that it has few or no covenant restrictions.

Credit risk: the possibility that a borrower may not fulfil its agreed repayment obligations. Also known as default risk.

Default: the failure by a borrower to meet repayment obligations. This can apply to regular interest or the return of principal.

Direct lending: bank-like loan financing extended directly to companies by non-bank investors on a private basis. Each loan is bespoke but typically a five to ten-year term with floating rate interest payments.

Distress: financial pressure on a borrower making it difficult for the entity to service its debt or fund its operations, so it faces insolvency and, possibly, a restructuring.

Incurrence covenant: a test of a borrower’s financial performance or stability that is triggered once the borrower wishes to undertake certain activities, principally incur more debt.

Junior debt: securities that occupy a relatively low position in a borrower’s capital structure, giving the owner a weaker claim on assets and a higher chance of loss absorption in a restructuring or default situation. Also known as subordinated debt.

Lien: a lender’s enforceable claim over an asset that is used as collateral. Borrowings can be secured on more than one lien, so lenders on the first lien have first claim over the assets and are repaid first, then the second lien, and so on.

Lease: a contract in which the owner of a hard asset such as land, property or machinery agrees to rent the asset to another entity (lessee) for a fixed period in exchange for regular rent payments.
**Leveraged loan**: a senior and secured debt security issued by a borrower, chiefly to finance internal growth, acquisitions, mergers and leveraged buy-outs by private equity sponsors.

**Loan**: a private transaction in which a lender provides a borrower with an agreed sum of money for a fixed period, with the expectation of full repayment by the end of the period and payment of regular interest.

**Liquidity**: ability to convert assets into cash immediately or in a very short time. A market is liquid or has deep liquidity if there are many buyers and sellers able to facilitate a trade very quickly.

**Maintenance covenant**: a test of a borrower’s financial performance or stability that must be passed periodically.

**Non-bank lending**: all private debt financing not provided by banks; can include direct lending, private placements and leveraged loans.

**Private debt**: non-listed debt instruments, including all non-bank lending. Instruments tend to be non-standard and, in many cases, change hands rarely in individually negotiated transactions.

**Private placement**: unlisted debt securities that can be structured as bonds, notes or loans. These medium to long-term senior debt obligations are issued privately by companies, typically on a fixed-rate basis.

**Recovery rate**: the proportion of a debt that is repaid or recovered after an issuer defaults or debt is restructured.

**Restructuring**: a major change to a company’s debt structure in which lenders can receive less than 100% of their money back.

**Secondary market**: marketplace for trading any financial security that was previously issued by an entity and which is now held by investors.

**Secured debt**: the pledge of hard assets or other collateral by a borrower to a lender as part of the lending agreement.

**Senior debt**: securities that occupy a relatively high position in a borrower’s capital structure, giving the owner a stronger claim on assets and insulation from loss absorption in a restructuring or default situation.

**Structural protections**: terms and conditions of credit agreements that offer safeguards to lenders, including the position in the borrower’s capital structure, covenants or the provision of assets as collateral (also known as security).

**Unsecured debt**: lending that comes with no claim on hard assets or other collateral.

**Work-out**: the process whereby lenders and borrowers seek agreement in a restructuring scenario.
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