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Lending & Secured Finance 2021

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The Continued Prevalence of European Covenant Lite

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Introduction

While 2020 started with a strong pipeline of leveraged finance transactions both in Europe and the US, the onset of the COVID-19 pandemic and the resulting lockdowns had a profound impact on the leveraged finance market in 2020. Notably, there was an increase in amendments and waivers required by borrowers (in particular relating to financial covenant compliance) under existing finance documentation and additional liquidity raisings (including pursuant to state aid programmes) required due to the lockdown measures to combat the pandemic. Notwithstanding the impact of the pandemic, there were a number of deals that were syndicated during 2020 and auction processes had started to return by the second half of the year. In respect of such transactions, global sponsors and their advisers continued the trend of successfully exporting their experiences from financing transactions in the US leveraged loan and global bond markets to the European leveraged loan market. Momentum behind the continued adoption of US covenant-lite and bond market terms into European loans remains strong as there is now a significant source of European "cov-lite" precedents to such an extent that cov-lite loans are now considered customary for European leveraged finance syndicated loan transactions (not, to date, in direct lending transactions) and will likely continue to be so considered in the absence of a market correction. While underwritten terms and investor focus were slightly more conservative during 2020, there has been no such market correction at the time of writing, with terms in leveraged finance transactions quickly returning to be broadly the same as prior to the onset of the pandemic. Investors were, however, more successful in pushing back on certain pricing and documentation terms during 2020. The use of terms that originally were designed for high yield bond augurs for consideration of a number of documentation issues.

Covenant-lite Loans

In a covenant-lite loan, typically there is a single financial covenant and it is solely for the benefit of the lenders under the revolving credit facility, with no financial maintenance covenant for the term lenders. The covenant benefitting the revolving lenders is almost always a "springing" covenant, i.e., tested only if the revolver is drawn as of the end of a fiscal quarter (often first tested from the second or third complete quarter after the closing date) and such usage exceeds a specified percentage of the revolving facility commitments (often 35–40%), with the applicable levels set with significant EBITDA "cushion" or "headroom" (from financing EBITDA included in the base case model) of around 30–40%, and often with no step downs. The types of drawings that are included in the calculation of the trigger are also narrowing to exclude all ancillary facilities and letters of credit, amounts utilised to fund fees, costs and expenses and flex at closing and, in some instances, amounts drawn to fund acquisitions and capital expenditure. In an increasing number of deals, cash and cash equivalent investments are deducted from the amount of revolving facility commitments that are drawn at the relevant testing date (with cash, unlike in an LMA-based credit agreement, not being defined).

Associated provisions customary in US covenant-lite structures are regularly being adopted in Europe. For example, the US-style equity cure, with cure amounts being added to EBITDA and no requirement for debt pay-down, has been accepted on cov-lite deals in Europe for quite some time. Interestingly, the European market generally permits over-cures, whereas the US market limits cure amounts to the maximum amount needed to ensure covenant compliance. Another divergence between European cov-lite loans and US covenant-lite loans is the prevalence of deemed cures in European cov-lite loans, which are rarely if ever seen in US covenant-lite loans. It is, however, common in both the US and Europe to have a cap on the number of permitted cures – most commonly limited to two quarters in any period of four consecutive quarters and a total of five cures over the life of the loan. In more recent European deals, the cap on permitted cures only applies to EBITDA cures and so debt cures are uncapped. Another interesting development in relation to equity cures in European cov-lite loans is the ability to prepay the revolving facility below the springing threshold within the time period a debt or EBITDA cure could be made following testing of the financial covenant (such that it is deemed not to be tested rather than actually curing the breach).

Documentation

In the past there was a "battle of the forms" in relation to documenting European covenant-lite loans, with the first cov-lite loans emerging in Europe in 2013 being documented under New York law. The next generation were governed by LMA-based credit agreements, stripped of most financial covenants and otherwise modified in certain respects to reflect terms that were based on looser US practice at the time. We now have 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 what in prior periods were regarded as "traditional" loan market baskets fixed at a capped amount. A more dramatic departure from US practice which is now widespread in European sponsor-led leveraged finance transactions is to base the reporting requirements, affirmative covenants, negative covenants, and events of default on high-yield bond-style terms, and which are tacked onto the English law governed secured facilities agreement as schedules interpreted under New York law (much like the format of a super senior revolving facility).

A number of the other features of current cov-lite European leveraged loans are considered below.

Increased Debt Baskets

Limitations on borrowings often have US-style characteristics, so rather than a traditional debt basket with a fixed capped amount, we now see permitted debt limited solely by a net leverage or secured leverage test with a fixed capped ("freebie") basket alongside (with that basket often being a soft "grower" basket). Occasionally, unsecured debt is permitted up to a 2x interest coverage test (a concept imported from the high-yield bond market). This debt can be raised through an incremental "accordion" feature or separate "sidecar" financings. European cov-lite loans may also permit acquired or acquisition debt subject to a "no worse than" test in terms of the leverage ratio of the group *pro forma* for the acquisition and incurrence of such debt (although this has seen investor pushback in certain transactions). This style of covenant leads to far greater flexibility for a borrower to raise additional debt as pari secured, junior secured, unsecured or subordinated loans or bonds (often with no parameters as to where the debt can be incurred within the group). In some financings, reclassification is permitted so that the "freebie" basket can be used if the ratio basket is unavailable, and then subsequently moved into the ratio basket once the ratio is met, thus freeing up the "freebie" basket. The net effect of these provisions is to allow borrowers to continually re-lever up to closing leverage plus the amount of the "freebie" basket, which itself often allows for up to another turn of leverage to be incurred. The most favoured nation ("MFN") protection relating to new incremental loans continues to be a focus of negotiation, both as to sunsets (typically six months – unlike the US cov-lite loan market where sunsets continue to be longer), carve-outs of certain debt baskets (acquired and acquisition debt and the freebie basket) and whether it applies to sidecar debt incurred outside the loan agreement. Other more recent areas of focus from investors have been the inclusion of a non-guarantor debt cap and whether revolving facility drawings are excluded from ratio testing (the latter point still being in a small minority of deals in Europe despite being more common in the US).

Builder Baskets

Another durable trend from the US cov-lite loan market (which is a long-standing feature of the high-yield bond market) that has been adopted in European loan deals is a "restricted payments builder basket" (the so-called "Available Amount"), where the borrower is given "credit" as certain items "build up" to create dividend capacity, starting with the borrower's retained portion of excess cashflow ("ECF"), IPO and other equity proceeds, unswept asset sale proceeds and (perhaps most aggressively) permitted indebtedness, usually subject to a net leverage ratio governor as a condition to usage. Typically, there is no limit to distributions (or the source of financing such distribution) if a certain leverage ratio test is met. An even more aggressive variant based more closely on the high-yield bond formulation that has become commonplace 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 and because the build-up may begin years prior to the onset of the ECF sweep. The builder baskets may also have additional "starter amounts," usually soft capped by reference to EBITDA, and in certain deals there is a "floor" on the CNI builder basket, such that, unlike bond transactions where 100% of losses are deducted from the CNI builder basket, no losses are deducted.

US-style Events of Default

While previously US-style events of default continue to be resisted by European loan syndicates, it is now more customary for loan financings to include defaults more akin to the US loan approach (such as removal of material adverse change default and no audit qualification default) or, more typically, the high-yield bond approach (more limited defaults, including cross-acceleration rather than cross default, with longer remedy periods, which regarding bankruptcy defaults is unusual in Europe).

Other Provisions

There are other provisions we have seen migrate from the US cov-lite (or high-yield) market to Europe (or otherwise evolve within the European market) to become well established, including:

- "Permitted Acquisitions" controlled by a leverage test (or no test at all) rather than by imposing absolute limits – and generally fewer controls on acquisitions.
- "Permitted Disposals" similarly trending towards a high-yield formulation that does not impose a cap and has varying requirements for reinvestment/prepayment and cash consideration.
- Guarantor coverage ratios are trending towards an EBITDA test only (at 80%).
- Change of control mandatory prepayment being adjusted to allow individual lenders to waive repayment (becoming effectively a put right).
- Increased use of general "baskets" (as distinct from and in addition to ratio-based incurrence tests) with a soft dollar cap that increases as total assets or EBITDA grows, including for "baskets" relating to events of default.
- Provisions that state 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).
- Use of the concept of a "Restricted Group" and ability to designate subsidiaries as "Unrestricted" and therefore outside the representations and covenants.
- EBITDA addbacks (as used in financial ratios for debt incurrence purposes) that are capped per individual action rather than per relevant period and often with a relatively high cap such as 25% or 30% of EBITDA. It is now unusual to see any third-party verification of addbacks, and realisation periods can extend to 24 or 36 months in certain deals.
- An increasing trend for Majority Lenders to be set at 50% rather than the traditional European percentage of 66⅔% (sometimes with the lower percentage used for consents and the higher percentage for acceleration rights).

- Greater restrictions on transfers to competitors and "loan to own" funds, with more limited default fall aways (e.g., payment and insolvency only).
- The inclusion of a "covered jurisdiction" concept whereby guarantees and security will only be given in a pre-defined list of jurisdictions (as opposed to all jurisdictions other than those which the agreed security principles will exclude).
- A more limited security package consisting of material bank accounts, shares in Material Subsidiaries and intra-group receivables in respect of proceeds loans.

While anti-net short provisions (limiting the voting rights of lenders that hold a net short position in respect of the relevant credit) have begun to emerge in the US syndicated loan market, such feature has not yet widely appeared in European cov-lite loan deals, although there are limited examples.

Economic Adjustments

Economic adjustments such as a 101% (or 100.50%) soft call for six or 12 months, a EURIBOR or LIBOR floor, and nominal (0.25%) quarterly amortisation are also often introduced to make loans more familiar to US loan market participants. Other relevant considerations for a US syndication in respect of a European credit include all asset security (which is typically expected in the US), whether a disqualified list in respect of transfers will be used instead of a more European approved list concept, more fulsome MFN and maturity restrictions in relation to debt incurrence and the inclusion of a US co-borrower in the structure.

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 and release provisions. At the 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 of action to disrupt a restructuring without having to resort to a bankruptcy proceeding to provide a stay 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.

Provisions allowing the incurrence of third-party debt do not typically require the debt providers to sign up to the intercreditor agreement unless they are sharing in the security package. With more flexibility to incur third-party debt, it is very possible that an unsecured creditor (or a creditor that is secured on assets that are not securing the cov-lite loan given the more limited security package) 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 seeing requests that third-party debt (including unsecured debt) over a materiality threshold is required to become subject to the main intercreditor agreement (and, therefore, the critical release provisions described above) but most cov-lite deals do not include this requirement.

These provisions become even more important to structure appropriately given the new trend is to seek to adopt "lifetime" intercreditor agreements which remain in place for future debt structures.

What Does This Mean for 2021?

While there remains some uncertainty around the pandemic and the timeframe for return to a relative "normal" at time of writing, it seems likely that low interest rates may continue to prevail in Europe, and the depth of the investor base looking for yield will continue to permit significant flexibility in covenant and documentation issues. The trend of greater investor push-back on certain deals is likely to continue. Experience suggests that it is only where a particular credit generates surprising losses upon a default that there is any significant resetting of market terms, and the pandemic does not seem to have reset the market in any material way.

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