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DEBT COVENANT FLEXIBILITY CREATES OPPORTUNITIES FOR HIGH STAKES HIDE AND SEEK

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Key takeaways

- Investor demand for yield has led to deteriorating debt covenants that protect creditors and has made the process of moving valuable assets away from creditors much easier.
- This poses a significant risk that creditors must be aware of when evaluating potential investments; however, it can also present opportunities for certain creditors to improve their position within the capital structure.
- We expect companies will continue to utilize the increased flexibility afforded under debt documents to facilitate opportunistic capital structure transactions, and thus, it's increasingly important to thoroughly analyze the risks and opportunities related to weaker debt covenants.
- We believe the market will continue to present an increasing number of situations for opportunistic investors to benefit from security selection and capital structure positioning as a result of weaker debt covenants.

Increased debt document flexibility could sour the deal

In exchange for higher yields, leveraged credit investors have seen declining debt document covenant protections, including provisions that restrict the movement of valuable assets, outside the reach of creditors. Creditors recognize the need for borrowers to have flexibility to make investments in order to grow their underlying businesses. Historically, debt document provisions typically required that these investments remain within the group of entities that creditors have a claim against – the "credit group" – and thus inure the benefit to creditors in the event of a default. However, loosening debt document terms have allowed borrowers to move assets into entities outside of creditors' reach, effectively stripping creditors of the benefit of such assets in the event of a default.

Recently, several companies have taken advantage of increased flexibility afforded to them under debt documents to move assets outside the reach of creditors (Exhibit 1). The assets are often transferred to an entity with no restrictions on how the assets are utilized (an "unrestricted subsidiary"). Subsequently, the transferred assets can be leveraged in various ways, including, among others to:

- Facilitate an exchange of debt to capture discounts and/or extend maturities;
- Fund a dividend to shareholders; and/or
- Retain optionality for future capital structure transactions

Exhibit 1: Examples of borrowers moving assets to unrestricted subsidiaries

Company	Summary
PetSmart	In June 2018, transferred portions of Chewy.com, an online retailer of pet supplies, to an unrestricted subsidiary and to fund a dividend to its sponsor.
Neiman Marcus	In March 2017, transferred My Theresa, a global women's fashion line, and real estate to unrestricted subsidiaries. In Sept. 2018, subsequently moved My Theresa outside the credit group to the ultimate parent.
J.Crew	In Dec. 2016, transferred intellectual property to an unrestricted subsidiary to facilitate a distressed exchange of HoldCo payment-in-kind notes into new debt secured by the intellectual property.
Claire's	In Sept. 2016, transferred intellectual property to facilitate a distressed exchange of second lien notes into new debt secured by the transferred intellectual property.
Scientific Games	In Sept. 2016, classified social gaming division as an unrestricted subsidiary.

Potential implications for credit investors

Aside from losing a claim on the transferred assets, the transactions present additional issues for credit investors to consider:

- **What assets are transferred?** In a highly controversial transaction, J.Crew moved its arguably most valuable asset, intellectual property, into an unrestricted subsidiary and out of the reach of senior creditors to facilitate an exchange of junior debt trading at a steep discount into new debt backed by the intellectual property. Lenders rely on the power of recognizable brands like J.Crew; without such, the stores would merely sell unbranded chinos.
- **Additional value leakage?** Following the transfer of intellectual property to unrestricted subsidiaries, J.Crew and Claire's were required to make annual rent payments for the continued use of the brands. The rent payments were used to fund interest payments on the newly issued bonds backed by the intellectual property. Therefore, senior creditors not only had arguably the most valuable collateral stripped away from them, they suffered from additional value leakage from annual rent payments going out the door.

- **How are the assets valued?** J.Crew valued the intellectual property stripped from senior lenders at $250 million, whereas an expert for the senior lenders believed the value could be in excess of $1 billion. The dispute is currently being litigated. Regardless of outcome, the issue raises critical questions on how the value of transferred assets—often extremely illiquid—is determined in order to comply with limits contained in governing debt documents. Many debt documents only require the borrower use "good faith" discretion to determine fair market value, thus leaving the door relatively wide open for interpretation.

- **Value today vs. future value?** Debt documents require that transfers of assets out of creditors' reach comply with the limits under governing debt documents at the time of the transaction, regardless of future value. In several instances (e.g., Neiman Marcus transfer of its My Theresa brand, Scientific Games transfer of its social gaming assets), assets which did not comprise a meaningful portion of total revenue at the time of transfer were moved away from creditors. However, these assets were experiencing very high growth rates that, if continued, would result in the assets being much more valuable in the future. Therefore, borrowers may opportunistically move assets away from creditors in order to comply with debt document limits and creditors could also miss out on any increase in future value.

Weakening debt covenants present risks and opportunities

We expect weak covenants in many leveraged credit debt documents will present additional opportunities for companies to move assets outside the "credit group" to facilitate various capital structure transactions. The transactions effectuated to date (Exhibit 1) have had limits on the amount of assets than can be moved out of the reach of creditors. However, the debt documents of an increasing number of borrowers provide no limit on the amount of assets that can be moved away from creditors.

To navigate the risks and opportunities posed by weaker covenants, we believe it is critical to carefully review the terms of governing debt documents, including whether and to what extent a borrower could move assets into unrestricted subsidiaries—effectively removing creditors' claims to such assets. Equally important considerations are the motivations of various stakeholders—private equity sponsor, junior creditors, and senior creditors—and the facts and circumstances of a particular situation (Exhibit 2). These factors, along with fundamental research and analysis, influence our view of whether a company is likely to pursue aggressive liability management transactions—including moving assets into an unrestricted subsidiary—and how to be best positioned in a particular capital structure.

Exhibit 2: Select factors in assessing risk of aggressive liability management transactions

Select factors	Commentary
Security trading prices	Trading near par vs. distressed
Security holder base	Concentrated vs. dispersed Hedge funds vs. traditional
Cross-holders	Do large holders own positions in various parts of the capital structure vs. concentrated in one tranche?
Benefit from maturity runway	Is there significant value from extending maturity runway or is capital structure unsustainable? Can valuation change meaningfully (e.g., commodity sensitive) vs. relatively stable?
Sponsor	Has private equity sponsor shown willingness to undertake aggressive liability management transactions?
Debt documents	Capacity to issue additional secured and/or structurally senior debt Ability to access capital markets
Presence of CDS	Presence of CDS may lead to sub-optimal economic activity in cash credit markets in order to benefit CDS market positions

A thorough understanding of underlying debt documents, including the ability to move assets outside the credit group, is critical to assess whether a potential investment provides adequate compensation for the associated risks. Typically, though not always, the ability to move assets into unrestricted subsidiaries presents a significant risk for senior creditors, like term lenders, as they will lose valuable collateral. Conversely, this situation can present an opportunity for junior creditors, such as high-yield bondholders, to improve their position within the capital structure. Overall, despite the concerns, we believe the debt covenant flexibility can provide opportunities for investors to benefit from security selection and capital structure positioning.

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