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"Covenant-Lite: The Rise Of A Fallen Angel"

Seminar: 06/11/2104: Article Part 2

As part of the White & Case "Risk In A Recovering Market" autumn seminar series on 6 November 2014, Stephen Mostyn-Williams, Chairman and founder of DebtXplained collaborated with White & Case bank finance partners, Jake Mincemoyer, Justin Wagstaff and Lee Cullinane, in a discussion on the various issues that may arise when structuring, negotiating and investing in covenant-lite leveraged loans in both the US and European market.

Most Favoured Nation

"Most favoured nation" is jargon for the concept that one party will be entitled to at least as favourable terms as another party in specified circumstances. In the current market, the MFN provision is more specifically a reference to yield protection i.e. if the yield on an incremental facility is greater than the yield on the existing term loan by an agreed number of basis points, the yield on the existing term loan will be "pulled up" until it is less than the incremental facility yield by the agreed number of basis points. It is common for the "yield" to be "all-in-yield" rather than just margin. In the US, the pricing differential is well-established at 50 basis points. In Europe, however, this differential is not uniform and varies between 50 and 100 bps.

What has been seen on both sides of the Atlantic is the introduction of a "sunset" into the MFN provision i.e. a limited time period post-closing during which the MFN protection applies. About 30% of English law or other European law deals reviewed in 2014 ("**2014 European Deals**") contained a "sunset" provision. Of these, about half were cov-lite deals. An 18-month period has been the most common time period, in just over 50% of such deals, with the next popular time period being 12-months.

In the current US market, where a "sunset" provision is built into loan documentation, the mandated lead arrangers will usually be granted a flex right to remove the "sunset" to permit lenders to benefit from the MFN over the life of the facilities. It is important to note that European deals will not always have this corresponding flex right. This is one (of many) examples of where a term which is well-established and accepted in the US market has encountered translation issues when adopted into European deals.

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Controlling The Debt Burden – The Ratio Debt Basket

The Rationale behind the Ratio Debt Basket

US leveraged loan investors are comfortable with the absence of a borrower group deleveraging requirement, which is a traditional protection that their European counterparts look for in a deal. US investors look to the borrower group's initial leverage, incorporate a "cushion" in their analysis to absorb a tolerable level of flexibility in borrower group's future EBITDA and debt, and allow the borrower group to borrow as and when business needs require it or to take advantage of expansion opportunities, so long as the rises and falls of the debt burden over time occur below this initial leverage. This is the so-called "ratio debt basket" applicable to incremental facility debt or incremental facility equivalent debt in the form of senior secured, junior secured or unsecured notes (called "**Incremental Debt**" here for the sake of simplicity).

In addition to promoting the growth of the business, the rationale for allowing ratio-based debt is that if the borrower group's leverage falls to a certain level, then there should be no concern if the it subsequently increases up to the level lenders were comfortable with when money was initially advanced (called the "**Initial Leverage Rationale**" for the sake of simplicity).

This ratio debt basket has found its way into European cov-lite loans to the same extent found in the US; 100% of European cov-lite deals reviewed contained a ratio debt basket.

The Formulation of the Basket Ratio

The aspects of leverage in the ratio debt basket which are treated differently in the US and in Europe and the points of negotiation are as follows:

- The ratio used is one of the most varied aspects of the cov-lite deals:
  - sometimes deals use a first lien/senior secured ratio, others a total ratio;
  - it is not uncommon for both to be used with first lien/senior secured leverage being used for incurring pari passu secured debt and total leverage being used for incurring unsecured or junior secured debt. There is no uniformity in either the US or European market on this point;
  - there is also no consistency on whether, if only first lien/senior secured leverage is used, the unsecured or junior debt is deemed as secured debt in calculating the ratio (so preserving to some extent the Initial Leverage Rationale) or whether any amount of unsecured or junior debt can be incurred outside of the first lien/senior secured ratio debt basket in the absence of any total leverage ratio cap for it. However, the US market has a more settled approach and deems all Incremental Debt as senior secured/first lien or will use separate ratios;
  - some deals have used an interest cover ratio or if the deal leans more closely to a high yield bond package, a fixed charge coverage ratio set at 2x, and these ratios can be used instead of or with the leverage ratios;
  - other deals have a cap which is the lower of closing leverage and a specified leverage; and
  - investors also need to be mindful that in the US, unrestricted subsidiaries debt will not be constrained or included in ratio calculations.

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- Investors should also consider what EBITDA add-backs are being allowed and how far can management go in including cost savings and synergies when calculating EBITDA.
- Again, there is no consistency in the US or European market as to whether a cap applies or if it does, what it might be.
- About 45% of 2014 Deals (i.e. European not US deals) which were cov-lite had no cap.
- Others capped it at 10% of EBITDA (a common cap in traditional deals). Separate caps for acquisition synergies and restructuring synergies has also been seen

Controlling The Debt Burden – "Free And Clear" And "Sidecar" Baskets

The "Free and Clear" Basket

There is another substantial basket now commonly present in US and, to a lesser degree, European deals for Incremental Debt which cuts across the Initial Leverage Rationale. This is the so-called "free and clear" (or "freebie") basket, being an uncommitted hard capped amount, or greater of hard cap and soft cap amount, with the soft cap usually based on a percentage of total assets or to a lesser degree EBITDA.

Of the 2014 European Deals which were cov-lite, 55% had a "freebie" basket (and all had a ratio debt basket). What is concerning is that a "freebie" basket can be used no matter the leverage at the time of its incurrence and its use could take leverage above the initial leverage at the start of the deal and the maximum leverage agreed for the ratio debt basket.

There is inconsistency in both the US and Europe as to whether the "freebie" basket is used after the ratio debt basket is full so increasing leverage above the deal's initial leverage and the ratio basket leverage, or whether used before. Use before is clearly the more conservative approach; if incurrence makes leverage overreach ratio debt leverage, this effectively prevents use of the ratio debt basket until subsequent debt repayments or EBITDA increases free-up space in the debt basket.

Increasing the "Free and Clear" Basket

Recent US and European deals allow voluntary prepayments of the term facilities, and/or permanent reductions in revolving loans, to increase this basket but there is variability on both sides of the Atlantic for these upward adjustments. Not all deals allow these adjustments.

To a lesser degree in both markets, borrower group debt buy-backs also increase the basket. However, some deals also reduce the basket by other debt incurrence, such as usage of the second lien incremental debt basket or other subordinated debt amounts, or use of the "Permitted Financial Indebtedness" general debt basket.

"Sidecar" Baskets

An additional concern has been the introduction of "sidecar" baskets, being debt allowed for specified purposes. Although not as prevalent as the "freebie" basket, they are often in addition to it, and again, can increase leverage above the ratio debt basket leverage.

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“Grower” Baskets

Baskets are a key focus of negotiations to ensure the deal works for both borrowers and investors in the medium-to-long term. “Grower” baskets are typically formulated as the greater of a hard-cap amount and a percentage of total assets or EBITDA of the restricted group and very much standard in US deals with a uniform application to only debt, restricted payments and investments baskets. The European market has adopted the concept: 41% of 2014 Deals European which were cov-lite included one or more “grower” baskets. However, the European market has also peppered “grower” baskets throughout the negative covenants, with no uniformity from deal to deal as to what the “grower” baskets are. For example:

- where there has been a specific non-Obligor debt basket in a European cov-lite deal, 16.66% have used a “grower” basket based on total assets; and
- for the attributable debt/finance lease/PMO basket in European cov-lite deals, 25% have a “grower” basket based on EBITDA or total assets.

However note that although “grower” baskets based on EBITDA or revenues have been seen on the margins of the European market they have not gained a foothold. Total assets still remain dominant as the soft-cap reference.

In the US, flex protection for arrangers will usually now include documentary flex regarding “grower” baskets so that the basket percentages can be taken back to the last position which cleared in the market if required to sell the deal.

Summary

MFN provisions, incremental debt and “grower” baskets have been and continue to be a fertile area of cross-over between the US and European leveraged loan markets, with “grower” baskets in Europe often allowing even more flexibility for borrowers than in the US. As terms continue to be introduced and as they adapt and develop in Europe, investors need to keep up-to-date with the latest developments to ensure they know what is “market” and understand how new or adapted terms affect their risk.

Know the Market: DebtXplained Representative Loan Terms Database

Representative Loan Terms allows for over 300 loan covenant provisions to be searched on a non-confidential basis across up-to-date transactions ranging from €50m-€1bn+

Why You Can’t Thrive Without RLT

- RLT provides, for the first time ever in the European market, a comprehensive and statistical breakdown of the terms of new and historic loan transactions.
- It enables Term Sheets to be constructed with reference to all the latest provisions going through the market.
- It ensures that our clients are never caught out in term negotiations by not having worked on a deal.
- It guarantees that our clients offer their clients the best market terms.

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- Our databases have been used for over 3 years by tier-1 investment banks, law firms and financial advisors with 100% renewal rates.
- They ensure our clients have complete purview of market terms, are never caught out in negotiations and can guarantee the best structures for their clients.
- No other provider has comparable systems.
- No other provider has such a strong team of lawyers.
- No other provider delivers with such reliability.
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