CLEARY GOTTLIEB

Latest in European Leveraged Finance – Market Flex

Introduction

Over the last ten years we've seen the European leveraged finance market grow into a deep pool of liquidity, whose demand for new deals sparked a cycle of pricing erosion and (more recently) terms erosion. A long-term change in the profile of the market participants, with increasingly sophisticated private equity sponsors on one side and a non-bank investor base used to dealing with the covenant lite loan product on the other, accelerated the transformation of the European debt landscape.

We saw over the course of 2018 that securing certain sponsor-friendly terms depended as much on the supply/demand dynamics at the time of syndication as on the credit quality of the underlying business or the strength of the financial sponsor backing the deal. That meant a renewed focus on the market flex provision, as misjudging demand could lead to a difficult syndication.

In this market wrap we look at how the market flex provision has developed, and how its use has evolved in the European market.

1. Purpose of the flex

In most leveraged buyouts there will be a period between the signing of the commitment letter (when the banks go 'on risk' for the funding) and the syndication of the deal to the broader market. In some cases that period can be quite lengthy. During this period, the lenders are exposed to the risk that the secondary market for syndicated loans deteriorates, to the point that the terms they have underwritten in the term sheet are no longer commercially acceptable to broader market participants.

In some markets, this risk is dealt with by way of making the underwriting commitment subject to a 'market MAC' condition. That is essentially a way for the underwriters to avoid funding on terms that have become off-market. But this vague and subjective level of conditionality in financing papers is clearly not acceptable where the funding is being used for a leveraged acquisition.

So it is to the market flex provision that underwriters must look if they want protection from adverse movements in the secondary debt markets. It allows the underwriters to sweeten the terms of the deal in order to make it more attractive in syndication. Historically, the exercise of a flex right was viewed as being extremely damaging to a relationship with a sponsor, and was only used in an attempt to avoid a 'hung deal'. However, in recent times, sponsors and underwriters have begun to use the flex right more frequently as a way of testing market appetite. According to Debtwire, 80-90% of deals saw changes in syndication in 2018, with an average of six changes per deal.

That being said, the right to alter key commercial terms is still subject to fairly tight constraints, which can be split into two broad categories:

a. The threshold for flexing

Every market flex provision is different, but here are some of the conditions we often see imposed on underwriters before they are entitled to exercise their market flex rights:

— ***Prior consultation with the borrower:*** This would usually happen as a matter of course for relationship reasons, and typically the provisions do not legislate in detail for the length of consultation required.

— ***Underwriters must flex as a group:*** If there is more than one underwriter, the flex right must be exercised by a majority of them (calculated by reference to their commitments). In cases where a single underwriter accounts for more than 50% of the commitments, it may be a requirement that more than one underwriter exercises the right, or if there are just two underwriters both must be in agreement.

— ***Time limit:*** Flex rights must be exercised within a pre-agreed syndication period. Typically, the parties will agree in advance how long this would be, and it would vary depending on the size of the deal and the complexity of the structure. The syndication period would normally end once 'successful syndication' is achieved (as to which, see below).

— ***Flex must be necessary:*** This is the most difficult to legislate for. The underwriters must determine that the exercise of the flex right is required in order to sell the deal down to their target hold levels. Typically, that test is formulated in a subjective way: the underwriters need to determine that exercising the flex right is 'necessary' or 'advisable' in order to achieve a successful syndication (or that no successful syndication is possible, even with the flex).

In many cases, the flex provisions do not require the underwriters to produce any objective proof of the need to flex. Historically, the negative effect flexing a deal has on a relationship with a sponsor client creates enough of a disincentive for the underwriters. Some flex provisions require the underwriters to act 'in good faith' and/or 'reasonably', but often the provision goes no further. Recently we have seen more detailed requirements in the flex provisions, setting out what the underwriter must show to the sponsor before exercising a flex right. These include:

- A summary of the responses from a reasonable number of market participants.
- A written certification from the underwriters themselves explaining their grounds for making a determination that exercising the flex right is necessary. Sometimes this requirement goes further, and requires the underwriters to certify that they reasonably believe they will be able to sell the deal to specific syndicate members if they make specific changes.
- Proof that syndication has in fact been conducted in accordance with a pre-agreed syndication strategy (if there is one).
- A general right for the borrower to request information from the underwriters relevant to the syndication process.

Successful syndication is almost always defined by reference to a specific hold level for each of the underwriters. Sometimes that is zero (where the underwriters do not wish to retain any of the risk).

— ***Underwriters have offered to pay away fees:*** Typically, underwriters are now required to pay or offer to pay to new syndicate lenders a portion of the arrangement fee and original issue discount or upfront fee that the underwriters would otherwise receive before they are entitled to invoke the flex right.

b. The limits on which provisions can be altered (and by how much)

— ***Pricing flex:*** Market flex provisions will give the underwriters the ability to increase the margin and/or fees payable in relation to the facility in order to enhance the attractiveness of the deal. That ability will be capped, either individually (i.e. the margin may not be increased by more than [x]% per annum), or in aggregate (i.e. the aggregate increase in margin and fees may not increase the weighted average cost of funding by more than [x]% per annum assuming the increased fees amortise over a 3 or 4-year period). The size of the cap varies from deal to deal, and we have seen caps increase as the markets become more volatile. Usually, they are in the range of 1 to 1.5%.

From a borrower's perspective it is important that the flex provisions require the underwriters to alter the financial covenant levels in the loan agreement if the pricing flex is used. This is to ensure that the same level of headroom over the financial model is maintained despite the increased funding costs.

Typically, the pricing flex provisions will also specify that the overall size of the facility will not be reduced as a result of the increase in fees, so the increased amount of the fees will be funded from an upsize in one or more of the facilities being provided, with no fees being paid on the upsize. Absent such a provision, the total amount of cash available to the borrower would reduce, which would adversely alter the debt/equity ratio the sponsor has agreed to.

— ***Documentary flex:*** Most flex provisions will also allow the underwriters to alter certain terms in the covenant package of the facility agreement. Over the last 2-3 years, we have seen an increase in both the number of provisions that are subject to flex, and the usage of that flex right. This is in part a result of the evolution of European leveraged loan documentation to a covenant lite product, with underwriters unsure of how far the secondary market participants are prepared to go. It is also in part a result of the changing way in which flex is viewed, and a willingness on the part of both sponsors and underwriters to use it as a way to test the market.

The following is a list of terms we see included in documentary flex provisions fairly frequently:

- The size of the incremental facilities basket.
- The 'most favored nation' rate, sunset period and exclusions.
- Call protection (both the time period and amount).
- Margin ratchet step down levels.
- Specific basket sizes in the covenants.
- The ability to add a cap on synergies addbacks for the financial covenant calculation.
- Prepayment provisions.
- Transfer restrictions.

2. Reverse flex

It is also possible that the syndication market is stronger than the underwriters expected when they committed to the deal, so most market flex provisions contain a provision requiring them to use reasonable endeavours to improve the deal for the borrower if it is oversubscribed. Typically, this is only required if the lead arranger believes (reasonably and/or in good faith) that it can still achieve successful syndication even if the terms are altered. Reverse flex provisions do not typically specify which terms may or may not be changed, on the basis that any improvement would be welcomed by the borrower. Typically, though, they relate to pricing.

In some cases, a success fee is used as an incentive for the underwriters to push for a reverse flex. That can be set up in a number of ways, but is often a percentage of the interest or fee expense saved in the first year of the deal.

3. Conclusion

The evolution of market flex provisions, and the increased usage of those rights to tweak documentary terms, is a reflection of the new dynamic in European leveraged loans. Participants recognize that terms are evolving, and that (within limits) the risk of pushing them further than the market can bear should be shared. However, with the exception of the last quarter of 2018, the syndication markets have been relatively stable and benign. As markets become more volatile in the end-of-cycle period, we may well start to see the outer limits of the flex rights being tested in more pressurised and less comfortable circumstances.

DEAL CONSIDERATIONS

1. What are the conditions for exercise of the flex right? ☐
   - Prior consultation? ☐
   - Majority underwriter consent needed? ☐
   - Time limit for exercising? ☐
   - Flexing is necessary or advisable to ensure successful syndication? Will objective proof of this be required? Must the underwriters act reasonably and/or in good faith? ☐
2. What is the successful syndication level? ☐
3. Underwriters must have paid away or offered to pay away a portion of the arrangement fee and/or OID? ☐
   - What provisions can be changed? ☐
   - Margin? If so, what is the cap? ☐
   - Fees? If so, what is the cap? ☐
   - Other pricing provisions? If so, what is the cap? ☐
   - Documentary terms – what may be changed and within what parameters? ☐
4. Is there a reverse flex? Will there be a success fee if the deal is reverse flexed? ☐

OUR TEAM

David Billington
Partner
London
+44 20 7614 2263
dbillington@cgsh.com

Carlo de Vito Piscicelli
Partner
Milan and London
+39 02 7260 8248 /
+44 20 7614 2257
cpiscicelli@cgsh.com

Ian Chin
Associate
London
+44 20 7614 2280
ichin@cgsh.com

Andrew Shutter
Partner
London
+44 20 7614 2273
ashutter@cgsh.com

Valérie Lemaitre
Partner
Paris
+33 1 40 74 68 00
vlemaitre@cgsh.com

Philip Herbst
Associate
London
+44 20 7614 2256
pherbst@cgsh.com

Pierre-Marie Boury
Partner
London
+44 20 7614 2380
pboury@cgsh.com

Aseet Dalvi
Counsel
London
+44 20 7614 2218
adalvi@cgsh.com

Adam Machray
Associate
London
+44 20 7614 2282
amachray@cgsh.com

clearygottlieb.com

Founded in 1946 by lawyers committed to legal excellence, internationalism, and diversity, Cleary Gottlieb Steen & Hamilton LLP is a leading international law firm with approximately 1,200 lawyers around the world. The firm has 16 closely integrated offices in New York, Washington, D.C., Paris, Brussels, London, Moscow, Frankfurt, Cologne, Rome, Milan, Hong Kong, Beijing, Buenos Aires, São Paulo, Abu Dhabi, and Seoul.

Under the rules of certain jurisdictions, this may constitute Attorney Advertising. Prior results do not guarantee a similar outcome.

Throughout this brochure, “Cleary Gottlieb” and the “firm” refer to Cleary Gottlieb Steen & Hamilton LLP and its affiliated entities in certain jurisdictions, and the term “offices” includes offices of those affiliated entities.

© 2019 Cleary Gottlieb Steen & Hamilton LLP

19.0109.030_011619