Chapter 25
Investing Issues: New Issuance

What's in this chapter:

- new-issue process
- pro forma adjustments
- supply and demand dynamics in the new-issue market

DEBT INSTRUMENTS HAVE maturities and lenders must be repaid. Companies that issue debt usually do not completely repay their debt obligations out of FCF, but do so by using cash raised by issuing new debt: a refinancing. This creates a natural flow of debt retirements and new issuance of debt in the credit markets. In the leveraged debt markets, companies are often in transition, which may trigger the need for additional issuance of debt to fund acquisitions or expansion. There are also first-time issuers that will raise debt in these markets. Perhaps a new leveraged buyout is being financed or a company that has always used smaller regional banks is expanding and has chosen the leveraged debt market as a source to raise money for additional funding. New issuance is a major part of the investment process in the leveraged debt credit markets, and understanding what drives the new-issue market can help an analyst understand a credit's refinancing options.

New-Issue Process

A large number of people involved in the leveraged debt markets spend a significant amount of time on structuring, pricing, placing, analyzing, and investing in and trading new issues. This includes company management, the sell-side investment bankers, lawyers, accountants, capital markets teams, and analysts, who may spend several weeks or even months working with the company and doing due diligence to assess the validity of its business and prospects. This team also is responsible for the preparation of documents for potential investors to review, which entails providing accurate information and meeting the detailed rules and limitations required by law. This team also usually prepares an informational presentation for management to give to investors, typically called a road show. More seasoned issuers may simply do a brief conference call for investors. Often when a new issue for a bond or loan is coming to market, analysts can get more detailed information about the industry and the company, as well as more access to management than they would from a quarterly conference call and press release.

The rules for bond offering documents tend to be more limiting than those for bank offering documents. In the documents for a bond offering, all of the information has to be public. In the loan market, investors can choose to go private on the bank side and can get projections, or they can stay public. Going private can limit the ability to trade the debt instruments.

The bank offering book (bond prospectus) has some items that investors should always read through:

- *Reason for transaction*: The use of the proceeds and the details of the reason for the transaction should be studied. Even if the investors like the credit, they may not want to fund a transaction they disapprove of.
- *Risks*: There is also a risks section that should be read. An analyst can decide which risks to focus on, which are of minimal concern, and which are priced into the transaction.
- *Structure and terms*: There is usually a structure and terms section, which should always be read. It should include covenants and transactions with affiliates, because they may give insight into the interaction among the company, management, and ownership.

- *Reason for new financings (sources and uses)*: While done for numerous reasons, new financings are often related to a merger or acquisition. A common item to look at in these transactions is the price that was paid for the asset. This price can be compared to other transactions and/or public equity multiples.
- *Proxy statement*: If the acquisition was of a public company, the company being bought typically has to file a proxy statement for shareholders to assess if the price was fair and how they want to vote on the transaction. This document can offer insights as well. Most notably, it often gives the price levels of other bids for the company, which can give an analyst comfort (or discomfort) that the winning bid was reasonable and that other bidders were willing to pay for the asset.

When a new issue is announced, the expected size of the offering is disclosed along with the use of proceeds and the tenor (tenor measures the time to maturity – at issuance, they are the same). Expected credit ratings are also released. Fairly soon after that, the offering documents are available, and the company will make itself available to investors. This is usually followed by the investment bank representing the company giving indicated price guidance. The price guidance is usually given in a yield or a spread. If the debt is going to be offered at an OID, that will be stated too.

At the same time, analysts and portfolio managers will be analyzing the new issue with the potential buyers and looking at the relative value to determine the price at which the investment would look attractive. They may also discuss any terms of the transaction they would like changed. Then begins a give and take between the potential buyers of the offering and the underwriters that are getting paid to place the debt for the company.

There are a significant number of rules governing the information that can be shared and rules designed to prevent collusion. There are times when the offering is just a single tranche of debt, such as an offering of a ten-year maturity bond. There are other times when multiple tranches of both bonds and loans may be offered and sometimes in multiple currencies. The underwriting investment bank will try to juggle demand across the various pieces of debt to get the best structure at the best price for the issuer.

Pro Forma Adjustments

Frequently new-issue transactions include pro forma results, especially if an acquisition is involved. These results may include a section on adjustments to EBITDA. It is important to look at the adjustments and the footnotes that accompany them. Although the debt offering documents may be allowed to show a number of adjustments to reach adjusted EBITDA, investors might be uncomfortable with including all these factors in their analysis. They might not want to give credit for certain items that are added back in the new-issue-adjusted EBITDA. These might include management fees paid to PE firms, planned cost savings, and cash costs related to restructuring. Analysts may choose different items to add back, or not, depending on what they are focused on. Acceptable add-backs may be different depending on whether the primary focus is on cash and liquidity or solely on operational trends.

Exhibit 25.1 shows how adjustments and add-backs might appear in a new-issue offering document. In this case there is a significant swing in EBITDA from negative reported EBITDA to a positive adjusted EBITDA.

Exhibit 25.1: Adjusted EBITDA in $000,000s

EBITDA	**(90.6)**
Management compensation one-time payments	(42.3)
Stock compensation expenses	2.1
Deferred revenue adjustments	159.6
Sponsor management fees	20.0
Implemented cost savings	50.0
Restructuring/reorganization professional fees	9.5
Internal restructuring cost	26.0
Total pro forma adjusted EBITDA	**134.6**

Supply and Demand Dynamics in the New-Issue Market

When the new-issue market is highly active, the number of new issues that are being offered to the investment community in loans and bonds can be daunting. When the market is strong and there is great new-issue demand, a new issue may get priced at a yield very comparable to its peer group or other bonds it has outstanding. Usually, new issues come with a slight discount to market levels of existing comparable debt to entice buyers and be able to place that large an amount of debt in the marketplace at one time. In addition to adjustments to the coupon and the offering price, the new issue will sometimes have other differentiated features to attract buyers. When the market is not as strong, there is a bigger new-issue discount in the pricing of the financing relative to existing bonds, because the price at which a company can sell $500 million of a bond may logically be lower than the price at which the company could sell $1 million of a bond.

In a period when the market has been strong for some time, more issuers may be drawn to try to raise money when funding is cheap. This can start to pressure the market as supply and demand rebalance. It is not just pricing of the yield that can change, depending on the supply and demand balance, but covenants and other terms may also shift, depending on market conditions. In markets that favor the buyers, when new issues may be more difficult to get placed, the buyers can often demand more stringent and debt-holder-friendly covenants in new financings. When demand outstrips supply, issuers can often get looser covenants.

In the loan market, new financing is often offered at an original issue discount, meaning that it is priced below 100% of face value. This discount pricing structure can offer a bit more protection to the loan investors, as they do not have much call protection. It can also be helpful for CLO structures, which are frequently big buyers of loans in the institutional loan market, as their structure can benefit from buying loans at a discount.

Closing Comment

Credits in the leveraged finance market are often in a state of perpetual change, and the marketplace is constantly changing as well. New issuance is a large part of life in the leveraged finance market and, over time, can change the characteristics of the market and the peer groups available for relative value analysis. The process of studying and analyzing new issues can give an analyst more insight into a company's operation and more access to information.