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Banking & Finance 2021

UK: Trends and Developments

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Trends and Developments

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Banking and Finance Emerging Trends and Developments in the UK

The year 2021 has been characterised by increased liquidity, favourable pricing, low default rates, and (the natural consequence of these factors) more borrower friendly terms. Leveraged loan issuance in the first quarter of 2021 was recorded to be up over 100% from the last quarter of 2020 and was dominated by refinancing or repayment of debt, which accounted for over 65% of the deals financed during that quarter. This was up from around 25% in the last quarter of 2020 although private equity and broader M&A activity also remained strong, helping drive strong market conditions.

Whilst COVID-19 is not yet in the "back mirror" from a macro perspective, S&P Global Market Intelligence reported only three defaults in the year to 22 June 2021, as compared to 17 in the same period in 2020. However, from a pricing perspective one commentator reported that following the significant pricing decline in the second half of 2020, the weighted average yield on European leveraged loans has risen relatively steadily during 2021.

Notwithstanding the pricing increases, the trend has been towards more borrower-friendly terms, including more permissive leakage and debt incurrence provisions, and more permissive pro forma adjustments addbacks to "EBITDA" definitions for anticipated synergies and cost savings, etc. In addition, tight approval deadlines for debt investors looking to deploy funds in the syndicated loan market continued. In the face of increased debt investor demand, borrowers were able to impose tight acceptance deadlines, leaving little time for in depth documentation review and comment of loan documentation.

Another trend that began to emerge in 2020, but really accelerated exponentially during the first half of 2021 and has continued since, is the focus on environmental, social and governance (ESG)-related margin pricing provisions. One commentator estimated that during the second quarter of 2021 ESG based margin-ratchets were present in almost two thirds of new paper in the European syndicated loan market.

Regulatory oversight has also played its part in documentary trends in 2021. The issuance of the Bank of England's "Dear CEO letter" setting supervisory expectations that there will be no new GBP LIBOR issuance from 1 April 2021, together with the US Federal Reserve System also issuing guidance encouraging banks to cease entering into new contracts that use USD LIBOR as a reference rate as soon as possible and in any event by 31 December 2021, has resulted in widespread change to the reference rate provisions of floating rate loans and parties to existing loans are currently moving quickly to implement LIBOR transition provisions as a matter of urgency.

ESG

The macro focus on ESG-related matters has increasingly filtered through to the loan markets during 2021. This is reflected primarily in "ESG-related margin grids", which generally

refer to loans that include a margin reduction (or increase) mechanism that is linked to either:

- compliance by one or more of the credit group with certain sustainability-linked key performance indicators; or
- environmental, social and/or governance related ratings of a particular entity or group.

Given that investor appetite for ESG and sustainability linked products is forecast to increase, it seems likely that the exponential increase in these types of provisions will continue to increase and the impact of ESG-related factors looks only to become more influential.

The market is evolving quickly and the following features are becoming more prevalent.

Type of margin adjustment trigger

It is more common for the pricing adjustment mechanism to be linked to achieving specified ESG-related KPIs, as compared to compliance with an ESG rating from an external independent provider. KPI-based pricing adjustments allow borrowers greater flexibility to determine their own environmental, social and governance performance indicators in line with their business or industry. Some market participants have expressed concerns regarding the unregulated nature of the KPI approach; and that "hollow" ESG KPIs could permit pricing reductions in circumstances where the sustainability targets are not sufficiently challenging/meaningful.

One possible approach that goes some way to addressing the highly discretionary nature of KPI targets is for those KPI targets to be set in loan documents by reference to objective standards or national or international benchmarks or recommendations or scientific standards (eg, the Greenhouse Gas Protocol, industry specific standards like the Sustainability Accounting Standard Board's materiality map, or the Hampton-Alexander review into boardroom gender diversity, to name a few).

How many targets? Where KPI targets are used, should there be just one KPI target or more?

More frequently loans tend to include two or three KPI targets. Where there are multiple KPI targets then the number of price reductions can be linked to the number of metrics satisfied. However, deals for businesses owned by strong borrowers with just one metric have been seen. The approach to this type of question is also influenced by the maximum pricing adjustment range (which in some deals provide for both upward and downward adjustments – please see below) and the spread being reported to have increased from between 5 and 7.5 basis points to 10 basis points (and in some cases 12.5 to 15 basis points).

Do margins go up as well as down?

In more borrower-friendly deals, the pricing only reduces, however in other transactions margins can be adjusted up (if the KPI target(s) are not met/latest ESG independent agency rating is less favourable) as well as down (if KPI targets are met or the latest ESG independent agency rating is more favourable). Where there is more than one KPI target, meeting one KPI target may not be sufficient to avoid a margin increase.

Do the KPI target levels stay the same or increase?

In some transactions the KPI targets stay the same over the life of the loan, in others they change over time – sometimes with a requirement for the borrower to demonstrate improvement. Depending on the nature of the KPI, it is possible to agree a "mix and match" approach, with some KPIs remaining static over the life of the loan and others increasing year on year. Another possible approach is for KPI targets to be reviewed and agreed annually between the

lenders and the borrower (however, this may be less attractive for both borrowers and lenders given the associated lack of certainty).

Is there an event of default blocker?

Typically, margin adjustments based on ESG factors are not impacted where an event of default is continuing (this is to be contrasted with the position in traditional leveraged loans where leverage ratio-based margin reductions are blocked during the continuing existence of an event of default (or in more borrower-friendly transactions specified events of default like non-payment or insolvency) such that the margin reverts to its highest level). However, in an increasing number of deals with ESG KPI-related targets, failure to deliver a sustainability report or certification of sustainability KPIs would result in an increase in the margin to its highest level.

If there is an independent third-party ESG rating, who can provide it?

Reference is normally made to reputable third parties and S&P or Fitch may be considered examples.

Reporting

Market practice in deals with ESG KPI-related targets remains mixed as to whether annual sustainability reports are required to be prepared and delivered by borrowers together with an audit opinion or verification confirmation (and delivered at the same time as the annual audited financial statements). Where the margin is adjusted by reference to an ESG rating, the margin adjustment typically occurs within a period after delivery of the rating.

Application of proceeds of discounted margin?

Some loan agreements require savings from margin adjustments to be applied to a specific purpose such as ESG investments. Without such a requirement the savings remain in the group and can be applied for any purpose.

Borrower-Friendly Changes to Debt and EBITDA definitions

The year 2020 was dominated by questions like the extent to which loss of revenue can be added back to Consolidated Net Income or EBITDA in the context of the COVID environment. These issues continue to be of relevance in 2021. Some borrowers have sought to explicitly include addbacks for revenue losses, which can be considered an express permission to addback lost earnings, for example as a result of the COVID-19 pandemic.

The effect of changes to financial definitions, whist seemingly technical, have very wide-ranging impact on, and flow through many of the key terms of, credit documentation. An increase in EBITDA will mean that a margin reduction is more easily achieved, and any EBITDA-based financial covenant more easily complied with as a result of the consequent lower ratios of EBITDA to debt. An increase in EBITDA will generally also increase capacity under all of the negative covenants which include EBITDA-based ratios and baskets (given many permissions having EBITDA-based "grower" baskets that are intended to grow with the business). So, at a very high level, the greater the scope for addbacks to EBITDA, the higher the EBITDA can be and the more flexibility for the borrower that results, especially under negative undertakings and financial covenants.

The year 2021 has also seen a broader movement, in transactions at the more borrower-friendly end of the leveraged finance spectrum, to follow the high yield bond market in allowing uncapped "pro forma" EBITDA addbacks for anticipated synergies (cost and revenue), cost savings, operating expense reductions and revenue increases in connection with a very board

range of transactions and activities (including for example, revenues increases or losses, new contracts, future lease commitments, start-up costs, new facilities, employee related costs and any other transaction).

Even in transactions where caps are included, 2021 has seen an increasing number of borrower requests for look forward periods for anticipated realisation of such anticipated synergies and other addbacks increase to up to 36 months in some transactions.

These adjustments are in addition to the more typical addbacks for extraordinary, exceptional, one-off, unusual or non-recurring items, losses or charges. Adjustments have also for some time been permitted to include those in the base case model, those taken into account in calculating day one "structuring" EBITDA on which the transaction is marketed or committed, and those made in any quality of earnings report provided as part of the due diligence process. This concept has been extended in some transactions to allow addbacks "of the nature" included in such model, structuring EBITDA or Day One diligence. This results in uncapped future EBITDA increases for anticipated synergies, etc, that are "of the nature" included in the Day One diligence, which is an effective means to circumvent any cap that applies.

At the same time, the definition of what counts as "debt" has gradually narrowed. There are exclusions from the "debt" definition at the most borrower-friendly end of the market including any revolving credit facility drawings (whether for working capital purposes or otherwise), securitisations (recourse and non-recourse), all receivables facilities and any cash management services. Where IFRS 16 applies, treatment of leases are, in some deals, inconsistent, so the EBITDA increase is counted but the debt is excluded.

Leakage

Whilst well-publicised litigation such as J Crew and PetSmart continued to play on debt investors' minds, the ever-increasing size of the dividend and investments baskets has meant there is significant flexibility for business owners to extract cash. There has also been an erosion of protective conditions like event of default conditions and the requirement for a ratio test to be met in order for certain dividend/investment capacity to be able to be used. In the context of investments (including in entities outside the credit group) there has been a clear increase in baskets which allow for value leakage by way of build-up basket without default or in some cases ratio tests being met.

The trend to include provisions which allow borrowers to dispose of material assets without the requirement that the proceeds are used to pay down debt continued into 2021. Instead, proceeds can be used to pay out dividends to business owners. These types of provisions continue to garner debt investor push back in the syndicated debt market but are increasingly commonplace and result in increased leakage capacity being available to business owners when trading conditions become more challenging.

Inclusion of leveraged-based step downs (whereby the percentage of proceeds required to be prepaid depends on the pro forma consolidated leverage in the group) has also increased from 2021. Disposal proceeds can often, to some extent, be used to pay junior debt ahead of senior debt, once again subject to pro forma leverage ratios.

Debt Capacity

With the onset of the uncertainty created by the COVID-19 environment, borrowers pushed for increased debt capacity to ensure they had "rainy day" flexibility to include liquidity facilities either as further senior secured debt or as

"priming" debt which is either structurally senior or benefitting from security over "crown jewel" assets. Given that collateral packages in leveraged loans have continued to be accepted with more carve outs (that is to say, operational assets, IP and real estate generally being excluded from any "fixed" security), increased debt capacity often creates greater opportunity to incur debt that "primes" day one debt investors.

Similarly, "pick your poison" baskets – which enable borrowers to use leakage capacity to build other baskets – have continued to see a resurgence in Europe. Broader formulations have been proposed where either specified baskets or, in some cases, any restricted payment or investment capacity can be used to create debt capacity, with a view to increasing future options for borrower liquidity, if needed. Borrowers have in some cases pushed for 200% "pick your poison" baskets (which are similar in concept to the 200% contribution debt baskets seen requested – where debt can be incurred in an amount equal to two times the amount of equity injected by business owners that could in many cases prime existing first lien creditors). This type of permission, where agreed by lenders, provides significant flexibility to build debt capacity.

Yield Protection

As in 2020, lenders' battle to protect their yield when future debt is put in place has been subject to sustained challenge given the borrower-friendly market conditions. Generally, in Europe, the periods for which yield protection on future debt is available has shortened (now almost exclusively six months in syndicated term loan B transactions) and the categories of debt to which the protection applies have reduced such that only a limited amount of pari passu ranking secured debt incurred under the same credit agreement (excluding debt incurred in connection with acquisitions, investments and capex, etc, in many cases) (along with the scope of the protection, so protection is tied only to the margin and not to the overall yield).

LIBOR Transition Facility Documentation

On 5 March 2021 the UK Financial Conduct Authority announced which LIBOR rates would cease immediately after 31 December 2021 and which would cease after 30 June 2023. The Loan Market Association has provided various recommended forms of proposed provisions incorporating compounded SONIA instead of GBP LIBOR and rate switch mechanics to facilitate a change in reference rates from existing benchmark rates (like US LIBOR) to a replacement (eg, SORF, in the case of USD LIBOR). EURIBOR is continuing for now although the working group on Euro Risk Free Rates is considering potential fallbacks to EURIBOR. The market trend we are seeing emerging is that for Sterling loans issued in the European markets, parties are generally adopting provisions based on the Sterling Working Group recommendation as reflected in the LMA forms.

Conclusion

Overall, after the relative turmoil of 2020 and with the COVID-19 backdrop persisting at a macro level, 2021 has been marked by increased liquidity. The LIBOR transition changes demonstrate the flow-on effect of the shortcomings identified with LIBOR by regulators some years back, and the increase in ESG-related pricing reflects an increasing macro focus in this area, including in the broader community. Whilst the market continues to evolve, especially in the ESG space, it seems likely that this is a trend that is here to stay given the broader economic and social environment.

Low default rates have increased confidence overall, notwithstanding the continuing impact of COVID in the broader community, and the net

result of these factors combined has been more borrower-friendly terms in the both the syndicated and private credit markets. Private credit providers are increasingly offering to take bigger stakes as lenders, and debt finance larger transactions. The overall increase in liquidity has been beneficial to borrowers and enabled them to achieve more flexible documentary terms, given lenders and other debt investors have been very keen to deploy capital.

The debt markets have proved resilient in the face of the global pandemic and regulatory developments to date. Looking forward to 2022, it will be important to consider how the macro environment continues to influence the evolution of the debt markets and the documentary terms that borrowers are able to secure.

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