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Trends and Developments

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Introduction

Year-to-date 2022 has been something of "a game of two halves" on documentary terms. Notwithstanding reduced leveraged loan volumes by almost 20% in the first quarter of 2022 from the last quarter in 2021, financial sponsors and corporate borrowers/issuers pushed the leveraged loan market to achieve increasingly flexible documentation terms in the early part of the first quarter of 2022, with opening total net leverage (the ratio of EBITDA (earnings before interest, taxes, depreciation and amortisation) to total net debt) reaching almost the same levels as in the first half of 2021. Indeed, whilst COVID-19 lingered from a macro perspective, Fitch reported the trailing 12-month default rate at 0.8% in June 2022 (down from 3.7% at end 2020).

However, not long into the first quarter of 2022, the combination of inflation (with the prospect of rising interest rates), tightening monetary policy, supply chain disruption and a war in Ukraine meant it was all-change and disruption in the syndicated debt markets. Given both the high-yield and leveraged loan markets were significantly impacted, both arranging banks and private credit providers scrutinised credit quality and documentary protections more closely in the knowledge that (for arranging banks) there was both an increased likelihood they would need to hold the debt on their balance sheets and (for both arranging banks and private credit providers alike) the prospect that supply chain issues, rising inflation and interest rates and recession concerns may result in poorer performance and increased default risk.

A new conservatism has begun to emerge. However, top-tier financial sponsors/high-quality corporate issuers continue to seek documentary terms that reflect significant levels of flexibility, which is often followed by increased negotiation of documentary terms. Whilst this has resulted in improvement in a number of the metrics closely monitored by market participants, leveraged loans remain characterised by significant leakage capacity, significant ability to incur incremental and priming debt, numerous EBITDA add-backs, transfer provisions remain restrictive on lenders wishing to exit a credit and numerous yield protection exclusions apply in relation to the incurrence of incremental debt. Taken together this means that notwithstanding a trend towards more conservative terms, significant flexibility for financial sponsors and borrowers still remains.

Opening Net Leverage

One metric market participants and market commentators alike monitor closely in assessing the strength of the syndicated loan market is opening net leverage. Broadly speaking, in bull markets these opening net leverage levels will be higher. Bear markets tend to see these levels reduce. The first half of 2022, however, saw opening net leverage increase in the high-yield bond market (from an average of 2.3x to 2.6x during 2020–21 to 3.75x for those few bonds issued in the first half of 2022). The story was somewhat different for leveraged loans. There was more volatility reported in opening net leverage for sponsor-backed leveraged loan transactions, and May 2022 commentators saw these levels increase to 4.89x, which was down from a high of 5.09x in the first half of 2021, but nevertheless an increase on those deals reported at the end of 2021.

Unsurprisingly, the reduction in opening leverage for sponsor-backed M&A activity has been accompanied by a reduction in purchase prices for leveraged buyouts and a corresponding fall in the equity contributions made by financial sponsors as a condition to the debt financing of a leveraged buyout. Anecdotal evidence suggests that prior to the summer break, M&A activity reduced as vendor price expectations relative to the multiples purchasers are willing to pay had not reduced sufficiently to justify a strong pipeline of M&A activity.

Given higher interest rates, less liquidity in the credit markets and tightening of documentary terms, M&A transactions structured so as not to trigger a change of control (either by falling within one of the exceptions or transferring equity interests just below the triggering threshold) and thereby leave existing facilities in place have become very topical. This is a trend to watch given the significant amount of repricing that has occurred in the last few years.

Lender-Friendly Add-Backs to EBITDA Definition and Carve Outs from Debt

A key focus for debt arrangers and lenders alike in the European leveraged loan market has been the borrower's flexibility to increase EBITDA by making add-backs (especially on a pro forma run rate basis for anticipated but not realised synergies, expense reductions, and other similar items).

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 add-backs to EBITDA, the higher the EBITDA can be and the more flexibility for the borrower that results, especially under negative undertakings and financial covenants.

A key point of focus for arrangers and debt investors and private credit providers alike has been to impose caps on previously uncapped "pro forma" EBITDA add-backs 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). More recent deals in the syndicated European leveraged loan market consistently included caps (which stands in stark contrast to previous years, although the sample size remains small because so few deals are being syndicated). The time horizon for anticipated realisation of those adjustments in the top-tier syndicated loan space has remained consistent at 36 months. Whilst in private credit deals lenders regularly sought caps and shorter anticipated realisation horizons in the private debt market, with many financial sponsors and corporate borrowers being forced to resort to the private credit market given the lack of liquidity in the more broadly syndicated debt markets, the caps at least have gained increasing traction.

In a sign of the market's responsiveness to the macro environment, however, in addition to some COIVD-19/pandemic-related add-backs that emerged during the pandemic, recent supply change disruptions have seen customary add-backs for facility consolidation or closure and other extraordinary or exceptional items expanded in some deals to cover losses, costs, expenses or other negative items relating to supply chain disruptions.

In relation to the calculation of financial covenant and ratio-based permissions for the negative undertakings (like the incurrence of debt, making of restricted repayments and making of investments), in addition to increasing the add-backs to the EBITDA definition, financial sponsors and other borrowers had also managed to reduce the scope of what counts as "debt". Whilst many of these exclusions still apply, the total carve out for any working capital or revolving facility for all ratio calculations that was increasingly commonly seen in the top-tier financial sponsor syndicated leveraged loan market has more recently been pared back to the Day One revolving credit facility to the extent drawn for working capital purposes, in some transactions.

Similarly, where financial sponsors had been pushing the market in the direction of excluding all fixed/EBITDA grower baskets from ratio calculations (such that only day one term debt and ratio capacity would be counted) during 2021, these types of provisions have more successfully been pushed back on deals coming to market after the first quarter of 2022.

Leakage

In turbulent markets the natural expectation is that reducing leakage to equity investors while structural debt remains outstanding will be an area of focus/tightening. During the second quarter of 2022, when market slowdown was pronounced, the average general restricted payments Day One basket capacity and "unrestricted subsidiary" investment capacity for those deals that successfully allocated accordingly reduced relative to the first quarter of 2022 (but, it is worth noting, still remained in excess of levels set in 2021).

In syndicated leveraged loans free and clear "starter" baskets for leakage – which allows leakage to be paid without any deleveraging requirement – has however remained stubbornly prevalent at about 30% of EBITDA, although this is now negotiated out in some deals. Similarly, additional leakage for specific sources (sometimes including the proceeds of permitted debt), has remained prevalent. In some transactions this equates to "free and clear" capacity – that is to say that no financial ratio (whether a leverage or fixed charged coverage ratio) is necessarily required for amounts to be paid to equity investors.

There have been attempts to increase investor protections by including parameters around disposal of material intellectual property assets from the credit group, and sometimes transaction security is extended to cover material intellectual property. There are a range of formulations in the market, but this is an area where arrangers and direct lenders alike have found it challenging to persuade financial sponsors and corporate borrowers to provide comprehensive protections.

However, 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 has nevertheless continued in 2022. Proceeds can be used to make payments to business owners. However, expect this to be an area of focus for investors going forward. The 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) at the beginning of May 2022 had increased from 2021. This type of provision has the effect of weakening the asset base of the credit group without requiring de-leveraging. Disposal proceeds can also often, to some extent, be used to pay junior debt ahead of senior debt, once again subject to pro forma leverage ratios.

Debt Capacity

Market commentators report on the average additional general purpose debt capacity relative to EBITDA. This additional debt capacity is on top of the Day One committed credit facilities and/or bonds. This debt can either be incurred to dilute the collateral pool or, in many cases, can be incurred on a structurally senior debt that "primes" the Day One debt.

Given the relatively low volumes of debt being sold in the syndicated and public markets in recent months, raw statistics can sometimes be misleading given the small sample size. Indicators seem to be, however, that use of the 2x fixed charge cover ratio for junior secured debt is being pushed back on, and an increasing number of deals are introducing non-guarantor debt caps. It is, of course, important to monitor how extensive these caps are, noting that there are still many deals that do not include this protection, especially in the first drafts of documentation. Similarly, while there has been a reduction in Day One general purpose debt basket capacity, this is coming off the highs of the first quarter of 2022. It is also to be kept in mind that credit support packages in Europe remain very limited, and there is very limited protection for Day One lenders in respect of release of guarantees and security by making subsidiaries non-wholly owned and using similar devices.

Yield Protection

Europe remains more permissive than the US market in terms of leveraged loan yield protection. In the European leveraged loan market it was and remains customary for the provisions providing protection to lenders in case of significantly increased yield to have a backstop or "sunset" date when additional debt is incurred under the same credit agreement. In the second quarter, the US market demonstrated just how beneficial to financial sponsors/borrowers the exclusions to the yield protection can be (either by having a backstop date on the yield protection or other carve outs) with USD5.4 billion of incremental loans being reported to have tapped the US market in May and early June of 2022 alone, without triggering any yield protection in their existing credit agreements. Nevertheless, backstop dates on the yield protection and other carve outs remain prevalent in the European syndicated leveraged loan market notwithstanding the difficult market conditions.

There has, however, been some improvement in the European leveraged loan market in relation to call protection (essentially the agreed period after closing during which, if a loan is refinanced, additional yield protection will be available, if other conditions are met). Whereas a six-month period had become standard in the European syndicated leveraged loan market, more recently deals have seen that period increased to 12 months.

Information Provision

Whereas top-tier financial sponsor financings had almost seen the abolition of the requirement to provide an annual budget, and annual lender presentations had been under threat, the documentary tightening of the second quarter of 2022 has seen these re-emerge as rights that may be flexed into deals when there is sufficient investor push back.

ESG

The macro focus on ESG-related matters continued in the broadly syndicated European leveraged loan market during the first half of 2022. This continues to be reflected primarily in "ESG-related margin grids", which predominantly refer to loans that include a margin reduction (or increase) mechanism that is linked to compliance by one or more of the credit group with certain sustainability-linked key performance indicators. In a small percentage of transactions, environmental, social and/or governance-related ratings of a particular entity or group.

Overall, it appears there is more work to be done to establish independently verified and meaningful ESG provisions.

Type of margin adjustment trigger

Whilst concern about possible claims of "greenwashing" remain, the vast majority of deals tend to use a pricing adjustment mechanism 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. Concerns remain 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.

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

It appears that the number of KPIs that need to be met in order to achieve a margin adjustment, whilst fluctuating, has broadly speaking remained consistent between 2021 and the first half of 2022 at between 1 and 2. There has been an increase in environmental KPIs but a reduction in social or governance-related KPIs.

Do margins go up as well as down?

There has been an increase in the number of deals that allow for both upwards and downwards pricing adjustments (instead of down only).

Reporting

Whilst the number of deals requiring delivery of an initial sustainability report or compliance certificate, or annual sustainability reports or compliance certificates, has remained relatively consistent throughout 2021 and 2022, market observers report that there is evidence that there is much room for improvement, particularly as regards independent auditing of KPI compliance.

Application of proceeds of discounted margin?

Whilst at the start of 2021 over one third of loans containing ESG ratchets required the ESG-related savings to be reinvested in sustainable projects, in 2022 this requirement has disappeared altogether. Without such a requirement the savings remain in the group and can be applied for any purpose.

Conclusion

At this stage in the year, the clear trend is for tightening of documentary terms in the European leveraged loan and high-yield markets. Original issue discount (the price at which loans or bonds are sold to investors) has increased significantly, margins have increased (with less step downs), loan deals are increasingly first lien only and there has been tightening in key ratios and general baskets, as well as increased inclusion of caps on pro forma add-backs for synergies etc to EBITDA.

However, it is fair to say that significant capacity continues to exist in the context of both debt incurrence and leakage. There also remain significant carve outs to the yield protection. Overall, this means that whilst there have been a number of creditor-friendly improvements, this is coming off a very financial sponsor/borrower-friendly base. For now, the trend looks set to continue. There are no obvious signs of a significant snap back in the market. On the M&A side, it is likely that the disparity that was evident in vendor and purchaser price expectations are set to remain, the approximately EUR200 billion of underwritten debt that remains undistributed in the syndicated leveraged loan market will continue to search for a home and there will be more incremental improvement on documentation protections for creditors.

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