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THE WALL STREET JOURNAL.

WSJ.com

CREDIT MARKETS | JANUARY 4, 2011

Bondholders Are Rattled by Prepayment Covenants

By CARRICK MOLLENKAMP And MATT WIRZ

Bond markets remain so frothy that corporate-bond buyers aren't worried they won't get paid; they are worried about getting paid too soon.

High-yield, or "junk," bonds typically include a stipulation, known as call protection, that forces borrowers to pay steep "make whole" penalties if they buy back the debt early, compensating investors for the interest payments they will miss. But as inflows flooded high-yield funds in 2010, managers became less picky about the protections they required in their scramble to put cash to work, avoiding the make-whole penalties.

Dozens of high-yield borrowers slipped terms into their bond documents last year allowing them to prepay up to 10% of their bonds annually at 103 cents on a dollar. That means that a bond trading at 110 cents on the dollar, as a number of corporate bonds are these days, can be retired at a discount, sticking bondholders with losses.



Associated Press

COVENANT CHEMISTRY: Workers at a Lyondell plant in Texas. The chemical company said it would redeem 10% of two secured bonds it sold in April, sticking investors with a loss of about \$20 million.

Just a few companies used the provision in 2009. But last year, at least 57 U.S. and Canadian secured-bond deals—more than one-third of all secured deals—included the provision, according to New York credit-research firm Covenant Review LLC. And while prepayment covenants initially appeared only in secured deals backed by hard assets, a handful of companies have introduced the language in unsecured bonds that would leave holders far less protected in a bankruptcy.

Investors are starting to feel the impact of the new trend. On Nov. 17, Lyondell Chemical Co. in Houston said it would redeem 10% of two secured bonds it sold in April with the early-buyback clauses, retiring a total of about \$275 million

of notes. The redemptions of the two series of bonds stuck investors with a loss of about \$20 million, representing about 7% of the market value of the bonds redeemed, Covenant Review said.

A Lyondell spokesman said the redemption was priced into the April 2010 sale of the junk bonds and investors knew the redemption was likely to be used.

Lyondell emerged from bankruptcy last year. It is the U.S. affiliate of [LyondellBasell Industries NV](#) of Rotterdam.

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"Clearly, this is becoming a serious dilemma for bondholders," Covenant Review stated in a December report. "Any company whose bonds are trading at a healthy premium and has this alternative available could announce a redemption at any time, which would cause the bonds to trade down."

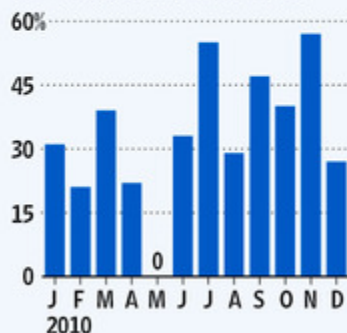
The early-buyback options aren't all bad for bondholders, said Arthur Calavritinos, manager of the John Hancock High Yield Fund. Regardless of what price the borrowers pay for the debt they retire early, they are reducing their debt loads, improving the underlying leverage metrics, he

said.

George Goudelias, a portfolio manager at Seix Investment Advisors, said he usually opposes the 10% prepayment covenant in new deals, but its proliferation in 2010 shows borrowers' growing power as demand for junk debt outstrips supply. And, he added, for stable companies generating strong cash flow, it is preferable for bondholders to let management buy back debt cheaply rather than repurchase stock or pay out dividends to shareholders.

Cheap Redemption

The percentage of secured junk-bond deals allowing companies to retire debt at 103 cents on the dollar, at a trading-price discount, increased in 2010.



While standard in leveraged-loan documents, the prepayment covenants didn't appear regularly in bonds until early 2009, when the loan market essentially shut down, said James Keenan, head of leveraged finance at BlackRock Inc.

At the time, bond funds still were willing to buy new deals but required most borrowers to provide liens on company assets, something typical in loan deals but rare to bond markets. In exchange for the collateral, investors accepted the inclusion of 10% annual early buybacks, which were also standard in loan documents, Mr. Keenan said.

Unsecured bonds with early-buyback covenants present a far less attractive risk-reward tradeoff than secured bonds with the provisions, bond investors say. Unsecured creditors recover little in the event of a default compared to their secured counterparts, Mr. Keenan said.

Still, the options became common to secured bonds sold throughout 2010. A new development surfaced toward the end of the year when companies such as [HealthSouth Corp.](#), a Birmingham, Ala., health-care company, and [Interface Inc.](#), an Atlanta maker of carpet tile, included the covenants in unsecured bonds for the first time. That turned the premise that unsecured debt holders should receive stricter call protection on its head.

HealthSouth included the option in \$525 million of bonds it sold in late September simply for the flexibility to prepay debt at a price it deems reasonable for the company and investors, finance chief Doug Coltharp said in an email.

"The terms—including the call protection—were fully disclosed to the investors in advance," Mr. Coltharp

said. "Each investor made their own decision to buy the bonds with this knowledge in hand."

While yield-hungry fund managers swallowed their reservations and accepted those terms from HealthSouth, a generally well-regarded borrower rated B+/B2, they have yet to give weaker companies the same concession.

In November, heating, ventilation and air conditioning equipment maker Nortek Inc. of Providence, R.I., yanked a proposed 10% prepayment option from a \$250 million bond rated CCC+/Caa2 amid investor pushback, according to Standard & Poor's Leveraged Commentary and Data.

"Indenture provisions are a result of various discussions and negotiations, and to comment on any one provision in isolation wouldn't be appropriate," said Nortek Treasurer Edward Cooney.

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