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Tricks of the trade

Refinitiv, the speculative-grade Thomson Reuters unit now in the market borrowing $13.5 billion despite weak or, indeed, nonexistent covenant protection for the hungry creditors, showed $1.88 billion in earnings before interest, taxes, depreciation and amortization for the trailing 12 months ended June 30, according to Bloomberg. It's a figure that rises to $2.53 billion after adjustment for the "synergistic savings" that are surely in the cards if everything goes exactly as the promoters promise. So assuming, pro forma leverage drops to 5.4 from 7.3 times adjusted EBITDA. Could one assume one's way to triple-A?

Which brings us to another sign of the times, a transaction long since signed, sealed and delivered, except for the court proceedings. In March 2015, a private-equity consortium led by BC Partners LLP bought PetSmart, Inc. for $8.3 billion plus $350 million in assumed debt. In this way began a chain of events to prove that, no, Mr. or Ms. Authority on Leveraged Finance, you haven't seen everything yet. What should a creditor expect in this time of debased accounting standards, eviscerated covenant protection and miniature interest rates? "Less" is the answer.

As befits a bellwether deal, PetSmart set records—for one, the biggest leveraged buyout of 2014 (the announcement having come in December of that year). It achieved what the bankers call a full price, too, thanks to the spirited bidding of Apollo Global Management, LLC and KKR & Co., Inc., among others. About $7 billion in debt, or 85% of the purchase price, left PetSmart leveraged at 6.4 times adjusted EBITDA. Of the total, $4.3 billion came from a covenant-lite, first-lien term loan that paid Libor plus 400 basis points—now 300 basis points over Libor, following a couple of refinancings. Shareholders have extracted $800 million in dividends even as the brick-and-mortar retailing business suffered from the competition of digital interlopers.

Not content to sit on its haunches, PetSmart bought Chewy, Inc., a six-year-old online pet-supply business, in April 2017, ringing the bell for the largest transaction for a digital retailer to date. The deal was valued at $3.35 billion and financed with $2 billion of debt and $1 billion of equity (existing cash and assumed debt paid for the balance). The profitless Chewy was thought to be an IPO candidate, but private-market bidders outshone the prospective public ones. Leverage at PetSmart, including operating leases, rose to 8 times adjusted EBITDA after the deal closed from 5.4 times prior, according to Moody's.

Promotional spending to drive revenue growth at Chewy has taken its toll. By the end of the second quarter, again according to Moody's, PetSmart was leveraged 8.5:1. By this time, too, Chewy, as a "restricted subsidiary," was a guarantor under PetSmart's $4.3 billion term loan—until, that is, PetSmart decided otherwise. On June 1, the parent announced that Chewy was no longer a wholly owned subsidiary because 36.5% of its stock (worth about $900 million) had been shunted out of the reach of the secured lenders, most of it in the shape of a dividend to PetSmart's own holding company. It was PetSmart's contention that the transfers had automatically triggered the release of Chewy's credit guarantee.

Thus came about what PetSmart's sadder-but-wiser creditors know today as the "Chewy Phantom Guarantee." Ian Walker, legal analyst at Covenant Review LLC, pronounces it "one of the most absurd provisions in all of leveraged finance." (Compare and contrast the "J. Crew Trapdoor" gambit; *Grant's,* July 13). The here-you-see-it-now-you-don't backstop is no one-off, says Walker, but a feature in a "significant minority" of leveraged loans: "Investors should be alarmed by the fact that the Chewy guarantees could have been released even if [PetSmart] had only distributed a de minimis amount of Chewy equity to the sponsors."

"Perhaps more importantly," observes colleague Fabiano Santin, "the Chewy gambit calls attention to the abuse of add-ins to EBITDA, which is a dubious enough construct to begin with (*Grant's,* Aug. 10). Inflating it through the addition of imagined future cost savings does not improve the quality of financial reporting."

Naturally, the PetSmart tussle has wound up in court, in this instance, the U.S. District Court for the Southern District of New York. On Sept. 6, Wilmington Trust Co., the administrative agent for the loan (and therefore an advocate for the creditors), answered representations by PetSmart. It claimed, in part, that PetSmart could not have legally spirited Chewy stock away from the lenders because the company was out of compliance with its fixed-charge coverage ratio test.

Then, too, the creditors' lawyers demanded to know why PetSmart's projected synergies and cost savings of $148 million were so far in excess of the $17 million actually realized. If the PetSmart loan price is any indication—it has rallied to 88½ from 76 in early June—the Wilmington Trust's arguments are making an impression in the court.

The proliferation of add-backs to EBITDA constitutes a marker of the progress (if that's the word for it) of the post-crisis credit cycle. In the first quarter of 2016, according to Covenant Review, more than 80% of newly issued leveraged loans capped the dollar value of projected synergies and cost savings that promoters might use to fluff up EBITDA. In the first half of this year, that figure had fallen below 50%, with large private-equity sponsors enjoying particular dispensation to inflate that faux cash-flow metric. It's a cycle, all right.

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