

DOCUMENTING DIFFERENCES



Pressure points

Negotiation between sponsors and lenders when arranging financing for deals is to be expected. Proskauer partners **Faisal Ramzan** and **Alex Griffith** run through some of the principal areas of push and pull in the European mid-market

As credit supply in the European loan market continues to exceed demand, financial sponsors and borrowers are increasingly able to push deal and documentation terms in their favour. Many of these terms in the mid-market have made their way into this space from the large cap market while others have been revived and are similar to those in the credit heyday of 2005-08. Set out below are a few of the key financing trends we have seen in the European mid-market over the past 12 months.

Cov-loose: Fewer maintenance covenants in European mid-market deals are increasingly becoming the norm as part of the trickle down phenomenon in a progressively borrower-friendly credit environment. As a trend, we have seen covenant packages in European mid-market deals with significantly increased headroom

against the sponsor's base case model and with only a leverage covenant or a leverage and cashflow covenant, removing the interest cover and maximum capital expenditure covenants altogether.

Cov-lite: Cov-lite loans are still not widely seen in the European mid-market owing to the increased risk (actual or perceived) they present. Typically, cov-lite loans are still only available for large cap deals as:

- a.) the lenders are likely to also be investors in high-yield bonds and so have familiarity with the concept;
- b.) the liquid market enables lenders to trade out more readily than in the mid-market. However, as noted above, even though cov-lite loans are still not widespread in the European mid-market, the current trend is very much against the inclusion of all four traditional maintenance covenants in the deal covenant package.



Equity cure: Lender protection has also been reduced as a result of the loosening of equity cure terms. There has been a gradual increase in the permitted number of equity cures over the life of the loan with the number of cures creeping up to four or, in some cases, even five.

Until recently, to the extent an equity cure was made, cure amounts were typically required to be applied by the borrower to pay down the outstanding loan. However, an increasing number of borrowers in the mid-market are now able to retain the injected cash on their balance sheets and to use it for any purpose not restricted by the terms of the debt documents.

Further, European mid-market lenders would require that the injected equity amount was used to reduce the outstanding indebtedness for the purposes of recalculating compliance with any breached financial covenants. The trend more recently has seen a move towards the US position where the additional injected equity amount has been deemed to be applied to increase earnings or cashflow. The right to add the injected equity amount to earnings for the purposes of recalculating covenant compliance is better from the borrower perspective given the



Ramzan: flexibility to boost EBITDA has become a focus at the documentation stage

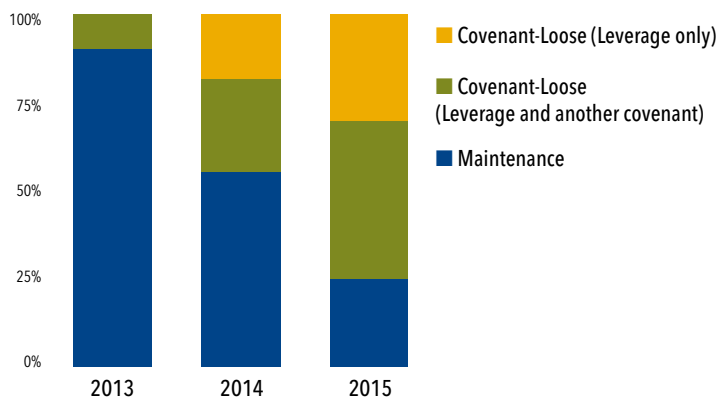
“multiplier” effect of such addition against a deemed paydown of the outstanding debt.

Separately, the definition of EBITDA itself continues to be the subject of discussion between borrowers and lenders as borrowers look for flexibility to boost EBITDA initially with exceptional items and with various add-backs such as “anticipated synergies and cost savings” on a look-forward basis (albeit usually on a capped basis and subject to third party verification).

Flexibility to grow: In today’s highly competitive deal environment, where purchase multiples are continuing to increase, sponsors cannot rest on their laurels once they have pushed through a successful buy-out. Houses need to ensure value accretion in their portfolio companies and accordingly many look to a business’s continued M&A and/or disposals strategy to drive growth.

Flexibility to conduct acquisitions, make disposals, give loans or incur debt and grant security each with limited “interference” from funders has therefore become a focus at the documentation stage. This has driven sponsors to push for a reduction in the scope of controls that funders would normally expect around these activities (for example, giving more flexibility to non-core

COVENANT PACKAGES FOR EUROPEAN MID-MARKET TRANSACTIONS OF UNDER €250M



Source: DebtXplained

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geographic or industry sector growth, allowing for less restrictive asset churns, less onerous diligence requirements on an acquisition, ability to acquire less than all of the shares in a target company and flexibility on whether target assets have generated positive EBITDA before acquisition or generous synergy treatment post-acquisition).

However, in recent months the biggest area of debate relating to operational controls has focused on basket flexibility. Sponsors are increasingly focused on two themes when it comes to baskets.

The first relates to the source of cash when considering whether an action (such as an acquisition, capex, debt buybacks or “yank the bank” prepayments) should or shouldn’t be included within a permission – amounts of “unrestricted cash” are now often carved out of basket caps and the scope of such a definition has grown to include some or all of the following:

- (i) all proceeds of insurance claims, disposals, acquisition claims and flotations (other than amounts required to prepaid debt);
- (ii) post cash-sweep excess cash (if there is a cash sweep!);
- (iii) all overfunding amounts;
- (iv) unused cash earmarked for capital



Griffith: debt transferability is an area of continued importance for sponsors

expenditure;
 (vi) permitted financial indebtedness;
 (vi) additional injections of equity or subordinated debt.

Secondly, sponsors now look to carry-forward or even carry-back annual unused basket amounts within a permitted activity and incorporate “grower” mechanisms for at least some of the baskets, whereby EBITDA increases generated organically and/or from bolt-on acquisitions are reflected, on a regular basis, in increased basket sizes. While some lenders have attempted to make equivalent

mechanisms apply when the EBITDA of the business decreases, it would be unusual to see this reduce a basket below the size that it was initially agreed upon.

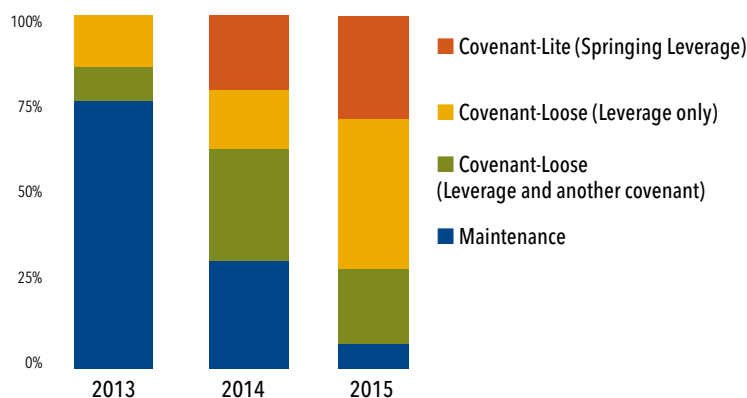
Flexibility to pay: Sponsors have argued that one of the other uses of the “unrestricted cash” pot is, in certain circumstances, to pay dividends by the borrower group to its shareholders. Lenders have looked at restricting the extraction of cash in this way as it is arguably not directly beneficial to the borrow. However requests for hard financial caps per year or over the life of the facility, an ongoing ratchet based on leverage hurdles or a matched debt prepayment obligation have sometimes been resisted on the basis that these amounts are freely available proceeds of the group and in absence of a default they should not be restricted.

Restrictions on transfers: Another area of continued importance for sponsors is debt transferability and the ability to control potential investors who can buy into their loans. While lenders have always insisted on being able to freely transfer debt to affiliates or related funds and to any party while an event of default is ongoing, outside of these parameters sponsors have pushed for greater controls. Pre-approval of counterparties on a “white list” is now commonplace (although “black lists” are still rare), as are restrictions on transfers to industrial competitors of the borrower.

More controversial are requests to extend such a prohibition to competitors of the sponsor or any other shareholder. Indeed sponsors now sometimes request an overriding notification mechanism before any transfer can take place with a right of first offer to the borrower and/or sponsor – any lender considering such a request should think hard about the timing impact of this on their ability to trade. ■

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COVENANT PACKAGES FOR EUROPEAN MID-MARKET TRANSACTIONS OF €250M-€500M



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