Latest in European Leveraged Finance – Guarantor Coverage

Introduction

Most European leveraged loan agreements will contain a guarantor coverage covenant. In its simplest form, this requires the bidder to ensure that certain of the target group subsidiaries provide upstream guarantees and security to the LBO lenders within a specified period after closing (and to maintain that level through the life of the deal). In reality, that obligation can become a great deal more complex, and is usually subject to a heavy degree of negotiation. The underlying purpose of the covenant is to balance the costs to the borrower group in providing security with the benefits that the lenders derive from such security. The aim is to ensure that lenders have sufficient collateral, without requiring every single one of the target group subsidiaries to provide guarantees and security.

WHAT'S THE THRESHOLD LEVEL?

The key commercial negotiation points relating to guarantor coverage tests concern the financial metric to be used for the threshold, and the level at which the threshold should be set. Typically the clause is written so that guarantees and security must be provided by target group subsidiaries who together account for at least a specified minimum percentage of the financial firepower of the group. A further prong of the test usually requires every 'material subsidiary' to become a guarantor and provide security. There are a number of elements to this:

What is the financial metric that should be used to determine the target group's 'financial firepower'?

This depends to a certain extent on the financial and operating profile of the target group. Typically, consolidated EBITDA is the metric most often used by banks and sponsors to model a transaction, and it is that which is very often used as the metric to determine the upstream guarantee and security package. Using this metric ensures (in theory at least) that the lenders will have a direct claim against the key profit-generating target subsidiaries.

In some cases, there could be additional metrics: total assets, total net assets or turnover. The latter is falling out of fashion and is rarely seen in the market today. Asset tests do appear in a number of deals. The added protection is that while EBITDA coverage protects the lenders in a going concern situation, asset-based coverage provides protection in an enforcement or insolvency situation.

What should the coverage level be, and how should it be calculated?

There is no 'right' answer here. The range is usually between 70% and 90%, but there are deals outside this band. Ordinarily an investigation would be made as part of the diligence process, in order to get an understanding of which companies in the group generate EBITDA and have significant assets. At best, this would be in the form of a spreadsheet breaking out the relevant metrics by subsidiary (organized by jurisdiction). In other cases, a more general sense of these metrics will need to be gleaned from financial due diligence materials.

As described under 'Agreed Security Principles' below, not all of the target subsidiaries will be permitted by applicable law to give a meaningful upstream guarantee and security package, and that might make it difficult to reach a high coverage threshold without adjustment. Two features have developed which help to make this covenant easier to comply with:

— First, when calculating EBITDA, any target subsidiary which generates negative EBITDA is disregarded and its EBITDA is deemed to be zero. This means that those subsidiaries which are loss-making 'count' as zero (instead of a negative number) for the purposes of working out whether the aggregate threshold has been met. A sponsor-friendly feature we have seen in some deals is that these 'negative EBITDA' entities are excluded only from the numerator (EBITDA of the guarantors), and not from the denominator (EBITDA of the group).

— Second, a provision stating that when testing whether the coverage threshold has been met, the contribution to total consolidated EBITDA/assets made by guarantors who are unable (pursuant to applicable law, which will usually be covered in the Agreed Security Principles which we discuss below) to give a guarantee should be excluded. This was traditionally viewed as a much more aggressive formulation, but is becoming more and more common in the market. Its effect can, in some situations, be extremely significant and care should be taken to ensure that all parties understand at the outset any legal issues in the target group's jurisdictions.

In some deals we have seen provisions that deem any entity whose shares have been pledged will count towards the threshold, even though the entities themselves have not granted guarantees or given security.

A further point worth noting is that in many cases the borrower will be incentivized to have as many of the target subsidiaries become guarantors as possible. In a traditional covenanted deal, the covenant baskets may well place limits on the permitted 'value leakage' between guarantors and non-guarantors. So, for example, the making of loans by a guarantor to a non-guarantor might be subject to an aggregate cap. If the intra-group funding or operational requirements of the target group require more flexibility than that cap allows, the borrower may wish to make a large number of subsidiaries guarantors (even if not required by the coverage ratio), in order to benefit from the unlimited baskets that often only apply to transactions between obligors.

At what level should the 'material subsidiary' test be set?

The starting point is usually 5 per cent, again of consolidated EBITDA and sometimes of the additional metrics of gross assets, net assets or turnover. However again this is very fact-specific. Typically, diligence would be carried out to identify precisely which target group subsidiaries would meet this criterion, and an analysis undertaken to identify whether those subsidiaries becoming guarantors would create any issues.

AGREED SECURITY PRINCIPLES

In cases where the target group subsidiaries are all private companies that are based in the UK it should be relatively straightforward for the lenders to obtain an upstream guarantee and security package from all of them. However, when dealing with target groups across continental Europe and beyond, there are often legal rules that would prevent or limit a company's ability to provide credit support for debt incurred by a parent entity. Typically those rules involve financial assistance, corporate benefit, thin capitalization and directors' duties issues. In addition, certain target group members may carry out a regulated business of some description and so be subject to minimum capital (or similar capital adequacy) requirements. The giving of a guarantee might materially adversely affect the capital position of such an entity, and so sponsors may seek to carve-out those entities from the requirement to become guarantors.

Any obligation to ensure that a guarantee is given or security interest granted would therefore ordinarily be subject to a set of 'Agreed Security Principles' (ASPs).

Those would be set out in a schedule, and would lay out the agreed position in relation to:

- which entities should give guarantees and security;
- which assets should be the subject of the security;
- what the enforcement triggers should be (typically acceleration of the debt not just an event of default); and
- any limitations on the scope of the guarantee obligation, or the representations and undertakings to be included in the security documents.

It is essential to have these reviewed by local counsel in the relevant jurisdictions before they agreed, in order to ensure that any specific issues are identified and dealt with appropriately. In addition to dealing with any legal issues, the ASPs also typically deal with various generic issues (for example, it is customary to state that the borrowers should not be obliged to give any security if the cost of doing so would outweigh the benefit to the lenders). In circumstances where the granular detail of the proposed security package is not going to be agreed up-front, these principles set the rules of engagement for the subsequent negotiation.

As noted above, in some jurisdictions there will be legal issues that prevent target companies from giving a guarantee for debt incurred by the bidder to finance their acquisition. But this prohibition does not generally extend to debt incurred for other purposes. In those situations it is possible to tranche the acquisition debt to separate out loans incurred to pay the purchase price to the vendor, and loans incurred for other purposes (e.g. refinancing target group debt, working capital purposes). Tranching the debt in this way allows certain parts of the debt to benefit from upstream guarantees, but it can also create issues in the secondary market (even if the lenders' sharing clause should result in recoveries being harmonized across all tranches).

TIMING

Whatever the guarantor coverage ratio, the borrower will normally only be obliged to comply with it from the end of a set period after closing. The length of that period depends on the complexity of the group, the jurisdictions involved, and the negotiating power of the sponsor. It is usually in the range of 90 to 150 days after closing. Sometimes it can be longer for specific reasons. For example, in early 2018 the law changed in Belgium to remove ad valorem duty on certain types of security interests. Those closing leveraged acquisitions involving Belgian targets in late 2017 mostly chose to wait until the law changed before documenting the Belgian security package.

After the initial package is put in place, the coverage requirement is then tested annually by reference to the audited financial statements. If those statements show that additional companies are required to become guarantors to reach the coverage requirement, a further period is allowed for the borrower to have additional subsidiaries negotiate and sign the relevant documents to become guarantors. Sometimes this period is shorter than the initial period (for example, it may be as short as 60 days).

DEAL CONSIDERATIONS

1. Is there a guarantor coverage covenant, and if so what is the coverage threshold? ☐
2. What is the metric by which coverage is to be measured:
   - EBITDA ☐
   - Gross Assets ☐
   - Net Assets ☐
   - Turnover ☐
   - Something else ☐
3. Do companies with negative EBITDA count as zero? If so, in both total EBITDA and the EBITDA of the guarantors, or only in the latter (which is more sponsor friendly)? ☐
4. Does the coverage test exclude companies who are prohibited from giving guarantees and security? ☐
5. Are there regulated entities in the target group and if so are they excluded from the guarantor coverage test? ☐
6. What is the 'Material Subsidiary' threshold? ☐
7. Do the agreed security principles legislate for all relevant jurisdictions and the key common terms of the proposed guarantee and security package? ☐
8. How soon after closing must the coverage requirement be met? ☐
9. When is the coverage requirement tested going forward, and how long does the borrower have to comply in case of deficiency? ☐

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