The PetSmart Case: A Deep Dive Into Its Equity Transfer Of Chewy Inc.

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RECOVERY ANALYST

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Key Takeaways

- The case illustrates how the interpretation of key terms and conditions in leveraged loan agreements and bond indentures could differ between lenders and borrowers.
- Areas of focus in the case include baskets that permit dividends and investments in unrestricted subsidiaries as well as disputes regarding the appropriateness of EBITDA addbacks used to size the capacity under covenant baskets.
- We note that, beyond the PetSmart case, the trend towards looser loan covenants is a growing lender concern because it increases potential event risk that borrowers may undertake various actions that could impair credit risk or recovery prospects for lenders in a default scenario.

As demand for leveraged loans continues unabatedly, terms are becoming more bond-like while looser negative covenants are giving more flexibility to borrowers under the credit documents to transfer assets from the collateral package to unrestricted subsidiaries or other entities where the liens cease to exist. While borrowers may undertake these types of transfers for various reasons, ranging from entering into a joint venture or monetizing transferred assets to raise liquidity, we think the potential weakening of collateral protection, especially when the credit cycle turns, could affect recovery prospects for leveraged loan lenders.

In S&P Global Ratings' view, two recent transactions help illustrate the potential risks of more flexible covenant structures from a collateral coverage and recovery perspective. Last year, J. Crew Group Inc. undertook a series of complex transactions that relied on various baskets under the negative covenants in its credit agreement to transfer a key part of the lender's collateral--its intellectual property (IP)--to "unrestricted subsidiaries," entities that are not governed by the covenants in the credit agreement and that are not required to provide guarantees or liens on their assets. Once it had moved its IP, J. Crew used the unrestricted subsidiaries to issue new debt secured by the IP. Certain of J. Crew's lenders challenged the validity of these actions in a lawsuit, but ultimately the majority of the lenders ended up negotiating a restructuring agreement with the company despite losing the transferred IP as collateral. This restructuring agreement included a modest repayment of the bank debt at par, a tightening of various document provisions, and an extension of certain debt maturities. (For more information on the mechanics of J. Crew's IP transfer, see "J. Crew's Intellectual Property Transfer: An Update For Distressed Lenders" published Sept. 12, 2017).

More recently, in June 2018, PetSmart Inc. announced the transfer of 36.5% of the equity interests in Chewy Inc., a key subsidiary, to a consortium of investors led by BC Partners (20%) and to an unrestricted subsidiary (16.5%). According to PetSmart, the Chewy share transfers were permitted under its credit agreement and bond indentures and resulted in the termination of Chewy Inc.'s guarantees and the removal of Chewy's assets from the collateral package for PetSmart's first-lien term loan and secured notes--effectively reducing the lenders security interest in Chewy to a pledge of 63.5% of Chewy's stock.

The validity of the Chewy share transfers and related transactions are the subject of an ongoing lawsuit in federal district court.

In this article, we review the Chewy-related litigation from the standpoint of the negative covenants in PetSmart's term loan credit agreement and bond indentures, including:

- Key provisions in the credit agreement, including restricted payment and investment baskets, that PetSmart contends allowed it to transfer the Chewy shares;
- The interplay of the Chewy share transfers and the terms governing release of liens and guarantees in PetSmart's credit agreement; and
- The position taken by the agent for PetSmart's term loan agreement, who argues that the Chewy share transfers violated the requirements of PetSmart's indentures and triggered a cross-default under the credit agreement.

Ongoing Litigation

- On June 26, PetSmart and its immediate parent (Argos Holdings Inc.) filed suit in federal district court against the administrative agent for PetSmart's term loan credit facility over the agent's failure to execute documentation confirming the termination and release of guarantees and liens resulting from the Chewy share transfers, which PetSmart argues the agent is required to do under the loan documents. (We refer to the June 26 complaint filed by PetSmart and Argos Holdings as the "PetSmart complaint".)
- On Sept. 6, Wilmington Trust N.A., which replaced Citibank as administrative agent for the term loan, filed its response and counterclaim to PetSmart's lawsuit. In its counterclaim, which have been amended twice as of the date of this article, the agent contends the Chewy transactions violated PetSmart's governing debt documents and were otherwise unlawful.

Because this article seeks to focus on the negative covenants in PetSmart's term loan agreement and bond indentures, we do not address all of the agent's bases for challenging the validity of the Chewy share transfers.

While our discussion of the Chewy transactions is based on the parties' court filings, we express no view in this article on whether or not the transactions comply with PetSmart's debt instruments or on any other matter relating to the ongoing litigation.

Debt Structure

Before we discuss the provisions PetSmart claims permitted the Chewy share transfers, we offer a brief overview of PetSmart's debt structure, including the debt the company took on to finance its acquisition of Chewy Inc.

PetSmart's current debt consists of:

- $955 million asset-based revolving credit facility (ABL revolver) (ABL agreement dated as of March 11, 2015),
- $4.3 billion first-lien term loan (credit agreement dated as of March 11, 2015),
- $1.35 billion first-lien secured notes (indenture dated as of May 31, 2017), and
- $2.55 billion unsecured notes (indentures dated as of March 4, 2015, and May 31, 2017).

PetSmart acquired Chewy in May 2017, financing the $3 billion purchase price with $1.35 billion in first-lien secured notes, $650 million in unsecured notes, and $1 billion in equity capital. We refer to the first-lien term loan and first-lien secured notes, which are pari passu with each other, collectively, as the "first-lien debt."

PetSmart Inc. is the primary borrower/issuer under the ABL revolver, the first-lien term loan, and the secured and unsecured notes. The company's holding company parent, Argos Holdings Inc., provides a downstream guarantee to secured ABL and term loan lenders, while the company's wholly owned domestic restricted subsidiaries provide upstream guarantees to secured and unsecured lenders. The collateral package for the first-lien debt comprises substantially all of PetSmart's and the guarantors' assets.

When Chewy Inc. was acquired in 2017, it became a guarantor of PetSmart's debt instruments and substantially all of Chewy's assets were added to the collateral package for PetSmart's first-lien obligations (with the ABL revolver having a priority lien on working capital assets and the first-lien debt having a priority lien on non-ABL assets). In addition, the collateral package for the first-lien term loan and secured notes included a 100% pledge of the equity interests in Chewy.

As discussed more fully below, PetSmart contends that Chewy ceased to be a wholly owned subsidiary following the share transfers, triggering the release of Chewy's guarantee and the termination of the liens on Chewy's assets (Chewy's guarantee and liens supporting the ABL revolver remain in place).

Moreover, PetSmart asserts that only 63.5% of the equity interests in Chewy--representing the interests still held by PetSmart (outside of unrestricted subsidiaries) following the share transfers--remain pledged to first-lien lenders and noteholders.

Mechanics Of The Chewy Equity Transfers

PetSmart relied on a number of provisions under the credit agreement to determine how much of Chewy's equity it could permissibly transfer. We outline the steps taken by PetSmart to effectuate these transactions, which took place on June 1, based on the PetSmart complaint. (We note that PetSmart's term loan credit agreement, otherwise referred to in this article as the "credit agreement", is an exhibit to the agent's second amended counterclaim.)

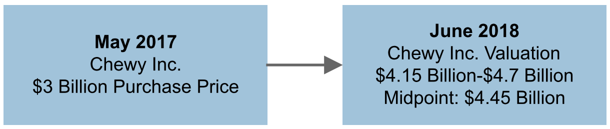
Valuation of Chewy

The PetSmart complaint sets forth the steps the boards of directors of PetSmart and Argos Holdings took to evaluate and approve the Chewy transactions.

As part of this process, a third-party advisor was retained to value Chewy. The valuation advisor estimated Chewy's enterprise value to be between $4.15 billion and $4.75 billion, with a midpoint of $4.45 billion.

Chart 1

Third-Party Valuation Of Chewy Inc.



Determination of basket capacity

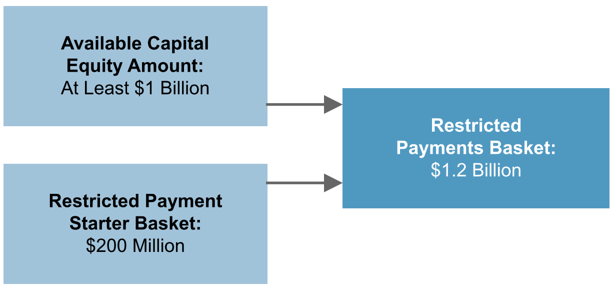
Restricted payment basket. While the credit agreement limits PetSmart's ability to make restricted payments (such as dividends and other distributions of value to equity holders), it does not prohibit them outright. PetSmart's complaint identifies two exceptions within the restricted payments covenant (Section 6.8) as the source of permission for the transfer (dividend) of 20% of the equity interests in Chewy Inc. to its investor group.

- First, the credit agreement permits PetSmart (and its parent Argos Holdings) to make up to $200 million of restricted payments (Section 6.08(a)(viii)(A)).
- Second, the credit agreement permits PetSmart and Argos Holdings to make additional restricted payments up to the "available equity amount," a defined term under the agreement (Section 6.08(a)(viii)(C)).

As noted in the complaint, the available equity amount definition in the credit agreement includes capital contributions received by PetSmart after the "effective date" (as defined in the credit agreement) in cash or permitted investments. PetSmart contends that because it received $1 billion in capital contributions related to the Chewy acquisition from the indirect equity owners of PetSmart after the effective date, the available equity amount was at least $1 billion. As a result, PetSmart calculated a total capacity of $1.2 billion under its "restricted payment basket" as of June 1.

Chart 2

PetSmart Inc.'s Restricted Payment Basket Determination



Investment basket. While PetSmart's analysis of the dividend of 20% of Chewy's equity involved the restricted payments covenant under the credit agreement, the transfer of 16.5% of Chewy's equity to an unrestricted subsidiary brought the "investments" covenant (Section 6.04) into play.

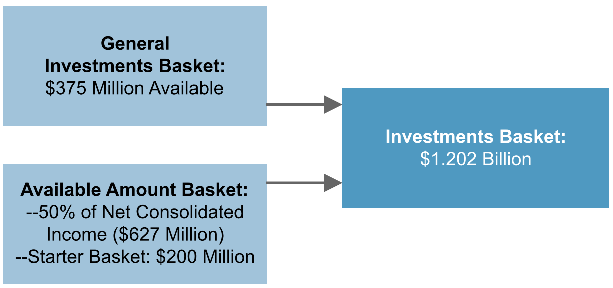
As outlined in the PetSmart complaint, PetSmart has a "general" investment basket under the credit agreement of $375 million (Section 6.04(n)(A)). In addition, the credit agreement allows the company to make investments up to an "available amount" that consists of:

- a) "starter basket" of $200 million; and
- b) 50% of consolidated net income for the period running from the effective date of the credit agreement to the end of the most recent test period (Section 6.04(n)(B)).

The company stated in its complaint that consolidated net income during this time frame was about $1.255 billion and therefore 50% of consolidated net income was about $627 million. In total, the available amount under the investment basket, as calculated by PetSmart, was $827 million (a plus b) and, together with the $375 million general investment basket, provided a total capacity of $1.202 billion.

Chart 3

PetSmart Inc.'s Permitted Investment Basket Determination



Transfer of Chewy equity

According to PetSmart's complaint, PetSmart transferred 20% of Chewy's equity to its parent (Argos Holdings), which in turn transferred the shares to an entity controlled by PetSmart's investor group. These restricted payments, which took the form of a dividend payable in Chewy shares, were determined by PetSmart to be valued at $908.5 million (based on the midpoint of the $4.45 billion third-party valuation)and were within the $1.2 billion that PetSmart had calculated as being available under the restricted payments basket.

At the same time, the company transferred 16.5% of Chewy's equity to an unrestricted subsidiary, which took the form of an investment. This investment was determined by PetSmart to be valued at $749.5 million (based on the midpoint of the third-party valuation) and was within the $1.202 billion investment basket that PetSmart had calculated.

The PetSmart complaint maintains that there were no other covenants under the credit agreement that prohibited the Chewy share transfers.

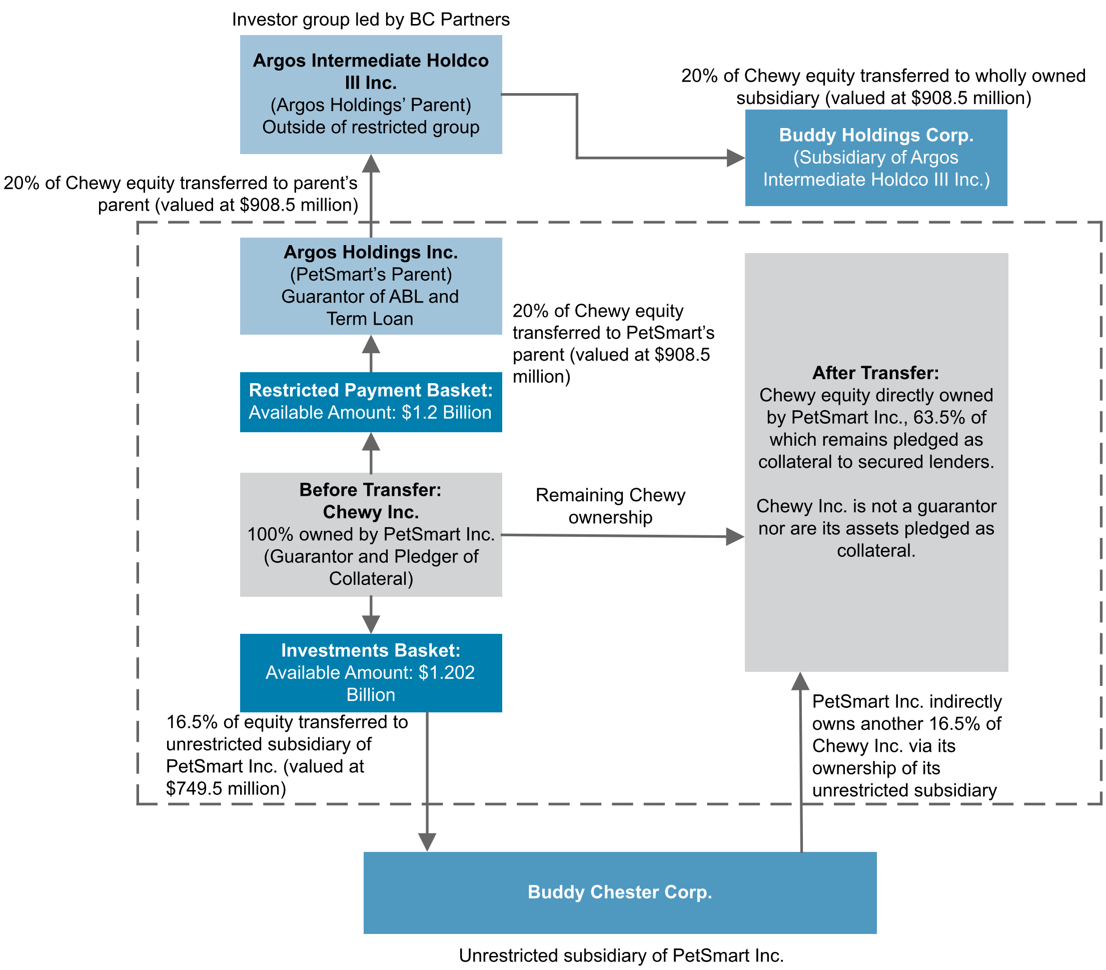
As PetSmart notes in the complaint, although the "asset sale covenant" prohibits PetSmart and Argos Holdings from transferring or disposing of any asset owned by them (Section 6.05), the restriction does not apply to restricted payments and investments permitted under sections 6.08 and 6.04 of the credit agreement.

Similarly, the PetSmart complaint notes that the "affiliate transaction covenant" (Section 6.09) does not apply to a restricted payment permitted under the baskets in Section 6.08 that PetSmart relied on. Moreover, PetSmart contends that the affiliate transaction covenant in the credit agreement did not prohibit the transfer of Chewy shares to the unrestricted subsidiary because PetSmart owns all of the equity interests in the unrestricted subsidiary. According to the PetSmart complaint, since PetSmart retains complete control of the transferred equity, the contribution to the unrestricted subsidiary is per se on terms at least as favorable as PetSmart could have obtained from an unrelated third party.

PetSmart's lawsuit contends that the Chewy share transfers complied with all applicable covenants under its secured and unsecured note indentures, with the dividend constituting a permitted restricted payment and the transfer to the unrestricted subsidiary constituting a permitted restricted payment or permitted investment. PetSmart also maintains that the Chewy transactions complied with relevant law.

Chart 4

PetSmart's Transfer Of Its Chewy Inc. Equity



Release of Chewy collateral and guarantee obligations

As noted in the PetSmart complaint, under the terms of the credit agreement, upon the request of PetSmart, a subsidiary is automatically released from its guarantee obligations, and any liens that subsidiary may have granted are similarly terminated, when it ceases to be wholly owned (Section 9.15). The same credit agreement section also provides for the automatic release of liens on any collateral transferred by way of a permissible transaction under the credit agreement.

According to the PetSmart complaint, Chewy was no longer a wholly owned subsidiary of PetSmart as a result of the transfers (since 20% of Chewy's equity interests were no longer held directly or indirectly by PetSmart).

PetSmart maintains that its delivery of a release request to the agent under the term loan credit agreement triggered the automatic release of Chewy's guarantee, the liens on Chewy's assets, and the liens on all of the transferred shares (36.5% of Chewy's equity) and resulted in analogous automatic releases under the PetSmart indentures.

(See PetSmart's complaint filed on June 26, 2018, in the U.S. District Court For the Southern District of New York for full details, at Pacer (Public Access to Court Electronic Records.)

The Term Loan Agent's Response And Counterclaims

The following discussion highlights the agent's position on the legitimacy of the Chewy transfers under the negative covenants in PetSmart's indentures and credit agreement.

Dividend of Chewy Shares

The thrust of the agent's challenge to the Chewy share dividend involves the restricted payments covenant in PetSmart's bond indentures.

In its counterclaim, the agent maintains that PetSmart's ability to effect the dividend in reliance on the applicable restricted payments basket (Section 4.07(a)(3)) first required PetSmart to meet a fixed-charge coverage ratio (FCCR) test (Section 4.07(a)(2)). Under the indentures, FCCR is defined as the ratio of consolidated EBITDA (as defined) to fixed charges (as defined).

In order to satisfy the FCCR test, PetSmart needed to have an FCCR of 2 to 1 immediately after giving effect to the (proposed) dividend on a pro forma basis. As described in the counterclaim, PetSmart's FCCR at the time of the dividend was 2.015 to 1. This ratio reflects consolidated EBITDA and fixed charges for the applicable test period of $972.6 million and $482.7 million. As noted in its complaint, PetSmart met the test by $7.3 million of consolidated EBITDA, which meant that PetSmart would not have passed the test if consolidated EBITDA were below $965.4 million.

Calculation of Addbacks to EBITDA. The agent alleges that PetSmart's FCCR at the time of the dividend was less than 2 to 1 because consolidated EBITDA was in fact less than $965.4 million. To support this contention, the agent maintains that the company's calculation of consolidated EBITDA improperly includes $148 million in cost savings and synergies from PetSmart's 2017 acquisition of Chewy. As stated in the counterclaim, the indentures allow PetSmart to include unrealized cost savings and synergies only if (1) PetSmart expects to realize them within 24 months of the Chewy acquisition date, and (2) the cost savings and synergies are factually supportable and reasonably quantifiable (see definition of consolidated EBITDA).

The agent alleges that PetSmart's $148 million number does not satisfy either of these two conditions. In support of its position, the agent notes that PetSmart actually recognized only $17 million in cost savings and synergies in the eight months that elapsed from the Chewy acquisition date (May 31, 2017) to the FCCR measurement date (Jan. 31, 2018). In addition, according to the counterclaim, PetSmart had told its investors when it acquired Chewy that it would realize $204 million of cost savings and synergies within 12 months. Against this backdrop, the agent argues that PetSmart will not meet its $148 million projection within the applicable time frame and contends that PetSmart's projection is inaccurate and unsupported. Accordingly, the agent asserts that PetSmart's calculation of consolidated EBITDA was in violation of the FCCR requirement. (As additional support for its position that PetSmart's consolidated EBITDA number was at least $7.3 million too high, the agent contends that even if the $148 million figure were correct, other addbacks relating to the fourth quarter of 2017 raise questions).

Cross-default under the credit agreement

The agent asserts that noteholders had the right to accelerate the principal amount owed under the notes in the wake of PetSmart's violation of the FCCR requirement (Section 6.03(a)(3) of each indenture).

As noted in the counterclaim, the "cross default" language in the credit agreement (Section 7.01(g)) provides that an "event of default" occurs under the credit agreement if, after the expiration of any applicable grace periods, the holders of any "material indebtedness" (obligations exceeding $100 million in principal amount, like the secured and unsecured notes) would be permitted to accelerate. Noting that this section does not require holders to actually accelerate their debt, the agent asserts that the FCCR violations, which gave noteholders the ability to accelerate, triggered an event of default under the credit agreement.

According to the counterclaim, the cross-default triggered by the dividend of Chewy shares also operated to prohibit the transfer of Chewy shares to the unrestricted subsidiary for the purposes of the credit agreement.

As a result, the agent argues, because neither the dividend nor the transfer to the unrestricted subsidiary was permitted under the credit agreement, the guarantee and lien releases did not occur.

Transfer of Chewy shares to unrestricted subsidiary

The agent maintains that PetSmart's transfer of Chewy shares to an unrestricted subsidiary was a violation of the indentures.

According to the counterclaim, PetSmart relied on an "investment in a similar business" basket for its transfer of Chewy shares to an unrestricted subsidiary. This basket, which appears within the "permitted investments" definition, allows for investments in a "similar business" (as defined) up to the greater of $300 million or 30% of consolidated EBITDA for the applicable test period.

The agent contends that Buddy Chester Corp., the unrestricted subsidiary to which PetSmart transferred Chewy shares, was not a similar business within the meaning of the indenture definition but rather a company with no operational role that PetSmart created only for purposes of holding the shares. As a result, the agent asserts that PetSmart's use of the indenture investment basket was prohibited.

Affiliate transactions covenant

Contrary to PetSmart's position, the agent contends that the Chewy transfers violated the affiliate transactions covenant in the credit agreement. In the agent's view, PetSmart would have gotten better terms from an unrelated third party because the transactions were set up to move Chewy's equity to corporate affiliates and increase Chewy's value at PetSmart's expense. As a result, the agent maintains that PetSmart would have been able to command a substantial premium if PetSmart were to propose such an arrangement to an unrelated third party.

See the response and counterclaim filed on Sept. 6, 2018, in the U.S. District Court For the Southern District of New York for full details at Pacer (Public Access to Court Electronic Records).

Recovery Rating Implications

Following PetSmart's announcement in June that it had completed the Chewy share transfers, we revised our recovery rating on PetSmart's secured debt to '4' from '3'. As we said in our June 26 recovery report, the release of liens on Chewy's assets and on 36.5% of Chewy shares weakens recovery prospects for secured creditors. However, our report also noted the existence of press reports indicating that secured lenders might be seeking to challenge the transfers of Chewy equity.

In light of the ongoing litigation, our recovery ratings remain subject to change. Moreover, our current recovery ratings do not constitute (nor should they be construed as) an opinion that the Chewy transactions comply with PetSmart's debt agreements or are otherwise valid.

PetSmart Inc.--Credit Profile

Issuer credit rating	**CCC/Negative/--**				
Estimated gross enterprise value at default	$3.9 bil.				
Year of default	2019				
Facility/issue	**Principal and interest outstanding at default**	**Recovery rating**	**Issue rating**	**Expected recovery (%)**	**Maturity**
Secured debt					
$955 mil asset-based revolver	$0.5 bil	NR	NR	N/A	March 11, 2020*
$4.3 bil 1st-lien term loan	$4.2 bil	4	CCC	30%-50%, rounded estimate: 45%	March 11, 2022
5.875% $1.35 bil 1st-lien secured notes	$1.4 bil	4	CCC	30%-50%, rounded estimate: 45%	June 1, 2025
Unsecured debt					
7.125% $1.9 bil unsecured senior notes due 2023	$2.0 bil	6	CC	0%-10%, rounded estimate: 0%	March 15, 2023
8.875% $650 mil unsecured senior notes due 2025	$0.7 bil	6	CC	0%-10%, rounded estimate: 0%	June 1, 2025

*$750 million of the $955 million in ABL commitments is extended until Dec. 10, 2021, with $205 million maturing on March 11, 2020. NR--Not rated. N/A--Not applicable.

For more details on our ratings on PetSmart Inc., please see the research update, published June 14, 2018, and the recovery report, published June 26, 2018. For more details on S&P Global Ratings' Recovery Ratings Criteria, please see "Recovery Rating Criteria For Speculative-Grade Corporate Issuers," published Dec. 7, 2016.

When The Cycle Turns, Will We See More Of These Cases?

As the PetSmart case demonstrates, key negative covenant terms and conditions in leveraged loan agreements and high-yield bond indentures and the boundaries of restricted payment and other baskets may be susceptible to differing interpretations. As borrowers experience financial distress and contemplate debt restructuring options to raise liquidity, push out debt maturities, and lower debt costs, they may look to see what flexibility they believe they have under the credit documents especially, in our view, when the credit cycle turns and the capital markets tighten up.

From our perspective, the trend towards looser loan terms in recent years exposes secured lenders to a broad spectrum of risks as loan documentation and debt capital structures have become more borrower-friendly.

We capture many of these risks in our loan and recovery ratings. For example, our entity ratings, and thus our loan ratings, reflect risks we view as inherent in financial sponsor-owned borrowers. In addition, our ratings seek to address risks related to "covenant-lite" loan structures (i.e., loans without financial maintenance covenants). Under our recovery rating methodology, the projected recovery for a leveraged loan with a financial maintenance covenant is generally higher than it would be for a covenant-lite loan (all else being equal). Our recovery ratings also reflect the impact of declining levels of cushion (junior debt in the capital structure) available to leveraged loans, in the advent of structures where the loans represent all or most of the company's debt. Recovery ratings tend to be lower for leveraged loans that lack meaningful debt cushion. Moreover, under both our corporate and recovery rating methodologies, we calculate EBITDA and leverage independently, without regard to EBITDA addbacks that may be present in the leveraged loan document definitions. For further discussion of these issues, please see the research articles referenced below.

In our view, the increased flexibility in negative covenant "baskets" in general, and the potential that the size of these baskets can be increased by EBITDA definitions that include "addbacks", creates incremental risk that can negatively affect lender recovery prospects if a company utilizes its baskets in ways that dilute collateral coverage or are otherwise adverse to lenders and subsequently defaults. However, we view these incremental risks as "event risks" that are extremely difficult to predict and quantify in our recovery ratings in a way that is reasonable and value-added to investors. If nothing else, we think the complex specifics and disputing opinions relevant in the J. Crew and PetSmart examples provide good context for these challenges. We continue to monitor these issues and evaluate whether and how these risks may be incorporated into our recovery ratings on a prospective basis.

Related Criteria

- Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016

Related Research

- When The Credit Cycle Turns: The EBITDA Add-Back Fallacy, Sept. 24, 2018
- Credit FAQ: A Closer Look At How Covenant-Lite Structures Affect Recoveries For Institutional Loans, July 10, 2018
- Recovery Report: PetSmart Inc.'s Recovery Rating Profile, June 26, 2018
- PetSmart Inc. Senior Unsecured Recovery Rating Revised To '6', Issue-Level Rating Lowered To 'CC', June 25, 2018
- PetSmart Inc. Corporate Credit Rating Lowered To 'CCC' From 'CCC+' On Potential Debt Restructuring; Outlook Negative, June 14, 2018
- Guidance | Criteria | Corporates | Recovery: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, May 18, 2018
- Lean Senior Debt Cushion Threatens Recovery Prospects For U.S. Leveraged Loans, November

30, 2017

This report does not constitute a rating action.