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Latest In Leveraged Finance – Springing Covenants

Evolution of the springing covenant

At least half of all European leveraged loan deals in 2017 were reported to be on covenant-lite terms, meaning that they do not benefit from maintenance financial covenants.

This is only true for the term loans, however. When covenant-lite made its reappearance after the leveraged finance markets were virtually shut down during the credit crunch, the banks acting as arrangers for the new deals (who are expected to retain an exposure to the RCF facilities) were no longer comfortable holding loans without any form of financial covenant protection. So, they insisted that, while term lenders could do away with it, the RCF lenders had to benefit from at least one maintenance financial covenant (usually in the form of a net leverage covenant).

As market conditions further improved, this net leverage covenant came to be tested only if the revolving facility is drawn above a certain level on the relevant test date. If, on subsequent test dates, the revolving facility usage has dipped back below the threshold, the covenant will not be tested.

The traditional financial covenant negotiations around leverage ratio headroom, equity cures, financial definitions and add-backs to EBITDA all remain relevant. But the springing covenant has introduced new battlegrounds:

— what should the RCF usage threshold be in order to trigger the application of the covenant?

— what constitutes RCF usage for the purposes of the trigger threshold?

— most recently, how should equity cures work?

Threshold percentage

The satisfaction of the trigger condition will determine whether the covenant is tested on a testing date. The condition is commonly drafted so that if the aggregate outstanding utilisations under the RCF exceed a certain amount, the condition is triggered.

That amount is usually expressed as being the greater of:

— a percentage of the total RCF commitments; and

— a fixed amount (which would be calculated based on the agreed threshold percentage of the total RCF commitments on day 1).

THRESHOLD PERCENTAGE... OF WHAT?

The early days of the springing covenant saw thresholds of between 25% and 30%. This has gradually crept up, such that during 2017, many borrowers had trigger levels set at 35% with some managing 40% and outliers up to 50%. The negotiation of this level will depend to some extent on the size of the RCF in relation to the rest of the facilities. If the RCF is large, even a small percentage of it will translate to a fairly large number. That may make the RCF lenders more nervous, given they could be owed such a significant principal amount without the protection of a financial covenant. Conversely, if the borrower expects to need to use a large portion of its RCF to cover working capital swings (as opposed to, say, as dry powder for future acquisitions), it may be wary of setting a threshold at a level where triggering the covenant will be virtually inescapable.

By formulating the trigger threshold as the greater of a fixed amount and a percentage of the total RCF commitments, the borrower is protected in the situation where the total RCF commitments are either reduced (through cancellation) or increased (through an accordion) in the future. Another way to express the threshold is to apply the percentage to the higher of the total commitments on the signing date and on the determination date.

WHAT COUNTS AS THE RCF OUTSTANDING AMOUNT?

Initially, this was referred to simply as all amounts outstanding under the RCF. Over the past few years borrowers have shrunk the usage number by carving-out certain types of utilisation.

This started with excluding utilisations by way of letters of credit. The justification being that a letter of credit isn't 'real' debt, it is only contingent debt. A letter of credit is an unconditional promise by the issuing bank to pay a certain amount on demand. In most cases no demand is ever made, and the issuing bank never pays out a penny. If a demand is made, the issuing bank pays the relevant amount to the beneficiary, and usually that amount is then deemed to be a loan under the facility agreement. At that point the liability would have been converted from a contingent exposure for the lenders into a real exposure.

Again, negotiation on this will be affected by the size of possible letter of credit usage – often sub-limits are agreed so that only a certain portion of the RCF can be utilised by way of letters of credit. If those are set at a high level (or are missing altogether), borrowers may find it harder to exclude all LC usage from the calculation of the threshold test.

Other popular carve-outs include:

- amounts of the RCF utilised by way of ancillary facilities, or at least ancillary facilities which are not by way of cash (e.g. overdrafts might be included but bank guarantees excluded); and
- RCF drawings made to fund market flex in syndicated deals, on the basis that these drawings aren't at the borrower's option.

EQUITY CURE

If, despite the borrower's efforts to include as many of the above bells and whistles as it can, the testing condition is triggered and the covenant is breached, the sponsor may yet be able to cure the breach.

Traditionally, the loan agreement would require any equity cure to be sized so that if the proceeds either increased EBITDA or reduced debt for the testing period, the financial covenant would be in compliance. However in recent deals, the equity cure provision allows cure proceeds to be applied to prepay the RCF, so that the usage part of the trigger condition goes down below the threshold. If, following such a prepayment, the trigger condition is no longer met, the breach of the financial covenant will be deemed to have been cured.

WHO BENEFITS AND WHO CAN AMEND IT?

In almost all cases, the right to take any of the acceleration steps as a result of an event of default triggered by a breach of the springing financial covenant shall be for the majority of the RCF lenders only. The term lenders' right to call a cross default is postponed until the majority RCF lenders have exercised any of their remedies as a result (or, more recently, only if they have accelerated).

A further technical but important point is that the amendments and waivers clause should make clear that the financial covenant and the related provisions may only be amended and waived with the majority RCF lenders' consent. This may require a bifurcation of certain provisions, as some of the underlying definitions are used both for financial covenant testing (which is relevant only for the RCF lenders) as well as for incurrence covenants testing and mandatory prepayment events (which is relevant for the term loan lenders as well.)

What does this mean for lenders' rights?

Much has been written about how the rise of covenant lite terms in Europe is a dangerous development for lenders' rights, and could be problematic for future restructurings. As we have written in the past (see *The Resurgence of Covenant Lite*, and *What it Means for the Restructuring Market June 2015*), it is unlikely that the borrower of a covenant lite loan would enter a period of distress without drawing its RCF. Yes, the RCF lenders can waive any covenant breach on their own, but history has shown that RCF providers do not have unlimited patience, and in some cases have used a breach of the springing covenant as a leverage point to sell the RCF to the term loan lenders (who usually have more skin in the game).

That said, it is certainly possible that the financial covenants may not be the trigger for future restructuring discussions as they have been for covenanted deals. In those situations, lenders will need to rely on borrowers to commence discussions sufficiently far in advance of an impending liquidity crisis so that there is enough time to work through any re-setting of the capital structure that may be required.

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DEAL CHECK LIST

1. Threshold trigger:
   - Set between 25% and 50% of cash drawings? ☐
   - Protection in case of upsizing or downsizing of RCF:
     - trigger threshold also refers to a set number; or ☐
     - the percentage is applied to the higher of the commitments at the signing date and the determination date. ☐
   - Exclude from the RCF outstanding amount:
     - LCs (funded, unfunded, or cash collateralised?); ☐
     - ancillary facilities (cash and non-cash distinction?); and ☐
     - drawings to pay OID or market-flex transfers to affiliates or related funds. ☐
2. Breach of financial covenant can be cured by prepaying the RCF below the trigger threshold after the test date? ☐
3. Event of default:
   - only at the majority RCF lenders' option; ☐
   - majority RCF lenders may waive or rescind; and ☐
   - term loan lenders can only call a cross default if the RCF lenders have accelerated? ☐
4. Amendments and waivers to financial covenant clause and any other relevant provisions with majority RCF lenders' consent. ☐

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