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Thinking Outside the Box: How to identify potential risks outside of the restricted group

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Executive Summary

- Amendment and waiver requests from borrowers during the pandemic highlighted the risks that blind spots caused by the current level of reporting obligations may pose for investors.
- Typically, such reporting obligations apply only to entities that are restricted by the covenants, which form part of a group that is colloquially referred to as being in "the box".
- Categories of information "outside the box" that can cause concerns for investors include immaterial or unrestricted subsidiaries, holding companies, supply chains, and material contractual arrangements. In this report, we highlight recent examples where failure to disclose information has left investors in the dark about what lies "outside of the box".
- We also suggest questions that investors should ask to help them obtain information that could be material to their decision whether to invest, or remain invested, in a credit.

Introduction

Lenders have spent much of the past two years responding to amendment and waiver requests from borrowers, assessing asks for covenant resets and addressing additional capital needs. The debt markets have long been focussed on "cov-lite" and "cov-loose" when it comes to financial metrics, but there has been minimal spotlight on the information and reporting requirements that lenders should, or assume they should, enjoy.

As lenders have responded to "Covid" requests, it has become apparent that a borrower is not necessarily obliged to disclose or report all pertinent information regarding the financial and other status of the borrower group and capital structure more generally.

Taking the various reporting obligations in turn: there are those that may oblige reporting from the "group" as a whole, which will address both the obligations and liabilities of both the restricted and unrestricted subsidiaries; and there are those which will attach only to the "restricted group", that is, the entities of the borrower that are subject to the restrictions of the covenants in the agreement in question.

But these requirements leave out significant potential risks for investors, which could result in blind spots absent additional information. How much further should the typical leveraged investor look beyond the cash-flows of the restricted group?

Some categories of information "outside the box" that can cause serious concerns for investors include:

- immaterial or unrestricted subsidiaries;
- holding companies;
- supply chains; and
- material contractual arrangements.

Cash-flows have long been the lynch-pin of the leveraged investor – but now that there is significant flexibility and opportunity for additional debt to be layered into the capital structure, and it is increasingly in vogue to maximise flexibilities within documentation to incur additional debt, should the focus change?

Equally, and given the wide-ranging consequences that an external event (such as a pandemic) has on supply chains, consumer contracts, business relations and tax affairs etc., what can, and what should, the lender request so that they are better prepared to assess every eventuality and guard against weaknesses that go beyond cash-flow?

In this report we explore the interplay between these relationships and contractual commitments and suggest specific questions for investors to ask that will help them obtain information that could be material to an investment decision.

What information is reported?

Generally speaking, reporting is limited to annual – and possibly semi-annual or quarterly – audited financial statements of the "group". Typically, this includes both restricted and unrestricted subsidiaries, although sometimes scope is limited to the former, but will only in very rare circumstances reach upwards to holding companies or owners/sponsors.

Provision of management accounts is still required by certain deals, although their scope is no wider than the above. To the extent that the lender has the right to request additional information, this will still be limited to either the "group" or the restricted group.

Generally speaking, information requests are tightly negotiated by the borrower/sponsor – for the very reason that in a downside scenario, they want to protect against the lender having the ability to request seemingly "onerous" information, including to probe above the borrower group.

What information might be missing?

As we have seen above, a typical covenant package only requires disclosure of what's "inside the box", but arguably it is necessary to think outside of the box to ensure that investors have all the information they need.

Whether the market permits this information to be requested at the outset of a new transaction is an open question (and, likely an uphill battle) but investors can consider asking for additional diligence and information when responding to the aforementioned amendments and waivers, and covenant resets.

These present ideal opportunities to request additional information and to formulate the best possible picture of the current banking group, its holding companies, any unrestricted subsidiaries, and as a result to fully gauge overall leverage and any leakage.

For example, the rise of alternative debt structures, such as holdco PIKs and other types of financings that typically sit above the borrower group – so outside of the scope of reporting covenants – can create blind spots for investors. These facilities may benefit from holdco share security and/or cross-default/acceleration that reaches into the borrower group. In addition, the facilities frequently would rely on the restricted group cashflows to cover interest or financing obligations at the holdco level.

The ability of borrowers to incur additional holding company debt, or debt at the level of an unrestricted subsidiary – in each case, which can go unreported – is exacerbated by the existing documentational flexibility present in most contemporary covenant structures. It is not uncommon for permitted payments provisions to allow the servicing of holdco debt, or aggregate capacity under restricted payments baskets that will facilitate the servicing of this additional debt.

As the capacity to both incur and service debt outside the group exists, it is only logical that lenders should be asking about its existence and key features.

This is just one example. Using case studies on the next page, we summarise several circumstances that demonstrate the dangers of failing to get information about what lies "outside of the box".

What questions should investors ask?

As noted above, amendment and waiver requests are a valuable opportunity for a lender to request additional information, including:

- the details of used / unused basket capacity;
- the identity of any unrestricted subsidiaries and indebtedness at those entities;
- the nature of any holding company financing arrangements; and
- an overall assessment of the assets of the group (in order to determine whether any additional security should be taken).

Asking the right questions and holding firm to such requests is key. As the case studies covered in this report demonstrate, the consequences of being left in the dark about what lies "outside of the box" can be serious.

Case Studies: Dangers that Lie Outside the Box

Benefits accruing to the shareholders

Excessive debt at Casino's majority owner Rallye and its parent entities led to years of large dividend pay-outs and underinvestment in the restricted group, ultimately culminating in Rallye falling into Sauveguarde and Casino's unsecured rating migrating from investment grade to the current Caa1/B (over a four-year period).

What can we learn from this precipitous decline?

With both Casino and Rallye being publicly listed there was more information available than there would be for private issuers, yet the scale of the debt problem still caught out investors. It can serve as a cautionary tale for investors in a private company with little onus to disclose anything other than its restricted group accounts.

To avoid being left unaware of leverage above them and potential conflicts of interest amongst stakeholders, investors should establish what leverage is present above the restricted group, and what kind of facilities these are (loans, PIK debt, margin loans or supply-chain finance and what the holdco maturity profile looks like).

Surprise supply chain finance obligations

Supply chain financing at either the restricted group or a parent entity (or both, as was the case with Shop Direct) can often go undetected because any debt-like obligation will likely be hidden within working capital on the balance sheet rather than be classified as short term debt.

In the case of Shop Direct, the collapse of their supply chain finance provider (Greensill), caused a cash need at the parent holdco that was not required to be disclosed to lenders in the restricted group. In this case, the company was able to make a factually correct public statement – that there was minimal exposure to Greensill – without noting the hundreds of millions of debt owed at the topco.

Spring 2021 was an extremely accommodative environment for lenders. In a less supportive market a topco may have been forced to rely on the restricted group to help fund any liquidity shortfall, potentially to the detriment of lenders.

In reality, the holdco obligation incurred by Shop Direct's parent that refinanced the Greensill liabilities will likely rely on a either a dividend stream from the restricted group or partial stake sale of a share of the restricted group to manage any interest or cash outflow obligations.

Interrelated debt obligations bring down the whole cap stack

Agrokor, a Croatian-based Balkan food retailer and manufacturer, fell into restructuring when it faced a liquidity squeeze and couldn't manage its debt maturities in 2017. While there were a number of financial issues at play (including allegations of fraud), the "trigger" event was a springing maturity in certain bank obligations that was linked to a refinancing (or lack thereof) of the holdco PIK debt.

This also had implications for the annual accounting audit opinion - auditors were concerned about what was happening at the holdco when considering the opco business as a going concern. When the holdco was unable to find a resolution to address its PIK maturity in the required timeframe, the maturity on the opco obligations with springing maturities accelerated and this put the opco into default, eventually leading to Croatia's largest restructuring in history.

In this case, investors had some disclosure on the springing maturity language in the opco financial obligations as lenders had been concerned about the implications of the looming holdco maturity and conflict of interest involved for the owner.

This is a clear example of how an indebted unrestricted holdco can have significant implications to the opco, and that there can be important linkages to assess opco credit quality to anticipate potential risks and escalation of conflicts of interest.

About ELFA:

ELFA is a professional trade association comprised of European leveraged finance investors from over 55 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. The ELFA seeks to support the growth and resilience of the leveraged finance market while acting as the voice of its investor community by promoting transparency and facilitating engagement among European leveraged finance market participants. For more information please visit the ELFA's website: www.elfainvestors.com.

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