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Structuring Covenants in Leveraged Loans and High-Yield Bonds for Borrowers and Lenders

Additional Debt Covenants, Equity Cures, Builder Baskets, Restricted Subsidiaries, Events of Default and More

TUESDAY, NOVEMBER 20, 2018

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Today's faculty features:

Maura E. O'Sullivan, Partner, **Shearman & Sterling**, New York

Michael J. Steinberg, Partner, **Shearman & Sterling**, New York

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STRUCTURING COVENANTS IN LEVERAGED LOANS AND HIGH YIELD BONDS FOR BORROWERS AND LENDERS

Strafford Webinar Program

November 20, 2018

Maura O’Sullivan – Partner – New York
Michael Steinberg – Partner – New York

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LOANS VS. BONDS

- Historically, syndicated bank loans were held by commercial banks and other financial institutions. Bank loans typically were not widely held (as opposed to bonds)
  - Bank lenders also historically had an ongoing relationship with the borrower so there was confidence that there would be continued dialogue between the borrower and its lenders
  - The banker who structured a covenant and negotiated its wording frequently was the same banker who would be relying on that covenant during loan administration
  - As a result, covenants in bank loans were tighter than those in high yield bonds, since amendments and/or consents were easier to obtain than in the bond context
  - Bank loans typically are secured by the assets of the borrower and guarantors. Therefore, bank lenders are at or near the top of the Borrower’s capitalization structure
  - Bank lenders historically have wanted to be first at the negotiating table with a borrower as its business operations deteriorate

LOANS VS. BONDS (CONT.)

- One of the main differences between bank debt and bonds in the past was the inclusion of financial maintenance covenants in syndicated loan agreements. The borrower had to “maintain” a negotiated and agreed (and frequently declining over time) maximum level of leverage, for instance, to avoid default or failure of a condition to further advances
- Customary maintenance covenants included:
  - Maximum leverage ratio
  - Minimum interest coverage ratio
  - Minimum fixed charge coverage ratio

LOANS VS. BONDS (CONT.)

- Other significant differences:
  - Bonds have “incurrence”-style negative covenants, rather than maintenance covenants
  - Loans historically had fixed dollar basket exceptions to negative covenants, while bonds expressed such exceptions as a percentage of Consolidated Net Income (they “grow” or are “grower baskets”)
  - Floating vs. Fixed interest rates
  - 5/6 year maturity for term loans vs. 8/10 year maturity for bonds

FINANCIAL MAINTENANCE COVENANTS

- Require borrower to maintain certain financial performance levels on a periodic basis
  - Performance levels generally tied to model provided to lenders prior to commitment and typically are set at a cushion to such model
  - Covenants can be applied on a quarterly basis or an “at any time” basis
  - Failure to comply results in an event of default (typically no grace period)
- Maintenance Covenants apply whether or not a borrower intends to incur debt or otherwise enter into a transaction limited by the negative covenants

FINANCIAL MAINTENANCE COVENANTS (CONT.)

- Most maintenance covenants can be categorized
  - “balance sheet covenants” frequently apply to high grade borrowers, testing items found on a company’s balance sheet (e.g., net worth, debt-to-capitalization)
  - “cash flow covenants” test a borrower’s income statement, measuring the borrower’s ability to de-lever or service debt. They are frequently seen in leveraged deals
- Pro Rata tranches (Revolver and TLAs) generally have some form of financial maintenance covenants

MAINTENANCE COVENANTS – THE USUAL SUSPECTS

- Maximum leverage ratio → the borrower cannot exceed a specific ratio of debt to a cash flow measure (typically EBITDA)
  - Total debt
  - Secured debt
  - First lien debt
- Minimum Interest Coverage Ratio → the borrower must have at least a specified ratio of cash flow (EBITDA) to interest expense
  - Total interest
  - Cash interest
- Minimum Fixed Charge Coverage Ratio → the borrower must have at least a specified ratio of cash flow (EBITDA) to fixed charges
  - Interest expense
  - Capital expenditures
  - Scheduled amortization payments
  - Rent expenses
  - Dividends

BENEFITS FOR LENDERS OF FINANCIAL MAINTENANCE COVENANTS:

- Maintenance covenants provide early warnings of financial difficulty
  - Without financial maintenance covenants, the Borrower's financial health could deteriorate and it could file for bankruptcy without ever having breached a financial or other covenant (assuming it did not seek to incur additional debt, etc.)
- Early warnings allow lenders to be pro-active in devising solutions
  - Early "seat at the table" with borrower
  - Bondholders – not having maintenance covenants – were typically excluded from restructuring discussions in early stages
- Maintenance Covenants can deter borrower from pursuing transactions that have negative impact on cash flow

BORROWER'S RESPONSE TO FINANCIAL MAINTENANCE COVENANTS

- Equity cures - Cash injection within 10 business days after delivery of financials
  - Standstill
  - Maximum 5 for life of loan and maximum 2 for every 4 fiscal quarters
  - Cure injection amount cannot exceed the amount necessary for the cure
  - Disregarded for other purposes and tests
  - Cash injection increases the cashflow component of the ratio and may also be negotiated to decrease the debt component
- "Net leverage" tests
  - Reduces numerator of ratio (debt) by the amount of unrestricted cash of the Borrower available for debt repayment
  - Cash should be unrestricted *and available* (e.g., not trapped in foreign jurisdictions where repatriation is difficult or costly)
  - May be a cap on the amount of unrestricted cash that may be netted

BORROWER'S RESPONSE TO FINANCIAL MAINTENANCE COVENANTS (CONT.)

- Springing Covenants
  - Triggered if outstandings under revolver exceed a certain percentage of commitments
  - Cash-collateralized letters of credit often excluded in calculation
  - Basket amount of non-cash-collateralized letters of credit also often excluded
- Cushion to base case model
- Covenant-lite term loans

COVENANT-LITE LOANS

- Key factors affecting current market dynamics:
  - Interest rates remain relatively low even given recent increases in the LIBOR and Fed rates, and debt investors are looking across the leveraged market for higher yields
  - Belief that interest rates will continue to increase causes investors to look for a mix of floating rate debt (loans) and fixed rate debt (bonds)
  - Leveraged acquisition activity has not increased enough to keep up with demand from CLOs and other investors for syndicated loans
- As a result, certain borrowers have more negotiating leverage to obtain more favorable terms
  - Private equity sponsors
  - Higher rated leveraged borrowers

COVENANT-LITE LOANS (CONT.)

- Investors flocking to the loan market over the last several years have historically relied on public debt ratings rather than independent credit review
  - Therefore, the specific terms of a credit agreement may not be as critical to such investors as they were historically to the commercial banks when the banks held the term loans

DEBT INCURRENCE

- Fixed dollar baskets - $[   ]
  - Grower components so that baskets can grow as business expands
    - Greater of $[ ] and __% of [Consolidated Total Assets] / [EBITDA]
- Ratio baskets - Tests: cash interest coverage ratio or leverage ratios
    - Interest Coverage: “the Issuer and the Restricted Subsidiaries may incur Indebtedness if (x) on the date of such incurrence and after giving pro forma effect thereto (including giving pro forma effect to the use of the proceeds thereof) no Default or Event of Default has occurred and is continuing, and (y) the Issuer’s Consolidated Interest Coverage Ratio for the most recent four full fiscal quarters for which financial statements are available, after giving pro forma effect to such incurrence, is at least equal to or greater than 2.00 to 1.00”
    - Leverage: ability to incur debt (a) secured with collateral on (i) a pari passu basis (up to a maximum first lien net leverage ratio) or (ii) a junior secured basis (up to a maximum total secured net leverage ratio), or (b) on an unsecured basis up to a maximum total net leverage ratio, and (c) subject (in the case of pari passu or junior liens) to an intercreditor agreement

ACQUISITIONS

- Historically, bank loans limited acquisitions to a fixed amount per year or over the life of the loan (sometimes with a per acquisition limit as well)
- Covenant lite loans allow unlimited acquisitions subject to pro forma compliance with an incurrence test (compliance with a net leverage ratio or interest/fixed charge coverage ratio) tested at incurrence or subject to just a no event of default standard
  - A "Limited Condition Acquisition" is one in which consummation of the acquisition is not conditioned on the availability of, or obtaining, any financing. With respect to Limited Condition Acquisitions, most sponsor deals permit ratio compliance to be tested at signing, rather than at the time of debt incurrence, at the option of the Borrower.
- If the covenant lite term loan is paired with a revolver then the test might be pro forma compliance with the financial covenant for the revolver regardless of whether it is then applicable
- Generally will include a limit on acquisitions of non-credit parties (or at least the banks may seek to have flex to impose such a limit in committed deals)

REPAYMENT OF JUNIOR DEBT

- "Junior Debt" can refer to second lien, unsecured or subordinated debt
- Traditional loans would have a small fixed dollar basket with which the borrower could prepay principal of junior debt
  - Junior debt is typically more expensive than first lien senior secured debt and therefor it can be beneficial for borrower to pay down the junior debt first
  - However, this would mean that borrower pays out cash, and the senior lenders would have lost the cushion of junior debt in a work-out scenario
- Covenant-lite loans may allow the borrower to prepay junior debt subject to compliance with an incurrence test (typically a leverage ratio) in addition to dollar baskets

BUILDER BASKETS

- In covenant-lite loans, “builder baskets” have evolved for dividends, acquisitions and investments, and repayments of junior debt – adopted from the Consolidated Net Income basket in high yield indentures
- Capacity intended to grow over life of the deal, but may represent a notional amount rather than actual cash on hand
- Starter basket (fixed dollar) + (x) retained excess cash flow or (y) 50% consolidated net income
- Plus:
  - Equity injections or issuances
  - Returns on investments
  - Asset sales proceeds
  - Declined prepayment amounts
- Use (at least for dividends and other distributions) is frequently conditioned on pro forma satisfaction of a leverage test + no event of default (sometimes with negotiated exceptions)

RESTRICTED SUBSIDIARIES

- Historically, loans would typically cover all subsidiaries of the Borrower in the representations, covenants and events of defaults
- In borrowing a construct from high yield indentures, covenant-lite loans permit "unrestricted" subsidiaries to operate free from representations, covenants and events of defaults
- Restricted subsidiaries vs. subsidiary guarantors – beware the difference
- Traditional loans would have restrictions on money/assets flowing from creditor group to non-creditor group
- Bonds typically have restrictions on money/assets flowing from restricted group to unrestricted group

RESTRICTED SUBSIDIARIES (CONT.)

- Bonds do not typically have restrictions on money/assets from credit group to non-creditor group
- Covenant lite loans are gradually moving more to bond construct (at least for top-tier sponsors) and may not have restrictions on money/assets flowing to non-credit group

EVENTS OF DEFAULT

	Bonds	Senior Bank Loans
Default in interest payment	30 days grace period	3-5 business days grace period
Covenant default	60 days grace period other than mergers, asset sales and failure to repurchase upon a change of control	None for negative covenants and certain affirmative covenants; 30 days for others
Default in other material debt	Cross acceleration	Cross default

TREND TOWARD INCREASINGLY FLEXIBLE STRUCTURES

- Most recent leveraged credit agreements have nearly identical covenants and events of default as high yield indentures
- Some recent loan deals are actually more flexible than high yield indentures
- These structures may include some or all of the following terms:
  - Up to 60-day default grace period for breaches of affirmative covenants
  - Representation breach may not result in automatic Event of Default:
    - Example: "Any representation or warranty… [is] incorrect or misleading in any material respect *and is adverse to the Lenders on or as of the date made or deemed made*"
  - High-yield style cross-acceleration (instead of cross-default):
    - Example: EOD triggered upon a "default under any other mortgage, indenture, agreement or instrument […], *if* that default: (A) is caused by a failure to pay *principal of such Indebtedness* at its stated final maturity (after giving effect to any applicable grace period provided in such Indebtedness; or (B) *results in the acceleration of such Indebtedness* prior to its express maturity"

MAURA O'SULLIVAN
Partner, Finance

NEW YORK
T +1 212 848 7897
mosullivan@shearman.com

BAR ADMISSION
New York

EDUCATION
Fordham University School of Law, J.D.
•Business Editor, *The Urban Law Journal*
College of the Holy Cross, B.A.

PRACTICE

MAURA O'SULLIVAN IS THE GLOBAL BANK FINANCE PRACTICE GROUP LEADER.

She focuses on acquisition financings, leveraged lending, restructurings and asset-based finance.

Maura represents financial advisors, lenders and borrowers, and her clients include Barclays, Credit Suisse, Deutsche Bank, JP Morgan Chase & Co. and Morgan Stanley.

Relevant experience includes representation of:

- Citibank, N.A. as Agent on a $6.3 billion DIP financing for Energy Future Intermediate Holding Company LLC and EFIH Finance Inc., consisting of a $5.475 billion senior secured DIP term loan facility and an $825 million senior secured delayed draw DIP term loan facility
- Morgan Stanley Senior Funding, Inc. and HSBC Bank USA, National Association in connection with a $2.425 billion financing for PTL Acquisition Inc. to finance the acquisition of Tumi Holdings, Inc. by Samsonite International, S.A. The financing also involved collateral located in multiple foreign jurisdictions including Belgium, Canada, Hong Kong, Hungary, Luxembourg and Mexico
- Morgan Stanley Senior Funding, Inc., The Bank of Tokyo-Mitsubishi UFJ, Ltd. and Deutsche Bank Securities Inc., as lead arrangers and bookrunners, in connection with the $2.475 billion financing of Microsemi Corporation's acquisition of 100% of the capital stock of PMC-Sierra, Inc.
- Bank of America as Agent on a $3 billion revolving credit facility for Visa Inc.
- Boston Scientific Corporation, as borrower, in connection with a $3 billion financing, including a refinancing of its $2 billion revolving credit facility arranged by J.P. Morgan Securities LLC and Merrill Lynch, Pierce, Fenner & Smith Incorporated, a new $750 million unsecured term loan arranged by J.P. Morgan Securities LLC and Merrill Lynch, Pierce, Fenner & Smith Incorporated, which backs the company's acquisition of Endo International's male urology business, and a $250 million revolving credit facility arranged by J.P. Morgan Securities LLC
- Credit Suisse Securities (USA) LLC, Macquarie Capital (USA) Inc. and ING Capital LLC, as joint lead arrangers and joint bookrunners, in the $245 million senior secured financing, consisting of a $195 million first lien financing and a $50 million second lien financing, related to the acquisition of Global Knowledge Training LLC by Rhône Capital LLC from MidOcean Partners
- BNP Paribas, as agent, in relation to a $15 billion financing, consisting of a $5 billion 364-Day credit facility, a $5 billion three-year credit facility and a $5 billion five-year credit facility for Toyota Motor Credit Corporation and its affiliates
- Morgan Stanley, Citigroup, Deutsche Bank Securities and RBC Capital Markets as joint lead arrangers and joint bookrunning managers in connection with a $640 million financing for Halyard Health Inc.'s spin-off from Kimberly-Clark Corporation, including a $390 million term loan B and $250 million of senior notes
- Morgan Stanley Senior Funding, Inc., Deutsche Bank Securities Inc. and Jefferies Finance LLC as joint lead arrangers and joint bookrunners in connection with a $725 million financing, comprising of a $450 million first lien term loan facility, a $75 million revolving credit facility and a $200 million second lien term loan facility, related to the acquisition of Grocery Outlet Inc. by Hellman & Friedman LLC

MICHAEL STEINBERG
Partner, Finance

NEW YORK
T +1 212 848 8213
msteinberg@shearman.com

BAR ADMISSION
New York

EDUCATION
University of British Columbia
Law School, LL.B.
University of British Columbia, B.A.

PRACTICE

MICHAEL STEINBERG IS A PARTNER IN THE FINANCE PRACTICE.

He focuses on various types of transactions involving leveraged acquisition financing, and also specialized finance structures, including securitization and asset-backed finance, as well as unsecured and secured bank financings generally, with experience in asset classes such as motion pictures, pharmaceuticals and aircraft.

Mike represents financial institutions, major corporations, investment funds and financial sponsors. His clients include BAML, Jefferies, Goldman Sachs, Credit Suisse, JPMorgan Chase & Co., Citibank and Morgan Stanley.

Mike was Clerk at the British Columbia Court of Appeals from 2001 to 2002.

Relevant experience includes representation of:

- UBS Securities LLC, as a joint lead arranger and bookrunner, in connection with $475 million financing, consisting of a $320 million first lien term loan facility, a $40 million first lien revolving facility and a $115 million second lien term loan facility, related to KKR's acquisition of C.H.I. Overhead Doors, Inc. from FFL Partners
- JPMorgan Chase Bank, N.A. as administrative agent and the joint lead arrangers and bookrunners in connection with a $2.2 billion senior secured refinancing for LPL Holdings, Inc.
- JPMorgan Chase Bank, N.A., as administrative agent, in connection with a $1.8 billion financing, including a $1.5 billion Term Loan A and a $250 million revolving credit facility, in connection with the spin transaction of the sports business of Madison Square Garden
- Merrill Lynch, Pierce, Fenner & Smith Incorporated, J.P. Morgan Securities LLC, BNP Paribas Securities Corp., Citigroup Global Markets Inc., Credit Agricole Corporate & Investment Bank, Morgan Stanley Senior Funding, Inc. and RBS Securities Inc., as joint lead arrangers and bookrunners, and Bank of America, N.A., as agent, in connection with the $2.1 billion second amendment and restatement of an existing multi-facility, multi-currency credit agreement for Sealed Air Corporation and various of its affiliates
- J.P. Morgan Securities LLC, UBS Securities LLC, Goldman Sachs Bank USA, Morgan Stanley MUFG Loan Partners, LLC (acting through The Bank of Tokyo-Mitsubishi UFJ, LTD.), Morgan Stanley Senior Funding, Inc. and Citigroup Global Markets Inc., as joint lead arrangers and joint bookrunners, and BMO Capital Markets, KeyBank National Association and Fifth Third Bank, as joint lead arrangers, in connection with a $647 million financing related to TPG Capital's acquisition of The Warranty Group, Inc. from Onex Corporation
- Bank of America, N.A., as administrative agent, and Merrill Lynch, Pierce, Fenner & Smith Incorporated, as joint lead arranger and bookrunner, in connection with a $650 million aggregate financing, including a $250 million revolving credit facility, a $110 million Term A-1 facility and a $290 million Term A-2 facility, related to the spin-off of the Performance Fibers business of Rayonier Inc. from its Forest Resources and Real Estate businesses
- Goldman Sachs, RBC Capital Markets and Macquarie Capital (USA) Inc. as joint lead arrangers and joint bookrunners in connection with a $475 million first lien financing and a $170 million second lien financing related to the acquisition of TNT Crane & Rigging, Inc. by First Reserve Corporation from of Odyssey Investment Partners, LLC

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