Re: Structures, Disclosures and Practices in the European High Yield Market

Dear AFME High Yield Board,

On behalf of the investor members of AFME listed in Appendix A and as part of the ongoing dialogue between the "buy-side" and "sell-side" in the European High Yield market (the "Market"), we are writing to highlight certain areas of concern that are currently foremost in the minds of investors.

As long-term participants in the Market, we feel it is an appropriate time to refresh and expand the AFME Recommended Market Practices Disclosure by Issuers of the Non-Investment Grade Debt Securities, dated December 2011 (the "Best Practice Guide")\(^1\), and continue our active and constructive dialogue with underwriters, sponsors and issuers. To this end, we believe increased transparency, consistent, timely and simultaneous disclosure and better and more deal-efficient structures will help the Market maintain its recent growth, develop a broader investor base and lead to more efficient pricing on both primary and secondary markets.

The issues that we raise in this letter include:

I. Disclosure;
II. Rule 144A Offering Process;
III. Covenants;
IV. Portability;
V. Voting, Ranking and Security; and
VI. Call Structures/Redemption.

We believe that through open and frank discussions and mutual understanding of the relevant issues, these matters can be resolved to the satisfaction of all market participants. We look forward to working with other stakeholders to address these issues for the good of the wider Market.

I. Disclosure

As a general point, we believe that the Market is best served by providing open and transparent reports and accounts, in line with practice in the US high yield market. In this regard, we encourage issuers to reference AFME HY’s Best Practices Guide.

Issuers have made great strides in furnishing investors with their Senior Facility Agreements and Intercreditor Agreements in recent years, although often doing so only on a bilateral basis. We believe that market practice should be to include such information in the relevant offering memorandum or to make it available on Bloomberg or the issuer’s investor relations page such that the information is accessible to all Market participants equally and promptly.

Similarly, it is essential that financial results are made available to all Market participants equally and promptly. Accordingly, we encourage issuers to post results on their corporate websites and/or Bloomberg, at a predetermined time in advance of, or simultaneously with, sending them via email.\(^2\) Investor relations pages on issuers’ corporate websites should be unrestricted and not conditional on prior registration, approval of access, acceptance of confidentiality obligations or other restrictions on the use or disclosure of the information disclosed on those webpages.

Finally, we acknowledge that it is up to the Market to evaluate the efficacy of the terms and conditions of any securities transaction but, in order for it to do so, individual investors require sufficient transparency. Given the increased complexity and subtlety of some of these issues, we think that it would be in the interests of both investors and issuers if more time were devoted to discussion of covenant features (particularly those that may be considered atypical) and call protection during the roadshow process.

II. Rule 144A Offering Process

The Market has traditionally followed the Rule 144A offering process and we note that the level of comfort, due diligence and information received under the "10b-5" standard remains critical to investors. This common, well accepted standard helps to sustain investor confidence in the primary market. Accordingly, we urge all participants to maintain the "10b-5" standard, which has been a critical component underlying the success of the Market.

III. Covenants

Over the last several years the scope of "carve-outs" has increased, thereby limiting the efficacy of the restrictive covenants. The Indebtedness covenant, for example, has become more generous and has the potential to allow significant additional leverage. Two examples of the widening scope of carve-outs include the increased use of soft capped/dynamic baskets for "Permitted Debt" and the inclusion of "Contribution Debt". Similar concerns apply to the Restricted Payments covenant with respect to broadening the definition of “permitted investments” and the scope of the other carve-outs to the covenant. In addition, the inclusion of anticipated synergy cost savings add-backs to EBITDA in ratio definitions where those synergies are uncapped or are not assessed by third parties can allow inappropriate inflation of EBITDA. This is not in keeping with the European leveraged loan market, where synergy EBITDA add-backs are typically capped at 10-20% of EBITDA. See also Section (V) below regarding our concerns regarding the limited application of secured leverage ratios.

IV. Portability

"Portability" arose in Europe and is less frequently seen in the US high yield market. The inclusion of this provision causes significant concern to investors particularly as it has evolved from being used in very specific circumstances where the market was aware of the possibility of a change of ownership in the near-term, to being incorporated more generally in the market transactions (30% of 2014 deals). In some cases it can be used more than once.

Portability through the use of a NET leverage ratio is particularly problematic due to the potential injection of equity or subordinated shareholder debt to manipulate leverage down

\(^2\) To highlight the importance of such simultaneous disclosure we cite the European Union Court of Justice case, *Michael Timmel v Aviso Zeta AG*. 

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for the simple purpose of taking advantage of portability. This is especially true if the restricted payments covenant does not then exclude such equity/subordinated shareholder debt injections from being added to the restricted payments build up-basket ("BuB") and the permitted payments carve-outs that can be funded from equity/subordinated shareholder debt proceeds.

Similarly, the current trend of not resetting the BuB on a portable change of control (i.e., the purchaser inherits accumulated dividend capacity in BuB and does not have to "re-earn" it through its better management of the business) only serves to exacerbate this concern.

Other related developments that are of concern to investors include:

- Leverage portability tests that are set close to opening leverage (rather than requiring deleveraging) and the omission of step-downs in the leverage portability test;
- "disguised" portability through an extended definition of "Permitted Holders"; and
- adding back to EBITDA synergies from the change of control transaction itself which can make it more likely that an issuer will meet the relevant leverage test, particularly as these synergies are often uncapped and not subject to third party assessment (see also section III above).

V. Voting, Ranking and Security

Where bonds are claimed to rank pari passu with other debt, this should be reflected in equal voting rights.

With respect to senior secured notes, there is often a dilution of the noteholders’ collateral through pari securing of other debt.

In order to effectively regulate dilution of the bondholders’ interest in their collateral and to protect the bonds’ position in the debt structure, a secured leverage ratio test should apply to the incurrence and securing of all items of debt (both ratio debt and any specific permitted debt baskets, but excluding items in the ordinary course, operation of law, etc.) that are permitted to be secured on the same collateral. It is a matter of concern for investors where certain categories of debt, such as uncapped "Contribution Debt" and acquisition debt (as distinct from acquired debt) can be secured on a pari passu basis with notes without being subject to a secured leverage ratio test as this may result in dilution of the noteholder’s security.

Finally, in the secured leverage ratio’s components, the numerator should also include all secured debt plus any effectively and structurally senior debt.

VI. Call Structures/Redemption

The shortening of non-call periods diminishes potential returns and increases reinvestment risk for investors. We further note that the inclusion of limited call protection in first time issuer bonds is particularly unappealing due to the resources allocation required to invest in a new credit weighed against an investment horizon that could be as short as 18 months. The
Market has generally been a total return market, and investors expect a sufficient level of upside for taking the risks associated with investing in high yield bonds.

Investors are also concerned by the expansion of the "Equity Clawback" feature. Equity Clawbacks should limit the funds which can be applied to redeem bonds during the non-call period to the proceeds of equity offerings of the issuer itself or a holding company whose only material asset is ownership of the issuer (and, in the latter case, which are downstreamed to the issuer as an equity or subordinated shareholder debt contribution). Definitions of “Equity Offering” (or similar drafting to achieve the same effect) which allow the proceeds of an offering by an unrelated company, or even simply an injection of subordinated shareholder debt (without a third party sale of equity), to fund redemption under the Equity Clawback undermine the rationale of this provision and makes it difficult, if not impossible, for investors to assess the likelihood of the Equity Clawback being used as it comes close to making the Equity Clawback a pure call option.
Appendix A

Alliance Bernstein LP
BNP Paribas Investment Partners
ECM Asset Management Limited
Fidelity Worldwide Investments
First International Advisors LLC
GLG Partners LP
Henderson Global Investors
Hermes Investment Management
Invesco Perpetual
Legal & General Investment Managers
Mirabaud Asset Management Limited
Muzinich & Co.
Neuberger Berman LLC
Northlight Group
Pictet Asset Management S.A.
Pioneer Investments
Robeco Group
Rogge Global Partners Plc
Schroders
Susquehanna Ireland Limited
T Rowe Price
Threadneedle Investments