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ALERT MEMORANDUM

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Here We Go Again - Convergence in the Leveraged Finance Markets, and What it Means for Future Restructurings

1. Introduction

- The buzzword that has dominated commentary on the European leveraged finance markets over the last two years is 'convergence'. While the fact that the terms of European leveraged debt are converging on a U.S.-style, covenant lite model (where terms of bonds and loans are increasingly similar) has made leveraged debt more attractive to issuers, it has been characterised by some as a negative recent development for the market as a whole.

- But convergence is not a new development – it is a trend that started over a decade ago. In a 2005 article RBS's then head of European High Yield said[1]:

> "*Booming liquidity and increasing investor 'convergence'…have created a more integrated marketplace offering borrowers a broader range of products.*"
>
> "*A multiplicity of funds has converged on Europe's non-investment-grade debt markets, driven by the search for yield in a low interest rate environment.*"

Yet this time around the rise of covenant lite has been greeted by some in the investor community with prophesies of doom. Moody's even published a report in 2013 warning of a 'covenant bubble'[2]. So what is it about recent developments that have spooked the market, and how will a restructuring of covenant lite debt really play out?

2. The 'push' and 'pull' of convergence

As with any large-scale development in the global financial markets, there is no single factor that moves the needle. It is a combination of factors that together 'push' and 'pull' the market towards change.

The Pull Factors

Commentary on the rise of covenant lite in the European loan market has focussed mainly on the increased demand from the buyside. This has been driven by the following key factors:

- ***Low interest rate environment:*** The hunt for yield in a low interest rate environment is of course a big part of the picture. That has contributed to a supply/demand imbalance – low-

[1] From 'Convergence in leveraged finance' by Nicholas Coates for Credit magazine, available at http://db.riskwaters.com/public/showPage.html?page=284465

[2] See 'Signs of a 'Covenant Bubble' – Suggest Future Risks for Investors, May 2013.

yields in safer assets have led institutional investors to look at riskier products they would never have previously considered, including the leveraged loan market. This is part of what we mean when we talk about convergence in the investor base – institutional investors in Europe have started to look at the leveraged loan product and that is creating a 'pull'.

- ***European borrowers tap the U.S. markets:*** In addition, since the effects of the credit crunch began to ease in the United States, European corporates and sponsors have started venturing into the U.S. leveraged loan market to satisfy their financing needs, which U.S. investors have been eager to fill in search for diversification. This has caused European leveraged loans to compete more closely with the U.S. Term Loan B product, which had long featured incurrence style and covenant-lite terms.

- ***European high yield market comes of age:*** In the immediate aftermath of the credit crunch much was made of the 'maturity wall' – the large number of pre-crunch leveraged deals that would need to be refinanced at roughly the same time. With the investment banks and CLOs unable (or unwilling) to refinance many of those deals, and an eager underlying investor base hungry for fixed income products, the European high yield market stepped in, with record issuance years in 2013 and 2014. Now that the banks are returning to the leveraged loan market in greater numbers, the loan product is having to compete with a high yield market that is much deeper and more liquid than ever before, and characterised by incurrence-style covenants.

These three factors have certainly increased demand for fixed income investments. However far from being the only cause, the demand side of the market is only partly responsible for the resurgence in covenant lite in Europe.

The Push Factors

What about the supply side? Despite record issuance in 2014 (€97bn in high yield and €116bn in leveraged loans issued according to Debtwire Analytics), the market still thirsts for more. Why aren't more issuers hitting the market? If they did, eventually the 'covenant bubble' would correct itself because there would be more deals to choose from and lenders would have a stronger negotiating position to push back on some of the borrower-friendly terms they find objectionable.

There are a number of reasons for this:

- ***Issuance windows:*** In the high yield space, the dynamics are driven by the fact that it is a public market, and therefore circumstances in the macro-economic and geo-political situation can disrupt the flow. The low oil price, tensions with Russia, the endless 'will they, won't they' speculation about Greece, and the most uncertain election in recent British history all conspired to make for a bumpy ride in 2015 after a record 2014. And even though yields remain low, spreads have trended up since the start of the 2nd half of 2014, leaving some issuers on the sidelines.

  This means that the high yield market still relies on 'issuance windows' opening, and once those windows do open there is a rush to price deals. In addition, there is a technical

blackout period when the financial statements of prospective issuers go 'stale' under SEC rules, preventing a bond from being launched. These factors ensure that the high yield market is periodically starved of supply, which serves to stoke demand further when issuance windows do open.

- ***Muted LBO activity:*** In the loan market, whilst there has been a fair amount of refinancing activity as sponsors seek to lock in low rates, LBO activity (particularly large deals) has been relatively constrained. This is driven by a number of factors:

  - A low-interest rate environment inevitably drives asset prices up. Most sponsors have no wish to over-pay, and many have bad memories of buying businesses at the top of their valuation cycle in 2007. That means that many financial sponsors are more interested in selling than buying, and that in turn explains why, when they do hit the market, they are very focussed on things like portability and minimising call protection.

  - For large assets requiring a significant debt package, there is increasing competition from strategic corporate buyers, who have managed their cost base well during the downturn and hoarded cash. Strategic bidders also benefit from the in-built ability to create value in acquisitions through synergies with their existing businesses, so are less sensitive about buying cheaply.

  - Although the UK economy is recovering strongly, many mainland European economies look challenging for the foreseeable future. Financial sponsors need to be able to build a 5 year business plan they can believe in, and when there is uncertainty about demand that becomes very difficult.

- ***A blockage in the pipes:*** Another key factor has been the reduced activities of European banks in originating leveraged loans. In part this was driven by regulation and capital cost issues, and in part it was driven by the nervousness of the banks having burnt their fingers with hung deals in 2007/2008. The result was that the origination activities of many European banks were sharply curtailed after the crisis. This created a blockage in the supply pipe, since big underwritten syndications by the investment banks were the traditional means of bringing the debt financing for large scale LBOs to the secondary market. The high yield market hasn't suffered from this as much because in a high yield deal the underwriting banks only agree to buy the bonds once they've already gauged investor demand and effectively pre-sold all the risk.

3. How will covenant lite affect future restructurings?

There has been plenty of media coverage of the growth of covenant lite, which has often characterised the trend as a dangerous erosion of lenders' rights, supposedly leading to disastrous consequences when the credit cycle turns again. Whilst this is a generalisation, it is certainly true that nobody really knows what the long-term consequences will be in Europe, and that uncertainty creates fear. But it is worth looking at some of the specific concerns to see if they are well-founded:

Issue 1: The deletion of maintenance financial covenants removes the early warning system that would alert a lender group to problems with the financial performance of the debtor, and force the debtor to sit down with the lenders to work things out.

One way of assessing this risk is to look at how creditors behaved in the last default cycle. It is certainly true that an impending financial covenant breach brought issues to a head, because borrowers were forced to seek waivers. In some cases, that acted as a catalyst for a broader restructuring discussion, where the underlying financial performance issues were deemed to be long-term rather than temporary. But in many cases the covenants were amended, the lenders extracted a fee for consenting, and life went on, with the business either recovering or continuing to deteriorate without any real intervention from the lenders. Far from being desperate to use financial covenant breaches to trigger a restructuring and 'bring the borrower to the table', many lenders were content to extend and pretend in the hope that performance would improve. Some lenders were positively unhappy that a financial covenant had created a situation where they were forced to do a restructuring deal at the bottom of the cycle when the value broke further into the debt than would have been the case had they been able to wait for more benign conditions.

This may be one of the reasons why, during the crisis, covenant lite deals have not historically suffered worse default or loss-given-default rates than comparable covenanted deals.

But in reality this risk of the lenders being forced to sit idle might not even materialise because, unlike in pre credit-crunch deals, most covenant lite deals do in fact contain a financial covenant somewhere in the picture – usually in the form of a leverage covenant that applies to the revolving facility only. The suppliers of revolving facilities are still relatively few in number and consist primarily of commercial banks, and, therefore, so far they have held the line that a maintenance covenant should protect their exposure at least if the revolver is drawn above a certain amount – the so called "springing" financial covenant.

For those deals, it is unlikely that a borrower would enter a period of distress without drawing its revolver above the relevant threshold, thereby triggering the covenant. So the trigger point for restructuring discussions will still be there in many (if not most) covenant lite deals. Yes, the springing covenant can usually be waived or amended with the consent only of a majority of the revolving lenders, and the lenders of a super-priority revolving facility may not have any incentive to accelerate (thereby cross-accelerating the term debt in most cases). But the providers of revolving facilities are not known for having unlimited patience, and will probably be unwilling to offer covenant holidays whilst they have significant drawn exposure under their facility.

That said, there is a risk that distressed borrowers with covenant lite debt facilities will not start restructuring discussions with their lenders until it is too late – when they are facing a payment default. At that point there simply may not be enough value left in the business to fund a lengthy restructuring process (or to make that process worthwhile). Unlike with a Chapter 11 process in the United States, bankruptcy processes in Europe tend to be a one-way street with companies entering them rarely recovering. Put another way, the past 7 years' experience with European restructurings has taught us that, in most cases, if you want to implement a consensual restructuring you need to do it pre-petition. That is not the case when you can rely on Chapter

11. However, unlike in the United States, where senior "stretch" structures have become increasingly popular, most European covenant lite deals feature a high-yield bond component in the capital structure, which should provide some junior debt cushion in the event of a restructuring.

In any event, the market will have to rely on both management and the financial sponsors who stand behind them being sensible in identifying situations where they need to engage with their creditors.

Issue 2: Covenant erosion is giving borrowers too much freedom to leak value out of the structure.

This isn't an issue specific to covenant lite loans. Un-capped baskets for (among other things) restricted payments where the pro forma leverage ratio meets a certain level have been around in covenanted deals for a long time, albeit with the incurrence level set at a very conservative threshold. So far, covenant lite deals in Europe have not settled into a predictable format. Some use full-on high yield style incurrence covenants. But most are based on the Loan Markets Association standard form with the financial covenants removed (except the springing covenant), and a fairly standard set of negative undertakings. The exceptions to those covenants may be looser and follow an incurrence style, but that was a trend seen in LBOs well before the rise of covenant lite.

This is symptomatic of a longer-term shift from a market where the creditors were predominantly banks (staffed by large teams capable of monitoring covenant compliance) to a market dominated by institutional investors who have neither the resources nor the interest in micro-managing the borrower's business through an overly restrictive set of covenants.

Issue 3: The ability to incur "ratio" indebtedness lets the borrower layer the lenders with debt that may be effectively senior to them.

One of the recognized recent trends in European leveraged loan documentation has been to include carve-outs from the debt covenant to permit an obligor to incur a potentially unlimited amount of additional debt subject only to compliance with specified leverage (or, in some cases, interest cover) ratios – a feature that had long been popular in the U.S. loan market.

Critics say that importing these terms into European structures is the final blow to senior lenders, because their unintended result is to permit the creation of a large amount of debt that may be structurally senior to the existing term debt. Because of the weakness of upstream guarantees in many European jurisdictions - the theory goes - if an obligor that has given a guarantee in name only to the lenders becomes the issuer of the ratio debt, the lenders will be structurally subordinated to that new debt.

This may be true but can be easily obviated by requiring the holders of ratio debt, even if unsecured, to become parties to the intercreditor agreement. Provided the ICA contains appropriate release mechanics, which include the release of debt claims as well as guarantees and the allocation of all post enforcement recoveries in accordance with the agreed waterfall, the position of the primary obligor of the additional debt should not matter. And indeed, may

recent intercreditor agreement do contain for that requirement, including those used for U.S. leveraged deals where the borrower had significant European operations.

Issue 4: Incurrence style covenants work in US deals and in bond deals because there is a huge depth of liquidity in the capital markets in the US, meaning investors can sell out easily if the borrower's performance declines.

This issue is admittedly acutely felt in the European loan market, where for years the settlement process has been clunky, and the secondary market has been an opaque private domain. Loans will continue to be bespoke instruments, a factor that has been aggravated by capital structures becoming more heterogeneous since the crisis.

That however is changing, as the converging investor base clamours for more standardized primary documentation, more transparency in the secondary market and more efficient settlement of trades. If loans are ever traded just as easily as listed bonds, however, that will potentially have regulatory repercussions – if it looks like a security and trades like a security, how long will it be before the regulators start treating it as a security?

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