Market Trends 2017/18: Investment Grade Debt Offerings

A Lexis Practice Advisor® Practice Note by
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OVERVIEW

The U.S. investment grade bond market had another robust year in 2017 with the total number of investment grade bond offerings in the United States and the total volume of those offerings exceeding corresponding figures for the year ended December 31, 2016.

For the sixth consecutive year, the U.S. investment grade bond market experienced an increase in total volume. A total of 963 U.S. investment grade bond offerings closed during 2017, with a total volume of $1.122 trillion. This compares to figures of 864 offerings and 809 offerings and a total volume of $1.012 trillion and $973.101 billion for the years ended December 31, 2016 and 2015, respectively. The U.S. investment grade bond market comprised 12.9% of the global investment grade bond market in 2017 in terms of number of offerings, a decrease from 24.5% in 2016. In terms of proceeds, however, the U.S. investment grade bond market comprised 29.7% of the global investment grade bond market, an increase from 25.7% in 2016.

Investment grade bonds have a rating of Baa3 or higher from Moody's Investors Service or a rating of BBB- or higher from Standard & Poor's (or both). They are considered attractive investments for risk-averse investors (e.g., institutional investors) who prioritize liquidity. This is due to the greater certainty that the issuer, typically a company with an established operating history and credit, will be able to make timely payments to investors and avoid defaulting on their obligations under the bonds. In exchange for the greater certainty of payment, investment grade bonds typically have lower interest rates and less restrictive covenants than sub-investment grade bonds.

Certain market trends and major issuances from the 2017 U.S. investment grade bond market are highlighted below, as well as practical considerations for certain terms of investment grade bond offerings in light of these trends. For additional information on investment grade debt offerings, see Top 10 Practice Tips: Investment Grade Debt Offerings.

NOTABLE TRANSACTIONS

In July 2017, AT&T Inc. completed a $22.461 billion offering, the largest U.S. investment grade notes offering of 2017 and the third largest offering on record, behind Verizon Communication Inc.'s $49 billion offering in September 2013 and Anheuser-Busch InBev Finance's $46 billion offering in January 2016. The deal helped AT&T secure funds for its planned acquisition of Time Warner Inc., which is currently subject to an antitrust blocking suit from the Department of Justice.

AT&T utilized a multi-tranche structure for the offering. The maturity dates for AT&T's notes range between 5 to 41 years from the issue date.

Other notable U.S. investment grade bond issuances in 2017 included:

- Microsoft Corporation's $16.947 billion offering
- Amazon.com, Inc.'s $15.936 billion offering in support of its acquisition of Whole Foods Market, Inc.
- Broadcom Limited's $13.506 billion offering
- Qualcomm Incorporated's $10.987 billion offering
- Verizon Communications Inc.'s $10.940 billion offering
- Apple Inc.'s $9.996 billion offering

DEAL TERMS

Practitioners advising clients in the investment grade space should be mindful of the differences in terms as bonds move up and down the investment grade chain, from high-yield to crossover credits to investment grade. A crossover bond sits on the line between investment grade and high-yield (typically BB- through BBB). Depending on whether a credit is moving up or down the credit spectrum, the issuance may have terms that are either better (if the issuer is moving up the credit spectrum) or worse (if the issuer is moving down the credit spectrum) than similarly rated and more stable credits. For additional information on credit ratings, see Credit Rating Process and Credit Rating Agencies, Credit Ratings Categories for Long-Term Debt Chart, and EU Regulatory Regime for Credit Rating Agencies.

Covenants

Bonds with crossover credits, particularly those nearer to high-yield credit status, may have covenant packages more similar to those provided for high-yield bonds than investment grade bonds. This may include highly restrictive negative incurrence covenants, which typically limit the issuer's ability to incur indebtedness, incur liens, make investments, pay dividends to equity holders, service junior debt, transact freely with affiliates, and merge or sell assets. Investment grade bonds typically limit restrictive covenants to limitations on liens, mergers, and sale of all assets. However, certain issuers which have attained credit ratings higher up in the investment grade spectrum are able to reduce the limitations imposed by these covenants even further, and certain investment grade issuers have been able to limit their covenant package to a restriction on their ability to merge or sell substantially all of their assets. Practitioners representing issuers in the crossover space should ensure that the indenture governing the issuer's bonds contains provisions for certain covenants (such as the limitation on investments) to fall away if the bonds achieve higher investment grade status. For a general comparison of high yield and investment grade covenants, see High-Yield vs. Investment-Grade Covenants. For more information on high yield offerings, see Market Trends 2016/17: High Yield Debt Offerings and Top 10 Practice Tips: High Yield Debt Offerings.

Liens Covenant

Investment grade issuers have historically been able to have the covenant limiting new liens only apply to liens on principal property. The definition of principal property varies from deal to deal and is often highly negotiated. The definition may be limited in such a way to exclude certain of the issuer's material corporate assets, or an issuer may not in fact have any principal property, thus mitigating the impact of the limitation. Furthermore, the limitation applicable to principal property is often worded to permit liens on such property up to an amount not to exceed a certain threshold (typically 15%) of the issuer's consolidated total assets or consolidated net tangible assets, in addition to other carve-outs. For a form of lien covenant in a high yield indenture, see High Yield Indenture: Limitation on Liens.

Redemption Period

Historically, investment grade bonds with an optional redemption feature were a rarity. In the last few years, the investment grade market has shifted to permit early redemption at a make-whole premium up to a certain point, at which time the bonds become callable at par. This trend continued in 2017 and this feature became more standardized for investment grade bonds. Make-whole premiums are calculated from a formula based on the net present value of future interest payment on the bonds (that will not be paid because of the early redemption) combined with the outstanding principal on the bonds. As a result, many newly issued investment grade bonds are callable at par for a period ranging from one month to six months prior to their maturity, depending on the term of the bonds. Many crossover bonds tend to follow the high-yield early redemption convention, which typically implements a make-whole premium for half the maturity of the bonds, with decreasing premiums to par for a period of time before maturity. Given that investment grade bonds typically have longer maturities than their high-yield counterparts, investment grade issuers and their counsel should be aware that investment grade bonds are typically coupled with expensive make-whole provisions and lengthy no-call periods. As a result, many investment grade issuers that would typically expect their bonds to be a permanent fixture of their long-term capital structure now have an option to redeem those notes at an earlier time, though subject to an expensive make-whole premium. For additional information on make-whole premiums, see Anti-dilution Adjustment Formulas in Convertible Bonds and Debt Securities Restructuring Options.

Equity Clawback

An equity clawback provision allows for the redemption of bonds using the proceeds from an equity offering during certain periods in the life of the bonds. Typically, equity claw provisions allow for redemption of up to 35% of the bonds for the first three years after issuance at par plus accrued and unpaid interest. Equity clawback provisions have been a mainstay in high-yield indentures and a feature of some crossover bonds, but were not typical in the investment grade space. That has changed over the last few years, as some issuers have begun to push for equity claw rights in investment grade bond deals. While still atypical for investment grade bonds, the continuing emergence of the equity clawback in investment grade bonds has provided issuers with greater redemption flexibility.

Change of Control Put

The principal function of the change of control put is to allow bondholders to exit the credit in the event the issuer is acquired or merged by giving the bondholder the option to put the bonds back to the issuer at 101% or 100% of the principal amount. Traditionally, investment grade bonds had a double trigger change of control which triggers the put right upon a change of control and a below investment grade rating event. Typically, the ratings downgrade must occur within a specified period of time following the public announcement of the change of control transaction. High-yield bonds typically only have a single trigger tied to the occurrence of a change of control. While the vast majority of new investment grade bonds still have a double trigger mechanism, some underwriters in the investment grade space have attempted to adopt the single trigger convention. A single trigger gives prospective bondholders greater flexibility to remove themselves from a credit they might deem to differ materially from their initial investment. Investment grade issuers and their outside counsel should be mindful of the single trigger approach, which may require increased purchase prices in mergers and acquisition transactions that will result in a change of control in order to satisfy the put right. In 2017, the market saw the issuance of a large number of investment grade bonds without a change of control put at all. With the market trending in that direction, rather than negotiating on a double or single trigger, investment grade issuers and their outside counsel should push to omit a change of control put entirely from their newly-issued bonds to avoid having to make an offer to bondholders to buy the bonds back at 101% or 100% of the principal amount in the event of a change of control. For an example of a change of control provision in a Rule 144A debt offering, see Indenture (Rule 144A and/or Regulation S Debt Offering). For an example of a change of control provision in a convertible note, see Convertible Note (Seed-Stage Startup).

INDUSTRY INSIGHTS

Issuers in the financial services industry and the energy and power industry were the most active investment grade issuers in the United States in 2017, consistent with prior years. The real estate sector, particularly real estate investment trusts (REITs), saw an increase of 66% in offerings from 2016 to 2017, representing its highest output since 2013. The consumer products and services industry saw an increase between 2014 and 2015 and then again between 2016 and 2017. The largest offerings of 2017 generally came from issuers in the high tech industry (e.g., Microsoft Corporation, Broadcom Limited, Qualcomm Incorporated, Apple Inc., and Oracle Corporation) and telecommunications industry (e.g., AT&T Inc. and Verizon Communications Inc.).

U.S. Investment Grade Bond Offerings by Industry

Industry	2012	2013	2014	2015	2016	2017
Financial Services	399 (153 banks)	382 (162 banks)	412 (217 banks)	393 (217 banks)	439 (206 banks)	382 (140 banks)
Energy and Power	143 (45 oil and gas)	135 (48 oil and gas)	145 (47 oil and gas)	126 (39 oil and gas)	138 (21 oil and gas)	159 (29 oil and gas)
Real Estate	88 (83 REIT)	67 (57 REIT)	55 (48 REIT)	52 (43 REIT)	66 (58 REIT)	90 (78 REIT)
Industrials	32 (15 transportation and infrastructure)	33 (19 transportation and infrastructure)	51 (28 transportation and infrastructure)	52 (27 transportation and infrastructure)	46 (26 transportation and infrastructure)	55 (24 transportation and infrastructure)
Consumer Products and Services	35	29	22	44	33	57

MARKET OUTLOOK

The U.S. investment grade bond market remained robust in 2017 and continued to be an active component of the fixed income market. While it is difficult to speculate as to activity levels in 2018, strong global capital markets have historically been a good indicator of investment grade activity and will dictate the volume for 2018.

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Ari Blaut is a partner in the firm's leveraged finance, restructuring and capital markets groups. Ari maintains a broad corporate practice advising clients on a wide range of financing transactions, including bank financings, high yield bond issuances, "PIPE" transactions, debt restructurings, liability management, creditor representations and joint ventures. Ari has particular expertise in leveraged finance, acquisition finance and strategic credit transactions.

Ari regularly acts for clients in connection with arranging committed debt financing (both bank and bond) for mergers and acquisitions.

Some of Ari's significant representations in the past year include, among others, advising (i) AT&T on its $40 billion debt financing for its pending acquisition of Time Warner, (ii) Tesoro on its $4.1 billion debt financing for its pending acquisition of Western Refining, (iii) Eastman Kodak in connection with its "PIPE" transaction with Southeastern Asset Management and (iv) the ad hoc committee of Key Energy's unsecured note holders in connection with financing matters related to the acquisition of Key Energy through its prepackaged Chapter 11.