Chapter 12

Structural Issues: Maturities and Calls

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DEBT INSTRUMENTS HAVE a finite life: they have a maturity date at which time the borrower has to pay back the money borrowed from the lender. A shorter maturity generally represents less risk than a longer maturity, because the longer a debt stays outstanding, the greater the probability that something will go wrong with the borrower. Where a debt instrument stands in line by maturity and where it stands in line by seniority can make a difference in what yields and spreads the debt will trade at. Many debt instruments have features that give the company an option to buy the debt back before it matures and retire it. An option to buy something is called a call option. These call options are a benefit to the issuer rather than the borrower.

Maturities

For a bond or loan, the maturity is the date on which the company must repay principal to the investors. There is no standard maturity. For below-investment-grade bonds, a ten-year maturity from the time of issuance is quite common, but maturities have ranged from three years to five, seven, and eight years as well. They can also be longer, such as a twelve-year bond. However, longer maturities are not common in the leveraged debt markets, given the uncertainties and changing nature of many leveraged companies. When there are structures of twenty-year maturities or longer in the leveraged debt markets, they are typically bonds that were issued as investment-grade credits but have since been downgraded to the high yield market.

Within a company capital structure, the bonds usually mature at a later date than bank loans. Usually, bonds are not only structurally subordinated to bank loans; they are more junior on a temporal basis as well. In some situations, a bond matures ahead of more senior bank debt. However, bank lenders (and other senior lenders) often require a springing maturity in these cases. This feature typically states that if the more junior bond is not retired at some point prior to maturity, say six months before it actually matures, the maturity of the bank loan springs forward and becomes due immediately. This feature helps the more senior security in a distressed company to have more control over forcing a company into bankruptcy or other actions related to the payment of debt.

Leveraged finance bonds usually do not require any payments of principal on the notes before maturity. Some bonds, in the past, had what was known as a sinking fund, which required the company to retire a small portion of the bonds in selected years ahead of maturity. This feature is rarely seen anymore.

Bank loans tend to have shorter maturities than bonds. It is not atypical for a loan to have a maturity of five years or less. While many institutionally placed leveraged loans do not have any required debt amortization payments during the life of the loan, it is more common to see an amortizing bank loan in leveraged finance than to see a bond with a sinking fund. In many cases when an institutional tranche of debt does require some principal amortization of the debt, retirements are very modest. An amortization schedule retiring one percentage point per year of the face amount of the loan would not be uncommon.

Calls

The most common way, other than a maturity, for a company to retire a bond or loan is through a call. A call gives the company the right to buy back the notes or loan (or call them) beginning on a specific date at a specific price. In a typical high yield bond that has a ten-year maturity, the bond may be noncallable for five years. Then, after the fifth anniversary of the bonds' issuance, the company starts to have a call option. Investors will say the bond is callable. In this situation, it is typical for the bond's first call price to be equal to par plus half the coupon. After that, the call price would reduce each year so that it is callable at par one year before it matures. Exhibit 12.1 shows common language for a call schedule for a 12% bond; in year 5, the bond is callable at par plus half the coupon, or 106. The debt-issuing company could call the whole bond outstanding or just call half of the issue. The company usually has to announce the call price thirty days before it can retire the bonds. This type of call data is typical of what is often seen in the market, but there are all sorts of variations.

Prior to December 30 year 6, these bonds were not callable. After this date, they were callable at the prices shown as a percentage of face amount, as laid out in Exhibit 12.1.

Exhibit 12.1: Call Schedule

From December 31, year 6 until December 30, year 6	106
From December 31, year 7 to December 30, year 7	104
From December 31, year 8 to December 30, year 8	102
From December 31, year 9 and thereafter	100

Bank loans usually do not have the same level of call protection as bonds do. Traditionally, bank loans could be called at any time at par, but over the years, some call protection has become more common. Loans frequently offer some premium for six months or a year. So, while they are still callable, the buyers get a slight premium, such as 101% of face amount. This can make it less attractive for the issuer to repurchase the debt. Depending on market conditions, a new loan might be issued with an original issue discount, which effectively makes any call premium a bit higher. When a debt security is callable immediately, but with a premium, it is sometimes called soft call protection.

A Quick Review of YTC

When calculating the yield on a bond, investors typically want to use the most conservative yield calculation. When a bond is callable and is trading at a premium, the most conservative yield calculation is probably not YTM.

When a bond is trading at a discount to its face value, the yield calculation that is most conservative will be the YTM, as shown in Exhibit 12.2. If it rises in price, the most conservative yield (or lowest yield) might be a yield calculated to one of the call dates and call prices. For example, if a bond is trading at 112, as shown in Exhibit 12.3, it may not actually be trading on a YTM; it may be trading on a yield to its worst call. In this case, the bond is trading to its call date in year 3, because if the bond is called in that year, it will result in the lowest yield. Exhibit 12.2 shows that if the same bond is trading at 101, the lowest yield is to the call date in year 5. Bond investors are always looking at the possible downside, so they tend to look at the most conservative yield and use the YTW measure unless otherwise specified.

The call schedule has an impact on the yield calculation when the bond is trading at a premium. For example, if the bonds are trading at a very high premium and investors buy the bond based on YTW, but the bonds are not called on that date and remain outstanding longer, they get a higher return than the YTW. Understanding that a company may leave a bond out past a call date can be an important part of the analysis as a bond starts to trade on a YTC basis. Call prices also adjust the duration of a bond. When a bond starts to trade to a call date, the duration calculation will assume that the bond is more likely to come out on that date, so as callable bonds trade at higher prices, the duration can move more with fairly small price changes. Duration measures the price sensitivity of the bonds to changes in interest rates or spreads. It is an important measure to watch because if a callable bond trading at a premium starts to see the bond price decline, its price can become increasingly sensitive to rate and spread movements and the duration will become longer.

Exhibit 12.2: Call Schedule for a 10% Bond Callable in Three Years Trading at a Price of 101

Call Date	Call Price	Yield	Spread
First call year 3	105.00	11.05	1,097
Call year 4	102.50	10.21	979
Call year 5	100.00	9.74	916
Maturity	100.00	9.78	897

Exhibit 12.3: Call Schedule for a 10% Bond Callable in Three Years Trading at a Price of 112

Call Date	Call Price	Yield	Spread
First call year 3	105.00	7.02	694
Call year 4	102.50	7.06	664
Call year 5	100.00	7.10	652
Maturity	100.00	7.48	668

Benefits of Call Options and Call Protection

Having an option is usually advantageous. The right to call the bonds or the bank debt is usually an advantage for the issuer (the company) as opposed to the buyer (investor) of the bond or loan. For example, if a company issues a 12% seven-year note, and the company dramatically improves as a credit over the next three years, that bond should trade up and may deserve to be trading at a yield of 7%. This would equate to a price of 117.2 if the bond could not be called before maturity. It also implies that the company could issue new debt at close to 7%. If there were no call protection, the company could retire these bonds at 100 and issue new debt at 7% and investors' bonds would never have had a chance to trade the bond at a price as high as 117.2. No one would buy the bond at 117.2 knowing the company could force people to sell back the bond at 100 at any time. Even if the bond were callable at a normal call schedule, it might be callable at 106 at the end of year 3, and it would trade higher than if it were callable at 100 at any time. However, the price level would still be below where the investor could sell the bond if it were noncall for life. The call is really

a benefit and an option for the issuer of the bond, not the buyer. The stronger the call protection is, the more attractive it is for the debt holders.

Investment-grade bonds generally see fewer extreme changes in credit quality than those rated below investment grade. Investment-grade bonds often are noncall for life. Another term for these bonds that are noncallable is bullet bonds. This structure is attractive to the buyer. Most leveraged companies hope to see meaningful improvements in their operations and therefore want opportunities to lower their cost of borrowing in the future. Issuers that want to refinance a bullet bond prior to maturity will probably have to pay a significant premium to get bondholders to sell back the bonds to the company.

Clawbacks

There are other types of call option that appear in some debt instruments. *Clawback* is a fancy word for a call option. Typical language for a clawback is as follows:

> Prior to the call schedule, the Company may at its option on any one or more occasions redeem the Notes in an aggregate principal amount not to exceed 35% of the aggregate principal amount of the Notes originally issued at a redemption price of 110% of the principal amount thereof, plus accrued and unpaid interest thereon, if any, to the redemption date, with the net cash proceeds of one or more Equity Offerings; provided that: at least 65% of such aggregate principal amount of the originally issued remains outstanding immediately after the occurrence.

What this means is if new money is raised in a stock offering, the company can retire some of the bonds earlier than otherwise allowed. Using this type of call usually requires a fairly high call price; the standard is par plus the full coupon. This option usually is available only for the first three years after issuance, or at least before the standard call structure is in effect.

Investors do not want their bond issue to be so small that it may not trade regularly. Therefore, this clause often has a restriction that after the clawback, a certain percentage of the original bonds still must be outstanding. The concept behind the clawback is that raising equity money for the company is usually a

credit improvement and something that bondholders would like the company to do. Therefore, if the company does this relatively soon after issuing the bonds, the bondholders are willing to give the company a call option as an incentive to retire debt early.

There are a few other points to note about this clawback option. Typically, a company's bank agreement requires the proceeds, or at least part of the proceeds, from an equity offering to be used to reduce bank borrowing. But companies can frequently get a waiver from the banks. Read the terms of the clawback and the defined terms carefully. The chapter titled "Structural Issues: Covenants" discusses defined terms in more detail. Usually, whenever a term is capitalized in a loan agreement, bond prospectus, or indenture, it is being used in a form that is defined specifically in the document. For example, in the clawback language shown at the beginning of this section, *equity offerings* appears to be a specifically defined term. When going to the definition section in the bond prospectus, read the definition of *equity offerings*. It may be defined as a new public share offering, or it may include private share offerings as well. In case this does not sound like enough fun, there is frequently a defined term within the definition of another defined term. So read these terms carefully and have something nearby to take notes on. Just because a bond has an equity clawback, do not assume it is standard. The defined terms can be critical to how the bondholders are treated.

Ten-Percent Annual Call

Another type of call feature is the right to call a certain percentage of the issue each year. This usually occurs when a bond is being issued on a senior secured basis in place of bank loans. The normal structure is that, at the company's option, it can use cash to call up to 10% of the original amount of bonds outstanding annually at a price of 103. The rationale for this feature is that bank debt usually is callable immediately, and the company can deleverage by retiring bank debt. Companies that issue bonds with these structures typically have bonds outstanding and no bank debt. The company wants to be able to deleverage in the early years when the bonds are outstanding, and this feature allows it to make the bond more like a bank loan substitute from the issuer's perspective.

Cash Flow Sweeps

Cash flow sweeps are most common in bank loans for leveraged companies, though they occasionally appear in bonds. The excess cash flow sweep takes several forms but utilizes a predetermined portion of a calculated net FCF number to retire, or make an offer to retire, existing debt at a preset price. This type of call is usually an annual option. This is done in part because cash flow calculations can utilize fully audited numbers. It sometimes is structured as a call, where the company has an option to call the loans or bonds, but it sometimes is a requirement for the company to offer the payment and it is the debt holders' option to accept this offer or not. This clause usually does not utilize the entire portion of the calculated excess FCF. Normally, it would not use more than 50%, or less, of the calculated excess FCF. When it is the company's option or a required excess FCF sweep, the debt retirement works like a partial call.

When the company is required to offer a FCF sweep, the company has an obligation to make a mandatory offer to purchase using a certain percentage amount of the defined excess FCF. The holder can either sell the bonds into the offer or not. If more debt is put back to the company than the size of the offer, the debt usually is accepted on a pro rata basis. Suppose the defined excess FCF is $90 million and the sweep requires 50% of it to be used to make an offer to retire a bond at par. The company makes an offer to all holders of its bonds to buy up to $45 million of its loans at 100. If less than $45 million is put to the company, all the bonds put are retired. For example, if $120 million is put back to the company, each holder would have only 37.5% of its loans retired ($45 million/$120 million = 37.5%).

This is another place where careful reading of the terms and defined terms can be very important. For example, within the definition of FCF, EBITDA may be defined. In the terms of one bond, the EBITDA definition might include one-time charges, but in another bond from the same issuer it might not.

Other Bank Prepayments

Bank agreements typically require mandatory prepayments upon the occurrence of a number of events. These often include all or a portion of the proceeds from asset sales. There is usually also some limitation on how much of the proceeds of an asset sale has to be in cash. In addition, usually, a minimal threshold must be met to trigger this feature, such as an asset sale of over $10 million.

Generally, there are also mandatory prepayments for all or a portion of the proceeds from the issuance of equity, and sometimes for the proceeds from the issuance of more junior debt securities as well. In practice, if one of these events occurs, the company can often negotiate a compromise with the banks for a partial paydown with the proceeds because this is often a credit-improving transaction.

Open Market Repurchases

Although they are not actually calls or puts, open market repurchases of debt by companies are important for analysts to understand, as are the differences in how this can be done with bank loans and with bonds.

Open market repurchases typically occur when a company utilizes cash on hand, or sometimes bank borrowings, to buy back bonds in the open market. Repurchasing bonds in the open market usually has to be allowed by the covenants in the bank loans and any more senior notes. Generally, a test such as a leverage test and a restricted payment covenant must be met. Also, in most cases, a basket of a certain amount of excess cash flow must be met before a company's bank loans, or more senior debt, allows these purchases to be pursued.

However, if the company is permitted to pursue open market purchases, it can buy bonds at any price. If the company's bonds are trading at a discount, it can buy them at that price. Another way of looking at it is that the company can buy them for less money than it would be required to pay at maturity, thus reducing its debt by more than the cash it is using. When doing such a trade and capturing the discount in the bonds, the company effectively uses $1 of cash to retire more than $1 of debt. Therefore, the company actually books a gain on its income statement (noncash) and reduces the amount of debt on its balance sheet. A company can also make a specific offer to purchase bonds in the market, through what is called a tender offer. A tender offer may also ask bondholders choosing to sell into a tender to vote to change the covenants or some other feature of the bonds.

Normally, the company cannot do discount buybacks in the bank debt. Generally, the company is restricted from buying back bank debt at a discount, even if it is trading at a discount in the secondary market. Bank agreements usually require any paydown of bank debt to be paid pro rata to all holders of the bank loans,

so companies are not likely to benefit from open market repurchases of bank debt. But there have been cases where waivers have been given.

If a company's debt is trading at a meaningful discount, and the company has enough cash on hand to retire debt, it is often most attractive for the company to look to retire its bonds rather than bank debt; the bonds usually have higher coupons and therefore are more expensive for the company.

Holding Bonds Rather Than Retiring

When buybacks happen, the bonds are not always retired. For various structural reasons, companies sometimes hold onto the repurchased bonds rather than retire them. Additionally, when a company is owned by a PE firm, the PE firm may buy back the company's bonds. Remember not to confuse the sponsor buying the bonds with the company buying back the bonds. The sponsor is a separate legal entity, and if it owns the notes (or the bank debt), they remain outstanding. The sponsor can also buy loans without the various par and pro rata restrictions that might apply to the company if it were purchasing them.

A Pragmatic Point on Early Debt Retirement

When a bond is trading at a yield much lower than its coupon, analysts often try to analyze whether the company will look to refinance the debt. Typically, this is done by running a net present value of leaving the bonds outstanding versus a net present value of issuing the new debt and retiring the old debt. This must include any premium payments necessary to call the old bonds and fees associated with issuing the new bonds and an assumption on the interest rate of the new financing.

A quick way to get a glimpse of whether it makes sense to do this is to take the existing bonds' call price; this gives a proxy for how much funding is needed to retire the existing bonds. Then multiply this amount by the likely new-issue coupon. (The YTW on the existing bonds is a good proxy.) Finally, see if this new figure, which is a proxy for new financing costs, is meaningfully

less than the bonds' existing coupon. If it is, then it is usually worth exploring refinancing possibilities in more detail. Exhibit 12.4 shows an example.

Exhibit 12.4: Quick Check on Refinancing

Existing Bonds	Coupon	Call Price	Recent YTW
Senior notes	10%	104.00	7%
Cost to retire bonds	104.00		
Assumed new coupon	7%		
Annual interest cost on new notes (104 × .07)	7.28		
Annual interest cost on old notes	10.00		

Also, if a bond is not callable, or is not callable yet, the company can tender for the bonds. This offer to repurchase bonds is made to all holders. Typically, the company prices this offer so that the yield on the bonds would equate to a yield that is at a spread of only 50 to 100 bps wide of the equivalent maturity Treasury or other government bond. Most bonds, even noncall bonds, have a make-whole provision that lets them call bonds at an equivalent Treasury note plus a 50 bps spread (typically referred to as T + 50) at any time.

Closing Comment

Call structures have a significant impact on the yield and duration of debt instruments and the return profile of these investments. Understanding how call prices impact the potential return profile of different debt instruments can be a major part of relative value analysis. Call structures also influence what corporate finance actions a company might look to pursue. While there are some standard aspects in call structures, each document can vary. Diligence is needed when analyzing the terms and definitions in the loan documents.