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Covenants
A Study of the German SME Bond Market

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Mittelstand bonds on the path to professional covenant standards

At Scope Ratings, we have performed an in-depth study of the covenants in bonds issued by German small and medium-sized enterprises (SMEs). Our analysis of the terms in 157 listed bonds issued by these Mittelstand companies yields a number of key results:

1. A noteworthy increase in covenant usage since 2010

Bonds issued by German SMEs are increasingly likely to include covenants:

- Bond indentures contained an average of just one covenant in 2010 – but this figure had risen to 3.5 in 2013.
- The covenants with the highest growth rates since 2010 are change-of-control provisions, payout restrictions and cross-default pledges.
- Under 6% of all listed bonds issued by German SMEs since 2010 contained no covenants and were unsecured.

2. Considerable differences in protection afforded by covenants

Even with covenant usage clearly on the rise, there are still dramatic differences in covenant quality. From our perspective, all too many bond indentures include nothing but boilerplate covenants offering bondholders no real protection.

3. Financial covenants under-used to date

Germany's SME bond market is still far from using a standard set of covenants on par with those typically seen in well-established markets like the German large-cap and US high-yield segments. Financial covenants in particular, which tend to provide substantial bondholder protection, have so far been woefully under-used. Only about one tenth of all bonds issued last year by German SMEs include financial covenants.

4. Greater investor interest in bonds with covenants

Although demand for bonds is shaped primarily by fundamentals and the specifics of individual issues, we nevertheless see a tendency for bonds with complex covenant structures to have above-average subscription rates. In other words, bonds with comprehensive covenants seem to be more valuable to investors. This correlation points to higher investor confidence.

5. Covenants from the rating agency perspective

As a rating agency, we are concerned with covenant quality, not quantity. We accordingly place higher value on covenants that improve an issuer's risk profile over the life of the bond – which is above all the case with financial covenants. We believe that the German SME market segment is in need of still higher professional standards for its covenants, and we believe that the covenants examined in this study could serve as a guide for developing a set of standards for SME bonds. But as a basic underlying principle, covenants should be tailored to the specific issue or issuer.

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The rationale behind covenants

Higher standards must be established for German SME bond issues

Germany's SME bond market has seen no lack of defaults in recent years. To restore investor confidence in this segment, greater demands must be made on issuers and higher overall market standards must be set.

Covenants are essential to this process. Designed to protect investors, these bond indenture clauses typically require an issuer to meet certain conditions or refrain from undertaking certain actions over the life of the bond. Covenants can therefore reduce credit risk by giving issuers less room to maneuver and clarifying the status of bondholders in the event of insolvency.

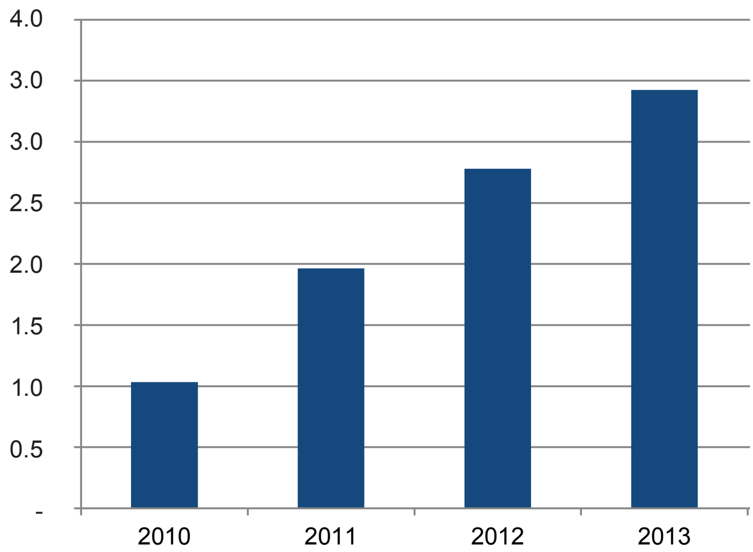
Particularly in the case of smaller issuers with higher operational and financial risk, covenants offer an effective way – as does collateralization – to lower bondholder risk.

Covenants – an increasingly common feature of bond indentures

The average number of covenants per issue has more than tripled since 2010

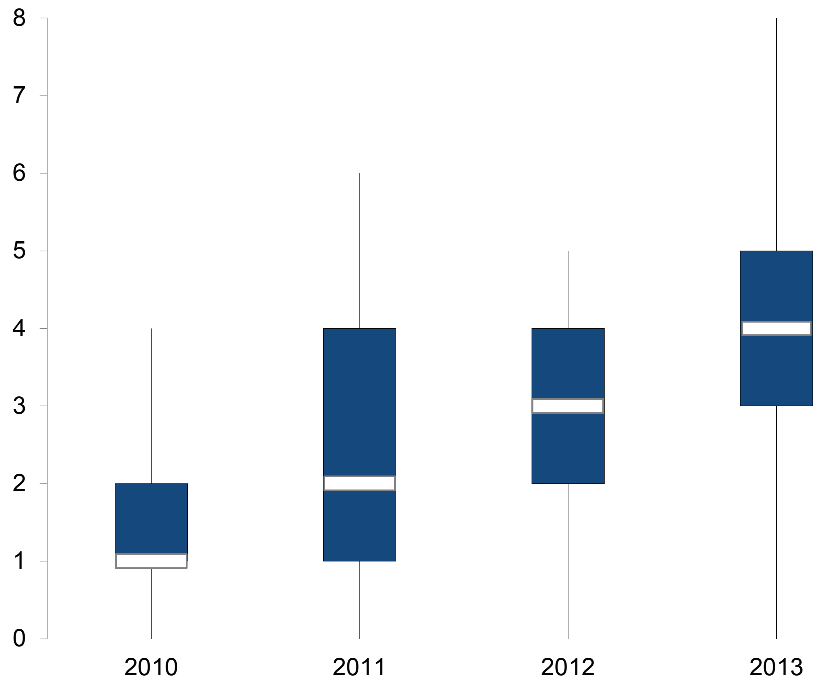
Practically all the types of covenants we examined appeared more frequently in issues of the past year than in those from preceding years. Just under 6% of our sample of listed bonds issued since 2010 (i.e., 9 out of 157) contained no covenants and were unsecured. Moreover, subsequent issues by the same companies confirmed this trend. Bonds issued in 2010 and 2011 had few or no covenants, whereas many of the same companies' subsequent issues included more numerous or more detailed covenants.

Average number of covenants per new issue



Source: Scope Ratings

Distribution of covenant provisions in new bond issues



Source: Scope Ratings

Outlook

Investors drive increasing covenant usage

We believe that covenants will take on growing importance as the market matures, with bond indentures containing more – and more detailed – covenants. Why? Because investors are investing more selectively and demanding covenants more consistently now than they were in 2010 and 2011.

Financial covenants in particular should gain ground

More specifically, we believe that financial covenants will gain considerable ground, since they can tangibly improve a bond's risk profile from an investor standpoint. Bank loan agreements routinely include them (see the research done by Roland Berger [2009] and Deloitte [2011]). In addition, higher covenant standards in general and extensive financial covenants in particular will be crucial to stimulating institutional investor appetite for Mittelstand issues.

Our findings in detail

Negative pledge clauses

Over two thirds of issues in 2013 included negative pledges

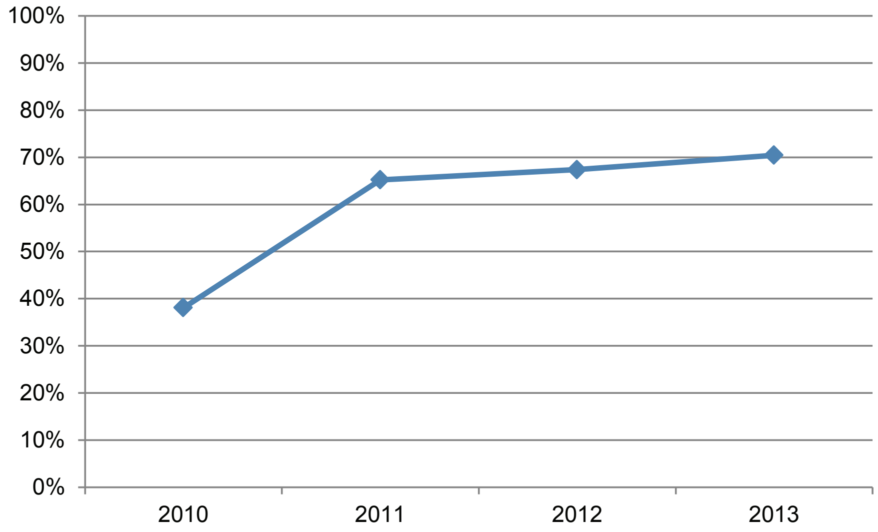
We saw an unmistakable trend in the use of negative pledge clauses: while only 40% of all bond issues in 2010 contained such clauses, the proportion was close to 70% in 2013.

A negative pledge clause prohibits an issuer from creating any further liens on its assets. Such a clause is intended to prevent a reduction in the assets bondholders can claim if the issuer defaults.

Negative pledges are not always of great value

While the high frequency of negative pledges in German SME bonds is a welcome development, we noticed that in a number of cases these are merely boilerplate clauses, since the issuers had no material assets that could be used to secure future liabilities. The actual protection afforded to investors was therefore negligible.

Percentage of bond issues with negative pledge clauses



Source: Scope Ratings

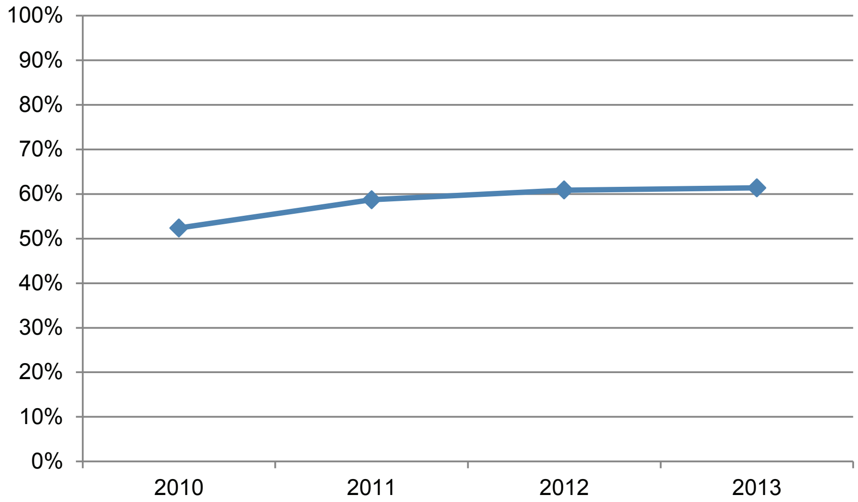
Pari passu clauses

Over 60% of all bond issues in 2013 included "genuine" pari passu clauses

Pari passu clauses are meant to guarantee that a bondholder's claims rank pari passu; i.e., have equal rights of payment with the issuer's other unsecured obligations, present and future. Roughly half of all the bonds issued between 2010 and 2012 had what we would call "genuine" clauses – a proportion that has shown little change since 2010, however.

What we would draw attention to is that a large number of German SME bond issues still fail to include genuine pari passu clauses. Instead of putting all obligations on an equal footing, many bond indentures contain clauses that rank the bond pari passu only with the issuer's existing obligations – thus maintaining the issuer's right to take on new obligations with greater seniority than the bondholder's claims. The upshot is inadequate bondholder protection.

Percentage of bond issues with genuine pari passu clauses



Source: Scope Ratings

Change of Control

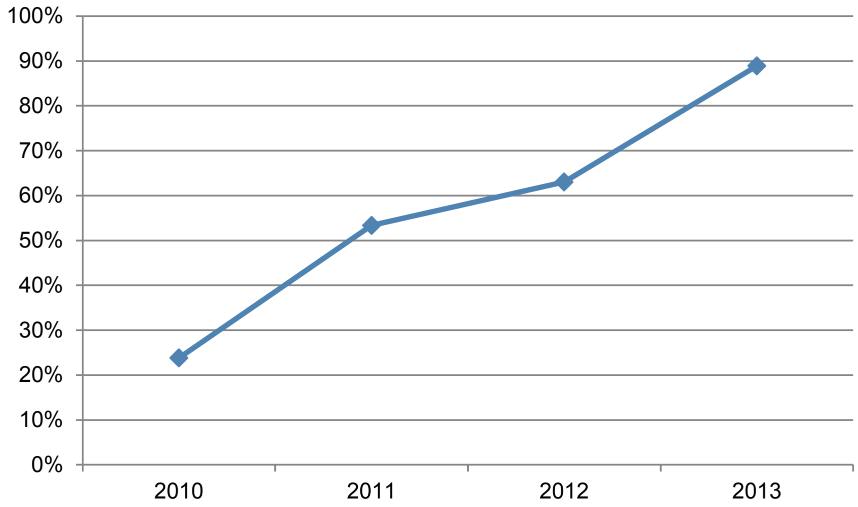
By 2013, nine out of ten bond issues included change-of-control clauses

We observed a significant increase in the use of what are known as change-of-control clauses, which are basically a put option in the event of a change of ownership of the issuer. Slightly under 20% of all bonds issued in 2010 had such a clause; by 2013, nearly 90% did.

If the majority owner of an issuer changes, bondholders protected by a change-of-control clause can require the issuer to repurchase their bonds either at face value or at some other price specified in the bond indenture.

At Scope, we welcome the increasing use of these provisions. A change in majority ownership can lead to serious shifts in strategic direction that may radically alter an issuer's risk profile. Change-of-control clauses thus offer bondholders a certain degree of protection from such events.

Percentage of bond issues with change-of-control clauses



Source: Scope Ratings

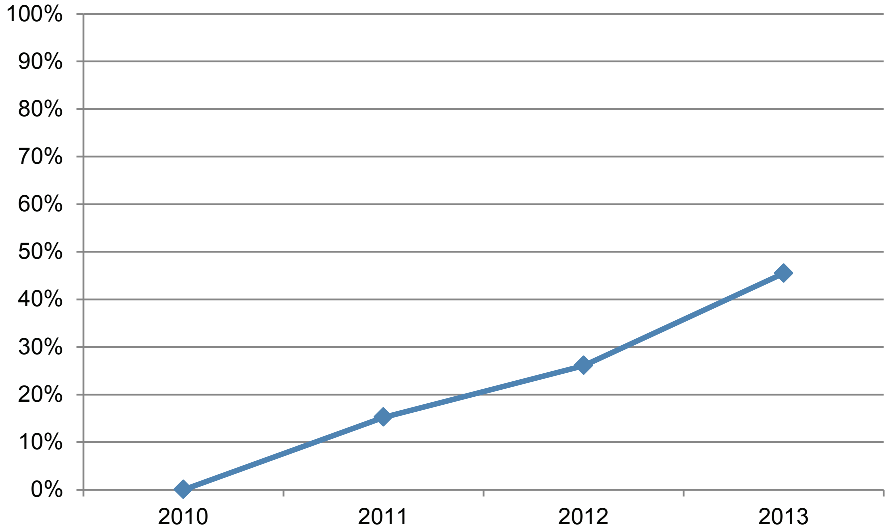
Payout restriction covenants

Substantial increase in payout restriction covenants – to almost half of all issues in 2013

The percentage of bonds in our sample with payout blocks rose substantially between 2010 and 2013, albeit from an extremely low starting point. No 2010 bond indentures included provisions prohibiting or restricting dividend distributions, whereas 40% of all 2013 bond indentures did.

Payout blocks, like restricted dividend payments, are designed to prevent issuers from giving equity holders an advantage over bondholders. Such provisions may for example specify that a percentage of the issuer's profit not be made available for distribution to equity holders – and give bondholders a put option if the issuer fails to comply with that percentage. From a rating agency perspective, such provisions can improve the quality of an issuer's balance sheet.

Percentage of bond issues with payout restriction covenants



Source: Scope Ratings

Cross-default provisions

Two thirds of bonds issued in 2013 included cross-default provisions

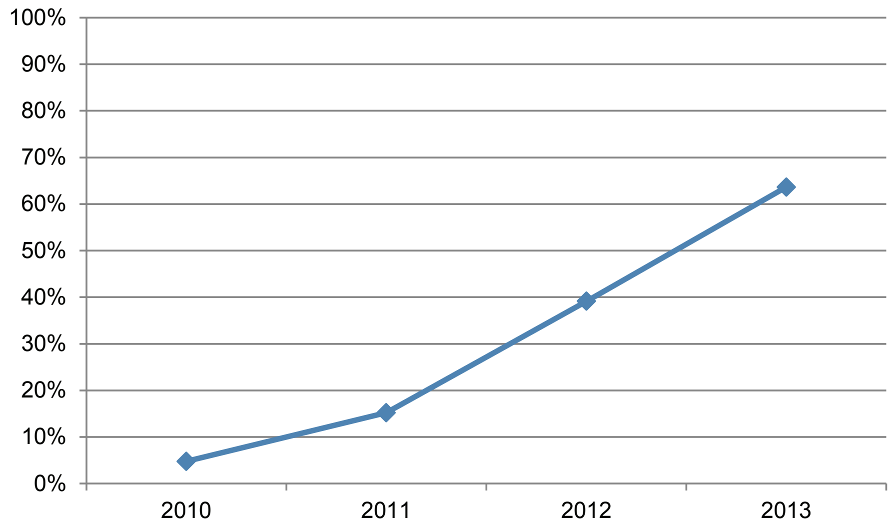
We noted a similar upward trend in the use of cross-default provisions. Close to two thirds of all bonds issued in 2013 offered such protection, up from just 5% in 2010.

A cross-default provision entitles bondholders to accelerate repayment if the issuer meets its obligations to them but defaults on its debt obligations to significant other creditors.

Comparatively little protection afforded by cross-default provisions in German SME bond issues

Although cross-default clauses do serve as a kind of early warning system, we found they afford comparatively little in the way of protection. Such clauses are mainly useful when issuers have complex arrays of debt obligations – which German SMEs seldom do. It seems unlikely that bondholders can forestall a default event just by forcing an issuer to accelerate payment of the principal owed to them after it has already defaulted on other debt obligations. Moreover, many existing cross-default provisions can be activated only when the issuer fails to meet relatively large obligations. By that time, the company is in any case on the brink of insolvency.

Percentage of bond issues with cross-default provisions



Source: Scope Ratings

Financial covenants

Only about one tenth of all 2013 issues included financial covenants

Financial covenants can greatly enhance bondholder protection. But while often included in conventional bank loan agreements and large-cap bond indentures, such provisions have so far been uncommon in the SME segment. Only about one out of ten German SME bonds issued last year contained financial covenants.

Financial covenants set minimum limits for a company's assets, financial position and earnings. They require a borrower to maintain specific financial ratios or prohibit it from breaching specific financial thresholds over the life of a loan. Examples would include:

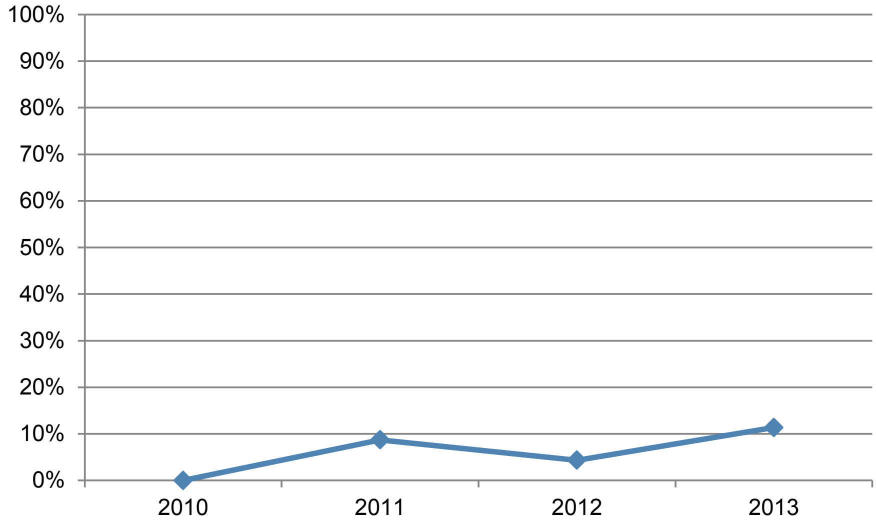
- Minimum equity level (e.g., Peach Property)
- Debt and leverage ratios (e.g., GIF, MIFA)
- Minimum liquidity (e.g., IPSAK)
- Debt service coverage ratio (e.g., MIFA)
- Limitations on additional borrowings (e.g., Estavis, Rickmers, Sympatex) and
- Minimum profitability.

If the requirements specified in an indenture are not met, the borrower may for example be prohibited from distributing dividends or even required to immediately repay the principal in full. Financial covenants help bondholders assess an issuer's business viability and balance sheet health – and can throw up early warning signs if either deteriorates.

We feel the limited usage of financial covenants is cause for concern

Furthermore, financial covenants offer in our view an effective way of imposing financial discipline on issuers, and in that respect they indirectly mitigate default risk. We are therefore highly wary of the low percentage of German SME bond indentures containing such provisions. We are unlikely to see any significant increase in the proportion of institutional investors among German SME bondholders until financial covenants gain traction.

Percentage of bond issues with financial covenants



Source: Scope Ratings

Other clauses for preserving creditworthiness

Little use to date of clauses restricting asset sales or changes of strategy

Like financial covenants, clauses that place restrictions on asset sales or changes of company strategy strongly limit the headroom available to an issuer's management. Companies may be prohibited in this fashion from expanding into new markets or industries under risky conditions, for example, or from withdrawing from specified business lines.

Such clauses tend to mitigate operational and financial risk over the life of a bond. Ultimately, they increase the probability that an issuer's balance sheet will stay on an even keel.

For the time being, protective covenants of this kind are a rarity in the small- to mid-cap bond market; only five bond indentures in our sample contain them. But we expect them to gain ground as German SMEs strive to make holding their bonds seem less like risk capital.

Issuer-specific covenants

The rise of issuer-specific covenants suggests a trend towards higher professional standards

In addition to the standard covenants described above, the bond indentures we looked at include further requirements for issuers that are designed to enhance investor confidence. A few examples:

- Escrow accounts with a liquidity fund (e.g., Golden Gate and IPSAK)
- Limitations on further bond issuance (e.g., Maritim)
- Pre-emptive rights in connection with an IPO (e.g., Karlie)
- Obligations in relation to trademark use (e.g., Peine)
- An obligation to transfer profits from subsidiaries (e.g., Porr)
- Reporting requirements (e.g., Peach).

Bonds with such "exotic" covenants were primarily issued in 2012 and 2013. In our view, this suggests that the German SME bond market is developing into a more professional investment segment, with indentures increasingly including terms tailored to the issuer.

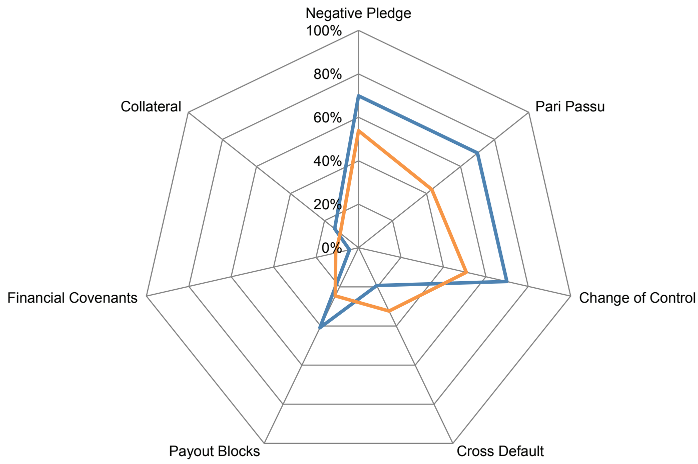
Successful issuance with complex covenant structures

Growing connection between complex covenants and high subscription rates

The success of a bond issue depends primarily on fundamentals such as the coupon rate, tenor, collateral requirements, the issuer's prior and future financial position, market environment, competitive position, idiosyncratic risks and the like. However, we see a growing connection between complex covenant structures and high subscription rates.

The following graph compares bonds with above-average subscription rates (>80% – blue line) with bonds with below-average subscription rates (<80% – orange line) relative to how complex and comprehensive their covenant structures are. The results suggest that investors show greater confidence in bonds with more comprehensive covenants.

Covenant structure in bonds with above- and below-average subscription rates (subscription rate threshold: 80%)

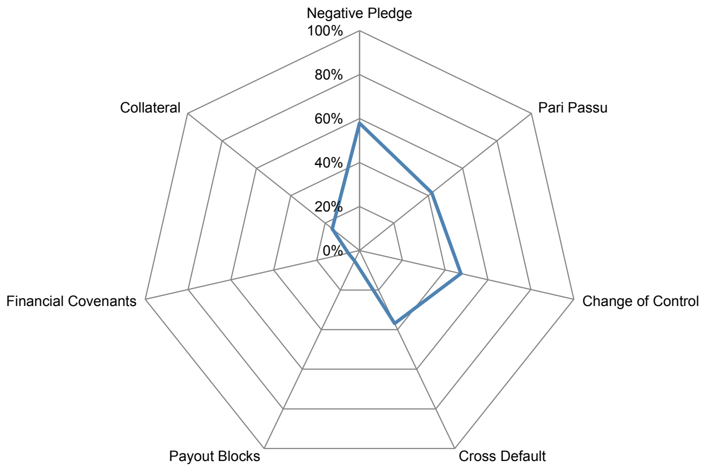


Source: Scope

Covenants should not be mistaken for automatic default insurance

But even complex and comprehensively designed covenants should not be mistaken for automatic default insurance. Some of the German SME bonds in our sample that ended in default or restructuring also had relatively complex covenants, as emerges from the graph below. What is most striking, however, is that only one of the bonds in default contained financial covenants.

Covenant structure of German SME bonds that went into default



Source: Scope

Collateral and guarantees

In the event of default, collateralization offers the most protection against losses

While most covenants, and especially financial covenants, are meant to lower or limit deterioration in the issuer's risk profile over the life of the bond, collateralization offers the most protection against losses in the event of default. It is common practice in bond indentures to include covenants that place a lien on an issuer's real estate, tangible assets, financial assets or trademarks (e.g., Sympatex, Peine), or that require guarantees from associated companies. In 2013, about one fifth of all German SME bonds had collateral pledged to them (see Scope SME Outlook 2014).

Major differences with other bond market segments

Despite the rising frequency of covenants in German SME bond indentures, we feel this market segment is still nowhere near the well-established covenant packages common in issues by Germany's large- and mid-cap companies. In this respect, even the US high-yield bond market operates under much higher standards.

Financial covenants are particularly under-represented

For one thing, other bond market segments tend to use much more comprehensive and standardized covenants. For another, those covenants provide far greater protection, whether through restrictions on risky undertakings or through financial covenants that require the issuer to maintain specific financial ratios and impose limitations on further debt issuance (limitations on indebtness). We believe that such provisions effectively protect bondholders by preventing issuers from making overly risky business decisions.

While substantial differences with other bond market segments have not gone away, we would like to point out that quite a few issues by smaller companies include covenant packages every bit as solid as those in better-established market segments. More specifically, we found that three of last year's bond issues had commendable covenant packages:

- Sympatex
- Estavis
- Sanha

The rating agency perspective

Quality, not quantity

In our basic view, covenants are an excellent form of bondholder protection when collateral and other asset guarantees do not reduce default risk. At the same time, however, it is vital to distinguish between quantity and quality.

Some covenants we saw are basically boilerplate provisions that offer extremely little protection. A good example would be negative clauses for issuers whose business models make it virtually impossible to enforce pledges of assets and other security interests. Much the same can be said of pari passu clauses that exclude future debt obligations – and thus leave the door open for the issuer to subordinate the bondholder's claims. Likewise, cross-default provisions that are not triggered until issuers have crossed very high default thresholds on other obligations do little to protect bondholders.

There are also covenants with protective clauses that are triggered only when specific conditions are met. For example, many covenants cannot be activated unless over 50% of all creditors agree to do so. This highlights the imperative need to examine bond indentures carefully – under all circumstances.

The importance of covenants depends on the specific circumstances

It would be impossible to generate a list of "must-have" covenants in order of importance for all bonds issued by SMEs. Covenants should be tailored to the unique circumstances of each issuer, so that they adequately reflect the issuer's company structure, balance sheet, financial ratios, ownership structure and outstanding agreements.

Risk prevention and early detection clauses are preferable to bondholder protection clauses triggered only in the event of default

The covenants that consistently contribute to improved bond ratings are those that do the best job of improving an issuer's risk profile over the life of the bond. Noteworthy examples include financial covenants that flag risks early on, and covenants that place limitations on risky undertakings like investments in high-risk assets, disposal of important business lines and changes of company strategy.

Covenants that cannot be activated until an issuer becomes insolvent or fails to meet its other debt obligations do not really start protecting bondholders until the threat of default is very real. It is no surprise then that such covenants usually play only a secondary role in investors' assessments of an issuer's creditworthiness.

A need for still higher professional standards in Germany's SME bond market

High covenant standards are a prerequisite for a truly professional bond market

We feel that the most important step toward putting the Mittelstand bond segment on the path to a truly professional market is the comprehensive introduction of high-quality covenants – especially financial covenants. Precisely because bonds issued by smaller companies tend to involve high operational and financial risk, their bondholders are particularly in need of effective protection.

We believe that covenants examined in this study could serve as a guide for developing a set of bond covenant standards. But in conclusion, it is essential that covenants always be tailored to the circumstances of the specific issue or issuer.

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