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Client Alert Commentary

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Impact of COVID-19 on Italian High Yield Issuers

A Q&A for Italian high yield issuers, focusing on capital markets implications and best practices.

Disclosure Requirements on COVID-19 Impact for High Yield Issuers

Q: How should companies disclose the impact of the pandemic on their business?

The Market Abuse Regulation (MAR) applies to all issuers with financial instruments admitted to trading on a regulated market or multilateral trading facility (MTF) in the European Economic Area (such as the Luxembourg Euro MTF, Borsa Italiana ExtraMOT, or Euronext Dublin). MAR requires that issuers disclose, as soon as possible, all "inside information" that concerns the issuer or the relevant listed financial instruments, directly or indirectly. Inside information is defined as precise, non-public information that is likely to have a significant influence on the price of such financial instruments. On March 11, 2020, the European Securities and Markets Authority (ESMA) publicly recommended to issuers that they promptly disclose relevant material information concerning the impacts of COVID-19 on their financial condition, operations, or prospects in accordance with MAR. Therefore, issuers should consider whether the pandemic has had or would be expected to have an impact on their activity, performance, or outlook or the issuer's ability to comply with covenants of listed debt instruments, as these developments could constitute inside information under MAR that would require disclosure.

Pursuant to MAR, the competent authority with respect to the bonds is the regulator that the relevant EU Member State has designated in the jurisdiction where the bonds are admitted to trading, not the competent authority in the jurisdiction of organization of the issuer, if different. The competent authority for MAR purposes for most Italian high yield bonds would likely be one or more of the following: Luxembourg's *Commission de Surveillance du Secteur Financier*, the Irish Central Bank, Italy's *Commissione Nazionale per le Società e la Borsa* (CONSOB), and the Austrian Financial Market Authority (AFMA). While the disclosure obligations under MAR do not vary from jurisdiction to jurisdiction, each competent authority may have released its own guidelines, which will be helpful guidance for issuers with bonds admitted to trading in such jurisdictions.

Q: Should this disclosure be made on an ongoing basis until the end of the pandemic?

Given the uncertainty surrounding the ongoing development of COVID-19, issuers should periodically reassess the materiality of existing and anticipated effects on their company's business, financial condition, and outlook to determine if additional disclosures of inside information should be disclosed.

Q: What form should this disclosure take?

Issuers should publish a press release to ensure equal access to relevant inside information for all investors. The press release should be posted on the issuer's website (and be maintained for at least five years), posted with the officially appointed mechanism (OAM) for regulated information under the EU's Transparency Directive (if the issuer has equity listed on a regulated market), or communicated to media that are reasonably relied upon by the public to ensure effective and immediate dissemination, with an indication of the date and time of communication. Inside information should also be provided to the listing authorities in accordance with the applicable listing rules.

Companies with high yield bonds listed on a regulated market or MTF in the European Economic Area should contact Latham & Watkins for assistance in determining appropriate disclosure under MAR.

Q: Should financial statements for the year ended December 31, 2019, include any disclosure regarding the impact of the pandemic?

In its statement of March 11, 2020, ESMA recommended that issuers disclose actual and potential impacts of COVID-19, to the extent possible based on both a qualitative and quantitative assessment of their business activities, financial situation, and economic performance in their 2019 year-end financial report if these have not yet been finalized or otherwise in their interim financial reporting disclosures or on a periodic basis if required under MAR as discussed above. Therefore, the impact of COVID-19 should be considered together with an issuer's statutory auditors, if necessary, as a post-closing event requiring disclosure in the financial statements of December 31, 2019 (or other applicable year-end date), in accordance with IFRS.

Issuers should determine the extent of disruption to their business and operations as a result of the pandemic and evaluate if they need to update their guidance, if any, to address COVID-19 and include risk factor disclosures in their 2019 year-end financial report discussing any risks related to the spread of COVID-19 on their business operations (due to quarantine of employees, customers and suppliers, travel restrictions, etc.). If applicable, issuers will have to consider, with their statutory auditors, the possible effects of COVID-19 on their future financial statements, for example, with regard to the valuation of their inventories and carrying value of their intangible assets.

Issuers Facing Liquidity Issues Due to COVID-19

Q: What are the likely impacts of the pandemic on a high yield issuer?

High yield bonds contain incurrence covenants, and therefore, as long as periodic reporting is provided within the proscribed time limits and with the required detail and interest payments are made, there is little chance of a default absent an affirmative action by the issuer (*e.g.*, incurrence of debt, granting of a lien) in violation of a covenant, a bankruptcy, or an adverse judgment of a material amount. Article 106 of the Cura Italia Decree has extended the deadline for providing annual financial statements for Italian companies from the 120 days provided for in Article 2364(2) of the Italian Civil Code to 180 days. High yield issuers should note that this law decree does not waive or modify high yield bond indentures' contractual reporting obligation, which typically falls 120 days following December 31, 2019, for calendar year reporting companies. Failure to provide such reports will constitute a default, which could restrict the making of certain restricted payments or taking other permitted actions under the indenture during the default period (even if it has not yet matured into an event of default) and eventually permit a percentage of the holders to trigger an event of default and accelerate.[1] Moreover, technical defaults under a bond indenture could, given the size of the debt, trigger cross-defaults under other instruments or contracts.

Additionally, high yield bond issuers should carefully consider their indebtedness and lien capacity when seeking emergency funding (see below) to avoid an inadvertent violation of their indentures.

Finally, although high yield bonds do not typically have maintenance covenants, drawing a revolving credit facility may require periodic testing of a financial covenant, which can then cross-accelerate into the high yield bond if the requisite ratio is not satisfied under the credit facility.

Q: How can a company raise emergency funds due to lost revenue resulting from the pandemic?

The financing arrangements that European high yield issuers have already used or are considering include: (1) drawing under existing super senior revolving credit facilities (oftentimes fully drawing such facilities as a defensive measure), (2) obtaining new super senior liquidity lines underwritten by direct lending funds or other financing institutions, (3) obtaining credit lines secured by assets not subject to security by other creditors or which are borrowed at a level structurally senior to the obligors of the issuer's existing financings (*i.e.*, at a subsidiary that is not an obligor in respect of the relevant indebtedness), and (4) incurring new subordinated shareholder instruments.

In addition, the Italian government has implemented several regulations to support the liquidity and financial status caused by COVID-19. In particular:

- Law Decree No. 23/2020 provides for guarantees by SACE S.p.A. (SACE), the Italian export credit agency, which is wholly owned by Cassa Depositi e Prestiti S.p.A. (CDP), with an aggregate limit of €200 billion (at least €30 billion of which is to be utilized for small and medium-sized enterprises (SMEs)) (the SACE Guarantees); SACE Guarantees are counter-guaranteed by the Italian state without recourse (*senza diritto di regresso*). SACE Guarantees can support up to 90%, 80%, or 70% (depending on the number of employees and turnover of the requesting company) of the principal amount of indebtedness under facilities granted on or after April 9, 2020, but in any case no later than December 31, 2020, to companies (other than banks and other financial institutions) based in Italy experiencing financial difficulties linked to COVID-19, not identified as "undertaking in difficulty" under European Commission Regulation No. 651/2014 as of December 31, 2019, and whose debt exposures were not classified as impaired credit exposures (*esposizioni deteriorate*) as of February 29, 2020. SACE Guarantees will be granted on a first-come, first-served basis, subject to the abovementioned aggregate limit of €200 billion. Eligible facilities must meet certain criteria, including being granted (1) by banks/financing institutions on or before December 31, 2020, with a term of up to six years (with a pre-amortization (*preammortamento*) period of up to 24 months), (2) for the purposes of funding employee costs, investments, working capital relating to production plants, or business activities located in Italy (*i.e.*, not refinancing), and (3) in an amount equal to the higher of (x) 25% of FY2019 group revenues and (y) 200% of FY2019 group employee costs, both as measured for their Italian operations. Annual fees for non-SME borrowers are equal to 50 bps for first year, 100 bps for second and third years, and 200 bps thereafter (each on guaranteed amount). In case a loan supported by a SACE Guarantee is granted, the borrower is required to comply with employment levels agreed in trade union agreements, and the borrower and any other company based in Italy belonging the group to which the borrower is party is prohibited from making dividend distributions or share buybacks until December 31, 2020.

- Article 57 of Law Decree No. 18/2020 provides that financings can be (1) made available by banks and other financing institutions granting loans to enterprises suffering a reduction in turnover due to COVID-19 and (2) guaranteed by CDP, which can be further guaranteed by the Italian state up to the equivalent of 80% of CDP's exposures (the State Counter-Guarantee). Such State Counter-Guarantees may be granted only in relation to financings granted to companies operating in sectors to be identified in the implementing regulations that are expected to be enacted within the coming weeks. However, until the State Counter-Guarantee scheme becomes operational, CDP offers the possibility to mid/large enterprises that have suffered a reduction of at least 10% of the turnover compared to 2019 to obtain bridge financings of up to €50 million, with a term of up to 18 months. Such financings can be made available by CDP in conjunction with other banks (in such a case, with CDP's participation in the syndication being capped at €50 million).

The State Counter-Guarantee and the SACE Guarantee schemes mentioned above are intended to facilitate loans by banks and financial institutions. While market conditions will dictate the terms on which financial institutions will be willing to lend funds that benefit from the foregoing guarantee arrangement, most of such debt is likely to be unsecured and thus, for most issuers, require simply satisfying the fixed charge coverage ratio in their indenture. It is fair to assume that the only authorized lenders eligible to benefit from such state-sponsored credit support will be financial institutions authorized to lend in Italy. Nevertheless, whether such guarantees can be granted in favor of bonds remains unclear. The Italian government is likely to address this and other uncertainties relating to the law decree in the coming weeks through additional rule-making and circulars. Companies with existing high yield bonds should contact Latham for assistance in analyzing their incremental debt and lien capacity under their indenture in order to make informed decisions regarding different financing sources and determine the most appropriate structure considering the issuer's constraints and borrowing capacity.

Q: How can a company make adjustments to EBITDA based on the impact of COVID-19?

IFRS offers some guidelines related to certain non-recurring and exceptional items that could be excluded from recurring income and hence impact non-IFRS measures published by issuers, such as EBITDA. Further, certain applicable financing documentations, such as credit facility agreement and high yield indentures, allow certain additional adjustments.

Issuers/borrowers may consider making adjustments to EBITDA (insofar as possible under their documentation), either because they are subject to maintenance covenants (*e.g.*, they have drawn their revolving credit facilities with a springing covenant at certain levels) or in order to incur debt for emergency funding.

It is typical and customary for non-recurring charges and expenses to form the basis of adjustments to consolidated net income (itself a component of consolidated EBITDA), including costs and expenses incurred related to restructuring, redundancy, or severance. This could be relied on, for example, when businesses are forced to make furloughs, layoffs, or idle workers and manufacturing sites due to the impact of COVID-19. Additionally, high yield documentation typically provides for adjustments related to non-cash charges to the income statement, for example, related to impairment of inventory, receivables, or goodwill, as well as unrealized foreign exchange transactions in respect of indebtedness or other obligations. The foregoing could be relied on for all manner of dislocations related to supply chain, unsaleable or unusable inventory or semi-finished goods, as well as the movement between the euro and the dollar for issuers with debt in multiple currencies. High yield documentation also provides for the ability to adjust for amounts received or reasonably likely to be received from business interruption insurance plans. Issuers that have contemplated various cost savings initiatives may also be able to adjust consolidated EBITDA.

The ability to adjust for lost revenue requires a case-by-case consideration of the relevant documentation. For new transactions that are still being negotiated, there may be room to tailor an adjustment for a specific business with a determinable impact over a particular period, depending on the circumstances.

Companies with existing high yield bonds should contact Latham for assistance in assessing their ability to make any such adjustments to EBITDA.

Q: Can a company repurchase its debt?

Market shifts are leading companies and their affiliates to actively consider debt repurchases. Important legal considerations to factor into that analysis include:

- Potential disclosure obligations. In light of the applicable US and EU regulatory framework, purchases of bonds should only be made when the purchasing entity does not have material nonpublic information (MNPI). Issuers and their affiliates should also consider whether the implementation of a securities repurchase program is itself MNPI that should be disclosed in the context of a purchase of securities by the issuer or an affiliate. Depending on the timing of the purchases, advance disclosure, if required, could be contained in a specific press release or as part of the issuer's usual reporting.

- The impact of tender offer rules. Unless an issuer or its affiliate elects to make an offer for any and all bonds at a certain price (including subject to a cap on the aggregate principal amount subject to the offer), issuers and their affiliates should consider the following factors in designing and implementing their bond repurchase programs in order to avoid characterization as a tender offer, which would require complying with certain regulatory conditions and limitations in respect of such purchases:

  - **Timing:** Make the repurchases over a reasonable period of time based on the circumstances — avoiding set time periods or deadlines in connection with negotiations.

  - **Number of Solicited Sellers:** Solicit only a limited number of potential sellers; the fewer the number of holders contacted, the better.

  - **Variable Prices and Terms:** Make purchases from multiple sellers at individually negotiated prices and on different terms. The greater the variation in price and terms, the better.

  - **Nature of Sellers:** Limit purchases to those from sellers that are sophisticated institutional investors. Market participants generally take the view that the purchase of 10% to 15% or less of a series of bonds from a limited number of sophisticated institutional investors does not constitute a tender offer.

  - **Character of Offer to Purchase:** Refrain from applying pressure to potential sellers to sell their bonds, such as "take it or leave it" offers, offers conditioned on other purchases, or offers open for very short periods before being rescinded.

In particular, under Italian law, selective or private repurchases of debt as well as cash tender offers involving debt securities (1) that are extended exclusively to qualified investors or (2) that have a minimum denomination of at least €100,000 launched by the issuer of such securities or its parent, or an affiliate or by an intermediary engaged by one of the latter are, in each case, exempt from the Italian tender offer rules. In addition, consent solicitations and amendment and waiver requests are not subject to the Italian tender offer rules.

- Contractual limitations or restrictions. Issuers considering a debt repurchase transaction should consider their contractual limitations that might limit flexibility. The indenture governing a particular series of bonds being repurchased is unlikely to prohibit or limit repurchases of those bonds by either the issuer or its affiliates. However, if the issuer has any outstanding bank debt, the credit agreement may prohibit the borrower from repurchasing other debt (including bonds).

- Potential tax consequences for debt repurchased at a discount. Issuers should carry out a tax analysis to assess any potential tax implications for both the issuer and the purchasing entity under both Italian law and the law of the purchasing entity's jurisdiction as a result of the purchase, resale, or contribution of the bonds by the purchase entity. For example, in the US and certain other jurisdictions, an issuer could incur a taxable gain if a person related to the issuer purchases the issuer's debt at a discount.

- Potential rating impact. Particularly when the current price level of the notes is significantly below par, one or more of the rating agencies may deem the repurchases at those levels to constitute a distressed exchange, which could result in a rating downgrade to a selective default. Therefore, issuers should either directly contact rating agencies in advance or liaise with an investment bank that is able to advise on the potential rating implications of such purchases.

For a more detailed discussion on this topic, see Latham's *Client Alert* Navigating Debt Repurchases: What You Need to Know.

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Endnotes

[1] Italian issuers who believe that they will not meet the 120 days requirement (or any other different reporting obligation provided by their indentures) may need to pass a resolution approved by a meeting of the bondholders in order to obtain a waiver or consent (or any other amendment to their indentures). This process may take up to three weeks, and therefore issuers should carefully plan it in advance.