TRAVERS SMITH

Debt buybacks

Investment opportunities and achieving additional covenant headroom

In the sixth of a series of briefings that looks at financial management in a downturn, this note considers the many aspects of debt buybacks.

Since the onset of the credit crunch in Summer 2007, the debt in many companies has been trading in the secondary markets significantly below par. More often than not this has been a reflection of the liquidity concerns of the holders of that debt rather than underlying concerns over the performance of the company. The continued discounts available on purchasing this debt have presented companies and their shareholders with both investment opportunities and also the ability to deleverage companies and obtain financial covenant headroom cheaply. However, whilst a lot has been spoken about debt buybacks since the credit crunch started, there are only a few real examples in the market.

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What types of debt buyback are there?

1. Shareholder Acquisitions: A shareholder acquiring debt in its own company (or another company) by way of an investment opportunity.

2. Borrower Acquisitions: A borrower acquiring (and therefore extinguishing) its own debt, which in practice equates to a discounted prepayment of debt. This structure can be expected to have negative tax consequences for the borrower and is therefore often discounted.

3. Affiliate Acquisitions: A group company purchasing the borrower's debt and becoming a lender. This may achieve additional financial covenant headroom at a discount because the debt, once acquired, would usually be regarded as intra-group debt, which would be eliminated on consolidation for covenant purposes.

What should a shareholder consider when proposing a debt buyback?

- Is the purchaser of the debt a permitted transferee under the facility agreement? The typical position is that the purchaser must be regularly engaged in or established for the purpose of making, purchasing or investing in loans, securities or other financial assets.

- Will any withholding tax be payable and will any other tax charges arise?

- Will the purchase be made from a single institution or will there be a 'Dutch auction' involving the whole syndicate?

- If the shareholder is proposing to purchase debt, is it permitted to do so under its own constitution and regulatory constraints?

- If a group company is proposing to purchase debt, what consents might be required under the banking documents, how would the debt purchase be treated under the financial covenants and what additional headroom can be obtained?

- Once the debt has been acquired, how would the purchaser deal with any interest or principal received and would it be able to exercise voting rights and participate in syndicate discussions?

- What rights and obligations would the purchaser be taking on under the banking documents? For example, many intercreditor agreements contain loss sharing provisions or may have the effect of subordinating the acquired debt.

How we can help

We can review your company's banking documents and advise what, if any, lender consents would be needed to effect a buyback and what effect a buyback might have on the financial covenants. We can also advise on the legal and tax strategies that might be appropriate in order to put any buyback into practice.

If you would like to discuss any of the issues covered by this note, please contact any of the following members of our Banking and Tax Departments:

Jeremy Walsh, Head of Banking
jeremy.walsh@traverssmith.com
+44 (0)20 7295 3217

Andrew Gregson, Banking Partner
andrew.gregson@traverssmith.com
+44 (0)20 7295 3206

Matthew Ayre, Banking Partner
matthew.ayre@traverssmith.com
+44 (0)20 7295 3304

Simon Skinner, Tax Partner
simon.skinner@traverssmith.com
+44 (0)20 7295 3242

Travers Smith LLP
10 Snow Hill
London EC1A 2AL
T +44 (0)20 7295 3000
F +44 (0)20 7295 3500

www.traverssmith.com