Chapter 13

Structural Issues: Ranking of Debt

What's in this chapter:

- ranking
- structural subordination
- subsidiary guarantees

DEBT SECURITIES HAVE different priority rankings within the capital structure of a company. During a bankruptcy, the debt with the most seniority in ranking has the first claim on the assets and the value of the company. Assuming there is enough value for the senior-most debt, the second-most-senior piece of debt would have the first claim on the remaining value, and so on, until any residual value would be available for the equity owners. This is sometimes called a waterfall. The priority ranking impacts how bonds and loans trade even if the risk of bankruptcy is remote because things can always go wrong. Even if a company appears far from being worried about a bankruptcy, the ranking and structure of loans and notes will impact how they trade relative to each other and to other investments. In general, the less risky a company appears, the less difference in yield the market will demand for differences in seniority. Ranking is critical when investors are looking to protect their downside. Many nuances in the legal language describing seniority and security can make what looks like a simple waterfall priority ranking vary greatly from its initial appearance.

Ranking

The ranking of securities affects the coupon that is decided at the time a bond or loan is issued and will affect how the bonds and loans trade throughout their life. When a company is strong and doing well, the difference in yield between more senior bonds and more junior bonds may be small. The riskier a credit is, the more of a spread between more-junior and more-senior securities is likely to be seen.

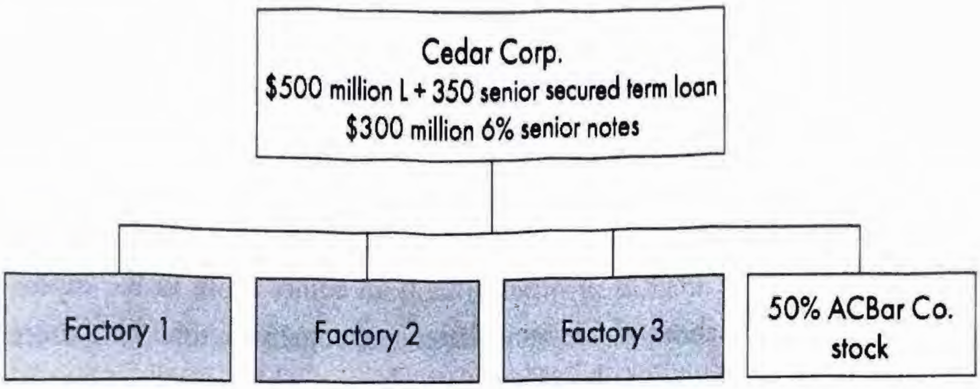
In some structures, there are many layers of debt; and in others it is quite simple, with maybe only one level of debt. Sometimes the corporate structure is quite simple, and all the debt resides at the same entity. In other cases, debt sits in different parts of the company: some debt has priority claims at one entity and other debt may have priority claims at another.

Bank loans usually are the most senior, but sometimes bonds or other securities have equal claims or even, occasionally, more senior claims. In legal parlance, having an equal claim on the same asset is often referred to as being pari passu (on equal footing). This phrase is used frequently in debt markets to indicate that two debt instruments rank equally.

A typical bank loan has a senior ranking and also security. The security is a priority claim on specific assets that lenders can, theoretically, take possession of if the contractual payments owed to them are not made. This is similar to a mortgage on a house: if the payments are not made, the mortgage holder has a first claim on the house. The key is how the security is defined. The agreements can be specific.

As an example, we'll look at a hypothetical company called Cedar Corp. As shown in Exhibit 13.1, it has three factories and also owns 50% of the stock of another company called ACBar Co. Cedar has a secured bank loan and senior-unsecured bonds outstanding. The security agreement (which is part of the loan document) may list all three factories as assets that are secured (as indicated by the shaded boxes in the figure). Other ways to describe this type of secured claim for the loan are that 1) it has liens on these assets, or 2) it is collateralized by these assets. In this case, the 50% stake in ACBar Co. is not part of the collateral. What does this mean for the loan holders? If the company were to go bankrupt, the loan would have first claim on all the factories' value. If the value of the factories were not enough to pay off all the loan, it would look toward the company's other assets—namely, the ACBar Co. stock. Because the stock is not part of the security agreement, the loan only has a senior-unsecured claim on these assets. It must share any value from this stock equally with other senior claims, such as the senior-unsecured notes. In theory the three factories are worth $400 million, and the stock is worth $100 million. In a bankruptcy, the $500 million bank loan would get back $400 million of value from the shares with the notes on a pro rata basis. If the notes were senior subordinated notes instead of senior, their claim on the stock would rank behind the claim of the loans.

Exhibit 13.1: Cedar Corp. Debt Structure
(Shaded Areas Represent Secured Assets)



Even if the security agreement says something such as "substantially all the assets of the company," it's important to read the definitions and the actual collateral agreement. Foreign subsidiaries are often not included in the security packages as they are often more difficult to securitize. Here is a simple ranking of priorities:

1. senior secured debt
2. senior-unsecured debt
3. senior subordinated debt
4. subordinated debt
5. preferred stock
6. common stock

Senior secured debt is the most common bank debt. Senior secured debt and senior (but unsecured) notes rank as a senior class of debt. Secured debt simply has the secured priority claim on selected assets that are in the security agreement. Bank loans sometimes are senior unsecured, but more often, senior-unsecured debt is in the form of bonds. There can also be several rankings of secured debt. For example, there can be a first priority secured issue, usually called a first lien and second lien.

Ranking below senior debt is subordinated debt. There can be senior subordinated debt and subordinated debt, which would rank lower. Senior subordinated has historically been the most common type of high yield bond issued. Bank debt is almost never subordinated. It is important to recognize that subordinated bonds have an actual subordination agreement. These become important documents in a bankruptcy. Be sure to read the subordination agreements, which can include an important intercreditor agreement. Sometimes they have unusual features or exceptions as to when these notes actually are subordinate to other debt.

Sometimes preferred stock is involved. This is an equity claim in the capital structure but comes ahead of common shares, and some structures have more debt-like features—for example, a preference date on which the shares are to be repaid, and a set dividend rate resembling debt more than equity. Typically, if the company does not meet the maturity or misses several dividends, there is no meaningful recourse relative to the survivability of the company. In other words, the preferred cannot, on their own, trigger an event of default. Perpetual preferred shares do not have a set debt to be repaid but typically have a set dividend rate and look more like straight equity. Preferred shares usually have a set face amount and a dividend. Sometimes the dividends are PIK. If the preferred is not paid, the dividends usually accrue, meaning the preferred holders' claim doesn't go away; it just builds. Sometimes the terms of the preferred share agreement offer other recourses for the company if dividends or repayment dates are missed. A typical recourse is that the preferred shareholders get to vote for a certain number of board seats. If a remedy is not spelled out in the preferred stock document, which is not the norm, the shareholders could, theoretically, sue in court for lack of payment, which could eventually lead to a default. The preferred shares do have preference over the common equity, and if the payments are not honored in the preferred agreement it is difficult for the common equity to monetize its value or receive any distributions.

The common equity/stockholders come last in the priority ranking.

Now that the priority ranking has been explained, it is important to understand there are some common ways in which bonds, and sometimes loans, are structured that can circumvent these traditional rankings. There are structural ways to make debt rank more junior or more senior regardless of its priority ranking. The two most common ways are through corporate structures and subsidiary guarantees.

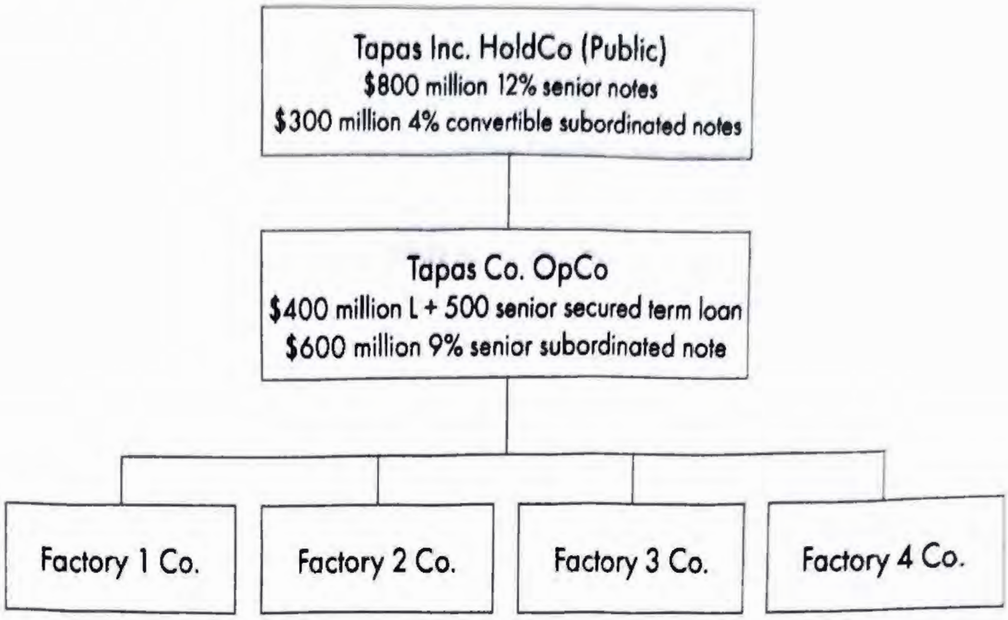
Structural Subordination

Corporate structures usually do not consist of just one legal entity; normally, there is a parent company and several subsidiaries operating underneath the corporate umbrella. In most of these cases, the structure is such that the parent company owns the stock of each subsidiary. Debt can be issued at any number of these entities, meaning the parent holding company or any of the subsidiaries.

When some debt is issued at an entity closer to the operating assets while other debt is issued at an entity that is further away, such as a holding company, the debt at the holding company is often referred to as being structurally subordinated. In a simple structure, if there were debt at the holding company and debt at subsidiary A, then the debt at the holding company would be structurally subordinated in its claims on the assets of subsidiary A to the debt at that subsidiary, regardless of the rankings of the two pieces of debt.

A common type of structure is shown in Exhibit 13.2, in which a holding company does not have any assets itself except for owning the stock of the subsidiary. This entity is called Tapas Inc. HoldCo (Tapas HoldCo) in our example. Its only asset is 100% of the stock (or a 100% ownership stake) in its main operating entity, Tapas Co. OpCo (Tapas OpCo), which performs its operations through four subsidiaries. These subsidiaries are where all the cash flow is produced and where the value of the company is generated.

Exhibit 13.2: Structural Subordination



Tapas HoldCo is where the company's public stock is issued. Shareholders who buy stock in the company own a stake in this entity. Exhibit 13.2 shows that two bonds are issued at this level. One is a 12% senior note, and the other is a 4% subordinated convertible note. Tapas HoldCo's only asset is its 100% ownership of Tapas OpCo. At Tapas OpCo, there is an L + 350 (LIBOR + 350 bps) senior secured bank term loan, secured by the stock of the factory subsidiaries. There is also a 9% senior subordinated note. Unless otherwise designated, a debt instrument only has a claim on the assets of the entity that issued the debt. Tapas OpCo's assets are the stock of the three companies that own the factories. In this case, there is no debt at those factory operating subsidiaries.

If this entire entity were to become bankrupt, the senior secured bank loan would have first priority on the cash-flow-producing assets. The Tapas OpCo senior subordinated notes would have the next priority claim on the factory asset value, even though these notes are subordinated and the HoldCo notes are senior. The Tapas OpCo notes were issued by the company that owns the assets. Anything that is left over after paying off the debts at Tapas OpCo would go to the equity shareholders of Tapas OpCo. This is the value available to repay the debt holders of Tapas HoldCo, including the 12% senior notes.

Said another way, Tapas HoldCo's only asset is the stock of Tapas OpCo. Although the 12% senior note is a senior note because of the corporate structure and whichever entity issued the note, it is structurally subordinated to the claims of all the debt at Tapas OpCo. It is critical to be sure of which issuers are the actual entity with the debt obligation and where assets are held.

A logical question is why a company would want to form a more complex structure. It would seem easier to issue junior debt at the OpCo. Corporate structures can be driven by many factors, including managing corporate liabilities to cost-of-capital considerations and operating in multiple jurisdictions.

One possibility is that the more complex structure of this company could be driven by the bank structure. Banks are often focused on how much debt is actually at their issuing entity because of their senior ranking and security and will allow more debt to be issued that is junior to the loan and at another entity. Theoretically, if the company defaults on the holding company debt, those debt holders may get control of Tapas OpCo's stock, but they cannot necessarily force Tapas OpCo into a bankruptcy. (It is not uncommon for a holding company to default and subsidiaries to not default, but there are also many cases where bank loans and bonds also often have cross-default provisions.) The lenders at Tapas OpCo are also likely to be in a stronger position in bankruptcy defending their position against a holding company claim rather than a junior claim at the same corporate entity. Another factor could be funding costs. When issuing the various debt instruments, a company will try to decide which structure will result in the lowest interest expense, or cost of capital. Is it cheaper on a blended basis to get a higher rate on the bank debt and issue all the debt at the operating company? Or is it better to get a lower rate on the bank debt and the senior subordinated notes and pay a somewhat higher rate on the most junior piece of debt issued at a holding company?

A holding company and operating company structure may be in place because not all the debt was issued at the same time. If the Tapas OpCo debt was issued first, the company, several years later, may have wanted to pursue an expansion or an acquisition. The covenants in the existing bonds may not have permitted more debt to be issued at Tapas OpCo. Therefore, the company pursued new financing at the holding company level.

Exhibit 13.2 shows that Tapas HoldCo also has issued convertible debt. Convertible notes are typically held by more equity and equity-like investors than fixed-income investors. They are definitely debt and need to be included in any analysis and also should be considered as an investment option. Commonly, they are ranked on a junior basis and issued at the holding company level because they will be at the same level at which the actual public shares are issued.

It is important to understand the notes' convertibility. These bonds have an option to be exchanged for company stock. This is an option of the debt holder. Therefore, the debt may not require cash for the company to extinguish them. Investors usually see a convertible bond as a hybrid in which part of the value is in the bond component of the structure and part is for the option to convert to stock. For these reasons, the coupon on convertible bonds is usually lower than comparable nonconvertible bonds.

As an example, if an investor had a $1,000 face amount bond of Tapas HoldCo convertible bond, and it was convertible into 100 shares, the investor could convert that bond and create shares at $10 per share ($1000/100 shares = $10 share price). If the stock were trading at $9, that would not create value. But if the stock were at $12 per share, it would be worth converting; the debt would be retired by issuing more shares. In this case, where the stock is trading over the conversion price, the convertible bond is said to be in the money. An investor who bought the bond at $900 would effectively be creating the conversion feature at $9 ($900/100 shares = $9). If the stock trades at a price at which the bond is in the money, analysts must decide how aggressively they want to treat this in their analysis. Can they be aggressive and assume that the bond gets converted and treat it as equity?

Additionally, converts sometimes have a feature whereby if the stock is trading at a big enough premium over the price at which the bond can be converted into equity, the company can force the bondholder to convert. Do not ignore convertible notes in structural analysis. It is important to recognise that they often have their own unique features that need to be understood to fully appreciate how they interact with the rest of the capital structure or may influence management actions. For example, some convertible bonds have puts allowing them to be sold back to the company; some may have mandatory conversions. Management is typically most focused on taking care of the equity holders, and this may prioritize how they handle convertible bonds in the capital structure.

Covenants, Structure and Servicing HoldCo Debt

When there is a holding company and an operating company structure, the covenants on the bonds and the loans at the operating company do not typically dictate what the holding company can do. However, the operating company covenants usually do control how cash or assets could move up to the holding company to service that debt. It is important to understand and analyze how the cash can get from the operating entities through an intermediate-level operating company and up to service the holding company obligations.

Subsidiary Guarantees

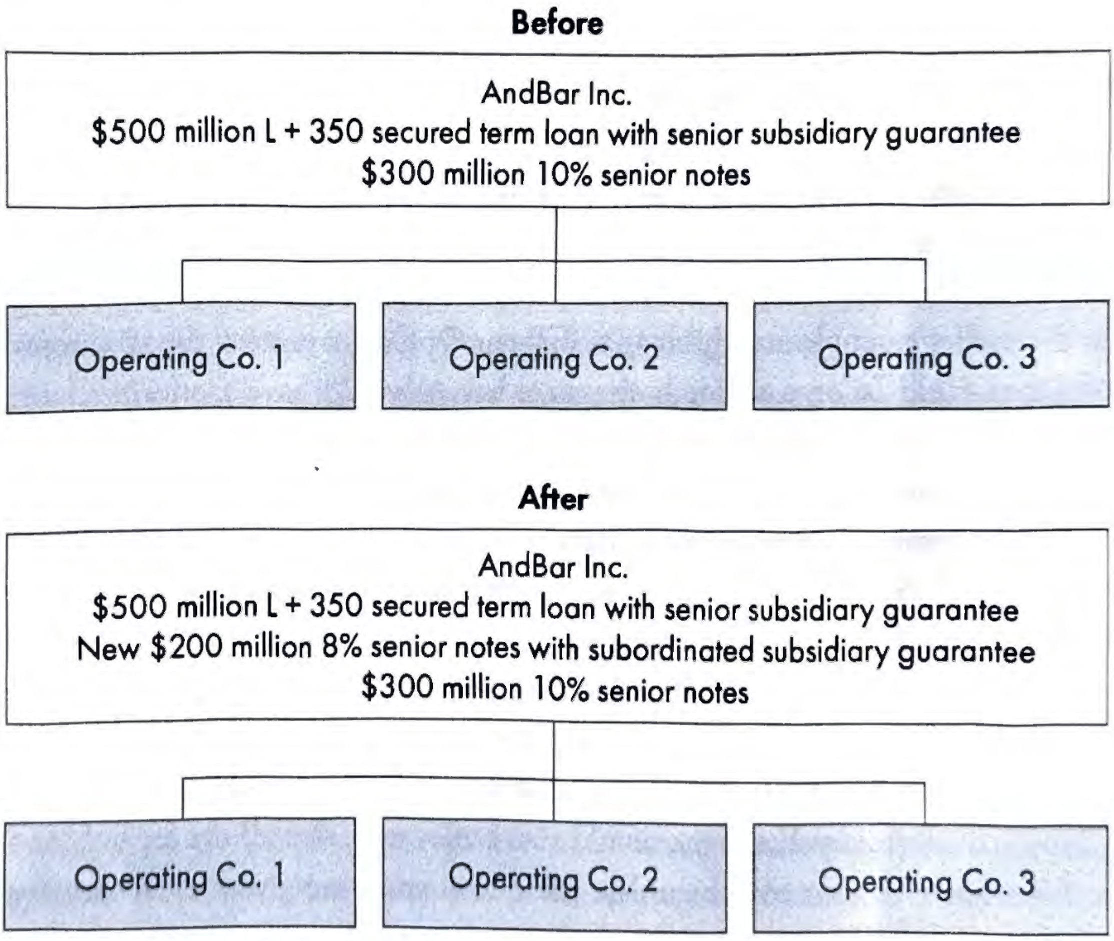
Subsidiary guarantees can also bypass typical seniority language. A guarantee from entity 1 on the debt issued by entity 2 effectively makes the debt of entity 2 an obligation of both entities. It gives the debt a claim and a priority ranking at entity 1 even if it did not issue the debt. It is common for bank debt issued at a holding company to be guaranteed by all of a company's principal subsidiaries.

In the earlier example in Exhibit 13.2, if Tapas OpCo guaranteed the 12% notes of Tapas HoldCo on a senior basis, these bonds would have a priority claim on all the assets of OpCo ahead of the senior subordinated notes of Tapas OpCo. If notes of equal rank are issued at the same entity and one bond has a guarantee from an operating subsidiary, this gives it a structurally senior claim on the assets of that subsidiary versus all other notes issued alongside it.

Exhibit 13.3 is a chart for AndBar Inc., which has three operating subsidiaries. The company has an L + 350 bank loan. The loan is secured by the stock of the operating subsidiaries that AndBar Inc. owns and also has senior guarantees from each subsidiary. It also has an old 10% senior note that allows for only $20 million more in secured debt unless these 10% notes are given equal security. This feature in a debt structure is called a negative pledge. The company wants to issue more debt to pay for expansion. It wants this debt to be lower cost and rank ahead of the 10% senior notes. However, the banks do not want all the new debt *and* the existing 10% notes to be secured. Management gets the banks to agree to a new senior-unsecured bond. To give it priority over the

10% senior notes and get a lower coupon, the company gives the guarantees from the operating subsidiaries, which allows it a structural claim ahead of the 10% senior notes on those assets. To make the banks happy, this subsidiary guarantee does not have a senior ranking as the banks do. The guarantee is a subordinated guarantee from the operating subsidiaries. This new 8% senior note effectively has become structurally senior to the old existing 10% senior notes, because the old notes do not have any subsidiary guarantees. But the new senior note is still junior to the banks because the guarantee does not rank as highly as the bank debt's guarantee. It also does not trigger the negative pledge. When this transaction is announced, it will probably cause the old 10% notes to trade down in price because, first, the banks, and now, the new notes have priority claims on the subsidiaries in which all the asset value lies.

Exhibit 13.3: New Issue with a Subsidiary Guarantee



When existing debt has debt issued senior to it, investors often say that the old existing bonds have been primed. Structural subordination and guarantees can prime existing debt and also sometimes get around existing debt covenants, accomplishing the same thing. If existing holders are unaware of the loopholes or features in the bonds they own, and they see the bonds trade down substantially because of getting primed, they often use a more colorful phrase for what has happened to them.

Guarantee Rankings

Subsidiary guarantees have rankings too. For example, a subsidiary could guarantee holding company debt on a senior secured basis or perhaps on a subordinated basis. This is not uncommon where a subsidiary may offer a bank loan a senior secured guarantee and a bond a senior subordinated guarantee, mirroring the structure at the issuing entities.

Closing Comment

Read all the language relating to rankings. For example, suppose a company has a revolver and a senior secured bond. The document may actually state plainly that both are equal (pari passu). However, deep in the document there could be a clause that expressly gives priority to the revolver in the case of a bankruptcy. This effectively gives the revolver what is called a first out. It is not only a factor in bankruptcies. The detailed specific language can also address how the two tranches are treated when proceeds are raised from an asset sale, equity offering, or other event. There may be language that even though they rank equal, the first $25 million of any asset sale proceeds is used to repay the revolver before the equally ranked senior secured notes share in the proceeds. Ranking of securities is one of the differentiating factors when analyzing relative value and it is vital to get the ranking correct.