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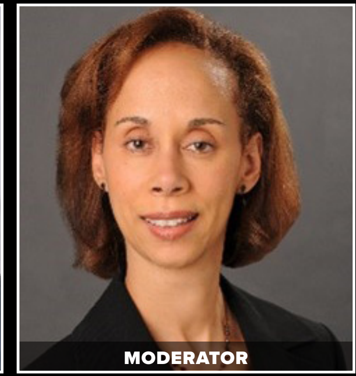
Session 203

RECENT TRENDS IN LEVERAGED FINANCE

Marty Dunn
Dinsmore & Shohl LLP

Vanessa Jackson
Davis Polk & Wardwell LLP

Kamal Nesfield
Milbank LLP



Elena Centeio
General Motors

EXECUTIVE SUMMARY

Recent Trends in Leveraged Finance: Latest Trends and Hot Button Issues in the Large Cap Leveraged and Syndicated Loan Market

MODERATOR:

Elena Centeio, *Assistant General Counsel,* General Motors

PANELISTS:

- **Marty Dunn,** *Partner,* Dinsmore & Shohl LLP
- **Vanessa Jackson,** *Partner,* Davis Polk & Wardwell LLP
- **Kamal Nesfield,** *Partner,* Milbank LLP

OVERVIEW

A panel of expert finance lawyers discussed challenges and trends affecting lenders and borrowers in the leveraged loan and syndicated loan marketplace. They discussed issues related to highly leveraged deals, the transition to a different benchmark interest rate (from LIBOR to SOFR), and the impact of the intense competition among lenders.

Current market conditions favor borrowers, as lenders are offering greater flexibility and more favorable terms. Also, flush with cash, private equity firms are entering the leveraged finance market, participating as direct lenders and giving borrowers even more options.

BIG IDEAS

- **The transition from LIBOR to SOFR has gone relatively smoothly.**
- **In this highly competitive lender market, leading terms that may have been shocking not so long ago have become widely accepted in large cap sponsor deals (and, to a lesser extent, in middle market or corporate borrower deals).**
- **Also entering the already competitive syndicated lending market are direct lenders, such as credit arms of private equity firms, giving borrowers more options.**
- **Lenders should take heed of the lessons learned when creative borrowers found and took advantage of "holes" (i.e. Chewy and J. Crew) in the lending documents.**
- **Various government programs provide incentives for project finance.**

KEY TAKEAWAYS

Despite some concerns, the transition from LIBOR to SOFR has gone well.

In 2021, the question of moving loan agreements from London Interbank Offered Rate (LIBOR) to an as-yet non-existent new benchmark caused a stir in the market. Lenders and borrowers were understandably concerned about the potential challenges associated with the transition of trillions of dollars' worth of loan agreements.

However, the move to Secured Overnight Financing Rate (SOFR) as the benchmark interest rate has gone relatively smoothly. After a year of gradual transition, the switch to SOFR has broad acceptance and there are few, if any, new contracts using LIBOR as the benchmark. As LIBOR goes away, amendments to existing agreements will be needed. Borrowers are encouraged to be proactive in dealing with this.

"It never hurts for borrowers to be proactive if they have not received a notice from their lenders regarding the changes. It may take some lenders time to catch up, but most have anticipated this, and there is going to be a flurry of activity."

— Marty Dunn, Dinsmore & Shohl LLP

The syndicated loan marketplace has become much more borrower friendly.

Because the syndicated loan market has become increasingly more competitive, borrowers have been successful at obtaining very favorable terms in their loan agreements. As Ms. Jackson said, "There has also been fewer differences in terms provided to 'top tier' sponsors as compared to those outside of that category. The focus now is really just on market appetite and whether the underwriters believe they will be able to successfully sell the piece of debt."

As a result of these trends, Mr. Nesfield sees greater "value leakage" or "flexibility" ("depending upon which side of the table you sit on") in the marketplace. This means greater flexibility in covenants, leverage tests, and more. For example, leverage tests are transitioning from total net leverage ratio to secured net leverage ratio and even first lien net leverage ratio. There has been removal of "no default" as a condition or limitation to payment/ borrower bankruptcy events of default. There is greater flexibility in asset sales and in leverage.

"An emerging development is leveraged tests for these types of covenants, transitioning from a total debt leverage to secured. This allows borrowers greater flexibility to lever up, assuming it is not secured debt, while maintaining the flexibility to send money out of the company, make investments, or pay down junior debt."

— Kamal Nesfield, Milbank LLP

Other attorneys on the panel who represent borrowers said that these borrowers are "enjoying the flexibility."

Despite global issues, the flexibility afforded to borrowers is likely to continue.

Regardless of the many disruptive events going on in the world, there is a strong likelihood that sponsors and borrowers will continue to find creative ways to get aggressive, borrower-friendly terms. Even the Russian-Ukrainian war does not seem to have an influence on how the lending market has been unfolding.

While the pandemic had an effect on countless areas of the financial world, it did not have a significant impact on borrowers' ability to continue to get flexible terms. During the initial days of COVID-19, lenders may have been momentarily tempted to shut down their peak capacity, but there was a quick rebound, and sponsors and corporate borrowers were able to rapidly get back to 2019 terms, if not even more aggressive terms. The reason this borrower advantage has remained steady is the intense competitiveness of the market. One caveat is that patterns differ for borrowers in different industries.

The increase in direct lenders in the market has been especially profound over the last year.

"The increase in credit arms of private equity firms acting as direct lenders in the market has been really profound over the last few years," said Ms. Jackson. These lenders often have significant cash reserves ("dry powder") and are able to write big checks for borrowers that rival the size of loans that traditional banks are able to provide.

Direct lenders traditionally do not syndicate broadly to the market; they hold the paper themselves. The terms offered by direct lenders have become more aggressive and favorable to borrowers as they continue to move closer to what we see in the syndicated market. When dealing with a direct lender, sponsors have certainty in funding with no execution risk, as direct lenders commit to fund without flex rights or the need for ratings.

"There are elements of a direct lending loan that borrowers find really attractive. Since there is no syndication, there is no need for 'market flex' provisions, which therefore creates a level of certainty in the terms of a loan that isn't necessarily there in a syndicated loan."

— Vanessa Jackson, Davis Polk & Wardwell LLP

When a private equity sponsor is looking to do a leveraged buyout, the landscape is competitive with both banks and direct lenders—neither of which knows who the other players are.

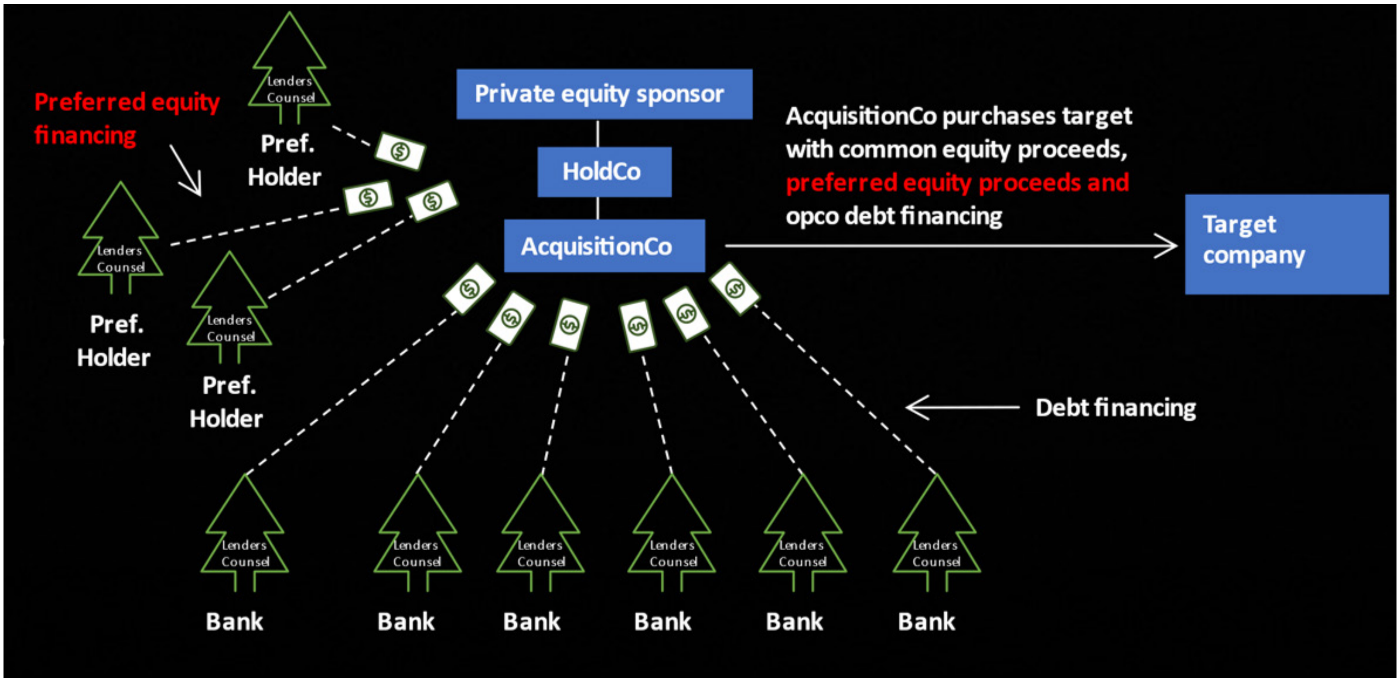


Figure 1: The Array of Potential Financing Options for an LBO

The competitive nature of leveraged buyouts has lenders putting their best foot forward in terms of what they can offer a private equity sponsor. The graphic in Figure 1 represents a potential scheme.

Typically, the traditional scheme is that debt financing is provided by lenders to either the target or the borrower, depending on the structure. A private equity sponsor sits at the top as the owner. In the wake of the Trump Administration, leverage lending guidelines became relaxed and leverage multiples increased. Banks and direct lenders are now able to provide loans at high leverage multiples.

There has also been an uptick in the number of deals being financed with not just traditional bank loans, but also preferred equity financing. The sponsor can use the preferred equity (which looks a lot like debt) to get additional cash without having a negative impact on the company's ratings.

Case studies demonstrate how creative borrowers have found holes in their agreements; counsel need to learn from these case studies and avoid such events in the future.

The case studies that were shared—PetSmart/ Chewy, J. Crew, and Serta—are not necessarily new, but they remain relevant. In each instance, a creative borrower found a hole in the lending agreement and took advantage of this hole in a way that was different from what was intended, to the great surprise of the lender(s). Chewy found a way to dilute the collateral package by selling off a minority interest in material guarantors (taking advantage of the traditional automatic release of guarantees and collateral from any subsidiary that cease to be a wholly owned subsidiary); J. Crew found a way to transfer valuable IP to an unrestricted subsidiary and then incurred debt at the subsidiary that was secured by the IP; and Serta obtained new debt and subordinated existing lenders without the agreement of all existing lenders, in a matter that is still in court.

After these instances became public, lenders have reacted to try to prevent similar holes in their agreements. The panelists help their clients seek to avoid a "Chewy hole" or a "J. Crew hole," as well as other holes. Mr. Nesfield said borrowers will say, "We would never do that [what Chewy or J. Crew did], but in extremely difficult situations, companies will be as creative as their documents allow to ensure their survival." Thus, scrutinizing these documents and holes is essential.

There is a great deal of incentivized project financing available.

Opportunity zones provided favorable capital gains tax treatment for qualified investments. Although opportunity zones did well in some areas, fewer than anticipated projects got off the ground as some were in essentially isolated islands detached from other desirable areas of development. New legislation is pending related to opportunity zones that aims to, among other things, boost urban revitalization.

Another incentivized project financing program is the New Markets Tax Credits Program, which provides a 39% tax credit over seven years for investors in certain eligible projects.

There is also financing in the Infrastructure Investment and Jobs Act, which created two new categories of tax-exempt bonds for companies trying to control emissions or for broadband in rural areas.

"I would say, find money everywhere. You can access it via traditional sources like financial institutions and lenders through syndicated debt. But there are public-private partnerships and government programs out there that can help corporations get facilities and projects underway."

— Marty Dunn, Dinsmore & Shohl LLP

BIOGRAPHIES

MODERATOR

Elena Centeio

Assistant General Counsel,
General Motors

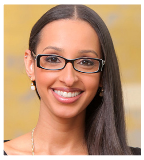
Elena Centeio is an experienced corporate attorney who started her career at Simpson Thacher & Bartlett LLP 25 years ago and has since spent more than 15 years in-house. She proactively partners with business leaders at GM to balance risk and opportunity utilizing broad-based legal and business experience. Elena leads a team of 10 lawyers who advise on M&A, financing matters, venture projects, co-developments, joint ventures, government contracting, and internal reorganizations. The team also supports the new business incubator within GM and ensures the incubator is well positioned to react quickly to differing risk profiles while remaining nimble. Elena gets to work on flying cars! Elena's passion is enabling GM to become the most inclusive company in the world. She leads GM legal staff's Committee on Awareness and Training which is driving better understanding and awareness within GM on the disparate treatment of certain people and increasing more open dialogue on diversity, equity, and inclusion. She is a practitioner of continuous improvement and holds a green belt in Six Sigma.

Marty Dunn

Partner, Dinsmore & Shohl LLP

Marty Dunn is a member of Dinsmore's executive committee and board of directors, and chair of the diversity committee. He is a leader in fostering economic development through strategic alliances involving for-profit, non-profit, and governmental entities. He serves as outside general counsel to both large and closely held companies. Marty has extensive experience representing clients in the acquisition, sale, lease, and development of a variety of commercial real estate properties, including shopping centers and large-scale plants, warehouses, and facilities. He also represents developers and owners in an assortment of structured finance transactions, many of which involve tax incentives such as TIFs, lease-bond transactions, and New Markets, Historic or Low Income Housing Tax Credits. Marty has also advised clients regarding Opportunity Zone projects. Earlier in his career, Marty had the distinction of serving as the partner-in-charge for the Cincinnati office of a statewide law firm, which made him the first African-American managing partner of a law firm in Cincinnati. Marty is very active in the community and recently served as one of the Growing Beyond Hunger campaign chairs for the Freestore Foodbank's successful $30 million fundraising effort to develop a new food distribution and workforce development center.

Marty Dunn
Dinsmore & Shohl LLP
marty.dunn@dinsmore.com



Vanessa Jackson

Partner, Davis Polk & Wardwell LLP

Vanessa Jackson is a partner at Davis Polk & Wardwell LLP, practicing in the Finance group. She represents borrowers and lenders on a broad range of finance transactions, including leveraged and investment-grade acquisition financings, spinoffs, debtor-in-possession financings and exit financings. Vanessa joined Davis Polk in 2012 and was elected partner in 2019. She received her B.S. in Economics from Duke University in 2009. In 2012, she received her J.D. from Columbia Law School, where she was a Harlan Fiske Stone Scholar and served as Managing Editor of the *Columbia Journal of Race and Law*. She serves as co-chair of the firm's Diversity, Equity & Inclusion Committee and is a member of the firm's Black Affinity Group Steering Committee. Vanessa is vocal advocate for the firm's efforts relating to the advancement of diverse lawyers, the promotion of equitable systems and the fostering of an inclusive culture. The Partnership for New York City named Vanessa to its 2022 Class of David Rockefeller Fellows and *Crain's New York Business* named Vanessa to its 2022 "Notable Women in Law" list. In February 2022, Vanessa was named among *Savoy Magazine*'s "Most Influential Black Lawyers." *IFLR1000* also named Vanessa among its Women Leaders 2022 – Americas.

Vanessa Jackson
Davis Polk & Wardwell LLP
vanessa.jackson@davispolk.com

Kamal Nesfield

Partner, Milbank LLP

Kamal Nesfield is a partner in the New York office of Milbank LLP and a member of the firm's Leveraged Finance Group. Kamal advises lead arrangers, private capital and other alternative financing providers, as well as borrowers on large-cap syndicated loans, middle market loans, and direct lending transactions, including syndicated term loans, asset-based loans, unitranche and mezzanine facilities, high yield bonds and investment grade facilities. His clients include investment banks, direct lenders, leading domestic banks, and leading European financial institutions. Kamal draws on significant prior experience representing private equity sponsors, corporate borrowers, and high yield bond issuers, which helps him maintain a constructive, commercial approach while providing clients with key industry insight. Kamal is a former football player at the University of Pennsylvania. He is also a member of 1844, a group of black male lawyers who practice primarily in prominent New York law firms and investment banks, with a focus on providing a support system for each other as well as fostering the next generation of black lawyers. Kamal earned his J.D. from Howard University School of Law and his B.A. from University of Pennsylvania.

Kamal Nesfield
Milbank LLP
knesfield@milbank.com