



James Chesterman
Partner – Latham & Watkins



Sam Hamilton
Partner – Latham & Watkins



Jane Summers
Partner – Latham & Watkins

US trends affecting the European leveraged loan market

The buoyant leveraged finance market in Europe has been continuing to develop in sophistication and depth this year, particularly as regards sponsor friendly terms, as global sponsors and their advisers apply their experiences from financing transactions in the US leveraged loan and global bond markets to the European leveraged loan markets. Current investor appetite means the most attractive terms potentially can be selected from both markets and across product lines, with the result that European based loan arrangers, investors and advisers are seeing more US market derived provisions than ever before. This convergence brings a number of new documentation issues to consider.

Covenant-lite loans

In the European leveraged loan market there historically have been relatively few covenant-lite loans, but over the last twelve months there has been a much more pronounced trend in that direction as the US model of covenant-lite is increasingly being adopted here. As is often the case with new market products, there has been a lack of clarity over what is meant by the term 'covenant-lite'. The easiest identifier of a covenant-lite loan is that there is no financial maintenance covenant or that there is a single financial covenant, in either case only for the benefit of the lenders under the revolving credit facility and no maintenance covenant for the term lenders. Moreover, it typically is a 'springing' covenant, i.e., tested when drawn or only when usage exceeds a certain percentage of the revolving credit facility, often 30%, with

significant EBITDA 'cushion' or 'headroom' of 30% and no or very few step downs. It is worth noting that associated provisions have not necessarily been adopted wholesale. For example, the US style equity cure, with amounts being added to EBITDA, is still resisted by some lenders in Europe. The European market generally permits over-cures, whereas the US market does not.

Documentary flux

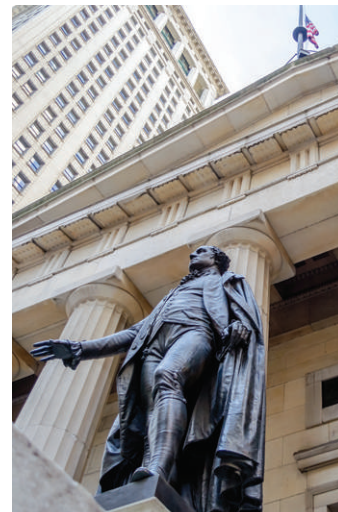
The characteristics of European covenant-lite loans other than financial covenants have to date been less uniform. This is in part due to a 'battle of the forms' that is ongoing in relation to documenting European covenant-lite loans. The first covenant-lite loans in the current cycle from 2013 were documented under New York law, used to acquire European assets and either partly or wholly syndicated in Europe. The next generation were LMA based credit agreements, stripped of most financial covenants and otherwise modified in certain respects to reflect 'looser' US practice on terms. The third generation, in the market in 2015, are hybrid LMA based loan agreements that in addition to the absence of financial covenants for the term loan adopt more wholesale changes based on US market practice, primarily in that they introduce leverage or coverage-based incurrence style ratio baskets rather than traditional loan market baskets fixed at a capped amount. A number of the other features of current covenant-lite European leveraged loans are considered below.

Increased debt baskets

Limitations on borrowings are developing

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European based loan arrangers, investors and advisers are seeing more US market derived provisions than ever before



US-style characteristics, so rather than a traditional debt basket with a fixed capped amount, we now see permitted debt limited solely by a leverage or secured leverage test with a separate fixed capped basket alongside. This debt can be raised both through an incremental 'accordion' feature or separate 'sidecar' financings. This style of covenant leads to far greater flexibility for a borrower to raise additional debt as pari secured, unsecured or subordinated loans or bonds.

Builder baskets

Another trend from the US covenant-lite loan market (which is also a feature of the US high yield bond market) that is testing the market for European deals is the 'restricted payments builder basket'. A version of this concept already exists in Europe (often called "Retained Amounts"), where the borrower is given 'credit' as certain items 'build up' to create dividend capacity and allow other uses, starting with the borrower's retained portion of excess cashflow ("ECF"), IPO and other equity proceeds, and un-swept disposal proceeds, predominantly subject to a leverage ratio governor as a condition to usage. The US loan market has seen even more aggressive variants based more closely on the high yield bond formulation, which credits a percentage of consolidated net income ("CNI") (usually 50%) rather than retained excess cashflow, with the disadvantage for lenders in that CNI is not reduced by the deductions used to calculate ECF, because the build-up may begin for years prior to the onset of the ECF sweep and because there is often no leverage ratio limiter.

US-style events of default

US-style events of default have generally been resisted by European loan syndicates but we have seen isolated loan financings that include defaults more akin to the US approach, e.g., removal of material adverse change default; no audit qualification default etc.

Other provisions

There are a few other provisions we are seeing arise on deals, such as:

- Provisions that mean that if FX rates result in a basket being exceeded this will not in and of itself constitute a breach of the debt covenant (or other limitation).
- Permitted Acquisitions controlled by a leverage test rather than by imposing absolute limits – and otherwise fewer controls on acquisitions.
- Change of control mandatory prepayment being adjusted to allow individual lenders to waive repayment (becoming, effectively, a put right).
- Increased use of general fixed 'baskets' (as distinct from and in addition to ratio-based single incurrence tests) with a soft dollar cap that increases as total assets or EBITDA grows.



Economic adjustments

Economic adjustments such as a 101% soft call for 6 months, a EURIBOR floor, and nominal (0.25%) quarterly amortisation are also being introduced to make loans more familiar to the US loan market participants.

Structural consequences – the intercreditor agreement revisited

Adopting products from other jurisdictions brings with it the risk of unintended consequences. US terms and market practice have developed over decades against a background of the US bankruptcy rules and US principles of commercial law. The wholesale adoption of US terms without adjustment to fit Europe's multiple jurisdictions can lead to a number of unintended consequences.

A good example of this relates to European intercreditor agreements, which have over time developed to include standstills on debt claims, as well as release provisions. At heart is the continuing concern that insolvency processes in Europe still, potentially, destroy value. Although significant steps have been taken in many jurisdictions to introduce more restructuring friendly and rescue-driven laws, it remains the case that in Europe there is a far greater sensitivity to the ability creditors may have in times of financial difficulty to force an insolvency filing by virtue of putting pressure on boards of directors through the threat of directors' liability under local laws. A significant feature of the restructuring market in Europe for many years has been the use of related techniques that creditors, particularly distressed buyers, adopt to get a seat at the table by threatening to accelerate their debt claims. Standstill provisions evolved to prevent creditors from using this type

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of action to disrupt a restructuring and thereby obtain increased recoveries.

Another intercreditor provision of great focus over the years has been the release provision, which provides that in the case of distressed asset sales following default and acceleration, the lenders' debt and guarantee claims against, and security from, the companies sold are released. In some deals from the last decade, these protective provisions had not been included, with the result that junior creditors could gain significant negotiating leverage because their approval was needed for the release of their claims and security, without which it is not possible to maximise value in the sale of a business as a going concern.

The potentially significant debt baskets referred to above become relevant in this context. In the US, where this flexibility originated, debt baskets do not legislate as to where in the group debt can be raised – structural subordination does not often play a significant role in a US bankruptcy because typically the entire group would go into Chapter 11. In Europe, structural subordination can have a dramatic effect on recoveries (as suffered by the first wave of European high yield bonds in the 1990s, which were structurally subordinated). Even if those subsidiaries have granted upstream guarantees, the value of the claims under such guarantees are often of limited value.

Until very recently, most provisions allowing the incurrence of third party debt did not require

the debt providers to sign up to the intercreditor agreement unless they were sharing in the security package. With this new flexibility it is very possible that an unsecured creditor under a debt basket can have a very strong negotiating position if the senior secured creditors are trying to sell the business in an enforcement scenario, given the lack of standstill and release provisions. We are therefore seeing a developing trend towards requiring third party debt over a materiality threshold to become subject to the main intercreditor agreement. It is of note that while this is becoming a trend in loan transactions, it has yet to become a focus in European bond transactions.

What does this mean for the rest of 2015?

It seems likely that ultra-low interest rates, likely to prevail in the Eurozone for some time, and the depth of the investor base looking for yield will limit investor sensitivity to covenant and documentation issues for the time being, at least on the bigger and most liquid financings. Currently most 'flex' amendments over recent months have reduced pricing and improved other terms for borrowers, other than in smaller non-liquid or niche financings where we have seen some flexes go the other way. 2015 is therefore very likely to be a year where deal terms continue to erode from the lenders' perspective. ■