INVESTMENT

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Implication Of BCE Transaction For Bond Covenants

The court case brought by some Bell Canada bondholders against BCE and its purchasers was an important hurdle in the largest leveraged buyout in global history – 10 times larger than any previous Canadian deal. The case was ultimately decided in favour of BCE and the purchasers in the Supreme Court of Canada. The reasons for the decision have yet to be released by the court. Subject to some subtleties, it is expected that the decision will uphold the principle that the main goal of directors in a change of control transaction is to maximize shareholder value and that bondholders must rely mainly on their legal contract with the company (the covenants contained in the trust indenture and supplements) for protection.

This ruling is already affecting the structure of bond covenants in the Canadian corporate bond market. Bond investors are increasingly demanding covenants that protect them if the company is subject to a change of control through a merger, acquisition, or leveraged buyout (a takeover financed with a large debt component), or if the bonds are downgraded. In light of the increased focus on covenants and event risk in the bond market, pension plans should be inquiring about external manager policies and methodology regarding security selection, valuation, and covenant analysis.

Trends In Covenants

As covenants place restrictions on the ability of issuers to carry on business, issuers generally prefer fewer covenants. There are trade-offs between covenant use and the yield on the bonds (the financing cost for the issuer), as well as the willingness of bondholders to purchase the securities (the size of the transaction). In some cases, investors will accept bonds with fewer covenants because market discipline decreases the likelihood that management will take actions that negatively impact bondholders. For example, if a company is growing and has an ongoing need to issue debt in the public market, there is an incentive for management to maintain a low cost of funds. Bondholders may have the ability to discipline management by withholding financing, demanding covenants, or pushing yields higher if the company changes its financial policies in a manner adverse to them.

After increased leveraged buyout (LBO) activity in the 1980s and the highly-publicized large LBO of RJR Nabisco in 1989, there was a period of greater use of protective covenants. This subsided as bondholders chose to accept fewer covenants. The global trend in investment grade bonds moved toward 'covenant-light' issues. Typical investment grade corporate bonds have included very little explicit protection, often just a 'negative pledge' that prevents the company from issuing debt that ranks senior to the existing debt. This trend away from covenants was fuelled by solid overall credit conditions, deleveraging of corporate balance sheets, and a decrease in LBO activity despite a large number of investors searching for yield and willing to sacrifice covenants to get it. Over the past few years, LBO activity has increased with private equity pushing into previously uncharted territory in terms of size of transactions and regulated industries, highlighting the need for covenant protection once again.

The boards of public companies generally seek to maximize shareholder value in evaluating potential transactions, including LBOs, which may alter the financial and operating strategies of the firm. LBOs can occur for almost any company, including very large companies, but are less likely for highly regulated companies such as utilities or financial companies. The likelihood of an LBO transaction may change over time as market conditions change and as company specific factors change, so that the event risk for a particular company is not constant.

Value Can Fall

A great deal of academic, rating agency, and practitioner research, as well as market evidence, has shown that bondholder value can fall when LBOs occur. Bondholders are aware of this risk, but different bondholders may have different estimates of the likelihood of an event and of the severity of its consequences.

When a company is ready to issue a specific bond, a supplemental indenture references a specific trust indenture and/or shelf prospectus. Conditions in this supplemental indenture can take precedence over the trust indenture, so covenants can be altered as market conditions and investor preferences change. Investors express to dealers and to the company their interest in new issues with the existing features and covenants, their preference for different covenants, and the impact on yield or the size of their investment in the absence of covenants. The larger the investor or group of investors, the greater the potential influence on covenants and bond yield.

On an ongoing basis, bondholders perform credit analysis to understand the financial and business conditions and risks of a company and to evaluate the value of bonds considering the risks. Bondholders have the opportunity to consider covenants and other information in trust indentures and prospectuses, along with other market and firm specific information, before they make a decision to purchase a bond.

Reasonable Expectations

Bondholders also monitor statements made by management regarding the company's financial policies to, among other things, determine whether there is any change in circumstance which would increase the likelihood of an event occurring. However, bondholders are aware that management statements regarding financing policies do not constitute a guarantee for the future, but reflect an intention that may change in response to changing market conditions and events.

This was an important point of contention in the BCE case. Under Canadian corporate law, in order to obtain a remedy, a complainant must establish that its reasonable expectations have been breached. Bondholders argued that they had a reasonable expectation that the company would live up to management's previous statements that it intended to maintain an investment grade rating. The company argued that the statements were subject to changes in market conditions and that the company being 'in play' merited a change in financing policy in the best interests of shareholders, while taking into consideration the contractual rights of bondholders. I believe that sophisticated Bell Canada bondholders ought to have been aware that stated management intentions are subject to change and are not a guarantee or the equivalent of a covenant. Accordingly, it would have been unreasonable for Bell Canada bondholders to expect that BCE's financial policies would remain unaffected even in circumstances where the company was subject to a change of control transaction and the board was under a duty to maximize shareholder value. Bondholders know the difference between a stated intention and a guarantee or covenant. When they are released, the reasons for the Supreme Court ruling in favour of BCE will shed additional light on this topic.

Even if there are no explicit covenants in place, event risk that may result in significant change in leverage can be avoided by monitoring characteristics of companies that make them vulnerable. For example, companies with a combination of low enterprise value relative to operating cash flows, low leverage, and poor recent equity performance are often good candidates for leveraged buyouts.

Ratings don't generally offer much insight into the potential impact of event risk for bond investors. Event risks may, or may not, be incorporated explicitly in ratings depending on rating agency policies, timing, and market conditions. Analysis of covenant protection is part of all agencies' regular ratings process, but the focus of ratings is on the probability of default without incorporating potential 'exogenous' events. Standard & Poor's explicitly excludes generalized event risk from its ratings. When specific event risk becomes a rumour, S&P monitors closely and when there is a concrete action taken, it will put the company on credit watch. Its final rating decision is delivered only when details of the transaction become available and detailed analysis is feasible, and "not in relation to transient market sentiment." This timing highlights the importance of investors' due diligence throughout the period of a transaction's completion.

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DBRS does not currently incorporate event risk into ratings, which are focused on the probability of default throughout the cycle, but offers comments on covenants and event risk in their ratings analysis. Moody's has a specific service (separate from its regular ratings) where it provides very detailed covenant analysis specifically in the context of events.

There is no standard language for change of control protection. Some covenants may not offer sufficient protection depending on how they are worded and different bonds issued by the same company may be subject to very different covenant protection. It is, therefore, very important that investors scrutinize covenant language and understand the subtleties.

For example, there were three different trust indentures involved in the BCE case, issued in 1976, 1996, and 1997. Some relevant differences in the trust indentures resulted in different treatment for various bondholders in the transaction. For example, there is a debt incurrence test in the 1976 and 1997 indentures that prevents the issuance of additional funded debt and the transaction met these covenants. None of the indentures contain change of control covenants. The 1976 and 1996 indentures contain provisions regarding the "reorganization" or "reconstruction" of the company that bondholders argued gave them a right to approve the LBO, but this argument was dismissed by the trial judge as well as the Court of Appeal.

Avoid Event Risk

Bondholders can obviously avoid event risk completely by choosing to invest in securities that are not subject to event risk or default risk such as Government of Canada bonds. In the current market environment in light of the BCE ruling, as well as trends in other markets, Canadian bond investors are pressuring companies to add covenants. Some new issues have already seen protective change of control language added and there is pressure to add covenants that increase the coupon payments in the event of a downgrade or that force the company to meet specific leverage constraints. These types of covenants can act as substitutes for each other as the main concern of bondholders is to control their risk profile or to be compensated if risk increases. Thus far, regulated companies and banks have not been subject to these covenants since their risk of takeover or LBO is perceived to be relatively low. Many investors are demanding extra yield to compensate them if protective covenants are not in place and many choose not to invest if the bond does not offer sufficient reward for their perception of risk. In current markets, the increased yield is likely in the range of 20 to 50 basis points depending on the risk level.

Plan sponsors should be discussing these issues with their bond managers to ensure that they are vigilant and that they understand the implications of the Supreme Court ruling once the reasons are released. ■

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