Vinson&Elkins

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HIGH-YIELD BONDS IN THE ENERGY INDUSTRY

Energy Series

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DISCUSSION TOPICS

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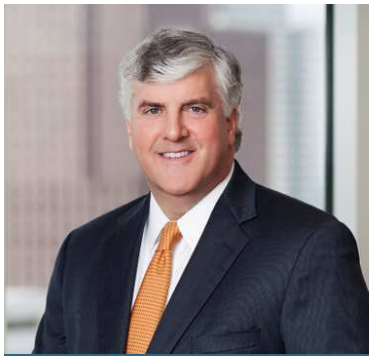
TODAY’S PANELISTS

NOEL HUGHES
CAPITAL MARKETS AND MERGERS & ACQUISITIONS

+1.212.237.0191 / +44.20.7065.6119

nhughes@velaw.com

Partner, New York & London



DAVID H. STONE
CAPITAL MARKETS AND MERGERS & ACQUISITIONS

+1.713.758.2236

dstone@velaw.com

Partner, Houston

DAVID W. WICKLUND
FINANCE

+1.212.237.0021

dwicklund@velaw.com

Partner, New York

INTRODUCTION

- Overview
  - Debt securities with below investment grade ratings (below BBB-/Baa3)
  - Compared to investment grade bonds:
    - Different covenants
    - Sold to different investor base
- Significance to the Energy Industry
  - Despite recent industry challenges and volatility, still significant volume in recent years
  - Extremely important source of capital to the Energy Industry
  - Often inverse correlation to leveraged loan volumes

INTRODUCTION (CONT'D)

- Key differences vs traditional bank loan products
  - "Flexibility" – more flexible in some ways, less flexible in others
  - Key is the longer term, fixed rate, call protected structure

  - Nature of counterparties
    - Indenture trustee
    - DTC/Euroclear
      - Increased liquidity for investors (freely tradeable, at least among institutional investors)
    - Underwriters
    - Bondholders

  - Different covenant philosophy
    - "incurrence" not "maintenance" covenants
    - More "upfront" flexibility –
      - Must provide for company's growth plans for several years
      - Waivers/amendments are not routine
      - Call protection makes the covenants more "permanent"

INTRODUCTION (CONT’D)

- Key differences vs traditional loan products (Cont’d)
  - Minimum deal size
    - +/-$300mm for new series
    - “add-on” issuances can be smaller
  - Securities offering mechanics
    - SEC Registered or Rule 144A/Regulation S
      - Rule 144A may include “A/B Exchange” registration rights
    - Disclosure
      - SEC “as registered” standard even if not registered
      - Historical/pro forma financial statement requirements
      - SEC compliant reserve disclosure for upstream issuers
    - Documentation – typical for securities offerings (underwriting/purchase agreement; auditor (reserve engineer) comfort letters; opinions of counsel)
    - Diligence process
    - Rating agency process

STRUCTURE

- 5-10 year maturity
  - 7-8 most common in current US market for unsecured bonds
  - 5 year maturity typical for secured bonds
  - Often a function of pricing, marketing conditions and issuer credit quality
  - Bullet maturity

STRUCTURE (CONT'D)

- Call protection
  - Provides pricing protection given fixed rate nature of instrument
  - Represents a key difference from TLBs and other loan products
  - Important in analyzing the viability of acquisitions
  - 8NC3 probably most common
    - o Dependent on market conditions
    - o Often set at 50% or 75% of coupon on first call date
  - Many other variations depending on tenor

    10NC5;7NC3;5NC2
  - Make-whole (T+50bps) prior to first call date
  - Equity claw

STRUCTURE (CONT'D)

Guarantees

- Subsidiary guarantees provided to prevent structural subordination
- Often "spring" into place and are released based on other indebtedness
- Parent guarantees not uncommon depending on placement of issuer in corporate structure

Unsecured vs secured

- Most of US market is unsecured with secured bonds more common in Europe

Secured bonds

- More common for distressed issuers or weaker credits
- Add significant upfront complexity – may be highly bespoke
- May attract a different investor class
- Impact on future financing flexibility
  - May limit ability to do additional pari or junior indebtedness
  - Make navigating in a restructuring more challenging

STRUCTURE (CONT'D)

Unsecured vs Secured (Cont'd)

- Lien priority
  - First Lien
  - Second Lien
  - "Crossing" Lien packages
  - Trust Indenture Act requirements should be considered
- Collateral
  - Intercreditor agreement issues (very bankruptcy focused)
    - Payment priority
    - Standstill provisions
    - Controlling parties
    - Releases of liens/amendments
    - DIP loan provisions
    - Buy-out rights
  - Attention given to intercreditor issues very fact specific

STRUCTURE (CONT'D)

Unsecured vs Secured (Cont'd)

- Outside U.S. (Europe) Intercreditors more complex due to lack of Chapter 11
  - Senior secured bond with SSRCF
  - Pari bond & loan
  - Second lien
  - Intercreditor "for life"
  - Recent RBL with senior notes structure

TYPICAL COVENANTS

- Restricted payments (dividends, equity repurchases, investments)
  - For corporate issuers (upstream, service, downstream)
    - “Builder Basket” concept
      - Most commonly based on 50% of cumulative net income, plus equity proceeds
      - Availability conditioned on meeting minimum FCCR (fixed charge coverage ratio) in debt test
      - Often “roll over” for serial issuers
    - Additional baskets and carveouts often negotiated
      - Specific existing stock dividends
      - Preferred stock dividends
      - General baskets
      - Other
    - Permitted Investments – important set of carveouts for JVs/unrestricted subsidiaries
      - Upstream – broad “Permitted Business Investments”

TYPICAL COVENANTS (CONT'D)

- Restricted payments (cont'd)
  - For MLP (and similar) issuers
    - If meeting minimum FCCR (often 1.75:1), no practical limit on equity distributions
    - Negotiated basket if not meeting FCCR (typically 4 quarters of dividends, plus equity proceeds and other items)
    - Permitted Investments/JVs/Unrestricted Subsidiaries – essentially unlimited if meeting minimum pro forma FCCR test

TYPICAL COVENANTS (CONT'D)

- Debt incurrence
  - "Ratio Debt" provision – debt allowed to be incurred if meeting minimum FCCR (2-2.5x is typical)
  - Other exceptions
    - Credit facility basket
      - Typically a fixed amount with a "grower" formula based on an asset measure (ACNTA, CNTA) or sometimes leverage test
      - Most important basket because it is allowed to be secured under the liens covenant
    - General debt basket
    - Purchase money/capital lease
    - Refinancing
  - Often limits within the covenant for non-guarantor debt

TYPICAL COVENANTS (CONT'D)

- Liens (permitted liens) – most often prohibits liens securing debt (as opposed to all liens)
  - Carveouts include
    - Credit facility basket
    - "grandfathered" acquired liens
    - Purchase money liens
    - Other negotiated carveouts

TYPICAL COVENANTS (CONT'D)

- Asset Sales
  - Generally require 75% cash (may include "designated non-cash" baskets)
  - Generally require proceeds to be used within a specified period (commonly 1 year) to:
    - Repay debt
    - Capital expenditures/investments
  - Mandatory offer to purchase bonds at par if proceeds not so deployed
  - Often specific definitional carveouts
    - $ carve outs
    - For upstream issuers, many types of oil and gas transactions (like farm-outs) in the ordinary course of business are carved out

TYPICAL COVENANTS (CONT'D)

- Change of Control/Mergers
  - CoC (as defined) triggers mandatory offer to purchase bonds at 101%
  - Definitional issues
    - Rating decline “double trigger” (portability)
    - Leverage based portability more common in Europe
    - Various exceptions for existing controlling persons
  - Important to analyze in the context of M&A transactions
  - Merger covenant operates independently

TYPICAL COVENANTS (CONT'D)

- Future guarantors
  - "Parity" formulation vs. "materiality" formulation
  - Can be significant in M&A analysis
  - Should be read in conjunction with the debt covenant as it relates to permitted non-guarantor debt
- "Unrestricted" subsidiaries
  - Mechanics allow subsidiaries to be "carved out" of the covenant restrictions
  - Limited by RP/Permitted investment basket
  - Important for joint ventures or projects with separate financing

TYPICAL COVENANTS (CONT'D)

- Financial reporting
  - For public issuers, SEC standard is often used
  - For private issuers
    - often more limited, negotiated financials and specific event reports
    - Often covenants requiring conference calls; website postings
- Others
  - Affiliate transactions
  - "upstream restrictions"
  - Sale/leaseback

RECENT CASELAW ISSUES

- *Wilmington Savings Fund vs Cash America International* (S.D.N.Y, September 2016)
  - Involved covenant interpretation surrounding a spin-off by the issuer
    - Company believed the transaction was permitted by the covenant; bondholders disagreed
    - No showing of insolvency or impairment of the credit
    - Court sided with bondholders
  - In addition, the Court held that in circumstances where a breach of a covenant was "voluntary," bondholders were entitled not only to accelerate and receive principal and accrued/unpaid interest, but also to receive the make-whole payment that would be due on optional redemption
    - no showing of bad faith
    - no showing of materiality
    - no language in the indenture stating that a make-whole was due on acceleration

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RECENT CASELAW ISSUES (CONT'D)

- Many law firms disagreed with the ruling and responded by trying to include express language providing that the make-whole was not intended to be a remedy for acceleration, which faced significant investor pushback in the market
- Net effect may be to cause issuers to be more conservative in interpreting covenants

RECENT CASELAW ISSUES (CONT'D)

- *U.S. Bank vs. Windstream Services* (S.D.N.Y., February 2019)
  - In April 2015, Windstream spun off significant assets to a real estate investment trust and then leased those assets back to its parent company.
  - In October 2017, Aurelius Capital filed a lawsuit alleging this transaction was in violation of Windstream's indenture covenants.
  - The Southern District of New York ruled in favor of Aurelius awarding them $310.5M plus accrued interest.
  - This case represents the rise of net-short debt activism in the bond market. Aurelius traded into the Windstream bonds in 2017 – two years after the corporate spin-off – and likely bought significant credit default swaps that paid out in connection with a payment default.

LIABILITY MANAGEMENT ISSUES

- Redemption
  - Contractual right
  - Conditionality/Minimum Notice (trend toward more flexibility)
- Open Market Repurchases
  - 10b-5/disclosure focus
- Tender offers
  - 14E rules instead of 14D rules apply
  - "5 business day" tenders for simple refinancings
  - "10 and 10" structure common
  - May include "exit consents"

LIABILITY MANAGEMENT ISSUES (CONT'D)

- Exchange offers
  - Tender offer rules may or may not apply
    - Private vs. broadly offered
  - Securities offering rules apply
    - Private placement vs. registered
- Consent solicitations
  - Recent DTC process changes have helped logistics

PRACTICE OVERVIEW
HIGH-YIELD DEBT OFFERINGS

Our nationally ranked High-Yield Offerings team has represented both the issuers and underwriters in high-yield debt offerings since the inception of the high-yield market. With more than 225 high-yield debt offerings (with a total transactional value exceeding $135 billion) completed since the beginning of 2011, Vinson & Elkins' High-Yield Offerings practice combines a historical understanding of the market with valuable insight into current market and industry trends gained through constant exposure to deal flow.

V&E's global leadership in the energy industry gives us particular experience and ability to handle high-yield offerings for energy industry participants, including upstream oil and gas companies, midstream companies, and oilfield service companies. Beyond the energy industry, we also work on high-yield offerings in a wide range of other industries.

#1 High-Yield Issuer's Counsel by Volume

- The Prospect News: High-Yield Daily, U.S. Market 2018

#5 High-Yield Underwriter's Counsel

- The Prospect News: High-Yield Daily, U.S. Market 2018

Our experience includes a full range of high-yield products and offering structures, including:

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- Senior unsecured notes
- Subordinated notes
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- High-yield unit offerings
- Offerings by foreign and domestic issuers
- Public and private issuers
- U.S. and other currencies

THANK YOU

Austin
T +1.512.542.8400

Beijing
T +86.10.6414.5500

Dallas
T +1.214.220.7700

Dubai
T +971.4.330.1800

Hong Kong
T +852.3658.6400

Houston
T +1.713.758.2222

London
T +44.20.7065.6000

New York
T +1.212.237.0000

Richmond
T +1.804.327.6300

Riyadh
T +966.11.250.0800

San Francisco
T +1.415.979.6900

Tokyo
T +81.3.3282.0450

Washington
T +1.202.639.6500

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