

Setting the right agenda for TLBs

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As cov-lite/cov-*loose* TLB enjoys its time in the spotlight in 2017, sponsors, borrowers, banks and advisors continue to focus on the key areas to consider when planning and marketing their deals, taking into account the flexibility sought by the business as well as investor needs. White & Case LLP highlights some of the provisions to consider when contemplating a new TLB deal.

Cov-Lite/cov-*loose* TLB: what are the considerations?

We believe the key to a successful transaction is to match the expectations of both the borrower and the investor. We offer the below as some examples of provisions that parties look to address upfront when considering a TLB and comparing TLBs where relevant to the alternatives offered in the high yield bond market.

Incremental facilities

A free and clear incremental facilities basket of the greater of a fixed amount and a multiple of EBITDA ranging between 0.25x and 1x, as well as unlimited indebtedness subject to a maximum leverage ratio, (often set at opening leverage) and an unlimited ability to refinance pari passu debt (see below “Intercreditor issues” below) is now commonly included in TLBs. Recently, we have seen underwriters asked to underwrite incremental facilities with no total leverage cap and instead rely on a senior leverage cap (often set at opening secured leverage) for senior secured indebtedness and a fixed charge coverage ratio (typically set at 2x) for subordinated or unsecured indebtedness, with potentially flex to include a total leverage cap if investors push back. Subject to certain considerations listed below, wide flexibility is offered under TLBs as to the types of debt (bank or bond), structure of debt (additional facility, tranches or side-car), currencies, sizing and pricing that can be incurred under this basket. The ability to incur further indebtedness under the original facilities documentation makes sense both from a liquidity and documentary efficiency perspective. However, this flexibility needs certain boundaries, to ensure that original TLB investors are being treated fairly as “Day 1” investors, compared to others who may only be willing to commit once the company has started to perform to its business plan. Many of the aspects discussed below are driven by these considerations.

MFN on pricing

While TLB investors are comfortable to provide the ability for the incurrence of sizable incremental facilities (either as additional facility tranches or side-car), they also want certain protections on their investment and return and to ensure they are not left with an illiquid tranche. Most favoured nation, or “MFN” clauses seek to provide investors an assurance that they will receive, for a time, pricing at least as favourable as (subject to the agreed headroom) any incremental facility provides. However, the range of options that this may cover is wide. A combination of the following aspects needs to be considered:

- Sunset period – how long should the MFN period apply for? This is typically between 6 to 24 months. Flex terms may also include the ability to extend to a later date or remove the sunset period altogether.

- Yield headroom – MFN will typically only be triggered to the extent the yield (which may include margin and OID but which would typically exclude one-off arranger fees) increases by a certain yield percentage above the yield on the original TLB. This headroom may increase to the extent the sunset period is extended past 12 months.
- Currencies – MFN clauses may apply to all tranches of a TLB in the same manner, or may be tailored to only apply to further facilities in the same currency as a particular tranche. The rationale for this being that costs of funding may be different across currencies at different times.
- Facilities – what types of additional debt should MFN clauses apply to? Should it be any additional debt that a borrower incurs within the sunset period, only incremental facilities within the finance documents (and not side-car debt), only pari passu secured debt, only debt issued in the syndicated term loan market or other types of debt? More often than not the MFN will apply to all syndicated pari passu secured bank debt (and not bonds), but we have seen instances where it does not apply to side-car debt which may be incurred as syndicated pari passu secured bank debt.

Restricted payments

There has been a recent trend in TLBs towards greater flexibility in restricted payment capacity for borrowers. It has been accepted in the loan market that borrowers are able to make restricted payments provided that they are able to demonstrate a deleveraging of the business, usually between 1.5x – 2x opening leverage. The current market position has moved towards an amalgamation of European loan market, high-yield and US yankee loan terms. Borrowers may be able to use, for example, a builder basket (see below) to make restricted payments at a higher leverage than was previously accepted in the market. TLBs may also include a yearly general basket (the greater of a fixed amount and a multiple of EBITDA), in addition to the ratio capacity.

A builder basket, that will build over the life of the facilities, typically comprises a starter basket (a fixed amount), as well as various other add-ons such as retained excess cashflow, retained disposal proceeds and so on. Current trends have moved towards increased flexibility for borrowers and parties should consider whether or not certain inclusions are acceptable for the particular transaction and credit.

Testing incurrence covenants

TLBs may contain optionality for the borrower when the incurrence covenants may be tested – either at commitment or at incurrence. Typically this is limited to debt incurrence for acquisitions, the rationale being that a borrower will want to test this at the date of the sale and purchase agreement. Otherwise, if leverage subsequently increases and, as a result, financing is unobtainable, it may breach SPA warranties if it is unable to complete the acquisition. That said, parties should be aware that borrowers are requesting increasing optionality as regards having the ability to test other incurrence covenants either at commitment or incurrence.

Representations, warranties and undertakings

While as discussed below, the form of the documentation is flexible, the substance of the representations, warranties and undertakings is important in ensuring the right balance between borrower operational flexibility and investor protection. While aspects of the key covenants, including indebtedness, restricted payments/investments and asset sales are often pre-negotiated in full at the commitment stage, points around other representations, warranties and positive undertakings are generally negotiated at the full documents stage. Our recommendation is to try and come to an earlier landing on these points. One approach is to agree a recent precedent from the particular sponsor/borrower as the basis for negotiations with appropriate amendments for the applicable credit and industry, and in acquisition financing, input from target management. See “*Documentation*”.

Intercreditor issues

As suggested below under “*Keeping options open*”, markets move quickly and so while a TLB may be at the forefront of considerations, future debt incurrence should also be borne in mind.

The issue of how an intercreditor agreement treats future types and classes of debt is still an evolving debate. Increasingly, “evergreen” intercreditor agreements are being established at the outset of a transaction, to leave flexibility for all types of future indebtedness, including further pari passu loans or bonds, derivative instruments, second lien debt and unsecured debt. In addition, certain transactions leave flexibility for a change of capital structure, to allow for a super senior RCF to the extent a TLB is refinanced. Similarly, flexibility for refinancing indebtedness is generally also included.

Parties should also note that most TLBs permit borrowers to leave in place acquired debt (i.e. the debt of a target group acquired by a borrower), provided it falls within the incremental facilities capacity available to the borrower.

Those creditors will likely not be required to sign the intercreditor agreement and, therefore, potentially benefit from being structurally senior to the TLB creditors.

The current market position is to include a requirement for certain types of creditors, which may be based on a value threshold (particularly if unsecured), to have to accede to the intercreditor agreement. Agreeing on the parameters to this up front is an important transactional step for all parties.

Soft call

The absence of call protection is an attractive feature of TLBs compared to a high yield bond. There is typically a 6-month period (which can sometimes be flexed to 12 months) post-closing during which certain repricing prepayments incur a 1% premium. Prepayment fees will be limited to prepayments in respect of repricing transactions only. Commonly negotiated exceptions may include a repricing on exit or a transformative acquisition. The rationale for the need for the soft call is to protect investors against repricing transactions, where a borrower may try and take advantage of improving market conditions to reprice their loans, a trend that accelerates in a buoyant market.

Change of control and portability

A “positive” hold requirement is still required in many TLBs with no portability, compared to the negative change of control formulation and inclusion of portability which is now the norm for a high yield bond. However, TLBs have continued to develop, and an individual lender put right, rather than an automatic cancellation and mandatory prepayment in full, is increasingly becoming standard.

Excess cashflow sweep and mandatory prepayments

An annual excess cashflow sweep (subject to a de minimis deduction and certain negotiated exclusions) and prepayments in respect of listing proceeds, disposal proceeds, insurance claim proceeds and due diligence report/vendor claim proceeds are standard. The parties may want to think about which exclusions they agree to reduce mandatory prepayments where they would have an adverse impact on business operations. For example, consider excluding de minimis amounts, certain types of disposals (e.g. envisaged as part of a group restructuring), identified types of insurance claims (e.g. third party claims), associated taxes and transaction costs. Allowing the borrower to reinvest (instead of prepaying) disposal proceeds, insurance claim proceeds and due diligence report/vendor claim proceeds is also usual, provided that such reinvestment is carried out within 12 or 18 months of receipt of the relevant proceeds. There are also other features that may be included to reduce the amount required to be prepaid under these circumstances such as certain deductions to the calculation of excess cashflow and provisions for trapped cash.

Transfers

TLB transfer provisions restrict the identity of the holders of the relevant loan. This is not possible in the bond market, where trading from the borrower’s perspective is anonymous through the clearing systems. Sponsors and borrowers may seek to prohibit transfers to financial or industrial competitors, as well as “distressed debt” funds (at least before the occurrence of an event of default), and in certain circumstances, prevent an investor from acquiring a controlling stake in a particular credit. There are some pitfalls to overly restricting the transferability of the loans, as it may inadvertently cause certain institutions, which cannot meet the sometimes vague criteria, from taking loan participations, thereby reducing the investor base and/or prospects of successful syndication. Sub-participations with voting rights are typically also subject to the same restrictions.

Flex

When arrangers and underwriters commit to a TLB, they will insist on flex rights in their commitment documentation. That flex could include the ability to amend any of the size, price, structure or terms of the finance documentation from the original documented position to the extent deemed necessary to achieve a successful syndication process. The rationale is that while arrangers and underwriters know the market and may be confident of bringing investors in on current market terms, some terms in the financing may be novel, commitment periods may be long and the market can change quickly. An arranger’s flex terms are therefore an attempt to estimate the downside case, in the event the market moves, such that it will still have sufficient buyers for the particular credit.

Documentation

TLB transactions can be documented in a number of ways. There will be certain drivers for picking a particular format for the financing documentation, such as investor base, sponsor/borrower precedent or familiarity for the company with a particular format. The documentary form may be LMA-style, New York credit agreement-style or

a schedule of bond covenants (and may be governed by English law, NY law or a combination of the two). Ultimately, the negotiated deal can be incorporated into any of these formats by counsel and other advisors.

Keeping options open

As well as the specific examples highlighted above, readers will note that, at time of printing, the market continues to move quickly. Supply and demand drives the leveraged finance markets across the globe. The availability of capital to investors and a requirement to get this to work means that attractive sponsors / borrowers are able to pick their form of debt in a manner that at any given time matches their highest priorities, subject to syndication considerations generally.

This ability to choose the form of financing is relatively novel, but brings about interesting dynamics within various institutions. Sponsors / borrowers need to work across products. An investment principal and a CFO cannot reject a type of financing simply because they are unfamiliar with it, and creditors need to manage their relationships with the same parties by being first to the table with the most up to date, and cost efficient, financing options.

Increasingly, we are working with our clients on dual (or triple) track processes. A financing package may be term loans (with a club of banks or institutional investors), high yield bonds (senior secured or unsecured) or private placement notes, or may include a more traditional but competitively priced local bank loan, and in increasingly competitive processes, each of these may go through to full documentation. In addition, whether a financing is being considered in the context of an M&A transaction (which may lead to additional “dual-tracking”), a refinancing, a dividend recap or other financing strategy may give rise to different considerations. The costs involved in this preparation are invariably minor compared to the potential cost of missing a market opportunity.

To best service clients, law firm teams may span the scope of departments and specialisms, including banking, high yield, capital markets, private equity and M&A, tax and regulatory. This also means that to the extent that the market moves again, the client is able to switch between products quickly in an efficient and seamless manner.

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