The Continued Growth of European Covenant Lite

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In 2018, 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 terms into European loans remains strong as there is now a significant source of European "cov-lite" precedents, in turn strengthening the argument for cov-lite, in the absence of a market correction. Investors were, however, more successful on pushing back on certain pricing and documentation terms during 2018. This convergence brings a number of documentation issues to consider.

Covenant-lite Loans

In a covenant-lite loan, either there is no financial maintenance covenant or there is a single financial covenant 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 typically is a "springing" covenant, i.e., tested only if the revolver is drawn as of the end of a fiscal quarter and such usage exceeds a certain percentage of the revolving credit commitments, often 35–40%, with the applicable levels set with significant EBITDA "cushion" or "headroom" of around 30% or more and no or very few step downs. The nature of drawings counting within the trigger is also narrowing to exclude all non-cash utilisations (and sometimes all ancillary facilities).

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, is now being accepted by many lenders in Europe on cov-lite deals. Interestingly, the European market generally permits over-cures, whereas the US market limits cure amounts to the maximum amount needed to ensure covenant compliance. It is 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.

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 "looser" US practice on terms for cov-lite deals. 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 traditional loan market baskets fixed at a capped amount. 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 2× interest coverage test (a concept imported from the high-yield bond market). This debt can be raised through an incremental "accordion" feature and increasingly separate "sidecar" financings. 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. 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 MFN protection relating to new incremental loans continues to be a focus of negotiation, both as to sunsets (after 6 or 12 months) and other carve outs of debt structures (e.g. side cars; acquisition debt).

Builder Baskets

Another trend from the US cov-lite loan market (which is also a feature of the high-yield bond market) that is being adopted in European loan deals is a "restricted payments builder basket", 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, and unswept asset sale proceeds, usually subject to a net leverage ratio governor as a condition to usage. In some cases there may be no limit to distributions if a lower leverage ratio test is met. There is an increasing trend towards an even more aggressive variant 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 and because the build-up may begin for years prior to the onset of the ECF sweep. The builder baskets may also have additional "starter amounts", some soft capped by reference to EBITDA.

US-style Events of Default

US-style events of default continue to be resisted by European loan syndicates, but we have seen more loan financings that include defaults more akin to the US loan approach, e.g.: removal of material adverse change default; no audit qualification default; or even 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 80–85%).
- 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.
- 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.
- A small number of financings have EBITDA addbacks (as used in financial ratios for debt incurrence purposes) which are uncapped.
- 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 calculation).
- Greater restrictions on transfers to competitors and "loan to own" funds, with more limited default fall aways (e.g. payment and insolvency only).

Economic Adjustments

Economic adjustments such as a 101% (or 100.50%) soft call for six months, a EURIBOR floor, and nominal (0.25%) quarterly amortisation are also often introduced to make loans more familiar to 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 and 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 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.

Until 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 more flexibility to incur third-party debt, 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 continuing trend 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). It is of note that while this is becoming a trend in loan transactions, it is not structured for in European bond transactions.

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 2019?

It seems likely that low interest rates may continue to prevail in the Eurozone, 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.

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Ms. Summers has been active in the syndicated lending market since its infancy in the mid-1980s, including serving as Deputy General Counsel for Barclays in the Americas, and from 2000 to 2005 acting as the LSTA's first General Counsel where she led the efforts to develop the organisation's legal, documentation and regulatory strategies for key industry issues that established standard market practices and procedures.

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