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The Dynamics of European Covenant Lite


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Introduction

Tempered by prevailing economic and debt-raising conditions as a consequence of geopolitical concerns and a combination of rising interest rates and inflationary pressures, the leveraged loan market was not as buoyant in 2022 as in the prior 12- to 18-month period. In addition, a dominant trend during this period has been a very significant shift away from the broadly syndicated institutional market to private sources of capital to finance private equity sponsors' purchases of large cap companies, where previously private debt transactions typically had been more confined to financings of the purchase of small-to-mid cap businesses. In addition, the latter part of 2022 saw a noticeable shift to liquidity raisings (primarily through incremental add-ons, liability management exercises and amend to extend processes) for their portfolio companies in anticipation of looming maturities both for term facilities and revolvers, which typically mature three to 12 months earlier than the term loans to the same group. Unsurprisingly, due to the current market dynamics and greater reliance on private capital (including deals where an arranger privately places the debt with a number of direct lenders), there has been a gradual market correction with greater investor focus not only on pricing but on key documentary terms. The origination of covenant-lite terms in the European leveraged loan market derived from the US leveraged loan and global bond markets, with global sponsors and their advisers looking to import their experiences from US financing transactions and to align terms across the debt facilities for their portfolio companies. Over time, European covenant-lite loans have become customary for European broadly syndicated leveraged loan transactions (although not yet wholly typical, to date, in direct lending/private capital transactions), which gives rise to a number of documentation considerations.

Covenant-lite Loans

In a covenant-lite loan, there is typically a single financial covenant tested on senior secured net leverage that benefits only the lenders under the revolving credit facility, with no financial maintenance covenant for the term lenders. The covenant benefitting the revolving lenders almost always is a "springing" covenant, *i.e.*, tested only if the revolver is drawn at the end of a fiscal quarter (often tested beginning only at the end of the second or third complete quarter after the closing date) in an amount that exceeds a specified percentage of the revolving facility commitments (usually 35–40%), with the covenant levels often set at a constant level (with no step downs) and with significant earnings before interest, taxes, depreciation and amortisation ("EBITDA") "cushion" or "headroom". The cushion is typically set with 30–40% headroom from the adjusted financing EBITDA included in the base case model and sets the debt level assuming either that the revolver is fully drawn or is drawn at a set level; moreover, the closing date levels used for these calculations may be set "gross", *i.e.*, assuming that there is no cash on the balance sheet to net against the debt. The type of drawings included in the calculation of the trigger have also narrowed to exclude all ancillary facilities and letters of credit, amounts used to fund fees, costs, expenses, flex original issue discount ("OID") and, in some instances, and sometimes subject to caps, amounts drawn on closing for working capital or general corporate purposes and/or to fund acquisitions and capital expenditures. It has also become increasingly common for cash and cash equivalent investments to be deducted from the amount of revolving facility commitments that are drawn at the relevant testing date (with cash, unlike in a Loan Market Association ("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 covenant-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 covenant-lite loans and US covenant-lite loans is the prevalence of deemed cures (provided no acceleration steps taken) in European covenant-lite loans, which are rare 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 (but with no requirement to use the proceeds of the debt cure to repay debt). Another interesting development in relation to equity cures in European covenant-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) or for any financial covenant breach to be deemed cured if the springing threshold is not met on the next test date, provided that a declared default has not arisen.

Where the term facility is provided by sources of private capital, *i.e.*, the so-called "direct lenders", the revolving facility may be provided by a commercial or investment bank. Where this is the case, the revolving facility often has "super senior" priority over the term loan in relation to proceeds of enforcement of collateral.

Documentation

In the past there was a "battle of the forms" in relation to documenting European covenant-lite loans, with the first covenant-lite loans emerging in Europe in 2013 being documented under New York law. The next generation were governed by English law 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 English law-governed 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 fundamental departure from US practice that became widespread in European sponsor-led leveraged finance transactions quite a few years ago is the practice of basing on high-yield bond-style terms the reporting requirements, affirmative covenants, negative covenants, and certain events of default (such as payment, insolvency and cross-acceleration/cross-payment default), and to tack those terms onto the English law-governed secured facilities agreement in the form of schedules that, in turn, are to be interpreted under New York law (much like the format of a super senior revolving facility).

A number of the other features of current covenant-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 including an EBITDA-based "grower" feature). Occasionally, unsecured debt is permitted up to a 2× interest coverage test (a concept imported from the high-yield bond market) instead of or in addition to leverage ratio-based baskets. This debt can be raised through an incremental "accordion" feature or separate "sidecar" financings. European covenant-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 as subordinated loans or bonds (often with no parameters as to where the debt can be incurred within the group). Reclassification is often permitted, which means that if the "freebie" basket is used when there is no capacity under the ratio basket, that debt can later be treated as if it were incurred under the ratio basket once capacity is created, thus freeing up (or "reloading") 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 covenant-lite loan market where they have in recent periods been longer or non-existent), whether it is tested on margin or yield, carve-outs of certain debt baskets (acquired and acquisition debt and the freebie basket), inclusion of a *de minimis* threshold and whether it applies to sidecar debt incurred outside the loan agreement. Other more recent areas of focus from investors have been resisting the inclusion of an inside maturity basket (which would extend to additional debt secured on the same collateral), whether revolving facility drawings are excluded from ratio and covenant testing (the latter point still being in a small minority of deals in Europe despite being more common in the US) and the asymmetrical treatment of pre-International Financial Reporting Standards ("IFRS") 16 leases with borrowers looking to receive the benefit of any EBITDA increase but discounting the debt element.

Where covenant-lite terms govern loans placed with, or provided by, private capital firms, those lenders have sought to limit the above-mentioned flexibility by negotiating smaller basket capacity. For example, debt capacity may be limited either to a *pro forma* leverage-based basket or a fixed amount, there may be caps on side car debt and non-guarantor (*i.e.*, structurally senior) debt, and there may be more robust conditions on incurring debt under the accordion facility by, for example, having more yield and pricing features that are more protective of existing lenders and that may also include a right of first refusal or a right of first offer.

Builder Baskets

Another durable trend from the US covenant-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, any closing overfunding and permitted indebtedness, sometimes 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 borrower-friendly 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 ECF, 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. Rather than being subject to a net leverage governor, usage of the CNI builder basket is typically conditional upon being able to incur an additional $1.00 of debt pursuant to the 2× interest coverage test after giving *pro forma* effect to the restricted payment, analogous to the operation of ratio baskets for debt incurrence in high-yield bond indentures.

As with debt incurrence, where the financing is placed with, or provided by, a source of private capital, the features described above have tended to be more limited from the borrower's perspective with either the builder basket feature not being included or the terms including greater governance around its use such as taking into account losses, including a *pro forma* leverage test (usually requiring a certain amount of de-levering) and removing the starter basket in relation to leveraged buyouts.

US-style Events of Default

While previously US-style events of default were resisted by European loan syndicates, it is now more customary for loan financings to include defaults more akin to the US loan approach (which does not include a material adverse change default or an immediate default based on audit qualification) or, even more prevalent, a reduced list of loan-style defaults, such as misrepresentation and breach of the intercreditor agreement plus high-yield bond-style defaults, which include payment default, cross-acceleration and cross-payment default (rather than the more robust cross-default), insolvency only of significant subsidiaries and subject to longer remedy periods (usually running from when the administrative agent notifies the borrower as contrasted with a construct where it is the earlier of the borrower becoming aware of the default and notification to the borrower by the administrative agent). Another feature sometimes borrowed from the US market is a feature that applies what is effectively a "statute of limitations" that cuts off the ability of lenders to accelerate or enforce remedies after a set period of time, typically two years.

Other Provisions

There are other provisions we have seen migrate from the US covenant-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 limited (if any) controls on acquisitions (with the control being with respect to any additional debt incurred in connection with an acquisition).
- "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 (with increasing flexibility to use the proceeds from a disposal for making distributions and/or junior debt payments subject to limited conditions).
- Guarantor coverage ratios are typically only tested on EBITDA (at 80%), coupled with the inclusion of a "covered jurisdiction" concept whereby guarantees and security will only be given in a predefined list of jurisdictions (as opposed to all jurisdictions other than those which the agreed security principles will exclude).
- Change of control mandatory prepayment being adjusted to allow individual lenders to waive repayment (becoming effectively a put right).
- Increased use of growers (as distinct from and in addition to ratio-based incurrence tests) with a soft dollar cap that increases as EBITDA grows including not only for "baskets" but also for thresholds that apply to events of default and other materiality standards.
- The automatic permanent ratcheting up of fixed capped "baskets" (*i.e.*, the so-called "high water marking") following an acquisition or other event to reflect any proportionate increase to EBITDA (notwithstanding that such "baskets" are likely to separately have a soft cap "grower" by reference to EBITDA).
- 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, covenants and events of default.
- 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 or, in increasing instances, no cap at all. 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. A number of covenant-lite deals also permit uncapped addbacks to the extent taken into account in determining financing EBITDA in connection with financing acquisitions and/or included in any related quality of earnings reports delivered to the agent.
- Quarterly financial statements only needing to be delivered for the first three financial quarters in each financial year.
- An increasing trend for Majority Lenders to be set at 50.1% rather than the traditional European percentage of 66⅔% (sometimes with the lower percentage used for consents and the higher percentage for acceleration rights), and in some instances for Super Majority Lenders to be set at 66⅔% (rather than 80%), with the effect that the decision to exercise acceleration rights requires super majority consent, while matters relating to the release of guarantees and security require only the lower consent threshold.
- Greater restrictions on transfers to competitors (which on occasion cover not only competitors of the group but also competitors of private equity sponsors; however, note that the latter is much disfavoured and resisted in US transactions), sanctioned lenders and "loan to own" funds, with more limited default fall aways for transfers to "loan to own" funds (*e.g.*, payment and insolvency only).
- A more limited security package consisting of material bank accounts (occasionally only with respect to the term facility borrower), shares in guarantors and intra-group receivables in respect of proceeds loans (although floating security or all asset security, where customary, still tends to be provided in, for example, England and Wales and the US).
- The inclusion of anti-net short provisions (which are designed to cut off the voting rights of lenders who hold a net short position in respect of the relevant credit, and to disqualify them from increasing their position in the credit), although this is another provision that has attracted investor focus both in the US and in Europe.

Economic Adjustments

Economic adjustments, such as a 101% soft call for six or 12 months, a floor on the benchmark rate, 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) in jurisdictions where it is feasible to grant such security, 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 over time have 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 that creditors may have to, in times of financial difficulty, 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, employ to get a seat at the table by threatening to accelerate their debt claims. Standstill provisions can be used to prevent creditors from disrupting restructuring efforts, and thereby obtaining increased recoveries, without having to resort to a value-destroying bankruptcy proceeding.

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. 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 covenant-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. While it would be unusual to see a requirement in covenant-lite deals for third-party debt (including unsecured debt) over a materiality threshold to become subject to the main intercreditor agreement (and, therefore, the critical release provisions described above), we are seeing requests to include a sub-limit on the amount of debt that can be incurred under the debt baskets by members of the group that are not guarantors (and, therefore, are unlikely to be subject to the intercreditor agreement); however, this is often a negotiated term in most covenant-lite deals.

These provisions become even more important to structure appropriately given the trend in covenant-lite deals to adopt "ever green" or "plug-and-play" intercreditor agreements that remain in place for future debt structures.

What Does This Mean for 2023?

The current view among market participants is that there is likely to be some form of global recession commencing during the course of 2023, albeit there is a divergence in views as to its length and impact. Based on this premise, it is not clear whether there will be a gradual resurgence of the broadly syndicated loan market (and, possibly, high-yield bond market activity as well) in the short-to-medium term or whether sentiment in private capital will remain strong and remain a viable alternative source of funding. Such systemic conditions will likely create a challenging backdrop for private equity sponsors and their portfolio companies to continue negotiating flexible terms discussed above, with an expectation there will be a certain level of rebalancing of terms. In particular, with the lack of M&A activity and looming debt maturities, impacted private equity sponsors and their respective portfolio companies are likely to shift focus towards amend to extend processes to increase maturities without needing to raise new debt but which may in turn result in higher pricing, re-setting of call protections and accordion MFNs and a potential renegotiation of documentary terms in order to align with market and investor sentiment.

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