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ALERT MEMORANDUM

# Trends and Considerations for Secured Notes Offerings During COVID-19

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In response to liquidity needs during the COVID-19 crisis, more and more non-investment grade issuers have turned to the secured notes market. These deals generally have a five-year maturity and are completed on an accelerated timeframe, with launch and closing taking place within a few days. While secured notes are not themselves a new product, we wanted to highlight certain recent themes and considerations in these transactions.

Secured notes have not historically been the first choice for issuers – they are issued alongside asset-based credit facilities and to improve marketability and provide downside protection in the right circumstances. In contrast, in the current COVID-19 landscape, issuers have turned consistently to secured notes offerings, in particular given the limited ability in some cases for issuers to access the leveraged loan market.

As a secured product that offers comparable protection to a secured credit facility with the addition of much more extensive call protection than the typical credit facility, noteholders have the benefit of favorable economics, which has led to attractive pricing for issuers. In addition, the "most favored nation" or "MFN" clause in many issuers' existing loan agreements may not capture secured notes offerings, allowing issuers to borrow in the secured notes market without causing existing loans to be repriced to match a higher interest rate and resulting in a much more expensive capital structure.


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## Disclosure

Secured note offerings require a significant upfront investment of time and effort from issuers compared to secured bank transactions. This includes assistance in the preparation of a detailed offering memorandum, additional interim financial statements and a detailed business description, participation in business and legal due diligence and coordination with outside accountants. The marketing process is also much more accelerated with launch and pricing often occurring on the same day.

## Covenants

Despite the current market environment, generally the covenants in these new secured notes deals are consistent with pre-crisis terms, other than including additional limitations on restricted payments. Lenders have been focusing on similar limitations in the loan market in the context of amendments, particularly restrictions on dividends and share repurchases. In general, covenants are based on prior unsecured notes offerings with technical changes to reflect the fact that the notes are secured. For first time note issuers, it is important to have some headroom to their existing bank covenants wherever possible, given that it is hard to amend note indentures.

## Call Protection

A common trend for these new secured notes offerings has been a five-year maturity, with two years of call protection, resulting in a much shorter tenor than the usual seven- to eight-year maturity for secured notes. This trend for a shorter tenor offers more flexibility to the issuer for refinancing if circumstances improve but still provides noteholders with more call protection than would be typical for a credit facility. There also have been a handful of deals that build in additional call rights with the proceeds of "regulatory debt" (debt provided under one of the various government backed loan programs). One feature in pre-crisis secured notes offerings, a 10% per annum call right at 103% for the first years after the offering (or if shorter, during the non-call period), appears to have fallen away in these recent secured notes deals.

## Collateral and Intercreditor Issues

Given the quick timeframe for these deals and the overlay of the current remote work environment, collateral issues have become a clear area of early focus:

- *Intercreditor Arrangements*. An element that can quickly become a timing issue if not addressed promptly is the intercreditor arrangement with the other secured debt holders. Secured notes issuers often have other secured debt in the form of credit facilities, and the key terms of the intercreditor arrangements will need to be ironed out with these creditors prior to launch, with intercreditor agreements or joinders being signed at closing. In situations where there are no existing intercreditor agreements and/or pre-agreed forms, it can be difficult for all parties to get aligned in a timely manner, especially if there are multiple layers of secured debt involved (*e.g.*, a first lien term loan with a first lien on non-current assets and an ABL facility with a first lien on current assets). Frequently, even if there is an existing senior / junior lien intercreditor agreement, there is no form of pari passu intercreditor available or the existing intercreditor agreements may not include mechanics for additional parties to be added. The short time frame between conception and launch of these new secured notes transactions also limits the amount of time for negotiation of these intercreditor arrangements and working through the mechanics with all of the relevant parties.

- *Post-Closing Timing*. Be aware of post-closing time periods and build in sufficient time, particularly in light of COVID-19. Pledging collateral in the current remote work environment presents timing concerns that can be hard to predict. In addition, as notes collateral trustees will not want to have much discretion to extend collateral delivery periods, care must be taken in order to properly provide sufficient time for issuers to comply with collateral requirements. It is also important to be mindful that some companies may have rotating furloughs or reduced staff which can further complicate timing. While a 90-day post-closing period is common, some issuers have been able to negotiate for periods as long as 150 days and occasionally with extensions if delayed due to COVID-19 related complications.

- *Scope*. When deciding on the collateral package for these secured notes offerings, there will be discussions on whether to match an existing secured credit facility exactly for purposes of marketing or whether there are reasonable deviations that can be agreed between the issuer and the lead underwriters for cost and timing concerns. Carefully matching up the exceptions that had previously been agreed between the issuer and the other secured creditors is also critical and can be difficult when the existing secured debt has been in place for a long period of time. One additional factor to consider is whether to provide a parent level guarantee if the issuer is a subsidiary as many unsecured notes do not have a parent guarantee whereas a secured parent guarantee is a common feature in secured credit facilities.

## Reporting

For private issuers that have not previously issued debt securities in the 144A market, issuing notes will likely result in incremental reporting. While these new secured notes deals are almost always done on a Rule 144A-for-life basis without any requirement for SEC registration, reporting requirements are likely more involved than the financial reporting that is typically required under credit agreements. One related point for issuers to keep in mind if adapting from an existing notes issuance is to make sure to incorporate SEC grace periods for reporting and to remove any separate hardwired requirement for guarantor / non-guarantor disclosure.

## Compliance with Existing Debt Agreements

In the tight timeframe for these secured notes offerings, in addition to the other concerns described above, issuers should also confirm compliance with their other debt documents:

- If relying on a ratio exception to incur secured debt, confirm the relevant measurement period, particularly differences between existing credit agreements, which usually refer to the period covered by the most recently delivered financials, and existing indentures, which often refer to the period for which financials are internally available. This can be critical in determining availability of certain exceptions depending on timing of reporting of quarters impacted by COVID-19.

- Typically other secured debt will have maturity limitations on new tranches of secured debt such that new secured debt cannot mature within the life of the existing secured debt. While usually not an issue in pre-COVID notes offerings where notes are expected to have a longer maturity than credit facilities, the issuer must confirm there are no issues caused by maturity limitations for any new secured notes offerings with a shorter than usual five year tenor.

- In addition, as referenced above, issuers will also need to be aware wary of any “MFN” provisions in existing debt agreements that have not expired if their scope would include secured notes issuances.

## Conclusion

While secured notes offerings can be a very attractive and effective means of providing additional liquidity for companies during the COVID-19 crisis, there are a number of trends to keep in mind and factors to be carefully considered when undertaking these offerings.

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