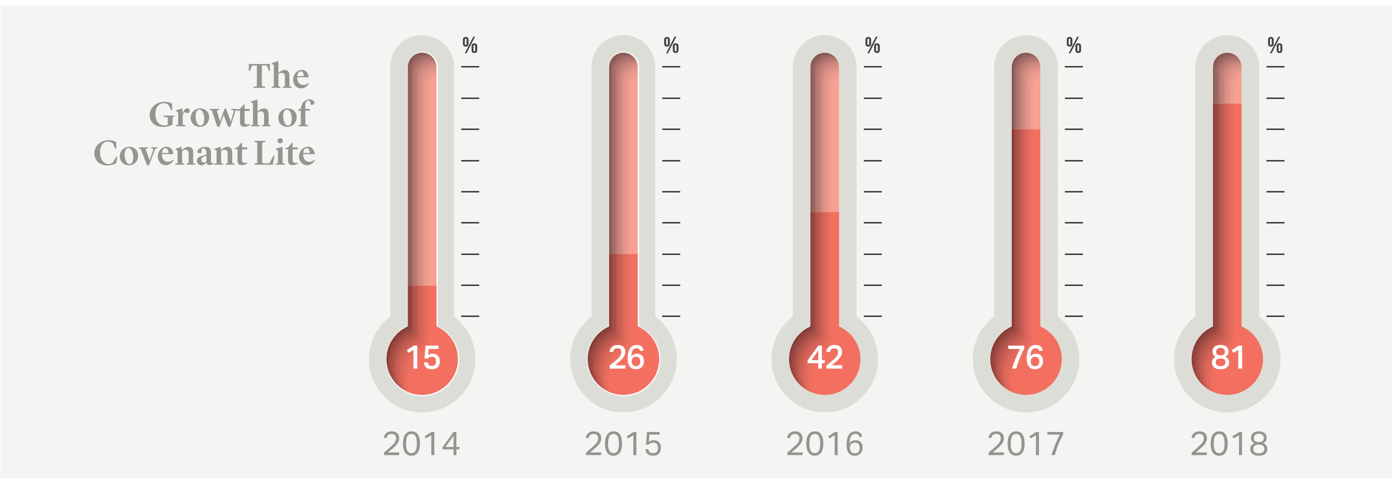
CLEARY GOTTLIEB

Has the European Leveraged Loan market reached boiling point?

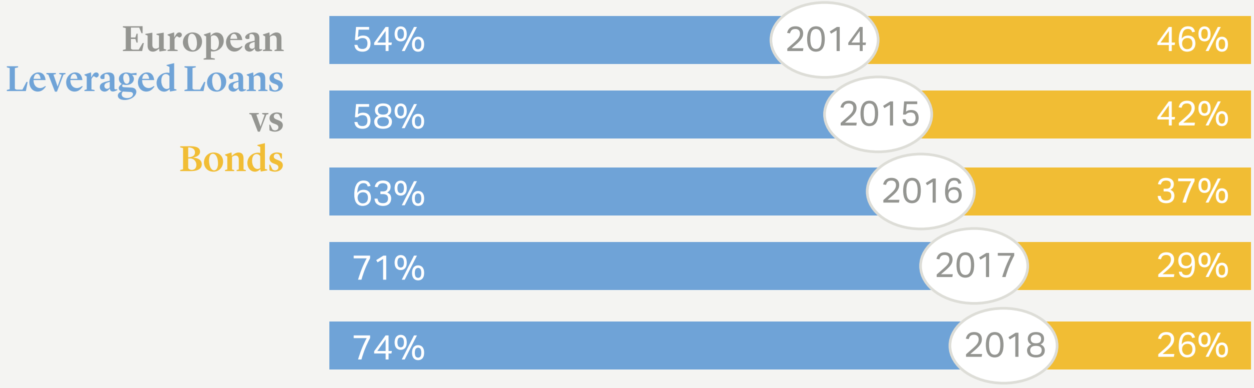
The impact of covenant lite loans on the next default cycle

With the current heat in the European leveraged loans market, we have witnessed a gradual erosion of covenant standards in recent years. The overall trend has been away from traditional LMA-style loan terms towards covenant-lite documentation, with little consistency in the documents.

Many commentators have highlighted the risks associated with this trend in the next default cycle, and questions have been raised as to how covenant-lite structures will perform under stress. However, there are a number of reasons to believe that the abundance of covenant-lite loans in the market will present opportunities as well as risks in any future downturn. There are a number of reasons for confidence in the performance of cov-lite loans.



While loan volumes have grown, high yield issuance has shrunk. Debtwire figures suggest that as much as three-quarters of European issuance is now in the form of leveraged loans, and that more than 80% of recently written paper is cov-lite. It is clear that high-yield bondholders will be less relevant when Europe moves into the next default cycle and instead these cov-lite lenders will be the key players.



THE CONSTITUENCY OF LENDERS IS DIFFERENT

The first point to highlight is that the lenders in cov-lite deals will almost certainly be different to the lenders who were present in the last default cycle in Europe, when it was the banks that held the majority of paper. That situation created a systemic problem when businesses defaulted on their loans. With bank creditors unenthusiastic about crystallising losses on their already stretched balance sheets, many businesses that badly needed a restructuring became zombies as their creditors extended maturities and waived defaults.

This time around, the lenders in these structures are far more likely to be non-bank investors of various shades, and so it is difficult to predict how that constituency might behave in a restructuring. They may be more proactive participants in the process, willing to engage in debt-for-equity swaps and enter into partnership with the owners of struggling businesses. Or they may have their own problems to deal with: many non-bank lenders rely on portfolio financing, which is usually structured as a borrowing base facility. Once an underlying investment goes into default it will very often cease to be eligible for the borrowing base, and that can trigger a range of consequences. The ultimate decision-maker in a restructuring in the next cycle could end up being the provider of the portfolio financing to the non-bank lender.

THE DEBT IS LESS LIQUID

Another consideration is the fact that the debt is going to be much less liquid as we move into the next default cycle than it has been in the past. One of the key terms to have been eroded over the last three years has been the lenders' right to transfer their participations in large leveraged loans, and it is no longer the case that a lender can sell the loan to anyone they wish if the loan is in default.

Following the financial crisis, borrowers focused on transferability as their bank lenders came under pressure to dispose of non-core assets at the same time as the range of potential buyers of leveraged debt expanded with the proliferation of non-bank investors. The deep liquidity in the secondary market has enabled borrowers to impose stringent restrictions on acceptable transferees, with most clauses now requiring borrower consent to transfers in all but a handful of cases.

The general principle of free transferability in the event of default has now gone, with most deals containing a provision that the requirement for borrower consent will only be disapplied if there is a payment or insolvency event of default. If a proposed lender does not appear on the white list of pre-agreed entities, the borrower will be able to refuse consent to a transfer, although in most cases they cannot do so unreasonably.

Many deals also contain an absolute prohibition on transfers to generically defined 'loan-to-own investors' or 'vulture funds'. That prohibition in many cases is only relaxed after a serious event of default, or in some cases acceleration of the loan. Of course, in a distress situation, the most likely (and possibly only) buyers of the debt would be distressed investors who may well fall within the definition of vulture funds.

What does this mean for a restructuring? The borrower will have a much greater degree of control over whom it will negotiate with. Creditors looking to exit the deal rather than devote time to a restructuring discussion will find it much harder if nobody on the white list wants to buy. Having said that, and despite the extensive restrictions on transfers, we think that most borrowers and sponsors will prefer to negotiate a restructuring with lenders who bought into the deal at a discount. It is easier to convince someone who bought the debt at 50 cents on the dollar that a restructuring which gives them 75 cents on the dollar is a good deal. Lenders who bought at par will find it harder to swallow.

So our expectation is that borrowers will be happy to allow transfers to the 'vulture funds', but only once a restructuring deal has already been agreed with those funds or if they at least believe they are going to be constructive partners in the process, and potentially long term co-owners of the business. If the borrower has a liquidity need, a potential lender bringing new money will no doubt be viewed more favourably.

NO EARLY WARNING SYSTEM?

With no maintenance financial covenants in the loan documents, another concern is that the lenders will have a very short window to restructure a troubled borrower. Historically, the breach or a prospective breach of a maintenance financial covenant has been the trigger point for a discussion between the lenders and the borrower about whether a restructuring is needed. Since covenant levels are usually set with a fairly significant cushion to the financial model, a breach should indicate under-performance well in advance of a liquidity problem. If those covenants are absent however, the concern is that such a discussion will only happen when the borrower is on the brink of bankruptcy, when it may be too late to agree a re-set of the capital structure.

In fact, most covenant lite deals will contain a maintenance financial covenant, which becomes effective in the event that the borrower draws down on its revolving credit facility above a certain point. The level at which the covenant is triggered has been growing, and is now typically set at 40%. But if the business has a liquidity need and can't avoid using its revolving facility, it is likely that it will be subject to a financial covenant unless they can use the permitted debt baskets.

Even if the covenant is triggered, typically it will only benefit the providers of the revolving facility, who may be unwilling to take enforcement action. However, there have been seen situations where the providers of revolving facilities use their right to enforce following a covenant breach to invite the TLB lenders to buy them out at par in order to take control of the situation.

HOW TO KEEP THE EARLY WARNING SYSTEM SWITCHED OFF

A covenant-lite deal should allow a borrower much more scope to seek other sources of liquidity and keep the financial covenant from being triggered.

Most deals should have an incremental facility provision, allowing additional debt to be incurred on a pari passu basis with the existing senior term debt. Whilst the amount of additional debt allowed would be constrained by reference to a financial metric, most of those provisions allow for a 'freebie' basket which can be incurred no matter what the financial condition of the borrower. That basket can be up to an additional 'turn' of EBITDA. The borrower would need to find lenders willing to provide the money, but should have flexibility to offer good terms if the 'most-favoured-nation' protection has fallen away, which would usually be the case after 12 months. In the most aggressive credit agreements, a portion of the new debt could have a maturity that is earlier than that of the outstanding debt, enabling the borrower to grant effective seniority to the provider of rescue financing. Usually the incremental facility can be provided under the existing credit agreement, or under an entirely separate document. A separate document would enable the provider of the new debt to benefit from enforcement triggers that are in its sole control.

The debt covenant itself should also provide for some flexibility to incur additional debt without having to comply with a financial ratio or seek consent from the term lenders. There will be a general basket, which should allow additional debt up to the greater of a fixed dollar or euro amount and a specified percentage of the most recent LTM EBITDA. Further, there may be scope to re-classify debt previously incurred under one basket so that it falls into another, freeing up headroom.

There may also be large baskets for specific types of financing (such as trade financing or factoring). If the intercreditor agreement does not give the senior creditors power to deal with those in a default, there could be an opportunity for certain creditors to hold out and disrupt a potential restructuring.

There is very little uniformity in the documentation of recent European leveraged loans, and each deal will have its own quirks.

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