KEY POINTS

- As leveraged buyout (LBO) deal sizes grow, the debt capital structures backing them often expand beyond the capacity of the Term Loan B (TLB) market.
- For certain borrowers, a significant part of the acquisition financing package may be more optimally distributed through a debt capital markets product – usually a high yield bond.
- But despite deep liquidity and shortened execution timelines, the need for certainty of funds in most LBO processes requires the borrower to have an underwritten loan commitment with no market "outs". The high yield bridge loan serves this need.
- High yield bridge loans involve an additional set of risks for both the underwriters and the borrower, and the documentation has developed into a relatively standardised pattern. This article examines the key features and latest market trends.

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Bridging the gap: high yield bridge loans in leveraged buyouts

In this article the authors examine the key features of high yield bridge loan documentation and latest trends in the leveraged buyout market.

BASIC ELEMENTS OF A HIGH YIELD BRIDGE LOAN

High yield bridge loans are committed in the same way as a Term Loan B (TLB): via a commitment letter and a long-form term sheet. But the terms differ in certain key respects, ultimately because neither the borrower nor the underwriters want to actually fund the bridge loan. In an ideal world, the high yield bond take-out issuance will be completed in the period between the signing and closing of the acquisition. If that has not been possible (and the bridge loan is actually funded), all parties will want to issue the high yield bond take-out as soon as possible. The terms of a high yield bridge loan are designed to incentivise the borrower to do just that.

Interest rate step-ups

A drawn bridge loan will get more expensive the longer it is outstanding. Typically, the margin is fixed for the first three months, then increases quarterly thereafter (often by 50 basis points each time) up to an aggregate cap.

High yield bond engagement letter

As a condition precedent to the funding of the bridge loan, the borrower will be obliged to formally appoint the underwriters of the bridge loan (or their affiliates) as the underwriters and bookrunners of the high yield bond issuance. The engagement letter obliges the borrower to pay them a fee for that service, and also gives the underwriters the right, in certain circumstances, to force the borrower to issue the high yield bond.

Fee rebates

As described in more detail below, certain fees paid by the borrower to the underwriters of the bridge loan should be credited against fees due to those same underwriters in connection with the eventual high yield issuance. However, the amount of credit given declines the longer it takes to issue the high yield bond.

Maturity

Most bridge loans have an initial maturity of one year, which will automatically[1] be extended to the maturity date that is contemplated for the high yield bond take-out. From this date (usually known as the "Conversion Date"), interest will accrue at the interest rate cap. Additionally, lenders will have the right to exchange their participation in the termed-out loans for "exchange notes", akin to private high yield securities with call protection and no transfer restrictions. Typically, the lenders are able to exchange their loans for exchange notes on a monthly basis, but the borrower will only be obliged to comply if it receives requests for a certain minimum principal amount of exchange notes (eg 20% of the total principal outstanding).

KEY POINTS FOR THE BORROWER

Get help from the target

If the borrower is going to launch (and ideally close) a high yield bond issuance before closing, it is going to need help from the target's management and accountants in order to conduct a due diligence process and prepare an offering memorandum. So, it is critical that the borrower includes in its mark-up of the share purchase agreement, an obligation from the vendor that it will (and will procure that the target company shall) provide the necessary assistance. This can often be quite a detailed provision. Its comprehensiveness will need to be balanced against the overriding drive to make the bid look attractive to the vendor.

Securities demand

Typically contained in the fee letter, this is a provision that allows the bridge loan underwriters to force the borrower to issue a high yield bond in certain circumstances. It is designed to allow the underwriters to force a refinancing of their illiquid bridge loans even if the borrower would prefer to wait for better market conditions. The borrower must ensure that it can only be forced into an issuance on certain terms, most importantly:

- A demand can only be made by a majority of the bridge underwriters, and on no more than two to three separate occasions. It is also customary to specify a *de minimis* principal amount (by way of a €/$ number and/or a specified percentage of the outstanding bridge loans).
- Usually no securities demand can be made until a period after closing has elapsed, ranging from 30 to 60 days, but it can be longer.
- The bond should only be issued after a reasonable marketing period (including a "roadshow").
- Certain key terms of the issuance should be spelled out clearly, including the currency, maximum interest rate (including a limit on any issuance discount), minimum maturity and non-call periods (plus exceptions).
- The regulatory framework for any issuance should also be explicitly set out. Typically

Feature

Biog box
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this would specify Reg S/Rule 144A without registration under the US Securities Act of 1933, and with no obligation to list the bonds other than on a reasonable efforts basis in relation to specified stock exchanges.

If the borrower fails to comply with a demand to issue, it is usually referred to as a "Demand Failure Event" and has a number of consequences. The Conversion Date will be deemed to have occurred, the rollover fee will be payable (see below), and the borrower's consent right to any lender transfers of the bridge loans will be diluted.

Fees

The fees payable in relation to a high yield bridge loan typically break down as follows:

- **Up-front fees**: For a typical term loan there is often a single arrangement/underwriting fee. For a high yield bridge loan, up-front fees are split into two components:
  - **Commitment fee**: Payable whether or not bridge loans are funded (but only payable if the deal closes), this will be a percentage of the total commitments as of the commitment letter date;
  - **Funding fee**: Payable only if the bridge loans are funded, this will be a percentage of the total commitments which are actually borrowed on the closing date.

If the underwriters are providing an interim facility in addition to the commitment for the bridge loan, there would also be a 100% rebate mechanism.

In addition, the Funding Fee is usually subject to a time-based rebate mechanism. If the bridge loans are funded (and the Funding Fee is paid), and the high yield bond take-out is completed shortly after, the borrower should expect to be able to credit all or part of the Funding Fee against the fees payable to the underwriters of the high yield bond. Otherwise, the borrower will be paying two fees for essentially the same financing. Typically, that credit mechanism tapers off the longer it takes for the high yield bond to be issued, for example see Table 1.

The time periods and tapering are all subject to negotiation. Note that no rebate mechanism usually applies to the Commitment Fee (which is paid to compensate the bank for going "on-risk" in relation to the bridge loan, not for funding it).

TABLE 1: CREDIT MECHANISM

TIME PERIOD AFTER CLOSING DATE	PERCENTAGE OF FUNDING FEE TO BE CREDITED
0-30 days	100%
31-90 days	75%
91-180 days	50%
181-270 days	25%
271 days or later	0%

- **Rollover or Conversion Fee:** This is payable if the bridge loan maturity is extended on the Conversion Date. This would be subject to a similar credit/rebate mechanism as the Funding Fee if the high yield bond is issued within a certain period after the Conversion Date.
- **Alternative Transaction Fee**: Sometimes called a "tail fee", this would be payable if the borrower terminates the high yield bond engagement letter and consummates the acquisition transaction within a defined period thereafter (often 12 months) with a similar financing provided by other underwriters. In that situation, the original underwriters would receive a fee which would be a percentage of the fees they would have earned had the transaction been funded with a high yield bond issuance underwritten by them. The borrower will want to ensure that:
  - the fee is only payable if the alternative transaction is a financing that is similar to the anticipated high yield bond. Often this is defined relatively broadly (for example: "any senior secured financing other than the high yield bond offering that ranks pari passu with the TLB");
  - no fee is payable if the engagement letter has been terminated due to a default by the underwriter, or the underwriter has declined to participate in an issuance;
  - no fee is payable if the underwriter is offered the chance to participate in the alternative financing (with at least the same percentage of the economics and the same or better roles/titles) and declines; and
  - no fee is payable if the rollover/conversion fee is paid.
- **Control of lender transfers:** The ability to control lender transfers has become increasingly important, particularly for financial sponsors. For a TLB, we would expect to see a requirement for borrower consent to transfers in most cases. For a high yield bridge loan however, the borrower's consent right for transfers typically falls away on a sliding scale:
  - **Before the Conversion Date:** Same controls as TLB,[2] plus often an additional requirement that the original underwriters must remain the "Majority Lenders".
  - **After the Conversion Date:** Whilst not exchanged for Exchange Notes, the lenders are free to transfer except to competitors of the borrower or vulture funds. Consent rights are disapplied if a non-payment or insolvency EoD is outstanding. Once loans are exchanged for Exchange Notes, there are no constraints on transfers.

CONCLUSION

Despite relatively high levels of standardisation in the documentation of high yield bridge facilities, market terms continue to develop, a dynamic we expect to continue to see in response to wider changes in the LBO market. ■

1 Provided the borrower is not in payment default or insolvent.

2 Usually, borrower consent is required unless the transfer is to another lender, someone on the white list, or is made when a non-payment or insolvency EoD is outstanding.

Further Reading:

- Investment and corporate banking: prohibition of restrictive contractual clauses (2017) 9 JIBFL 582.
- Bridge to high yield bond: mind the gap (2017) 4 JIBFL 225.
- LexisPSL: Banking & Finance: Practice note: Bridge to bond facilities.