Feature

KEY POINTS

- Historically, the circumstances in which the borrower of a leveraged loan was required to prepay its debt were well-settled.
- Investors' hunt for yield has led to a convergence between traditional LMA-style leveraged loans, US-style Term Loan Bs and high-yield bond covenants.
- Mandatory prepayment provisions have not been spared and have become fertile ground for negotiation, with borrowers (particularly strong sponsor-backed entities) seeking greater means of keeping cash that would previously have been required to be applied in prepayment.

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Mandatory means mandatory? Recent trends in leveraged finance prepayment clauses

In this article, the authors consider the evolution of mandatory prepayment provisions in leveraged loans as borrowers seek greater means of keeping cash.

THE (OLD) EUROPEAN STANDARD

Traditionally, LMA-style leveraged loan agreements required the borrower to prepay the facilities in the circumstances set out below:

COVENANT EROSION

The shift in market dynamics has led to borrowers seeking greater flexibility in mandatory prepayment provisions. In some cases that has led to some chipping away at the edges of these provisions. In others, it has led to more dramatic changes.

Change of control

- **The rise of the lender put right:** In contrast to the automatic requirement to prepay all lenders upon a change of control that you would find in a traditional LMA-style loan, high-yield bond covenants usually give the

Prepayment trigger	Consequences	Other points
Change of control	Immediate prepayment of all lenders required	Change of control is usually triggered if the initial investors cease to hold at least a majority of the shares in the borrower. That threshold would often drop to 35% after a listing of the borrower, with the initial investors being required to remain the biggest shareholder. Note that in US deals, change of control is usually an event of default, not a mandatory prepayment event.
Receipt of proceeds from asset disposals, and insurance claims	Prepayment of all lenders *pro rata* using net proceeds	The market developed fairly well-settled reinvestment rights and baskets for the borrower before prepayment could be required, as discussed in more detail in this article. The theory here is that if EBITDA-generating assets have been turned into cash they should either be reinvested in replacement or new EBITDA-generating assets, or the proceeds should be used to prepay the lenders to avoid leverage creeping up.
Receipt of proceeds from claims against the vendor of the target company under the Share Purchase Agreement (SPA) or against the provider of any diligence report	Prepayment of all lenders *pro rata* using net proceeds	If there has been a claim against the vendor or the provider of diligence, that indicates the target business is worth less than initially thought by all parties, and the borrower should de-leverage to reflect the reduced valuation of the target.
Excess Cashflow	An annual requirement to use "Excess Cashflow" to prepay all lenders *pro rata*.	The amount of Excess Cashflow required to be prepaid would vary, based on the total net leverage of the borrower at the time – the higher the leverage, the greater the percentage of Excess Cashflow required to be applied in prepayment.
Listing on a recognised stock exchange of the borrower's (or relevant parent entity's) shares	Prepayment of all lenders *pro rata*.	A listing that did not trigger a change of control would trigger a prepayment requirement.

Biog box
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holders a "put right at 101". That means each bondholder has the right, within a given timeframe following the change of control, to cash in its bonds upon a change of control and receive 101% of the face amount from the issuer. Alternatively, a bondholder may decline to exercise such right (or if it fails to respond within the given timeframe, it is deemed to have declined to exercise such right). Whilst the 1% prepayment premium on change of control has not become customary in loan deals, the construct of a put right for lenders in leveraged loans has. This development provides more flexibility for both lenders and borrowers. Certain lenders in the syndicate may not want to be prepaid if the profile of the new owner is acceptable. The traditional provision effectively imposes prepayment on them, as a waiver of the borrower's prepayment obligation typically requires all lender consent. How often this flexibility will be used in practice by a borrower is an open question. Where a prospective acquirer is dependent on leverage to complete the acquisition, it will have to be prepared for all lenders to exercise their put right, and will need to have its own financing in place to cover that eventuality; so the acquirer may find it simpler to just prepay the target's existing financing in full.

- **Portability**: Perhaps the most contentious evolution has been the concept of portability. This provision dis-applies the change of control mandatory prepayment requirement if certain conditions are met. Typically those conditions are:
  - a ratio test, whereby prepayment is only required if a leverage ratio is complied with; or
  - a ratings test, whereby prepayment is only required if the borrower's credit rating is downgraded or withdrawn within a fixed observation period.

  Where portability is acceptable in principle, the ratio test has proven to be the more common condition. Portability is particularly useful for an existing financial sponsor owner that is expecting to exit its investment in the near term, allowing bidders to avoid the need for their own financing and thus reducing transaction costs. Its genesis was in the high-yield bond market, where the greater liquidity of bonds mitigated the risk for bondholders – if they do not like the new owners, they could simply sell out. With the more constrained rights to sell that are now found in European leveraged loans, the same rationale does not apply. Consequently, portability is still relatively rare in loans, as lenders remain alert to such a provision and would often resist this strongly.

Disposal proceeds

The traditional form of language requires the net proceeds of all asset disposals to be applied in prepayment, typically excluding ordinary course and intra-group disposals, among others. Over the years, that requirement became subject to a number of qualifications:

- ***De minimis* threshold:** The proceeds of single asset sales (or the aggregate of a series of related asset sales) that fall below a certain fixed threshold are not required to be prepaid. Consistent with the recent trend for "soft baskets", we now often see that fixed amount as being the greater of a certain euro/dollar/sterling amount, and a specified percentage of EBITDA or gross assets.
- **Overall basket:** In addition to a single transaction basket, an overall annual basket is also typically included – the requirement to prepay only applies where the aggregate of all non-excluded asset sales exceeds a pre-agreed threshold, which again may be set as a grower basket, ie the greater of a percentage of EBITDA or gross assets and a fixed amount. In some deals, only the excess of the disposal proceeds over the annual cap is required to be "swept". Note that the proceeds which fall within the *de minimis* threshold described above do not count towards this overall basket.
- **Permitted uses**: Most leveraged loan agreements would allow the borrower to use disposal proceeds for reinvestment in the business, for capital expenditure, or for the purchase of replacement assets, instead of prepayment. Such reinvestments do not need to occur concurrently with the receipt of asset sale proceeds. Typically, reinvestment or commitments to reinvest (ie signing of definitive agreements) must be made within 12 months of receipt of proceeds and, in the case of a commitment made within that initial 12 months, the actual reinvestment must be made within 18 months of the initial receipt. Recently, some sponsors have been able to persuade the lenders that the proceeds of an asset disposal could also be used to pay a dividend or to fund M&A transactions. The right to use the proceeds to fund a dividend would most likely be subject to a ratio test, with the relevant portion of the proceeds permitted to leave the group for those purposes being determined by reference to a total net leverage test.
- **Prepayment waterfalls:** With the rise of covenant-lite and soft baskets, most large leveraged loan agreements allow the borrower to incur significant additional debt beyond the initial financing. In many cases, that additional debt can rank *pari passu* with (or even senior to) the initial financing. The providers of that additional debt will usually expect to have customary prepayment rights, so we now see payment waterfalls being built into the initial financing documents from the outset. Those provisions specify that where proceeds are required to be applied in prepayment of the initial financing, they can be shared with other *pari passu* creditors on a *pro rata* basis. In some deals, the borrower may even be permitted to prepay junior debt (without prepaying senior debt or prepaying such junior debt *pro rata* to senior debt) if certain conditions are met, usually in the form of a leverage test.

Some provisions dropping away

The inclusion of a prepayment requirement triggered by the receipt of claims against the vendor or the provider of a due diligence report seems to be waning. The hot M&A market and prevalence of private auctions have led to an erosion of terms in purchase agreements, lowering the likelihood of a successful warranty claim. The same is true of due diligence providers, whose liability is often limited to fairly small amounts in the context of the overall deal. Substantially, that means that if a claim is made under the SPA or against a diligence report provider, its proceeds will go to

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the bidco and the bidco's use of these proceeds will be subject to the broader covenant package.

There has also been a decline in the inclusion of a requirement to prepay an acquisition financing with the proceeds of insurance claims. This requirement was always subject to a similar range of thresholds and reinvestment rights as those applicable to disposal proceeds, described above. In addition, certain types of insurance proceeds were excluded altogether (for example, third party liability, loss of profit and business interruption policies). Recently, borrowers have been successful in persuading lenders in certain deals that the insurance claim proceeds are better off being reinvested in the business to repair whatever damage has been done, and that the treasurer's administrative headache of monitoring this is not worth the benefit to the lenders.

Excess Cashflow

The basic format of the Excess Cashflow prepayment provision has not changed dramatically in recent times. Here the focus of negotiations has been on areas which impact on the amount and timing of prepayment:

- ***De minimis* thresholds:** This now common feature disapplies the prepayment obligation if the amount of Excess Cashflow is below a specified amount. Again, that fixed amount is now typically replaced with or supplemented by a soft basket, the size of which is creeping up. Often the *de minimis* amount is deducted from the percentage of Excess Cashflow which the provision would otherwise require to be prepaid (rather than from the amount of Excess Cashflow itself), further eroding the prepayment amount.
- **Other reductions:** Historically, borrowers would benefit from dollar-for-dollar reductions of the Excess Cashflow amount where voluntary prepayments of term loans and, in some cases, the revolver (where there is commensurate cancellation) have been made within the relevant period. The dollar-for-dollar reduction concept has now been widened to include prepayments of any incremental loans, *pari passu* ranking debt, refinancing debt, and, in some cases, second lien debt. Borrowers might also benefit from timing flexibility – the reductions from such voluntary prepayments may, at the election of the Borrower, be applied to a future year. Borrowers may also elect to have any prepayments made after the end of the relevant financial year, but prior to the next prepayment due date, count towards the reduction.
- **Leverage step-downs:** Typical prepayment step-down levels are often set at 50%, 25% and 0%, with the leverage level at which the prepayment percentage first steps down set with a comfortable buffer below the opening leverage. All of these metrics are being put under pressure in negotiations.

Listing proceeds

The traditional LMA provision would require full prepayment of the facility in the event the borrower group is listed, even where such listing does not result in a change of control. This has been pared back in almost all leveraged finance deals to simply require prepayment in amounts equal to the net proceeds of the listing received by the borrower group. However, even the more limited formulations have been watered-down in the years since it was first introduced. The main tool used to minimise its impact is through the use of leverage step-downs, in the same fashion as applied for the Excess Cashflow provision (see above), with the same step-down and leverage ratio levels.

Some transactions further allow listing proceeds to be excused entirely from the mandatory prepayment requirement if applied towards certain permitted uses (for example, capital expenditure or permitted investments). Some even extend so far as to excuse prepayment if such proceeds are applied in any manner that is not prohibited by the agreement, which could mean tremendous flexibility for borrowers. The most aggressive of borrowers in the market (which would be strong sponsor-backed entities) may even successfully negotiate removal of this mandatory prepayment requirement entirely.

CALL PROTECTION

Whilst fixed rate high-yield bonds in Europe normally carry call protection, floating rate loans have not historically done so. That is changing, with an increasing number of deals that require a 1% prepayment fee in certain circumstances. Usually, that requirement only applies if the prepayment occurs within a short period after closing, typically between 6 and 12 months. It is also often subject to a number of exceptions, so that a prepayment triggered by a change of control or a listing would not attract the prepayment fee. Some facilities go further and only impose a prepayment fee if the original LBO financing is prepaid during the call protection period using other syndicated term loans where the primary purpose is to lower the funding costs for the borrower. This suggests that the call protection is designed more as a form of "anti-embarrassment" for the original lenders than as a way to compensate them for lost future returns on the original debt.

CONCLUSION

What is certain is that mandatory prepayment rights across European leveraged loan documentation signed in recent years will bear little uniformity. The various trends noted above do not come as a package – each departure from traditional LMA provisions can be selectively applied and the multiple permutations mean that no single prediction can be made as to what lies in an existing credit agreement. Secondary market investors should review the underlying mandatory prepayment terms carefully should any of the innovations above be of concern.

The anticipated tightening of credit markets as central bank rates rise and as quantitative easing is tapered may lead to covenant momentum swinging back in favour of lenders. Early evidence of this is being seen across both the loan and high-yield bond markets. H1 2018 saw certain reported leveraged loans with changes made during syndication to tighten mandatory prepayment provisions, for example, tightening of Excess Cashflow exclusions and reduction of leverage levels for listing proceeds. It remains to be seen whether these were one-offs or the start of covenant momentum swinging back in favour of lenders. ■

Further Reading:

- The evolution of "soft cap" covenant baskets in the European loan market (2016) 5 JIBFL 285.
- "Make whole" provisions under New York and English law (2015) 2 JIBFL 93.
- LexisPSL: Banking & Finance: Acquisition finance – mandatory prepayment clauses.