Chapter 21

Market Information: Reacting to News Events

What's in this chapter:

- scenario: issuer makes an acquisition
- scenario: issuer gets bought
- scenario: issuer announces an IPO
- scenario: issuer is facing a maturity
- a pragmatic point on the blended price to retire debt

WHILE THE LEVERAGED finance market is not as reactive to news events as the equity market, it does tend to be more responsive than most other fixed-income markets. These below-investment-grade companies also tend to have more transformational events than companies in the investment-grade market. Unfortunately, no set of rules governs how a company's debt securities will react in response to a certain type of news event. Often, the entire market may view an announced event as positive, but investors may have significantly different views on how much the news should impact security prices. There are times when news is positive for both the equity and debt of a company; but there are times when a headline is positive for a company's equity but negative for its debt, and vice versa.

Most credit events come with a fair amount of uncertainty. When there is an acquisition announcement, an initial public stock offering, or a new debt financing, the transactions do not close immediately when they are announced, and there is market risk of these transactions never closing. In some cases, all of the terms of the transaction are not announced, so the impact on the prices of debt instruments cannot be fully analyzed. This should cause the bonds and loans to trade at some discount (or premium) to the true pro forma value of the investment. This risk discount, or premium, can rise or fall prior to a closing as the probability of closure changes. This chapter reviews some common scenarios and some of the thought process that should go into analyzing these events.

Scenario: The Issuer Makes an Acquisition

In the first scenario, the restaurant chain Fast Food Co (FFC) announces a plan to buy a smaller competitor, Good Food Co (GFC). The following are some key facts about the acquisition. Sometimes not all of these items are included in the announcement.

Fast Food Co (FFC) Facts

- revenue: $1,500 million; EBITDA: $300 million
- debt: senior secured, bank debt, term loan $800 million L + 350, due in five years
- bonds: $400 million, 8% senior subordinated notes, due in seven years
- leverage: bank debt/EBITDA 2.7×; total debt/EBITDA 4.0×
- cash on hand: $100 million; net leverage: 3.7×
- preannouncement trading levels: bank debt at par, bonds at 8.5% YTW

Good Food Co (GFC) Facts

- revenue $500 million; EBITDA: $80 million
- debt: revolver $50 million; term loan: $50 million

Deal Facts

- FFC is paying $480 million, including assumption of GFC's debt, $380 million for the equity and $100 million of debt (often the revolver would

not be counted if it were seasonal). The acquisition is being made in cash (as opposed to doing all or some of it with a stock swap).
- The acquisition price is 6.0× EBITDA multiple.
- FFC expects $60 million of cost savings in the first twelve months.
- Both boards have approved the transaction. Board members represent more than 50% of the voting rights of the stock of both companies.
- Quick pro forma analysis assuming 100% debt financing to pay for the equity:
  - pro forma debt of $1,680 million
  - pro forma EBITDA of $380 million
  - pro forma EBITDA with cost savings $440 million
  - leverage: pro forma debt/EBITDA 4.4×
  - with cost savings 3.8×

These are some of the analytical observations that will arise once this transaction is announced:

- If FFC uses debt to finance the entire transaction, the leverage will initially go up. But if and when cost savings are achieved, the pro forma leverage will actually be relatively unchanged, and the company will be bigger. The analyst must decide how much credit, on day one, should be given for the planned cost savings. A cynical analyst never gives the company 100% credit.
- The analyst should ask whether the cost savings look reasonable. In this case, it can be seen that GFC's operating margins are meaningfully lower than those of FFC, and there is a difference in scale, so it can be assumed that FFC should be able to get some meaningful operational gains.[19]
- There appears to be a low level of deal risk because a majority of shareholders and the boards have both approved the transaction. The major risk would likely be from a regulatory basis.

Here is a partial list of unknowns:

- Will GFC be assumed by the main operating entity of FFC where the FFC debt is currently outstanding, or will it be kept as a separate wholly owned subsidiary, and the GFC debt will be at that entity, having less impact on the FFC debt issues? If GFC will be a subsidiary, where will the new financing debt be issued?

19 Also note that if the cost savings are applied to the combined company, the margins are not out of line with FFC's historical margins, so this would appear reasonable.

- How is the transaction being paid for? To be conservative, it was assumed that the company was using all debt to fund the purchase. However, FFC could plan to sell some stock. Another factor is that FFC could plan to use some of its cash on hand. However, given its cash position and that it appears to have no revolver, it likely uses the cash for working capital.
- The analyst needs to look at the debt incurrence covenants and see if they would allow the transaction to be funded with all debt under the debt incurrence test. It would also be worth investigating the covenants' definitions of EBITDA to see if pro forma cost savings could be included in the calculation.
- What cash costs are expected to achieve the cost savings? Savings rarely happen for free. Are there system integration costs, severance payments, or costs related to breaking leases?

Other questions could include the expected timing of the closing; potential breakup fees if the transaction doesn't close; whether GFC management has noncompete clauses; whether GFC's capital spending needs are greater than, equal to, or less than those of FFC; and what GFC's operating trends have been.

There are also a few tangible items to consider about the transaction as well:

- Is making an acquisition such as this a departure from FFC's strategy? (If so, this increases risk to the credit.)
- Is this a good fit for FFC? For example, is there much geographic overlap? Do these two companies operate similar/complementary types of property?
- How did FFC management communicate the acquisition? Did they put out a short, tersely worded press release and nothing else? Or did they offer a more detailed press release with the rationale for the acquisition and other details? Did they hold a conference call to make themselves available to investors? If so, were they responsive or nonresponsive to questions?

These types of factor can all impact how FFC debt may trade shortly after the announcement and how it might trade longer-term.

It is unlikely that, in any given transaction, analysts will get all their questions answered and receive all the information they would like. Therefore, assumptions and decisions must be made based on imperfect information.

It would not be uncommon for FFC to decide to fully integrate GFC into its operations and to fully fund the transaction with new term bank debt and a new bond. The GFC bank debt would be retired, and the company would hope that the investors in the old bank line would roll into the new bank deal. The banks might be willing to increase the leverage at the senior secured level to 3×. This would allow $340 million of the acquisition funding to come from the bank line; the balance would need to be funded in the bond market. The new bank line would replace the existing FFC term loan and retire the GFC bank lines. There would likely also be an increase in the rate on the bank debt. Exhibit 21.1 shows how a sources-and-uses table might look for this transaction. It contains a line item for expenses related to the transaction.

Exhibit 21.1: Sample Sources-and-Uses Table for the GFC Acquisition in $000,000s

Sources		Uses	
New senior secured loan	1,140	Retire GFC bank lines	100
New senior notes	150	Retire old FFC bank lines	800
Total sources	1,290	Buy GFC equity	380
		Fees	10
		Total uses	1,290

The bank debt gets a takeout and a chance to roll into a new, higher-coupon, loan facility with a similar risk profile, so it is fairly positive for the bank debt.

If it is assumed that FFC management has a good track record with acquisitions, that this acquisition is in line with its overall strategy, that the bond covenants allow the transaction, and the company doesn't have to offer any consent payments to the bondholders, it might appear relatively neutral for the bondholders. However, it is not. Notice that the existing bondholders have senior subordinated notes and that the new notes are senior. The existing notes are getting hit with the brunt of the increase in leverage and are getting primed. Wherever the market decides to price the new notes, the existing notes will assuredly trade behind them. Although the transaction is not transformative enough and the increase in leverage is not large enough to cause a major sell-off in the existing senior subordinated notes of FFC, they will likely trade down. At the same time, management has sent a message that they are willing to prime

existing note holders in future transactions if the covenants permit. Analysts should check how much more room for senior debt the covenants allow.

Scenario: The Issuer Gets Bought

The preceding case was analyzed from the perspective of the buyer of a company. The example in this section looks at the perspective of the company being bought. The sale of a company can have many twists. In most cases, bank debt gets refinanced, but this can sometimes eliminate an attractive holding from the bank market. The possible outcomes for the bonds are more varied.

The biggest factors are who the buyer is and how that buyer is structuring the acquisition. If a company is being sold to a stronger credit, this should be a positive for the existing bonds. If a company is being sold to a credit of equal quality or to a PE firm, it depends on whether the existing bonds need to be retired to complete the transaction. The buyers could leave the bonds outstanding and increase the leverage to pay for the transaction. The scenario described in this section looks at how the bonds of the company being acquired may act.

The other important factor is how the buyer is paying for the transaction. This is not always disclosed at the same time as the acquisition is announced. The acquirer could be planning to issue debt to pay for the acquisition, which would add leverage. The acquirer could be planning to use cash-on-hand, which would increase net leverage. The acquirer could be planning to issue equity to pay for the acquisition, which would be a big positive, and usually, deleveraging. The acquirer could use a stock-for-stock swap, which is similar to issuing equity but usually has less market risk. Finally, the acquirer could be using a combination of these funding paths.

When an announcement is made that a company is being acquired, the first thing an analyst should look at in the covenants is the change of control language in the bonds and loans. The analyst would want to see if the transaction would trigger this covenant and set a floor for what could happen to the bonds. However, because almost all change-of-control offers to repurchase the bonds occur at 101, this becomes a factor only if the bonds are trading at 101 or below. If the bonds are trading substantially over 101, the potential for some meaningful losses exists if the change-of-control tender price is the floor and actually ends up being used by investors.

In this case, we will assume that a German dialysis company, DeutscheDialysis (DD), is up for sale. After an auction, DD is being sold to an investment-grade company that is a health-care conglomerate, EuroMed (EM).

The first thing an analyst needs to discern is how EM will structure the acquisition. Some common ways this could be structured might include the following:

1. *DD as subsidiary*: Keeping DD as a separate wholly owned subsidiary means that DD will still be a separate credit. Although there is implied support from the stronger parent, the bonds of DD are likely to stay outstanding and trade at some yield higher than EM's bonds but lower than where they had been trading prior to the transaction. The analyst must try to analyze how much wider than EM's bonds the DD bonds should trade. This will be based on the reaffirmation of the underlying asset value due to the acquisition, the size of the new investment by EM, any synergistic cost savings that the combination may bring to DD, and the likelihood that EM will eventually refinance the existing bonds in an effort to get cheaper financing and perhaps better covenants.
2. *Retired/refinanced DD bonds*: EM may choose to either retire or refinance the existing DD bonds. Why might it do so?
   - First, EM might want to be able to lower the cost of financing costs, since it should have a lower borrowing cost than DD as it is investment-grade rated.
   - Second, EM might want to get rid of the covenants. Perhaps it wants to take more money out of DD than the restricted payments test allows.
   - Third, EM might not want separate reporting requirements that might be required in the covenants of the DD bonds.
3. *Refinanced bonds*: EM might look to refinance these old bonds or seek amendments from the investors. One analysis could be to see whether it is cost-effective to refinance the bonds, factoring in any call premiums or tender premiums that would need to be paid to retire the debt, and analyze whether some of the covenants are too onerous for EM to live with.
4. *Assumed bonds:* EM may also look to assume the bonds and make them part of the EM debt structure. This should cause the DD bonds to trade in line with the investment-grade EM debt and should be a big positive for bondholders.

What might be different if DD were sold to a PE firm in the auction?

One of the first questions should be how the PE firm will pay for the acquisition. Typically, the acquisition includes an equity component paid by the PE firm. This equity check does not add to the capital of DD. Instead, it goes directly to the shareholders, so it usually does not adjust any balance sheet or covenant terms. The second component of the acquisition funding is usually debt borrowings.

The PE firm often looks to see if it can keep the existing bonds in place so that it does not have to pay premiums to retire the debt. Any new borrowings to fund the acquisitions, if they were raised at the same corporate level or at a subsidiary of the existing DD bonds, would have to meet the debt incurrence tests of the old notes. If the money being raised were being used to effectively purchase company stock, it would need room under its restricted payments covenant tests and room in its basket to do this. One way around adding more leverage on the company and not having to work within the existing covenants is to form a new holding company that is not a party to the covenants of the subsidiaries.

Although the new holding company structure may not actually increase the leverage at the level where the old DD bonds reside, the new owners obviously still expect to be able to use the DD cash flows to service the new holding company bonds. Bondholders would want to analyze whether the DD credit now has to help service the new holding company bonds. Any buyers of the new holding company bonds would want to make sure that the holding company had access to enough cash flow that those bonds could be serviced. The buyers of the new notes would want to examine whether there is enough room under the restricted payments test to upstream this money to service the new bonds. This is obviously a concern for the existing DD bondholders, but it's an even bigger concern for the potential buyers of the new holding company bonds. DD bondholders will also want to check what senior and senior secured capacity there may be within the covenants. If there is capacity, it could allow debt to come in above the existing bonds and prime these notes.

An analyst has to look at the new structure and the levels of where the old DD bonds are trading and try to determine whether, in a given market environment, the new holding company financing could successfully be completed or whether the structure needs to be changed.

What if a company of relatively equal credit quality decides to buy DD? The same questions arise. How is the company paying for DD? If it is paying with stock, it is relatively neutral for the bondholders from a financial viewpoint, and the analyst must look at the strategic advantages of the combination. If the company is paying cash, it probably will have to leverage up. Then look at it on a combined basis, with assumptions about the new funding.

These two examples primarily dealt with the financial aspects of mergers and acquisitions. It is also important to consider the strategic aspects for the business of any merger or acquisition. An analyst will want to not only consider the merits of the acquisition that is being analyzed and how it fits with the company's strategy, but also if it indicates something about a shift in the industry or how the company is being managed.

Scenario: The Issuer Announces an IPO

When a company announces that it will raise financing through an equity offering, it is a significant event. Management is deciding that they are willing to dilute the ownership position of existing shareholders. In many cases the management are significant shareholders as well.

In this example, NewDisc is a computer memory company owned by a PE firm and it has announced it is going public. It has produced healthy growth for the past three years, ever since it was bought by the PE firm. It has lowered its leverage, as measured by a debt/adjusted EBITDA ratio from 6× at the time of the buyout to 4×. The company announces it will issue stock and go public in what is called an initial public offering (IPO).

How should a leveraged finance analyst react?

An IPO is usually a positive for a company's credit quality. This is due in part to the following factors:

- A meaningful amount of proceeds is often used for deleveraging. This may include some premium takeouts of the bonds.
- A public stock price helps solidify a valuation of the company.
- There is usually better information flow and therefore greater trading liquidity in the debt of a public company.

- If the company is acquisitive, a public stock often gives it another currency with which to buy assets other than by having to raise cash through debt issuance. Although shareholders may not always like the dilution from an acquisition paid for in stock, debt holders usually like it.

So, on the surface, everything looks good, and NewDisc's bonds should trade up. However, an analyst has to look at the details.

First, the IPO is probably being pursued so that the equity investors can get back some of their investment. It has to be examined how many shares the company is selling, in which case the proceeds go right back to the company (primary shares), versus how many shares are being sold by the PE firm, in which case the proceeds from the sale of stock go to the PE (secondary shares) and not to NewDisc.

The next item an analyst should look at is what the company plans to do with the proceeds it will receive. Sometimes, this information is in the initial document that is filed about the IPO. Other times, it takes a while for it to appear in the company filings. The leveraged finance analyst will want to look at how much deleveraging is expected to occur. The analyst should try to discern how and where that deleveraging is taking place, such as whether the company will look to retire bank debt or bonds, and which tranches.

An important factor for the bondholder, if NewDisc is planning to retire some of the bonds, is how it intends to do so. If the bonds are in their callable period, the company can simply call them. If they are not, the company could use the equity clawback (assuming this feature is in the bonds). Some bonds have a feature that allows 10% of the notes to be called annually with a 103 call. The company could utilize this feature, which is usually only in senior secured notes. Although this isn't typical in an IPO, the company could pursue a tender for bonds too. These features are discussed in the chapter on call prices.

Another valuable piece of information from the IPO may be how the company is being valued for the IPO and what multiple of EBITDA this equates to. This information is usually unavailable until near the actual marketing of the IPO, which may not occur for several months after the initial announcement.

The analyst must include in any model what the credit will look like pro forma for the IPO. What will the leverage be? What will the net FCF be? Does the document state if the company intends to pay dividends? Paying a dividend means that less money will likely go to debt service or deleveraging. An analyst also wants to see whether the IPO materially changes the flexibility under the covenants, particularly the restricted payments test and the debt incurrence test. Usually it does, as carve-outs in these covenants often include adjustments for proceeds raised from selling equity.

An analyst should look at the IPO filing for new information or insights into how the company operates. Frequently, these documents offer more information about the business than the typical annual and quarterly filings that the company provides, which can be helpful for analyzing other companies in the same industry as well.

It is also important to examine the overall stock market and get a sense of the type of valuation the company is using to see if the IPO is doable or if it will eventually be pulled. If the company's valuation expectations are unrealistic, the prices may end up disappointing market participants. If the IPO is pulled, the bonds and loans will likely trade down from their post-IPO announcement levels. This can happen even if the IPO is completed at what is viewed as a disappointingly low price.

If the IPO gets pulled, consideration should be given to whether the ownership of the company will try to do something else to get value for shareholders. The ownership and management were trying to accomplish something from the IPO, and just because that avenue was closed does not mean they will not look for another. Here are some possibilities:

- *Sell*: Will they look to sell the company? If so, what entities would be the natural buyers? Would a likely buyer be an investment-grade company that might improve the debt securities trading level, or could it be another PE firm that might look to releverage the company and hurt the trading levels of the debt securities?
- *Leveraged recap*: Could the ownership decide to do what is known as a leveraged recap (recapitalization)? This typically entails issuing new debt (usually bonds) and using this money to pay a dividend to the owners. This releverages the company and usually hurts the trading levels of the existing bonds and loans (assuming the loans do not require a refinancing).

- *Inaction*: The company's ownership may choose to do nothing and simply bide its time.

Scenario: The Issuer Is Facing a Maturity

In another scenario, a company is facing a debt maturity. Concern usually develops six to twelve months before the maturity. If the markets are healthy and the company has been doing well, this refinancing of a maturity is usually not a problem. New bonds or loans can be issued in the markets to retire the maturing debt. The coupons might be different on the new debt, but the refinancing is doable.

If the company is doing much worse than it had been in the past, or the markets are very bad, a pending maturity could be a major problem for the company. A new debt financing in the traditional markets could be unfeasible. The company will need to look for other funding or asset sales, find new equity investors, or try to negotiate a restructuring with banks and bondholders. It may be forced into bankruptcy.

If the company can access new financing, it may be required to pay a higher cost. An analyst needs to factor in market conditions and try to see what the company's options may be and what the credit might look like after such a higher-cost financing is completed. This is especially true if multiple tranches of debt are outstanding, meaning that one tranche is being refinanced while others remain outstanding. While addressing a near-term maturity for a company that is struggling or in difficult market conditions is a positive for a company, a higher cost of borrowing typically weakens a credit. When calculating the various options for a refinancing, the analysis must also see if the various scenarios that are being modeled can be done within the framework of the remaining debt's covenants.

In the scenario shown in Exhibit 21.2, the company is fairly leveraged and needs to refinance its bank debt. The new rate on the bank debt that the market demands is almost twice the prior rate. This does not change the leverage, but it clearly cuts the FCF dramatically and lowers the interest coverage ratio. The cost of capital can have a major impact on the company's credit quality, so that scenario analysis becomes very valuable in these cases These refinancings can have as large an impact on credit performance as an IPO or acquisition.

Exhibit 21.2: Simple Refinancing Scenario (in $000,000s Except for Ratios)

Debt Structure	Interest Rate	Operating Data	Pro Forma with Bank Rate of 6%
Senior secured bank loan	3%	1,000	1,000
Senior notes	8%	400	400
Senior subordinated notes	10%	250	250
Total debt		1,650	1,650
Total Interest Expense		87	117
FCF			
EBITDA		180	180
Interest expense		87	117
Capital expenditures		30	30
Cash taxes		0	0
Uses of working capital		3	3
Net FCF		60	30
Ratios			
EBITDA/interest expense		2.1×	1.5×
Debt/EBITDA		9.2×	9.2×
Net FCF/total debt		4%	2%

A Pragmatic Point on the Blended Price to Retire Debt

When a transaction occurs and it appears likely that the bonds in the structure will be retired, the analyst must assume that the company will choose the cheapest method to do this. Sometimes this may mean waiting for an upcoming call date to approach. If the bonds are not callable, it might involve a tender. Do not automatically assume the bonds should trade at the tender price. The company may look to utilize an annual 10% call if it is in the structure, and depending on the type of transaction, it may be able to use the equity clawback feature as well. The analyst should incorporate these factors and come up with a blended price to value the bonds. In the blended price (or weighted average), the analyst looks at the price at which bonds would be retired by each method and then multiplies this price by the percentage of the debt that can be retired from that method. These percentage weighted figures are then added

up to equal the blended price. As shown in Exhibit 21.3, the blended price is meaningfully lower, in many cases, than the tender price would likely be.

Exhibit 21.3: Blended Price

Method of Buyback	% of Issue Retired	Price of Buyback
Tender price	55%	118.0
Equity clawback	35%	110.0
Annual debt call permitted	10%	103.0
Blended price		113.7

Closing Comment

There is no perfect way to prepare for all news events in the credit markets. As news items on a credit break, it is important to be able to analyze the most impactful aspects of the news. It is also important to recognize which information is lacking and try to develop the probability of likely outcomes with the combination of known and unknown information. Decisions will often have to be made with imperfect knowledge and those decisions can be refined as new information becomes available.