HIGH YIELD DEBT RETURNS!

Posted on March 30, 2011

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Investors looking for yield after the demise of income trusts and Canadian issuers looking to raise capital at competitive rates are cheering the burgeoning Canadian high yield debt market. With more than $3.4 billion of Canadian high yield issues in 2010 and many companies seeking to boost debt capital before interest rates climb, 2011 is expected to be another strong year. Of course, the size of the domestic market does not take into account the vibrant market in U.S. cross-border high yield debt.

The high yield debt market is expected to remain strong as Moody's estimates that over the next 4 years approximately US$30 billion in high yield debt from Canadian-based companies will mature.

key features of high yield debt

Almost uniformly, high yield bond covenants are incurrence-based and include a requirement to repurchase on a change of control and limits on restricted payments and asset sales but do not typically include financial "maintenance" covenants. Maintenance covenants are intended to measure the financial health of an issuer and to give an early warning signal to lenders if the issuer's business could be facing difficulties. In the case of bank debt, the lead or agent bank can negotiate with the issuer on behalf of the lenders to deal with a covenant breach. However, an issuer's high-yield bonds are generally relatively widely held, making bondholder consent a challenge for even the most minor breach. From a practical perspective, therefore, the absence of maintenance covenants is sensible as any problem means that a maintenance covenant default would be hard to manage.

While this structure gives issuers flexibility, it means investors have to be comfortable that the other key components of the credit analysis are understood: the issuer's management and ownership, its business and sectoral history and its past and anticipated future financial performance. It is important to keep in mind that the likelihood of default is much more immediate for high yield issuers than for those which are investment grade. As a result, the detailed covenant package, along with any accompanying security, needs to be negotiated to match the risk assessment, such that "market" covenants, including limits on restricted payments, debt incurrence and priority debt and change of control provisions are properly attuned both to the issuer and to investor tolerance.

Rating agencies in particular will apply a more intensive level of analysis when reviewing a high yield debt instrument than they do in an investment-grade scenario, and will tend to focus on how the various protective features included in a deal are likely to function with respect to a particular issuer. Depending on a particular issuer's characteristics, not all investor protections – covenants, security or otherwise – will be equally effective or even applicable to any given high yield issue. Some generalities are possible though. We note for example that, to date, recent high yield issues have typically included a limit on restricted payments, a limit on the incurrence of debt and a limit on liens.

recent developments

Given the recent resurgence of M&A activity beginning in 2010, it is perhaps not surprising to see the use of high yield debt to finance M&A transactions. In this context, a high yield debt issuance is often used in conjunction with a working capital facility and/or term loan facility placed in the bank loan market. To the extent a high yield debt offering is secured, there can be a sharing of security packages amongst the facilities, although priority issues will always require close attention at both the structuring and execution phases. As the Canadian M&A market heats up, it is reasonable to expect high yield debt issuances to be a growing part of this landscape. Furthermore, it is expected that market developments south of the border will continue to influence terms and conditions in Canadian transactions, particularly when an offering is made in support of an LBO transaction involving U.S.-based equity sponsors, or as part of a cross-border Canada/U.S. offering.

conclusion

2011 may be the year of the high yield bond in Canada. Market observers expect investor demand for yield to remain strong, expect to see dealers committing resources to the market and foresee a high yield market open to all types of issuers. It is important to keep in mind, however, that timing is extremely important as this particular market can be unpredictable. Issuers which remain on the sidelines too long may find the high yield option in Canada suddenly unavailable to them.

For more information on this topic, please contact McMillan's High Yield Debt Team. McMillan's 100 year history of leadership in financial services, including its extensive knowledge of leveraged finance, can help you take the lead.

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A Cautionary Note