KEY POINTS

- Despite their commercial appeal for both financial sponsors and banks and their broad use in the direct lending market, capital structures in which super senior revolving credit facilities (RCFs) sit alongside senior leveraged loans (TLBs) have not yet become mainstream in the European LBO market.
- This may be due to three different factors, involving credit ratings, CLO demand and the uncertainty of market reactions, but none of these is insurmountable.
- Rolling out the alternative capital structure in new LBO financings should be less about jumping into the unknown than about extending a relatively well tested tool to the next stage of its commercial possibilities.

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Are the times ripe for "super senior" capital structures that include term loan debt?

In this Spotlight article Francesco Lione considers the pros and cons for rolling out "super senior" capital structures that include term loan debt, in addition to or as an alternative to secured bonds.

In the pan-European leveraged finance market's early stages, bondholders and banks often approached each other with circumspection. The bondholders, mainly US-based asset managers, had just started lending money across the Atlantic in search of yield and diversification. The most active banks, in contrast, comprised London-based institutions that boasted a long tradition of offering a wide range of banking services to European borrowers. Bondholders provided slivers of higher risk capital in the form of unsecured, junior-ranking claims and had no experience navigating European companies' financial distress. Banks, on the other hand, furnished sub-investment grade borrowers with the bulk of the credit they needed as secured, senior-ranking debt and had coordinated their responses to corporate defaults since time immemorial, in keeping with the Bank of England's non-binding guidance known as the "London approach". The London banking club had devised the rules of the game. Should financial trouble arise in the European corporate sector, a clear script dictated how things should play out: bondholders, unknown quantities whom banks perceived as prone to rash behaviour, would have a fair shot at recoveries but had to remain passive spectators in enforcement proceedings; members of the banking community, on the contrary, who could rely on their mutual predictability and alignment of interests, would have their hands firmly on the steering wheel and retain the sole power to direct work-outs to their orderly and value-preserving destination.

Such was the state of play, broadly speaking, until the global financial crisis, which upset the long-standing balance. In its immediate aftermath, banks were reeling from huge losses in their loan portfolios and just learning to cope with the more stringent capital requirements being ushered in by regulators. Banks had less capital available, were much more afraid to lend it out, and had to stash away a good chunk of it to comply with the new capital ratios. Bank credit retrenched at a galloping pace, exposing European businesses to maturity walls that rating agencies and financial commentators questioned how borrowers could possibly refinance. Bondholders, by now a more numerous population of financial institutions with experienced investment personnel in both London and New York, then stepped in to offer a spare tire to the European corporate system, which was perilously teetering on the edge of a financial abyss. Bondholders began lending money to starved borrowers in unprecedented amounts, stepping into the influential position of secured, senior-ranking creditors that white-shoe bankers had monopolised until then. To graduate to the new role, however, the newcomers had to assuage old fears pervading the banking community. They would be allowed to control work-outs upon corporate defaults only if the banks that provided revolving credit lines to satisfy European borrowers' working capital needs received payment first with any enforcement proceeds. Bonds would be swapped for bank loans as leveraged capital structures' main pillar and be granted a senior ranking only if revolving banking lines would be made superior to them, or "super senior", as the newly coined label went.

Outwardly, things have not changed much since. European borrowers continue to carry one of two capital structures: super senior or *pari passu*. When borrowers' long-term debt entirely consists of secured bonds, a super senior capital structure exists, in which banks that hold revolving lines of credit get first dibs on any enforcement proceeds. When borrowers' long-term debt still comprises bank loans, a *pari passu* capital structure exists, in which all secured claims rank equally on the conventional theory that no group of banks should have a superior status to another, regardless of whether they hold revolving debt or term debt. Beneath the surface, however, the leveraged finance system's metabolism has undergone profound change. Today, calling the leveraged loan market a "bank" market would be anachronistic, for leveraged loans no longer sit on the books of a small bloc of banks. They are instead widely distributed to a flowering multitude of investors that include commercial banks, finance companies, mutual funds, collateralised loan obligation

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vehicles (CLOs), hedge funds, insurance companies, pension funds, and high-yield bond funds. The lines of separation between investors buying leveraged loans and those buying high-yield bonds have long blurred. The blending of the investor base has resulted in the progressive convergence of terms across the two instruments, to the point where covenant schedules are now often lifted from bond indentures governed by New York law and dropped into an English-law governed credit agreement with little adjustment.

The European leveraged finance market's current state begs the question whether the difference between super senior and *pari passu* capital structures has become obsolete. When the identity of creditors holding secured bonds and leveraged loans is largely the same and the two types of claims bear uniform terms, it becomes harder to distinguish the remaining justification for configuring the capital structures so differently, depending on whether their senior secured layer includes bonds only or gives partial accommodation to loans as well. The widening gap between this established market norm and the economic realities that underpin it has brought to the fore the idea of a novel transactional template, which credit participants toss around in conversation with increasing gusto: capital structures with super senior revolving credit facilities (RCF) and senior leveraged loans (TLB).

Much is at stake for private equity regarding this new blueprint's viability for leveraged financings, which could revolutionise how liquidity lines are raised. Undrawn liquidity lines are essential to the investment calculus of private equity and serve as a back-up if a mismatch in the working capital cycle arises where cash flows can be collected only after a stack of payments has become due. These liquidity lines provide comfort for a rainy day, storing financial wherewithal that businesses can readily deploy to keep afloat and stave off defaults when operating conditions become challenging. They preserve access to capital and deal-making when volatile capital markets happen to be temporarily closed. In short, the deft financial modelling that supports private equity investments would not be possible without the failsafe that undrawn liquidity lines provide. On the supply side, banks remain the only institutions that can offer undrawn revolving commitments, with few exceptions. Alas, the product commands tight pricing in the market and is not very profitable. Banks do not view revolving credit facilities as a compelling investment on a stand-alone basis and treat them as relationship-driven transactions, ie tools that grant access to other types of non-credit business with the borrowing companies. Before a bank puts an RCF on its balance sheet, it will take a hard look not only at the facility's remuneration, but also at other sources of revenue from the relationship, such as cash-management services, capital markets activities, and M&A advisory work. This imbalance between private equity's rabid demand and banks' scanty supply leads to the ritual dance with which all leveraged finance practitioners are well-acquainted, where underwriting syndicates routinely slash financial sponsors' initial requests for RCF commitments.

The imbalance is less acute in super senior capital structures. The recent wave of restructurings demonstrates that super senior facilities rarely become impaired, even when the *pari passu* creditors suffer exorbitant write-offs of their claims. Because the super senior lenders often may upset a work-out process if they do not receive repayment in full shortly after a declared default, creditor committees almost invariably resign to the necessity of re-instating super senior credit lines at par, exonerating the lenders from the trouble of sharing the financial pain. Banks that hold *pari passu* RCF commitments are not so fortunate. Their claims rank equally with those of other secured creditors in distressed situations, and their only right is to cast their votes proportionally to the share of the senior debt that they own. As a result, they typically end up with the same scaling-down of claims on which other secured creditors settle to reorganise the business. The sharp difference in recovery outcomes explains why banks apply a more lenient capital charge to super senior revolving lines than to *pari passu* ones, why their credit committees have fewer reservations about booking super senior commitments than *pari passu* ones, and why the former can sometimes be slightly cheaper than the latter.

The new capital structure model emerging in the industry gab may seal a mutually advantageous bargain for private equity and banks when the debt stack includes senior term loans. Financial sponsors may get what they want more easily: between a half-turn and one full turn of leverage in undrawn revolving lines at a lower price. Banks may more generously extend that type of credit for relationship and business development purposes, when they can rest on the comfort of super senior security, deal with fewer constraints under their capital ratios, and expect a more liquid secondary market should they wish to sell down their RCF commitments and free up capital. Precedent supports this transactional model, including several instances of super senior revolvers sitting alongside senior term loans in mid-market financings, in which direct lenders have accepted that their security would rank behind bank revolvers to build market share in the traditionally bank-dominated space. Fewer but notable instances exist in mainstream leveraged finance too, though these are capital structures (such as Altice's) that were initially marketed with senior secured bonds and super senior RCFs and that evolved to include senior TLBs only at a second stage. Despite their commercial appeal for both financial sponsors and banks and their broad use in the direct lending market, capital structures with super senior RCFs and senior TLBs have yet to play a role in a large European leveraged buyout financing, due to three potential factors.

- First, PE executives are afraid of irking the population of leveraged loan investors, who might be displeased at being demoted to the second tier of borrowers' capital structures and might react to the change by increasing the pricing of institutional term loans. Accepted market norms are sticky and

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neither PE houses nor investment banks pitching financing ideas to them are incentivised to act as guinea pigs for a novel transactional experiment.

- Second, there is a degree of uncertainty on the upper limit of super senior RCF that the new hypothetical capital structures may carry, given that CLOs' documentation terms restrict super senior debt as a percentage of overall senior debt.
- Third, super senior facilities larger than 1-1.5 turns of leverage may negatively affect credit rating outcomes for senior debt: when super senior debt's size exceeds that upper limit, rating agencies might treat super senior debt and senior debt as two distinct brackets of the borrower's liability structure and "notch down" the senior debt's rating or recovery classification.

None of these impediments, however, looks insurmountable. Leveraged loan investors, including CLOs, routinely buy senior secured bonds in primary syndication with no pricing penalty on account of their security ranking behind super senior revolvers and should therefore have little reason to price TLBs more stiffly. Investment banks underwriting new deals are well-equipped to reasonably advise financial sponsors regarding the maximum amount of super senior RCF that they can pair with a TLB without losing demand from CLOs that act within their investment constraints or penalising rating outcomes. Lastly, it seems far-fetched to fret over an insurrection of institutional lenders against the novel transactional template, when one of the largest issuers in European leveraged finance (Altice) prominently and imperturbably features the same template that the debt market's private placement segment has long accepted. Overall, rolling out the alternative capital structure in new LBO financings should be less about jumping into the unknown than about extending a relatively well-tested tool to the next stage of its commercial possibilities.

As the anomaly of existing transactional norms becomes more widely acknowledged, it will be for PE firms to decide whether the benefit of injecting super senior RCFs into leveraged loan deals will ever be worth the risk of small crests forming in the waves of a few TLB syndications. ■

Further Reading:

- Intercreditor considerations for super senior lenders in Unitranche financings (2016) 4 JIBFL 213.
- Curing debt-ills with more debt: can this be done and how does it work? (2012) 5 JIBFL 275.
- LexisPSL: Restructuring & Insolvency: Practice Note: Basic introduction to super senior, senior and mezzanine and junior debt.