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IN THE KNOW: INTERNATIONAL

Leveraged Finance Newsletter

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FALLING ANGELS: THE EFFECTS OF THE COVID-19 CRISIS ON CORPORATE RATINGS AND THE IMPLICATIONS OF A SUB-INVESTMENT DOWNGRADE FOR CORPORATE ISSUERS

Overview

In the wake of the COVID-19 crisis, organizations of all types are enacting measures to preserve liquidity, reduce costs and plan for the potentially slow recovery back to pre-crisis levels or, in some industries, a return to a new normal. As a result, corporate risk profiles for the near, medium and long term are facing new scrutiny, including from their auditors when evaluating the "going concern" criteria for their audit reports, and ratings agencies (Moody's, S&P and Fitch) when stress testing worst-case scenarios for rated corporates.

One result of these evaluations is that certain corporates, particularly those in industries most affected by the COVID-19 crisis, have already or may find their ratings downgraded. As of the end of April 2020, more than 1500 issuers were negatively impacted by COVID-19 and oil prices. In the case of a corporate with Baa3 and BBB- ratings, the resulting downgrade may move them into a sub-investment category, which could have several knock-off effects. In February, the OECD estimated that approximately $261 billion of corporate (non-financial) bonds were at risk of losing their investment grade rating by the end of the year. When they added financial institutions to into the mix, the number grew to approximately $500 billion.[i]

Corporates that move from investment grade to sub-investment grade are sometimes referred to as "Fallen Angels". This issue of "In the Know" discusses some of the implications for corporates and their treasury departments (and their advisors) who face this situation, with some considerations and recommendations.

Why do ratings matter?

Ratings from the three main ratings agencies (Moody's, S&P and Fitch) provide a picture of credit quality and default risk for a corporate and/or its debt or equity profile that is used by a wide variety of market participants, including finance providers, investors, customers and suppliers. The market draws an important distinction between an "investment grade" credit (i.e., falling into one of the top four ratings categories) and a "sub-investment grade" credits (anything below that), which are also sometimes referred to as "high yield" or "leveraged" credits.

	Moody's	S&P	Fitch
Lowest IG rating	Baa3	BBB-	BBB-
Highest sub-IG rating	Ba1	BB+	BB+

Each rating agency has developed complex methodologies to evaluate credits. After the onset of the COVID-19 pandemic, the agencies have undertaken stress testing of its rated corporates. Given the business impact of the crisis (in particular in industries such as travel and leisure or retail), several previously investment grade credits are threatened with the possibility of a downgrade into non-investment grade territory.

Losing investment grade status can have variety of knock-on implications for a corporate group. Beyond the underlying issues which led to the rating downgrade, as a result of the downgrade,

[i] Çelik, S., G. Demirtaş and M. Isaksson (2020), "Corporate Bond Market Trends, Emerging Risks and Monetary Policy", OECD Capital Market Series, Paris, www.oecd.org/corporate/Corporate-Bond-Market-Trends-Emerging-Risks-and-Monetary-Policy.htm

the fallen angel shall face an increased cost of capital, with investors likely to require additional protections in the form of more restrictive covenants, additional collateral and/or guarantees. As the impact of the COVID-19 pandemic evolves in the short, medium and long-term, a fallen angel will need to take into account additional challenges to liquidity, operational flexibility and covenant compliance due to the adoption of such investor protections. In the long-term, a fallen angel will have to assess whether it can regain its investment grade status and return to pre-COVID-19 crisis financing arrangements.

Falling Angels - First Considerations

Below is a high level description of some of the areas that a corporate should evaluate if it finds itself under ratings pressure, with the threat of a downgrade that would move one or more of its ratings from investment grade to sub-investment grade.

Are there any triggers?

Finance documents in the two categories often have different starting points (e.g., LMA/LSTA investment grade v. LMA/LSTA non-investment grade forms), with greater restrictions placed on a sub-investment grade credit to undertake corporate actions (e.g., incur debt, pay dividends) and stricter credit support in terms of subsidiary guarantees and secured lending. Some (but not all) investment grade financing facilities include penalties when a downgrade into sub-investment grade territory occurs, which may include an interest rate ratchet, a requirement to grant security or guarantees, of the imposition of more restrictive covenants. Failure to comply with these additional restrictions could result in a default. This document review should extend to ancillary documentation as well, including, in particular, hedging arrangements and lines of credit.

In addition, commercial agreements (e.g., supply contracts, performance or other guarantees or indemnities or insurance premiums) often contain a credit rating components. A prudent corporate should determine which of these types of arrangements could be affected by a downgrade and take appropriate steps to seek a waiver or a renegotiation of terms.

Why Financial Definitions Matter

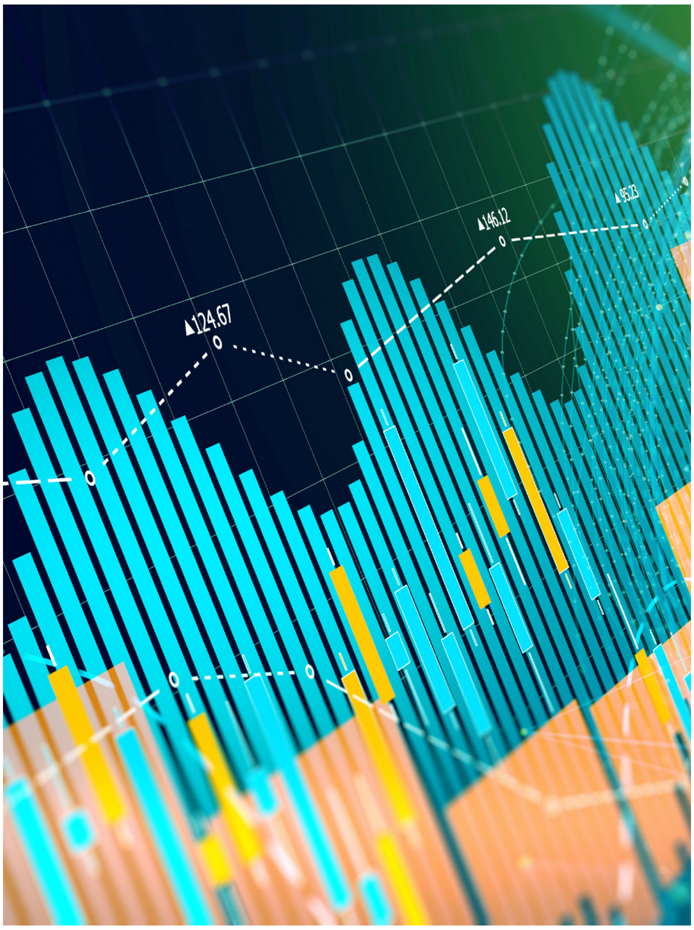
Finance documents rely greatly on financial definitions when imposing certain requirements and restrictions on corporates as to maintenance (e.g. maintaining a debt to EBITDA (leverage) ratio below a certain threshold) or incurrence (e.g. only being able to incur additional debt if the EBITDA to fixed charges (fixed-charge coverage) ratio is greater than a certain threshold).

Typically, financial definitions used for covenant compliance differ from the more prescriptive GAAP or IFRS derived versions. One particularly important concept in the COVID-19 crisis is the fact that covenant EBITDA typically allows for some form of add-back of non-recurring or one time charges, which may relate to expenses, loses or other specific items. A corporate should carefully evaluate its financial definitions to determine whether it may be able to utilize certain EBITDA add-backs to blunt the impact of COVID-19 expenses without needing to enter into formal waivers or amendments with its lenders. For example, a corporate may be able to disregard, off-set or add-back its costs or expenses in response to COVID-19 in connection with capital expenditures to enable employees to work remotely or other costs related to re-establishing a new supply chain, refunds for cancelled or postponed bookings or fines imposed by counterparties for missing deadlines. Corporates should also scrutinize their business interruption insurance arrangements to assess their ability to add-back proceeds of business interruption insurance or other reimbursable costs to EBITDA.

To the extent a corporate is being constrained by covenant calculations (if its documents include maintenance covenants for instance or it needs to incur additional debt in order to alleviate liquidity pressures), it could approach its lenders for amendments or waivers either (i) adjusting EBITDA calculations by looking back to pre-COVID-19 periods (either deeming EBITDA to be a certain pre-agreed amounts with reference to historical periods or annualizing historical periods for instance) or (ii) providing for a maintenance and/or incurrence covenant holiday period.

COVID-19 Disclosure Considerations

On March 25, 2020, the United States Securities and Exchange Commission ("SEC") published CF Disclosure Guidance: Topic No. 9 (the "Disclosure Guidance") which provides guidance to corporates regarding their disclosure obligations with respect to the impact of COVID-19 on their business, financial condition and results of operations. While the SEC recognizes the challenges of corporates to assess the rapidly evolving effects of COVID-19 on a business, the Disclosure Guidance encourages corporates to evaluate the current and expected impact of COVID-19 through the eyes of management and to revise and update disclosures as facts and circumstances change.



The Disclosure Guidance sets forth a series of non-exhaustive questions in order to assist corporates with their assessment of current anticipated COVID-19 related impacts. These questions include the extent to which COVID-19 has impacted a corporate's capital, financial resources and overall liquidity position and outlook The Disclosure Guidance also contains specific factors for consideration which include a corporate's ability to service its debt or other financial obligations, access the debt markets, including commercial paper or other short-term financing arrangements, maturity mismatches between borrowings sources and the assets funded by those sources, changes in terms requested by counterparties, changes in the valuation of collateral, and counterparty or customer risk. To the extent that a material liquidity deficiency has been identified, the Disclosure Guidance highlights the importance of a corporate disclosing what course of action it has taken or proposes to take to remedy such deficiency.

In light of the Disclosure Guidance, where a corporate has had their ratings downgraded, this may necessitate appropriate disclosure in the corporate's Management's Discussion and Analysis in its next periodic report.

We issued a client alert on March 27, 2020 in which we highlight key considerations for US public companies with respect to disclosure and other securities law obligations related to COVID-19.

Getting three vs. two ratings

Historically, the test for ratings triggers was tied to a Moody's and an S&P rating, with a requirement that both (although sometimes just one) retains investment grade. While regulators, including the SEC, frowns on "rating shopping", more recent deals have included the option for getting ratings from two of the three agencies (including Fitch), which provide an issuer with more flexibility when trying to retain its investment grade status, particularly in jurisdictions or industries where the agencies vary on approach.

Fallen Angels - Where to next?

The BB+/BB space - high yield "lite" - what is it?

The good news for corporates that fall into one of the higher sub-investment grade categories is the advent of high yield "lite", which in emerging markets may be referred to as the "covenanted Eurobond". For these credits, the starting point for the structure and restrictive covenants would be the investment grade model, under which one or more "customized" covenants may be added to the investor protections to address specific concerns, but otherwise the protections are the more flexible investment grade style. If possible, corporates raising new debt after a downgrade into BB+ space should evaluate with their advisors to avail themselves with a high yield "lite" structure.

Security and fall away security

Lower rated credits are often required to grant share or asset security and/or corporate guarantees to lenders. In the case of a fallen angel, where there would be an expectation that the corporate would in the future regain investment grade status, it is important to provide that such security or guarantees would fall away once the investment grade status is achieved.

The negative pledge in existing debt - Can you get it to work?

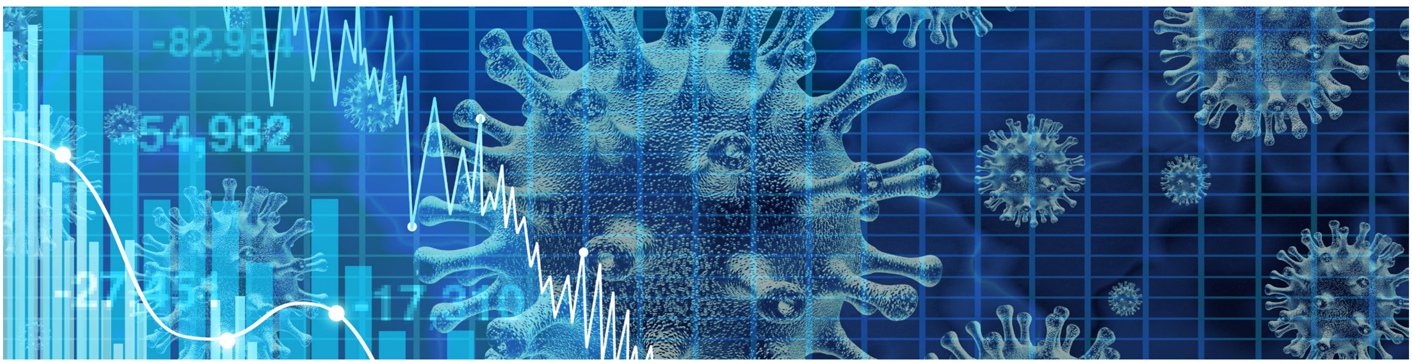
In connection with the above, once a corporate falls into the non-investment grade space, creditors may demand asset security with respect to any new financing (or an existing financing as described above). Corporate bonds (and sometimes bank facilities) will typically include a negative pledge, which allows the granting of security only if the outstanding bonds are equally and rateably secured.

A complexity that can arise when trying to comply with this requirement is that typically an investment grade bond or Eurobond-style covenant will not provide specific guidance as to how this equal and rateable ranking can be achieved (e.g., is the trustee authorized to enter into an intercreditor agreement without bondholder consent?). Further, a typical Eurobond-style covenant will include the requirement that the arrangement be "acceptable to the trustee", which requires an additional level of sign-off and negotiation (a typically US investment grade bond does not include this requirement, so allows additional flexibility on how to address this concern).

To the extent a corporate needs to address a negative pledge of this type in its existing debt arrangements (particularly one that would require trustee consent to comply), it should take early action to provide a structure acceptable to the trustee to avoid a possible late determination that bondholder consent may be required.

Will COVID-19 governmental relief programs be extended relief to non-investment grade credits?

The initial COVID-19 relief programs (e.g., the ECB's PEPP program or the UK's CCFF program) are focused on investment grade credits. Some of these programs have indicated that under certain circumstances they will provide relief for sub-investment grade credits. Indeed, the ECB has already moved to grandfather corporate bonds that were rated investment grade prior to April 7 for the purposes of Eurosystem



collateral eligibility and has not ruled out expanding the PEPP to these fallen angles. The Federal Reserve has gone a step further announcing that it would purchase high yield bonds by purchasing exchange traded funds. While there is some backlash in the various markets as to why a "levered" credit should get any government relief, in fairness this objection should not be applicable to a fallen angel credit that would otherwise have maintained an investment grade rating. These interventions have seen spreads in the high yield market tighten in recent weeks and the primary market return to both the US and Europe. While covenant packages seem to be largely unchanged from pre-crisis issuances, the high yield market is adjusting to the expansion of government support schemes to non-investment grade credits by providing issuers with the flexibility to access comparatively cheap financing under these schemes. For example, a number of recent high yield bond issuances have given the issuer the ability to a partially redeem 35%-40% of its newly issued bonds during the make-whole period with the proceeds from a government sponsored financing albeit at a premium to the original issue price.

Corporates who fall below investment grade should look carefully at what government programs remain available to them (either directly in the form of government sponsored financings or indirectly in the form of government bond purchasing programs) and discuss options with their advisors to deliver best execution of any bond issuance and provide for future flexibility where possible as their business (and capital structure) recovers.

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Conclusion

Falling angels should perform due diligence of their existing financing and commercial documents to fully understand the implications of a potential rating downgrade and to assess what options they shall have to weather short and medium-term liquidity concerns. Fallen angels may need to consider high-yield "lite" financing and, in connection with a downgrade, be required to provide additional credit support. Fallen angels should also carefully consider participating in governmental relief programs as part of balancing their near-term liquidity concerns with their long-term objectives.

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