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Lenders – Caution Required

Lenders need to adopt some risk mitigation techniques as the market operates in frothy conditions

Against a backdrop of optimistic asset valuations driving increased leverage multiples across the large cap and mid-market leveraged finance spaces and fuelled by a seemingly endless supply of debt capital, it is perhaps not surprising that there has been a recent increase in popularity of holding company (holdco) financings. Whether in the form of loans or bonds, these have been deployed both in dividend recapitalisations and forming part of the sources of funding in traditional acquisition financings.

The inclusion of a holdco payment in kind (PIK) instrument in the debt capital structure will add leverage without necessarily imposing an additional cash interest cost on the operating group, and, from a structural perspective, will generally not interfere with the main operating group's senior financing solution. From a covenant compliance perspective, the borrowing group will need to have substantial consistency of terms between the holdco debt and the senior debt, so the question then arises as to how the PIK holders, in an unsecured, structurally subordinated position, can tailor their documentation to provide adequate downside protection.

TYPICAL CAPITAL STRUCTURE

Holdco PIK instruments are, understandably, issued at a level in the capital structure structurally junior to the senior secured debt. They are not guaranteed by, or secured on the assets of, the members of the operating group. Instead, the PIK lenders normally benefit from a share pledge over the shares of the PIK borrower and a security assignment of all receivables owed by the PIK borrower to its direct shareholder.

As the concept of group for the purposes of the holdco PIK instrument should, in theory, capture the PIK borrower and all of its subsidiaries, the nature of the PIK documentation as regards the format and scope of the covenant package will largely be dictated by terms of the senior financing at the operating group level. Much the same as with a first lien/second lien capital structure, because the majority of the group's third party debt will be incurred at the operating company (opco) level, the sponsor is very likely to first cut a deal with the group's senior banks, or at least substantially progress the senior terms, before turning to negotiate the PIK.

The appetite for holdco paper, in light of its position in the capital structure, will be greater amongst private credit funds than traditional senior banks. Two quite different lender groups must sit side by side in the same capital structure, with private credit funds typically holding risk under the PIK to maturity/refinancing, and the senior debt often being the product of an originate to distribute model. Private PIK lenders therefore, often in a weaker negotiating position if the senior terms have already been agreed, must try to tailor the terms of the holdco instrument to mitigate the additional risk, particularly in a downside scenario. So, while the senior debt may tend to follow whatever will clear the market (which in the current climate, is quite a lot), because the holdco piece is likely to be privately placed, certain additional protections for the PIK lenders, both structural and documentary, will need to be considered.

STRUCTURAL PROTECTIONS

Prudent PIK lenders should consider some combination of the following protections.

Incurrence of additional PIK debt at PIKco If the concept of incremental PIK debt is to be permitted at all, as should be a consideration for all junior debt providers in a privately placed deal, the PIK lenders should push to keep control of their creditor class to prevent voting dilution. This can be achieved either through a blanket restriction on additional PIK debt, or permitting a capped amount of additional debt such that the original lenders always constitute the majority. Any additional debt should be subject to a right of first refusal for the original PIK lenders.

Anti-layering Depending on the acquisition structure, to prevent value leakage ahead of the PIK, the group should have no ability to incur additional debt at the level of the holdco entities established between the senior bank group parent and the PIK borrower. These entities should, in any event, be subject to traditional holding company covenants.

Anti-short circuit The PIK-only share security is one of the few tools in the PIK lenders' armoury, effectively acting as a hammer on the equity in the event of a PIK default. To ensure a clean single point of enforcement over the shares in the PIK borrower, there should be no shareholder or other claims permitted to bypass the PIK borrower into the senior bank group (and as a corollary, no cash leakage by way of repayment of such instruments should be made around the PIK borrower).

DOCUMENTARY PROTECTIONS

Generally, the PIK instrument should allow the opco group much of the flexibility negotiated in the senior deal in its form as negotiated on the closing date (and not as subsequently amended). However, as the motivations and considerations of the two adjacent lender groups are unlikely to be perfectly aligned, there are a number of additional controls which are appropriate for inclusion in the PIK.

Controlling debt incurrence at the opco level Given the over-heated state of the leveraged loan market, with extremely permissive top- tier sponsor friendly terms trickling down with increasing regularity into mid-market deals, it is critical that the PIK lenders have some ability to control debt incurrence down below, both in terms of overall quantum and, if possible, pricing through a fixed charge cover test. The likelihood is that the PIK will be covenant-lite and debt levels tested on an incurrence basis only. In that regard, PIK lenders should therefore consider including a combination of total leverage and senior leverage caps through the PIK and the senior debt respectively, pro-forma for the incurrence. Given the scope for mischief in modern documents, attention should also be paid to the components of the senior and total leverage calculations, both in terms of exactly what debt is captured and what is excluded, and how pro-forma adjustments are treated.

Tightening the tap on dividends and restricted payment capacity Again, potential for value leakage from the opco group via multiple channels is likely to be permitted by the senior documentation, whether through investment capacity in unrestricted subsidiaries, loans and disposals to non- obligors or by way of general distributions to shareholders in the form of dividends and various advisory or monitoring fees. Increasingly, and especially if a term loan B- style document sits downstairs, dividend capacity available to sponsors will come with a starter basket, permitting the sponsor to take cash off the table, past the PIK, on day one. Private PIK lenders holding risk are likely to want to turn the screw tighter here, on the basis that it is difficult to justify permitting value to stream past the PIK borrower to be returned to the sponsor and its investors. This can be achieved through a general restriction on ratio based and starter basket distributions, regardless of what the senior permits. Alternatively, a lower threshold on the ratio basket requiring meaningful deleveraging of the structure (or repayment of the PIK) or some form of pro rata pay down of the PIK to ensure commensurate de-risking of their position could be a reasonable compromise. The extent to which these additional controls are appropriate will of course depend on the nature of the borrower's interest obligation under the PIK instrument (ie this could be any combination of a full PIK, PIK toggle, pay if you can or a pay if you want construct).

GETTING A SEAT AT THE TABLE

With interest payments capitalising and little or no prospect of a payment default until final maturity, holdco PIK instruments are generally more difficult to default than the senior loan, not least due to their covenant- lite nature. Ironically, from the perspective of keeping the full capital structure intact, a covenant-lite senior deal down below is likely to be more preferable to a PIK lender than a covenanted senior deal. The market has seen some sponsors attempting, largely unsuccessfully, to make the prospect of a PIK default even more remote via a number of mechanisms. This includes, for example, limiting the application of covenants in the holdco documentation to the PIK borrower only, and not to the opco group or material subsidiaries, and increasing headroom on back baskets and thresholds in the PIK versus the senior loan documentation (the basket set- back provision appears to be a mistranslation of US second lien practice into European junior debt terms). While these provisions are generally resisted, lenders and their counsel should proceed with caution.

As their collateral package is comprised solely of a share pledge and receivables assignment, the PIK lenders very much look upwards towards the equity for protection and not downwards to the assets of the opco group. Negotiation of the negative covenants and events of default, including cross-default and cross acceleration provisions, will therefore be key in giving the PIK lenders' share pledge real teeth as a material threat, increasing the likelihood of getting a seat at the table in any restructuring process. The offer of a second ranking opco guarantee is potentially a Trojan horse and probably best avoided. Leaving aside potential jurisdictional up-stream support restrictions, this could result in lower pricing for the PIK and a risk that the senior lenders will try to impose a standstill not only on the PIK guarantee claim, but on the PIK-only security package itself, which should of course be enforceable independently.

As in any restructuring, access to timely information and management will also be critical for the PIK lenders in order to effectively strategise and assess their options in the context of financial instability in the opco group. Soft good faith undertakings from the sponsor in such circumstances are customary and go some way towards providing additional comfort that a co- ordinated collusion between the sponsors and the senior lenders, to the detriment of the PIK, will be avoided. There are a host of other lender protections available which, when taken individually may not move the needle to a material extent in terms of providing a safety blanket for the PIK. However, when taken together, they will give the PIK lenders, if not a seat behind the wheel, then at least a firm grip on the hand-brake in a restructuring process.

CONCLUSION

Widespread use of such instruments can sometimes be indicative of an overheated market, but for the right credit and the right sponsor, it can make more sense for a group from an operational perspective to include a turn or two of PIK in their capital structure, versus a more expensive solution such as a stretched senior, or a second lien. For sponsors, this has the positive effect of reducing the group's on-going debt service burden, and keeping more cash in business for growth purposes, particularly important for acquisitive businesses in expanding sectors, such as software and technology. The downside: it creates a ballooning liability which can lead to considerable refinancing risk for the group if the business plan does not unfold as anticipated, and/or macro events come to bear negatively on the credit.

Lenders should tread carefully and keep documentary and structural shields at the forefront of their minds. However, while some leveraged market participants have been anticipating the end of the current cycle for some time now, it would appear that properly constructed holdco PIK instruments look likely to remain an ongoing feature of the leveraged landscape.

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