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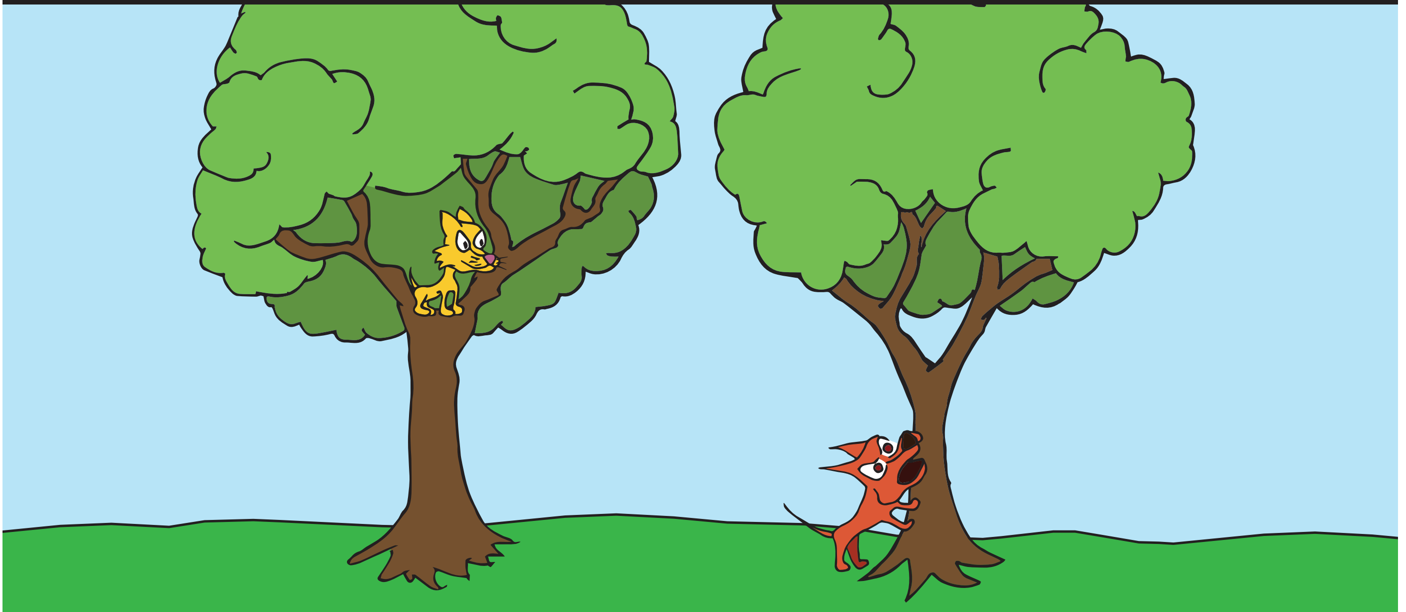

Latest in European Leveraged Finance – PetSmart: Barking Up The Wrong (Covenant) Tree?

Overview

— PetSmart, Inc. ("**PetSmart**") announced in June that it had spun-off a 20% stake in Chewy, Inc. ("**Chewy**") – the internet retailer that it had acquired less than a year earlier – to its shareholders (the "**Chewy Dividend**"), and transferred another 16.5% stake to an unrestricted subsidiary (the "**Chewy Investment**"). This followed months of rumors that a spin-off of a portion of the rapidly-growing Chewy might be in the works (as well as keen speculation as to how large a spin-off might be feasible under PetSmart's loan and bond covenants).

— As part of the transactions, Chewy's guarantee of PetSmart's secured term loan and senior bonds, as well as security over Chewy assets pledged to the secured term loan and senior secured bonds, appear to have been automatically released (although this is the subject of an ongoing dispute).

— The transactions have renewed investor concerns with "J. Crew"-like transactions in which valuable assets are removed from security packages and used to issue new senior secured debt to previously unsecured bondholders as part of distressed exchanges – thus reorganizing the capital structure to the detriment of existing secured creditors.

Did unusual covenant features facilitate the Chewy Dividend and Chewy Investment?

It doesn't appear so. In contrast to the J. Crew transaction, which entailed creative structuring to expand flexibility for unrestricted subsidiary investments, PetSmart appears to have sized the Chewy Dividend and Chewy Investment to fit into market standard (and fairly transparent) covenant exceptions in its 2025 Notes:[1]

— PetSmart, based on a complaint filed in U.S. federal court (against the agent under its Term Loan) (the "**Complaint**"), determined the fair market value of the 20% and 16.5% stakes transferred to be $908.5 million and $749.5 million, respectively (valuing Chewy at roughly $4.5 billion, based on the midpoint of a range recommended by its valuation expert).

— The Chewy Dividend thus required PetSmart to find at least $908.5 million of room under its restricted

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1 PetSmart's capital structure primarily consists of three series of bonds – US$1.35bn Senior First Lien Notes due 2025 (the "**2025 Secured Notes**"), US$650m Senior Notes due 2025 (the "**2025 Unsecured Notes**," and together with the 2025 Secured Notes, the "**2025 Notes**") and US$1.9bn Senior Notes due 2023 (the "**2023 Notes**") – as well as a US$4.3bn secured term loan (the "**Term Loan**"). It also maintains an ABL facility of up to US$750m.

payments covenant, while the Chewy Investment required $749.5 million of room under its restricted payments covenant *and/or* linked permitted investment flexibility.

— The restricted payments covenant includes a build-up basket, which likely (based on statements in the Complaint on similar Term Loan provisions) had $627.0 million of room *solely* through its earnings component and another at least $200.0 million though a "free and clear" component,[2] and a $200.0 million general basket (leaving aside EBITDA growers) – so *at least* $1.027 billion of room (versus the $908.5 million required).

— The permitted investment definition includes a $150.0 million basket for investments in unrestricted subsidiaries, a $300.0 million basket for investments in (broadly defined) "similar businesses" and $375.0 million as a general basket (leaving aside EBITDA growers) – so *at least* $825.0 million of room (versus the $749.5 million required).

Moreover, although the capped baskets noted above are sizeable, they are not eye-poppingly so in current market practice for a repeat issuer of PetSmart's size and with a private equity sponsor. Indeed, if these were the baskets relied on, then PetSmart will have now used the bulk of its obvious current restricted payments and investments room (absent clever structuring or reliance on the equity contribution discussed below).

What about that $1 billion equity contribution?

The 2025 Notes were issued to fund the Chewy acquisition, and formed part of a financing package that included a $1 billion equity contribution from PetSmart's private equity sponsor. The drafting of the equity injection components of the restricted payments build-up basket though are arguably unclear as to whether that equity contribution was intended to build room under the covenant. Much market speculation has thus revolved around whether PetSmart might seek to rely on this $1 billion equity contribution to expand its restricted payments flexibility.

These interpretive questions are likely still important (to understand PetSmart's flexibility for additional Chewy equity transfers). That said, if PetSmart's endgame is a distressed exchange, it may well have acquired ample (and perhaps under-appreciated) flexibility to undertake the same just as a result of the transactions undertaken to date (as discussed below).

Did unusual covenant features facilitate the release of Chewy's guarantee and Chewy asset security?

Yes, they did. The guarantee release provision in the Term Loan was triggered just by Chewy ceasing to be "wholly owned" by PetSmart. This is an awkward concept; indeed, it would permit an aggressive issuer to eviscerate a guarantee package by paying out very small dividends of equity stakes in each of its wholly owned subsidiary guarantors. The more common approach would trigger release on a disposal of equity only if the guarantor ceased to be a restricted subsidiary thereby (*i.e.*, restricted group ownership fell to less than a majority stake) – a standard which would, of course, have been much harder for PetSmart to meet using its available restricted payments and permitted investment room.

The release of the Term Loan guarantee had a domino effect. The guarantees of the 2023 Notes and 2025 Notes were automatically released because the guarantee of the Term Loan was released. The asset security was automatically released as part of the release of the guarantees. Neither of these follow-on releases were particularly unusual.[3] In the context though, they likely came as a surprise for the bondholders.

The potential for the guarantee release to facilitate a distressed exchange may not have been fully appreciated

The market appears to now be expecting a distressed exchange using the 16.5% stake transferred through the Chewy Investment – and with such a valuable interest free of restrictions, perhaps with good reason.

However, the implications of the release of the Chewy guarantee and asset security for a potential distressed exchange may actually be more significant. This is because, with the Chewy guarantee and asset security released, there are now few obvious restrictions on the

2 The earnings component uses a standard 50% of "consolidated net income" construct, but backdated to March 11, 2015 to align with the start date under the 2023 Notes (which is not unusual for repeat issuers that have built up restricted payments capacity under a prior issuance, and the build-up is often disclosed, as it was here).

3 Bond terms will often defer to guarantor coverage requirements in loan documents – releasing bond guarantees when loan guarantees are released and requiring bond guarantees to spring up when new loan guarantees are provided. Similarly, it is not controversial to release asset security when a guarantee is released since, in the narrow circumstances where guarantee release is typically permitted, it is seldom appropriate to retain security over a guarantor's assets.

incurrence of significant new debt secured by the released Chewy assets:

— The liens covenants under the different series of Notes only restrict security over assets or property of the issuer and guarantors. With Chewy having ceased to be a guarantor, there are no seeming covenant restrictions at all on its ability to grant security over its assets.

— The debt covenants under the different series of Notes appear to offer considerable flexibility for debt incurrence by non-guarantor restricted subsidiaries (including, as a result of the transactions, Chewy) that could be secured with Chewy assets and offered as part of a distressed exchange – including a likely $1 billion at least of room under the credit facilities basket and $500 million under a general basket.

— Chewy assets likely need not be limited to securing non-guarantor debt in any event. Many liens covenants permit liens over non-guarantor assets that secure non-guarantor debt (on the theory that non-guarantor debt is in any event senior to the bonds). The PetSmart liens covenant goes further though, simply not restricting liens over non-guarantor assets at all – which opens the door to additional routes for debt secured by Chewy assets (for example, at issuer or guarantor level, or indeed, at the level of the new unrestricted subsidiary).

It is possible that some of these issuer-friendly constructs with respect to non-guarantor debt and liens wouldn't be troubling to investors amidst a more robust guarantee package, of course; and indeed, a robust guarantee package was likely what PetSmart investors thought they were getting (with non-guarantors accounting, when the 2025 Notes were issued, for only 6.2%, of total net sales, 4.3%, of operating income and 1.7%, of total assets). Amidst easy guarantee release provisions though, this non-guarantor flexibility takes on much greater significance.

It remains to be seen how the new issue market will react

There are specific lessons to be drawn from PetSmart – notably, that unusually easy release provisions need scrutiny, including those in any related senior secured term loan; and that the interplay between equity contributions that are part of a common acquisition financing package with the bonds and covenant flexibility needs careful consideration.

Yet PetSmart (like J. Crew and other recent transactions), in more subtle ways, highlights how covenant trends of recent years, taken together with generous baskets, might well mean that the potential for value-stripping transactions and distressed exchanges are lurking in many issuers' covenant packages – even those *without* any particularly unusual features.

In part, this is just because the fixed component of restricted payments and permitted investments baskets will necessarily tend to cover a proportionately larger piece of an issuer's overall value as the issuer becomes troubled (and its overall value shrinks). (For example, although J. Crew relied on a "trapdoor" that permitted investments by loan parties in non-loan parties to essentially "pass-through" into unrestricted subsidiaries in the second step of its transaction, the preliminary step – *i.e.*, the transfers of relevant IP assets from loan parties to non-loan parties –took place *entirely* through (transparent) capped general baskets. As those IP assets roughly equaled the group's enterprise value, its ability to effect even the preliminary step through capped general baskets is thus fairly surprising.)

Yet today's covenant packages also reflect a range of innovations over the more traditional high yield package that also potentially facilitate such transactions by reducing transparency and limiting external checks on an issuer's actions. These include, for example:

— "fair market value" determinations that are to be made in "good faith" by the issuer or an accounting officer of the issuer – versus the independent checks that were required in large transactions some years ago. (In PetSmart, for example, the valuation of the transferred Chewy stakes was a crucial determinant of covenant compliance, yet this determination was left to PetSmart's board and officers; and while a procedure was followed that involved a "valuation expert," it is unclear from the Complaint whether the valuation expert retained was independent and of recognized standing);

— generous exclusions from "consolidated net income" for covenant purposes, including for "unusual" and "non-recurring" items – which, traditionally (especially for cash items) might have been added back to EBITDA (facilitating debt incurrence) but not excluded from consolidated net income (which builds room for restricted payments as well). (In PetSmart, this appears to have been a key factor in the build-up of restricted

payments capacity from the time the bonds were issued in 2017 (at which point, built-up room including the $200 million free and clear basket was only $593 million), given that GAAP net income since issuance was reportedly negative);

— carve-outs for permitted investments in "similar businesses" that, through broad definitions, have become akin to additional general baskets in all practical effect; and

— the dilution (or outright deletion) of "ring-fencing" requirements that traditionally limited the ways in which entities within the restricted group might interact with and support unrestricted subsidiaries, and vice versa.

These trends are not necessarily bad for creditors – for the most part, they provide issuers with flexibility to grow and manage their businesses effectively (to the benefit of creditors as well) without compromising the basic integrity of the restrictions at which the covenants are aimed. Yet they do also loosen the rigor of covenant protections in ways that, in some scenarios, may facilitate transactions that are to creditors' detriment.

It thus remains to be seen how the new issue market will digest and react to the PetSmart transactions (and those it might still undertake) – whether by focusing on the narrow, clearly troublesome issues that they give rise to, or going further through new bespoke restrictions (for example, on distressed exchanges) and/or more general tightening of the covenant package.

DEAL CONSIDERATIONS

1. Have the guarantee and security provisions been considered in full detail and do they strike the right balance, *i.e.*, are they appropriate given the credit but with reasonable flexibility for the issuer's legitimate needs? Has the interaction between the guarantee release provisions in the senior notes and any related term loan been studied? ☐
2. If day-one equity contributions are made, have these been appropriately included / excluded from the covenant package in a manner consistent with the credit analysis? ☐
3. Have any unusual provisions in the above been clearly disclosed in any bond offering memorandum? ☐
4. Do basket sizes and related formulations and definitions in the various covenants strike the right balance, *i.e.*, are they appropriate given the credit but with reasonable flexibility for the issuer's legitimate needs? ☐

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