

## IN THE KNOW

Leveraged Finance Newsletter

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### NORDIC CORPORATE BONDS – WHAT HAPPENS NEXT

Over the last decade, the Nordic bond market has experienced significant growth in terms of volume and number of issuers and has become a viable alternative for issuers across substantially all industry sectors (not only the real estate sector) and varying credit profiles seeking debt financing. At the end of 2019 the total outstanding amount of the Nordic bond market was EUR 1,112bn, of which EUR 102 billion consisted of corporate bonds (i.e. excluding FIG and public sector issuers) after approximately 9% of growth over the preceding year. The markets in Sweden and Norway are by far the larger among the Nordic countries, although Finland and Denmark have seen increased activity as well. Marketing is conducted primarily within the Nordic markets, although depending on the transaction it is fairly common that investors in other jurisdictions are approached as well.

The Nordic bond market has tracked the exponential growth of debt securities offerings outside the US generally following last decade's financial crisis, supported by the lending restraints imposed on traditional banks, demand for instruments that offer some yield in the low interest rate environment, the shorter average execution timelines, less management involvement required, lower advisory costs and more developed options for restructuring a credit if it becomes distressed. Still, many international banks have yet to participate as placement agents or underwriters for Nordic bonds, citing concerns over liability, reputational risk and adherence to stricter disclosure standards. This, in turn, has given some local players an opportunity to develop the market further.

#### **Nordic Market vs. Traditional Reg S/144A Market**

The Nordic bond market originally developed locally, with standards, as will be described below, that deviate from those traditionally associated with Regulation S (outside the US) or Rule 144A (inside the US to sophisticated investors) offerings, in particular with respect to the scope of disclosure and concerns over potential liability under US securities laws. While the market is still substantially limited to Nordic issuers, as a more robust international investor base develops, these considerations continue to be revisited.



The following chart sets out certain material differences between the process and structure of a Nordic corporate bond issue and a Reg S/144A offering:

	Nordic bonds	Reg S / 144A
<b>Public Credit Rating</b>	Not required. While some issuers have a public rating from one or more credit rating agencies, particularly in the investment grade segment, most issuers are not rated and bonds typically do not have individual ratings.	Required. Although not strictly required by law, investors rely on corporate and/or instrument ratings in making their investment decisions and the market standard is to provide at least two ratings. Credit ratings may also be triggers for covenants being suspended (upon achievement of investment grade status) or a requirement for a change of control.
<b>Due Diligence</b>	Limited diligence conducted. Often handled only by way of a due diligence questionnaire that the issuer fills out and a diligence bring down call conducted prior to launch. Unless a particular issue comes to light based on responses received from the company that would prompt further review, the investment bank and its counsel would typically not request relevant documentation or otherwise conduct an independent review of any materials.	In-depth due diligence conducted. Full legal, documentary and financial due diligence of the last three financial years and interim period conducted in order to protect underwriters against potential liability (see below). Due diligence will generally include a full review of material legal documentation, several due diligence and drafting sessions and bring down calls. In a "significant" acquisition or carve-out financing transaction, the scope of due diligence will also include the target.
<b>Comfort letter</b>	Not required.	Required. AU Section 634 (SAS 72) comfort letter and accompanying circle-up required, as well as auditor due diligence call.
<b>Offering Documentation</b>	Lighter and consists primarily of a term sheet, a company description, risk factors and financial information. As the marketing of Nordic bonds is typically limited to institutions and other accredited investors there is no requirement for a formal prospectus or other approvals prior to the issuance.	Extensive disclosure included in the Offering Memorandum. Although not strictly required in Reg S/144A offerings, market practice is that the disclosure in such offerings is guided by the requirements of registered offerings in the US and the requirements of underwriters in order to avoid reputational risks.
<b>Exchange Listing</b>	Typically listed on an exchange or alternative market some time after the issue date. In Sweden, bonds will usually be listed on the regulated market NASDAQ Stockholm. This is not due to a formal requirement, but rather because many investment funds have such listing as a prerequisite for investing in the bonds.	Similar requirements and rationale as for Nordic bonds, although generally listed on unregulated markets. Choice of listing venue may also be influenced by MAR considerations, especially in the high yield market, depending on the jurisdiction(s) of the corporate group.
<b>Underwriter Liability</b>	No express or clearly defined liability imposed on mandated banks. No requirement to establish due diligence defense.	In 144A offerings, Rule 10b-5 under the US Securities Exchange Act of 1934 creates potential liability for any person who, in connection with the purchase or sale of a security, (1) employs any device, scheme or artifice to defraud or <b><u>(2) makes any untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.</u></b>
<b>Execution timeline</b>	Shorter, mainly due to more limited due diligence exercise and lighter offering documentation.	Longer, mainly due to full diligence exercise and extensive offering documentation.
<b>Mandated banks / Underwriters</b>	Nordic-based investment banks	Large international investment banks.
<b>Investor base</b>	Generally limited to more local, nordic-based investors.	International investors.
<b>Principal amount</b>	Typically in the range of US\$10 million to US\$100 million (equivalent).	Typically greater than US\$100 million (equivalent).
<b>Maturity</b>	Typically 4-5 years, but can often be as short as 3 years.	Typically 5 or 7 years, but can be up to 10 years.
<b>Call Schedule</b>	Typically no call period for 1-2 years, with redemption in full permitted thereafter at a premium which decreases in steps until maturity, subject to some ability to refinance at par during last 3-6 months prior to maturity. Equity claws or partial redemption options are unusual, but are sometimes included.	Fixed rate bonds are generally callable at a make-whole premium for the first 2-3 years, and thereafter at a premium, which decreases until par. May also include equity claws or partial redemption options (such as 10% at 103%).  Floating rate bonds will generally be callable at par after one year.
<b>Terms</b>	Generally more restrictive than bond terms in the international markets as maintenance covenants are common and less flexibility is offered under baskets and permitted exceptions, but looser than for a corresponding loan financing and fewer covenants.	No maintenance covenants. High yield bonds only include incurrence based covenants. Restrictions will largely be a function of credit rating and interest rates although generally looser than for corresponding loan financing.

As outlined above, Nordic bond issues offers some features that sets them apart from a Reg S/144A issue. The absence of any requirement for a public credit rating is an important reason for how this form of financing is accessible also for smaller issuers and issues (a Nordic bond offering can be very small although SEK 100,000,000 is often viewed as a minimum threshold for issues where there is a desire to ensure some level of liquidity). A rating from an independent credit rating agency is associated with significant cost and effort, both upfront when the rating is obtained and continuously in order to maintain it, and this can be a major hurdle for issuers in the small to mid-market segment of international debt markets. Underwriters needing to establish a due diligence defense in 144A/Reg S offerings similarly involves a costly and time consuming process which can be avoided in Nordic bond offerings. The more limited due diligence and disclosure also benefits the issuers by making the process less cumbersome and costly.

Taken together these features of the offering process in connection with Nordic bond offerings have resulted in an efficient and low cost alternative of debt financing, benefiting both issuers by giving them an alternative form of financing and investors who wish to invest at attractive yields and in instruments that offers some level of liquidity. However, since the Covid-19 pandemic hit with full force earlier this

spring the activity in the market for new issuances of Nordic corporate bonds has been very limited, and it seems that outstanding bond issues will now be put to the test more broadly for the first time since this market grew into a significant force after the last financial crisis. In this context we find it interesting to explore certain aspects of Nordic corporate bonds that are particular for this instrument and that could potentially involve challenges.

- *No credit rating and limited disclosure, diligence and arranger liability.* The strength of Nordic corporate bonds is also its weakness in that the efforts of minimizing transaction costs for a bond offering also means that less information is made available to investors and no meaningful vetting of the issuer and its business is conducted. It could be argued, however, that since offerings of bonds are often done in connection with an acquisition or after a recent IPO they can benefit from the typical vetting process involved with such event. Furthermore, it is probably the case that investment banks, in the interest of protecting their reputation, exercise some level of gate keeping role when selecting which issuers to market a bond offering for, based on relationship with such issuers and available information. However, the space is competitive and participating banks may be tempted to look the other way in order to secure a mandate. If

we see an increase of defaults under outstanding bonds it may bring to light information that the investors would have wanted to know at the time of their investment decision and which would have been discovered if just slightly more diligence and vetting would have been done.

- *Financial covenants.* It is fairly common for high-yield bonds in the Nordic market to have maintenance covenants, and the trend over the recent years has actually been for more high-yield issues to have maintenance covenants. Based on statistics available through Nordic Trustee 55% of high-yield issues in Sweden and 73% of high-yield issues in Norway during 2019 have financial covenants. While some of these may be a more manageable version of financial covenants such as maximum debt to equity, minimum liquidity or similar, many will consist of the more traditional EBITDA based financial covenants such as maximum leverage. As of the date hereof, issuers have already begun seeking relief under their financial covenants from the investors due to the Covid-19 pandemic, and it seems likely that these requests will increase as we approach the financial reporting for Q2 and Q3.
- *Costly process for amendments and waivers of bond terms.* The definitive documentation for a Nordic bond consists of terms and conditions entered into with an agent appointed to act for the bond investors (Nordic Trustee and Intertrust are most often seen in this role). The investors in turn hold the bonds through a book entry system maintained by a clearing system (e.g. Euroclear for issues in the Swedish market). As in the international bond markets, most issues in the Nordic corporate bond market are held by a widespread investor collective without any other relationships or ties to the issuer. This can put issuers in a difficult situation if a need would emerge for any kind of relief under the terms. Amendments and waivers





require that a formal bondholders' meeting is held or written procedure is conducted through the appointed agent in order to obtain the requisite consents from the investors. Since the investors generally do not have any incentive to maintain a long term relationship with the relevant issuers they tend to act opportunistically in this context and require consent fees and/or other concessions in exchange for consent even for limited changes. In addition, fees charged by investment banks for assisting with the strategy and communication with investors as well as the legal fees can often be viewed as disproportionately high from the issuer's perspective in light of amendment requests that seem minimal. While issuers under other debt financing arrangements with large investor groups will be in a similar situation, maintenance covenants and generally more restrictive covenants will add strain. Furthermore, the generally smaller sizes of Nordic bond issues may make the issuers more vulnerable to distressed debt investors and other investors with a loan-to-own strategy.

- *Short maturities.* Maturities for Nordic bonds varies greatly but are generally shorter than for loans or bonds in the international markets. Maturities are typically 4-5 years, although it is not uncommon to have maturities as short as 3 years, particularly when necessary in order to build a book of investors for less attractive credits profiles in the high-yield segment. Based on information made available through Nordic Trustee, much of the outstanding volume of corporate bonds will need to be refinanced over the course of the upcoming three years. In Sweden 18%, 24% and 23% of outstanding corporate bonds will need to be refinanced during 2020, 2021 and 2022, respectively. A significant portion of these will consist of high-yield bonds that may not find sufficient demand for another bond

on acceptable terms to refinance the maturing bond unless the conditions in the market improve.

- *Transaction counsel.* In the interest of further limiting the transaction costs in connection with Nordic bonds, it has been common for the parties to appoint a "transactional counsel" with instruction to act for both parties in the bond offering. However, as the mandated bank is the one who directs which law firm should act in this capacity (and decides whether the same counsel would be appointed again for other issues) it can be questioned whether the issuing companies for these transactions have the benefit of fully independent advice from counsel. If the legal counsel is incentivized to first and foremost ensure that the marketing of the bond will be successful it may be less inclined to negotiate for flexibility under the terms or raise issues that could potentially impact the efforts required by the investment bank in the marketing of the bond. Chances are that issuers who have agreed to a "transactional counsel" arrangement will more often later find themselves in a situation where they have insufficient flexibility under the terms and will need to seek relief from the investors. Fortunately, as the market has matured and the typical issuer has become more sophisticated the trend in recent years has been that more issuers choose to appoint their own separate legal counsel.

- *Exchange listing.* The listing provides for a trading venue and some liquidity for the bonds (although in practice the actual trading activity tends to be limited) and also subjects the issuer to certain reporting obligations and market surveillance, which is viewed as beneficial by investors. While there are positive aspects to a listing, it adds to the burden and cost for the issuer. If the issuer does not previously have a listed instrument, it will become subject to the Market Abuse Regulation as well as

the rules on the stock exchange, which both set out rules regarding disclosure of inside information and other market disclosure and reporting obligations. If a problem would arise under the bond terms it provides for another layer of complex issues that the issuer will have to navigate since the principle rule is that any inside information in the issuer must be disclosed as soon as possible.

## Where is the Nordic bond market going from here?

The Nordic bond market had another great year in 2019, and the popularity and steady growth of issuances over the last decade certainly shows that it has filled a demand from both issuers and investors. As noted above, however, aside from some temporary rough stretches in limited segments of the market (e.g. issuers in the oil and gas industry during 2015- 2016), the Nordic corporate bond market as a whole has never yet been tested in any significant way. When the spread of the corona virus developed into a global pandemic earlier this spring, the activity in the primary market for Nordic corporate bonds came to a halt, and for high-yield issuers ceased almost entirely. Over the last months we have already seen some increased activity from issuers seeking covenant relief from investors due to the effects from Covid-19 and there will likely be an increase in insolvencies resulting from upcoming maturities and issuer defaults under outstanding bonds. It seems likely that we are now in the beginning of a difficult stretch for issuers and investors in the Nordic corporate bond market.

If the problems arising in connection with outstanding bonds increase as the effects of the pandemic materialize, the features particular to Nordic corporate bonds may result in difficulties for both issuers and investors. Since these aspects may not have been relevant and fully appreciated during the booming years since the last financial crisis, it could bring some important structuring and legal lessons for these transactions going forwards. Issuers may

re-evaluate the shorter maturities, financial covenants and absence of independent legal advice from an issuer appointed counsel in the high-yield segment as they incur excessive costs later when forced to seek concessions from investors and/or refinance (or even restructure its debt) at an inopportune time. Investor's on their end may see more clearly the cost associated with investing based on the more limited disclosure and diligence requirements in a scenario where more issuers default on or otherwise run into trouble under the bond terms causing losses on the investments.

In the context of the challenges for issuers and investors of Nordic corporate bonds that lie ahead, it may be useful to think about how these debt arrangements can be further improved without taking away from the very reason for which the market participants find these so attractive in the first place. Given the smaller size of issuers and issues in the Nordic bond market it may

however not be feasible (or cost-effective) to fully adopt the standards for bonds in the international markets. The efficient process and limited cost associated with issuances of Nordic corporate bonds are often highlighted as the main benefit of this form of debt financing. In our view there may however be reason to consider some measured steps in that direction. It seems likely that some additional requirements in terms of diligence and disclosure, whether self-imposed or through regulation, could have a positive impact on the Nordic bond market by opening up for demand from a larger collective of international investors who are used to invest based on more information and currently view Nordic bonds as being too opaque. A larger group of potential investors would result in more demand and a larger and more liquid market overall, also benefitting issuers through lower yields. For issuers who are looking to issue

Nordic bonds or initiate any kind of process with the investors under an outstanding bond our advice is to retain their own legal counsel. Unless the economy and the markets improve, the costs associated with bond terms that have not been subject to any real review and negotiation from the issuer's perspective will materialize and become more clear.

Whatever may come, issuing and investing activities in the Nordic bond market are here to stay and will likely resume across all segments (including high-yield) when the dust has settled after the ongoing corona virus crisis. If the Nordic corporate bond market continues its upward trajectory, however, it is important to consider how it can be further improved and the effects from the Covid-19 pandemic may end up giving us some valuable pointers in this respect.

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