

## Corporate bonds

### Should there be a call for enhanced protection?

*by Michel Bourque*

The media often overlooks the Canadian corporate bond market, even though it represents over \$200 billion and most Canadian pension funds are invested in corporate bonds. There is a simple explanation for this: prices for corporate bonds have been relatively stable over the years compared to equity prices. However, a plethora of rumours surrounding leveraged buy-outs (“LBOs”) has caused major fluctuations in the value of bonds issued by targeted firms.

The impact of an LBO on bondholders is rarely positive; the amount of new debt is substantial, such debt sometimes ranks ahead of existing bonds and this new higher level of leverage results, more often than not, in a downgrade of the target firm’s credit quality. It’s important to note that lenders are not all afforded the same treatment following an LBO. Indeed, bondholders tend to be less protected than lending banks.

Bank loans are governed by a credit agreement that is negotiated directly between the company and a consortium of lending banks. Such credit agreements are usually full of restrictive covenants, so that a bank’s consent is often required before an LBO is even considered.

The situation is different for bondholders, as their securities are governed by a trust indenture. This document contains all of the loan’s terms and conditions, including restrictive covenants, the company’s obligations and the various events resulting in default. A trust indenture is negotiated between a company and its same lending banks, although it is not necessarily

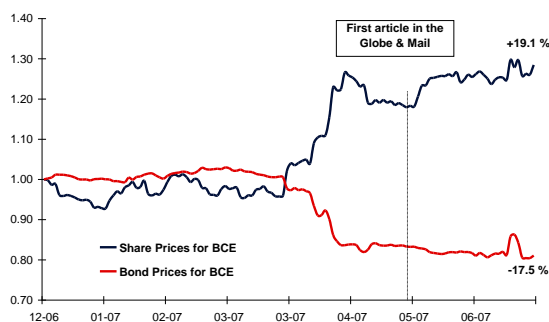
subject to the same restrictive covenants! Investors have traditionally had little say in the elements contained in a trust indenture, their only option is to take part in a new issue or not.

It should also be understood that, during an LBO, banks charge significant fees to put in place any new funding that is used to close the deal. This source of income, which is highly profitable for the banks, prompts them to minimize obstacles to an LBO. Since any restrictive covenants granted to bondholders may reduce the attractiveness of an LBO or even prevent the transaction from occurring, the banks have an incentive to limit the protection provided by restrictive covenants in a bond’s trust indenture. However, without restrictive covenants, the impact of an LBO is habitually devastating for bondholders.

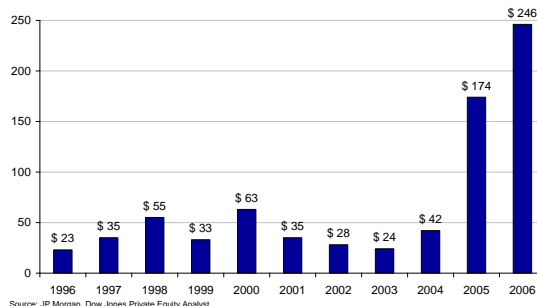
The Canadian corporate bond market was rudely awakened to the reality of LBOs with the first rumors of a possible privatization of BCE. The risk premium required for investors to hold a 30-year Bell Canada bond (compared to a government bond with the same maturity) increased approximately 1.50%, moving from 1.50% prior to the announcement to about 3.00% at the end of April 2007. Such an increase in the risk premium represents a decline of a whopping 17% in the value of the BCE bond.

The assumption that the sheer size of BCE would stand in the way of a takeover is surely one of the reasons why bondholders were so laid back when it came to adding restrictive covenants in the trust indenture. This was probably the case a few years ago, i.e. before LBO firms began to raise massive amounts of funds and before large pension funds began to make increasingly large allocations to alternative investments.

Creating or transferring value?



Amounts Raised by Private Equity Funds in the United States (billions of \$ US)



A record year for LBOs was observed in 2006, with a total of US\$246 billion in the United States (US\$432 billion worldwide) being committed to LBOs, dwarfing the 2005 volume, which was US\$174 billion in the U.S. (\$232 billion worldwide). In February, Goldman Sachs managed to raise a hitherto unheard-of US\$20 billion in a single fund. It is common for managers of these funds to receive annual fees of 2% on the amount invested. This powerful incentive pushes these funds to consider transactions in which several billion dollars can be pooled quickly.

Nearly 20 years ago, the largest LBO transaction was carried out by KKR following the takeover of RJR Nabisco Inc. for US\$31 billion. KKR broke its own record in November 2006, acquiring a U.S. hospital chain, HCA, for US\$33 billion. This new maximum only lasted a few months, since two new transactions bypassed this amount in February 2007, i.e. the acquisition of *Equity Office Properties* by Blackstone for US\$39 billion and the acquisition of TXU by KKR for US\$45 billion. The size of these transactions has most corporate bond investors worldwide very worried.

The risk of an LBO remains the most widespread concern for corporate bond managers in Europe. In fact, corporate bond investment strategies are developed solely with that in mind. In order to protect their portfolios against the devastating impact of an LBO, corporate bond investors require a return to the inclusion of restrictive covenants in trust indenture. The major covenant that is being called for is a put option to sell bonds back to the issuer in the event of a change of control at the company. This covenant protects the value of existing bonds should there be an LBO. HSBC Bank estimates that, during the past year, 50% of new issues in Europe (with the exception of issuers from the financial and public utility sectors) included a change of control covenant, though such a provision was practically unheard-of a mere two years ago. This covenant is also becoming increasingly popular in the U.S., as it was added to 34% of new issues during the first quarter of 2007, compared to 25% during the second half of 2006 and 0% during the first half of last year.

Since early April 2007, the increase in risk premiums of Canadian corporate bonds has not been diverted to BCE issues. Indeed, the risk premiums of several issuers, including Telus, Manitoba Tel, Loblaws, Métro, Thomson, Trans Alta, Yellow Pages, Enbridge, Trans-Canada Pipelines and Canadian Tire have risen substantially, as investors feel that the risk of an LBO is present for these issuers as well.

Ever since the BCE LBO has turned the corporate bond market in Canada upside down, only Brookfield Asset Management, an issuer that is not active in the financial or public utility sector, has dared to float a new issue. Its bonds are subject to a change of control covenant that allows bondholders to redeem 101% of the original value of their securities should there be a change in control that results in a downgrade on the part of three of the four rating agencies.

The addition of a change of control covenant is not enough to prevent each and every occurrence of an LBO. For instance, the risk premium for Sobey's bonds advanced approximately 0.70% when Empire Co., Sobey's parent, announced that it was being taken private following an LBO. The addition of a change of control covenant would not have protected Sobey's investors, as the proposed transaction did not result in a change of control!

Investors purchase corporate bonds in good faith and accept the issuer's business risk. It is perfectly normal for those investors to require protection from an event, such as an LBO, that is likely to modify the nature of this risk. Such protection could take any of the following forms:

- imposing limits on debt;
- ensuring that assets cannot be sold or pledged;
- ensuring that a bond's seniority in the company's capital structure is protected.

Are we now witnessing a return to restrictive covenants in Canada?



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