WHITE & CASE

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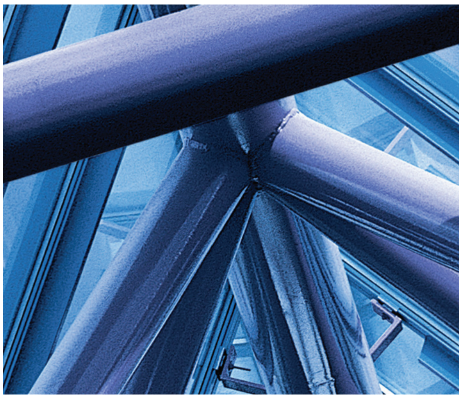
If "builder" baskets grow and "grower" baskets build, what is the difference and are either of these a "scalable" basket?

"Builder" baskets, "grower" baskets and "scalable" baskets: as the leveraged loan and high yield bond markets and the US and European markets continue to converge, technical alerts and debt capital markets updates throw these terms about with an ever-increasing degree of frequency.



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However, are these terms always being used in a consistent manner? It appears that sometimes market participants employ the terms "builder", "grower" and "scalable" baskets interchangeably, when they are, in fact, quite distinct concepts. As the words on their face have similar meanings, it is understandable that a degree of confusion exists as to what these terms mean.

Starting from the basic building blocks, a "basket" is an agreed exception to a negative covenant in a loan. A general basket is often expressed as subject to limits based on a fixed amount (which is also known as a "hard cap" (e.g., not to exceed €50,000,000)), a percentage of a specified variable (e.g., Total Assets, EBITDA, Consolidated Net Income, Equity Contributions, retained Excess Cash Flow) and/or compliance with certain financial covenant metrics (e.g., a "ratio" basket, commonly requiring compliance with a leverage or fixed charge coverage ratio).

"Builder" Baskets

What is a builder basket? A "builder" basket is a basket that traditionally "builds" following the signing of the facility agreement based on the performance of the Borrower Group through either retained Excess Cash Flow or 50% of Consolidated Net Income. Builder baskets are also referred to in the US as an "Available Amount" or "Cumulative Credit" basket. The availability under a builder basket can typically be used for restricted payments, investments and payments of junior secured/second lien, unsecured or subordinated indebtedness that would otherwise be restricted by the respective negative covenants (these are essentially the negative covenants that restrict cash leakage out of the Borrower Group by way of distributions to equity holders, third party investments or repayment of junior/second lien, unsecured or subordinated debt). It is not uncommon for there to be a requirement that the Borrower Group has de-levered sufficiently to meet a reduced leverage or fixed charge cover test before amounts from the builder basket can be used, particularly where the basket is being used to make a dividend, and event of default blocks also sometimes apply.

In addition to builder baskets increasing based on retained Excess Cash Flow or 50% of Consolidated Net Income, they may include a de-minimis starting amount (or "free and clear" basket as it is sometimes called) and also the ability to build for some of the following items occurring after signing: equity contributions, amount of debt exchanged for equity, declined proceeds from mandatory prepayments and returns on investments originally made using the builder basket.

What is the key idea behind a builder basket? Builder baskets generally recognise a Borrower Group's ability to utilise a portion of the profits or cash flow generated in the business, such that better performance by a Borrower Group results in greater increases in the quantum of the builder basket, providing freedom to utilise spare cash for purposes other than debt service. Unlike "grower" baskets which will fluctuate over time with the growth or decline of a business, once amounts are added to a builder basket from historical performance those amounts continue to be available for use even if the business may experience a downturn in the future (subject to certain reductions from losses when using 50% of Consolidated Net Income as the builder).

Which is the better variable to use to build with? Consolidated Net Income is typically seen as preferable from a Borrower's perspective, as it can build faster than retained Excess Cash Flow (though, traditionally, 100% of Consolidated Net Income losses reduce the size of the builder basket). We continue to see a split between the use of retained Excess Cash Flow and Consolidated Net Income as the variable on which the basket builds. It is interesting to note that where an Excess Cash Flow sweep features in a facilities agreement, tying the builder basket to retained Excess Cash Flow may not necessarily result in building up the basket. This is a result of Excess Cash Flow often being drafted in a manner that results in little or no Excess Cash Flow being generated in order to minimise the amount of the loan repayment obligation under the Excess Cash Flow sweep through various deductions agreed with the lenders, such as amounts which are used to prepay the facilities mandatorily or voluntarily, permitted prepayments of third party debt and cash paid or committed to permitted acquisitions. If a Borrower is successful in minimising the quantum of excess cash flow swept there will be little room for the builder basket to build as retained Excess Cash Flow will be nominal.

"Grower" Baskets

What is a grower basket? A "grower" basket is typically formulated as the greater of a hard-cap amount and a percentage of a specified variable, being either Total Assets or EBITDA of the Borrower Group. While EBITDA is often the better performance measure for cash flow-centric or asset-lite businesses, the downsides are that it can be volatile and in some industries, very cyclical. Total Assets, on the other hand, may be a more suitable indicator for tangible asset-heavy or real estate-focused businesses but less attractive for businesses that have significant assets which are difficult to accurately value, such as certain intangible assets and goodwill.

Unlike builder baskets, which uniformly build with 50% of Consolidated Net Income or retained Excess Cash Flow, there is no established rate by which particular grower baskets are set. Instead, often the hard-cap component of the grower basket is negotiated among the parties. This leads to the percentage level in the growth component of the "grower" basket then being set at the level that would produce an amount equivalent to the hard-cap amount based on closing date EBITDA and/or Total Asset levels.

What is the key idea behind a grower basket? Unlike a builder basket, which represents an additional level of flexibility within a covenant package by providing for an additional performance-based covenant exception, a grower basket is really just the addition of a growth component based on a percentage of EBITDA or Total Assets to a covenant exception that has traditionally been a hard-cap amount only. Ultimately, the availability under a grower basket at any point in time is intended to reflect the size of the business at that point in time, and the corresponding increased needs of a larger business. So, like a builder basket, a grower basket will increase over time with improved performance of the Borrower Group, namely, a better EBITDA position or a bolstered balance sheet.

Since grower baskets are formulated based on a "greater of" concept, if the growth component initially increases but then later decreases, the quantum of the basket will also decrease but only ever back down to the hard-cap amount. Since grower baskets are included in incurrence style covenant packages, which only test baskets at the time they are utilised, if a grower basket subsequently reduces in size (for example, down to the hard-cap amount), any historical utilisation of the basket at the higher level will be grandfathered.

In the US, grower baskets will represent almost all covenant exceptions that have traditionally only included a hard-cap amount. On the other hand, the European market has developed a less than consistent approach to the use of grower baskets, with no uniformity from deal to deal as to which covenants grower baskets will feature in, particularly as they apply in covenanted deals.

"Scalable" Baskets

A "scalable" basket is a hard cap basket which has the ability to increase or decrease by the same percentage as EBITDA increases or decreases against historical EBTIDA performance or projected EBITDA performance in the base case model for that testing period, above a certain threshold. For example, if EBITDA of the Borrower Group exceeds or has not achieved (as the case may be) projected EBITDA by more than 5%, a scalable basket shall increase or decrease by the same proportion that EBITDA has increased or decreased against projected EBITDA.

The two key points of difference from a grower basket is that (i) scalable baskets do not grow organically with EBITDA; they require a threshold to be met (e.g. EBITDA must have grown by 5% against projected EBITDA) at which point the basket level will "jump" and (ii) the required growth in EBITDA may be tied to projected EBITDA performance in the base case model rather than measuring it as an increase to the previous fiscal period EBITDA numbers.

It is common for a floor to be attached to a scalable basket, which will provide that the basket will not decrease to a level lower than that set on the signing date of the facilities agreement. In addition, as scalable baskets may often not be incurrence based exceptions (i.e. usage of the particular basket is not permitted to exceed the value of that basket at any time, and not just at the time such basket is used), it is very common for agreements to include a proviso that no event of default will arise as a result of a decrease in a scalable basket where that scalable basket has been utilised to a higher level prior to such decease.

As with grower baskets in European transactions, there has been no uniform approach as to which negative covenants scalable baskets will feature. It is also important to note that the scalable basket concept appears to primarily be a feature of the mid-market. Consequently, arrangers could foreseeably ask for a documentary flex right to replace grower/scalable baskets with traditional hard-cap baskets.