A Primer For The European Syndicated Loan Market

Focus: Distress

2015

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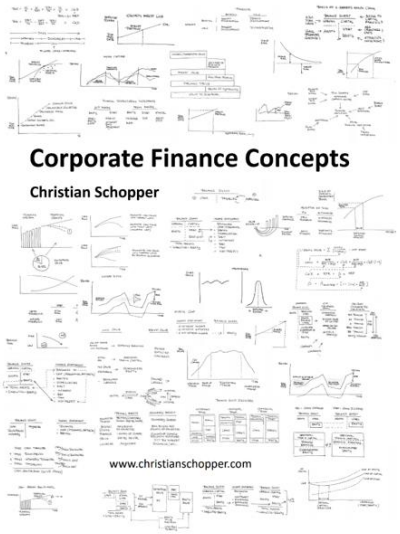

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Introduction

- A syndicated loan is one that is provided by a **group of lenders** and is structured, arranged, and administered by one or several commercial or investment banks known as **arrangers**
  - They are **less expensive** and more efficient to administer than traditional bilateral, or individual, credit lines

- At the most basic level, **arrangers** raise investor funds for an issuer in need of capital
  - The issuer pays the arranger a **fee** for this service, and, naturally, this fee increases with the loan's complexity and riskiness of the loan
  - As a result, the **most profitable** loans are those to **leveraged borrowers —** issuers whose credit ratings are speculative grade and who are paying sufficient spreads

- **Large high-quality**, or investment-grade, companies pay **little or no fee** for a plain-vanilla loan …
  - … typically an unsecured revolving credit instrument that is used to provide support for short-term commercial paper borrowings or for working capital
  - In many cases, moreover, these borrowers will effectively syndicate a loan themselves, using the arranger simply to craft documents and administer the process

- However, a new **leveraged loan** can carry an **arranger fee of 1% to 5%** of the total loan commitment, depending on the complexity of the transaction, market conditions, and whether the loan is underwritten
  - Merger and acquisition (M&A) and recapitalization loans will likely carry high fees, as will exit financings and restructuring deals

Introduction (cont´d)

- The "**retail" market** for a syndicated loan consists of **banks** and…
- … in the case of **leveraged transactions**: finance companies, hedge funds, and **institutional investors**
  - In the **U.S**. – having a capital market - pricing are linked to **credit quality** and institutional investor appetite
  - In **Europe**, **banks** remain a key part of the market. Consequently, pricing is not yet fully driven by capital market forces

- **Before** formally **launching** a loan to retail accounts, arrangers will often get a **market read** by informally polling select investors to gauge their appetite for the credit

- Based on these discussions, the arranger will **launch** the credit at a **spread and fee** it believes will clear the market
  - In the **early years** of the market, once the **pricing was set**, it was set, except in the most extreme cases
  - If the loan were undersubscribed, the arrangers could very well be left above their desired hold level
  - **After the 2007 credit crunch**, however, arrangers have adopted **marketflex language**, which allows them to change the pricing of the loan based on investor demand—in some cases within a predetermined range—as well as shift amounts between various tranches of a loan, as a standard feature of loan commitment letters
  - In essence, using market flex, a loan syndication today is practically a "book-building" exercise

Voting Rights

Amendments or changes to a loan agreement must be approved by a certain percentage of lenders

"Required-lenders" level

- Simple majority, used for approval of **nonmaterial amendments** and waivers or changes affecting one facility within a deal

Full vote of all lenders

- … including participants, required to approve material changes such as **RATS** (rate, amortization, term, and security; or collateral) rights
  - But, there are occasions when changes in amortization and collateral may be approved by a lower percentage of lenders (a supermajority)

Supermajority

- Typically 67% to 80% of lenders
- Sometimes required for certain **material changes** such as changes in amortization (in-term repayments) and release of collateral

"Yank The Bank" Clause

- Provides for the **replacement of a minority non-consenting lender** where the majority of lenders are in agreement
  - In Europe, this is generally only seen in LBO transactions

"You Snooze, You Lose" Clause

- **Excludes** from the final calculation any lender who **fails to reply in a timely fashion** to an amendment request

Covenants

Affirmative covenants

- State what action the borrower must take to comply with the loan, such as that it **must maintain**
- Are usually boilerplate and require a borrower to pay the bank **interest** and **fees**, maintain **insurance**, pay **taxes**, and so forth

Negative covenants

- **Limit the borrower's activities** in some way, such as regarding new investments
- May be highly structured and customized to a borrower's specific condition
- Can limit the type and amount of **investments**, **new debt**, **liens**, asset **sales**, acquisitions, and guarantees

Financial covenants

- Enforce minimum **financial performance measures** against the borrower, such as that he must maintain a higher level of current assets than of current liabilities
- The presence of these maintenance covenants - so called because the issuer must maintain quarterly
  - Bonds and covenant-lite loans by contrast, usually contain incurrence covenants that restrict the borrower's ability to issue new debt, make acquisitions, or take other action that would breach the covenant

Covenants (cont´d)

Financial covenants (cont´d)

- As a borrower's risk increases, financial covenants in the loan agreement become more tightly wound and extensive
- Coverage covenant
  - Requires the borrower to maintain a minimum level of cash flow or earnings, relative to specified expenses, most often interest, debt service (interest and repayments), fixed charges (debt service, capex, and/or rent)
- Leverage covenant
  - Sets a maximum level of debt, relative to either equity or cash flow, with the debt-to-cash-flow level being far more common
- Current-ratio covenant
  - Requires that the borrower maintain a minimum ratio of current assets (cash, marketable securities, accounts receivable, and inventories) to current liabilities (accounts payable, short-term debt of less than one year)
- Tangible-net-worth (TNW) covenant
  - Requires that the borrower have a minimum level of TNW (net worth less intangible assets, such as goodwill, intellectual assets, excess value paid for acquired companies), often with a buildup provision, which increases the minimum by a percentage of net income or equity issuance
- A maximum-capital-expenditures covenant
  - Requires that the borrower limit capital expenditures (purchases of property, plant, and equipment) to a certain amount, which may be increased by some percentage of cash flow or equity issuance, but often allowing the borrower to carry forward unused amounts from one year to the next
- Mulligan
  - Essentially allows the borrower a "**do-over**" on the covenant tests. If, for example, a company does not comply with its covenants for one quarter but is back in line the following quarter, the previous quarter is disregarded as if it never happened

Covenants (cont´d)

Mandatory prepayments

- **Leveraged loans** usually **require** a borrower to prepay with proceeds of **excess cash flow**, **asset sales**, debt issuance, or equity **issuance**
- Often, repayments from excess cash flow and equity issuance are waived or relaxed if the issuer meets a preset financial hurdle, most often structured as a debt/EBITDA test

Collateral and other protective loan provisions

- Collateral usually includes all the **tangible and intangible assets** of the borrower and, in some cases, specific assets that back a loan
- A common rule is that an issuer can borrow against 50% of **inventory** and 80% of **receivables**
- Some loans are backed by capital stock of operating units
  - In this structure, the assets of the issuer tend to be at the operating company level and are unencumbered by liens, but the **holding company pledges the stock of the operating companies** to the lenders
  - This **effectively** gives **lenders control** of these **units** if the company defaults
    - The risk to lenders in this situation, simply put, is that a bankruptcy court collapses the holding company with the operating companies and effectively renders the stock worthless
    - In these cases**,** loan holders become unsecured lenders of the company and are put back on the same level with other senior unsecured creditors

Covenants (cont´d)

Springing liens/collateral release

- Borrowers that sit on the cusp of investment-grade and speculative-grade must either **attach collateral or release it if the issuer's rating changes**

Equity cures

- These provisions allow issuers to fix a **covenant violation by making an equity contribution**
  - Generally found in **private equity-backed deals**, giving the sponsor the right, but not the obligation, to inject equity and cure a violation without having to request a waiver or amendment

Intercreditor agreements and cross-guarantees

- European borrowers tend to have complex corporate structures (eg **multi-jurisdictional nature**)
- As a result, intercreditor agreements and cross-guarantees are significant parts of ensuring lender rights regarding a loan transaction particularly with regards to underperformance or default

Asset-Based Lending

These loans are **secured by specific assets** and usually governed by a borrowing formula (or a "borrowing base")

- The most common type of asset-based loans are **receivables and/or inventory lines**
- These are **revolving credits** that have a maximum borrowing **limit**, but also have a **cap** based on the value of an issuer's pledged receivables and inventories

Subsidiary guarantees

- Most leveraged loans are backed by the guarantees of subsidiaries so that if an issuer goes into bankruptcy all of its units are on the hook to repay the loan (**cross-defaul**t)

Negative pledge

- Issuer agrees **not to pledge any assets to new lenders** to ensure that the interests of the loan holders are protected

Loan math—the art of spread calculation

- Unlike most **bonds**, which have **long no-call periods and high-call premiums**, …
- … but: **Most loans are pre-payable at any time** typically without prepayment fees.
  - Therefore, affixing a spread- to-maturity or a spread-to-worst on loans is little more than a theoretical calculation

Default And Restructuring

Technical default

- Issuer **violates a provision** of the loan agreement
- Usually, the **lenders can accelerate** the loan and force the issuer into bankruptcy
  - In many cases, the issuer and lenders are able to agree on an amendment that waives the violation in exchange for a fee, spread increase, and/or tighter terms

Payment default

- A **company misses either an interest or principal payment**
- There is often a pre-set period of time - say 30 days - during which an issuer can cure a default (the "**cure period**")
- **After that**, the lenders can choose to either provide a **forbearance** agreement that gives the issuer some **breathing room** or …
- … take appropriate action, up to and including **accelerating**, or **calling**, the loan

Amend-To-Extend

This technique allows an issuer to **push** out part of its loan **maturities** through an amendment, **rather than a full refinancing**

Amendment

- At least **50.1%** of the bank group **approves** the issuer's ability to roll some or all existing loans **into longer-dated paper**
  - Typically, the **amendment sets a range for the amount** that can be tendered via the new facility, as well as the spread at which the longer-dated paper will pay interest
  - The **new debt is pari passu** with the existing loan
  - As it **matures later** and, thus, is **structurally subordinated**, it carries a **higher rate**
  - in some cases, accounts insist on **most-favored-nation protection**
    - Under such protection, the **spread of the loan would increase if the issuer in question prints a loan at a wider margin**

Conversion

- Lenders can exchange **existing loans for new loans**
- In the end, the issuer is left with **two tranches**
  - The legacy paper at the initial price and maturity and …
  - … the new facility at a wider spread

Sub-Par Loan Buybacks

Opportunity for borrowers to **repurchase loans via a tender**, or in the open market, **at prices below par**

- In fact, most loan documents do not provide for a buyback
- Instead, **issuers typically need obtain lender approval** via a 50.1% amendment

Distressed exchanges

- A negotiated tender in which classholders will **swap** their **existing** paper **for** a **new** series of **bond** that typically have a **lower principal amount and**, often, a **lower yield**
- In exchange the bondholders **might receive stepped-up treatment**, going from subordinated to senior, or from unsecured to second-lien
- Standard & Poor's consider these programs a **default** and, in fact, the **holders** are **agreeing** to take a principal **haircut** to allow the company to remain solvent and improve its ultimate recovery prospects
- This technique is used frequently in the bond market but rarely for first-lien loans

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