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Structuring Leveraged Finance Transactions for Private Equity Acquisitions: Key Loan Terms and Trends

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1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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December 18, 2014

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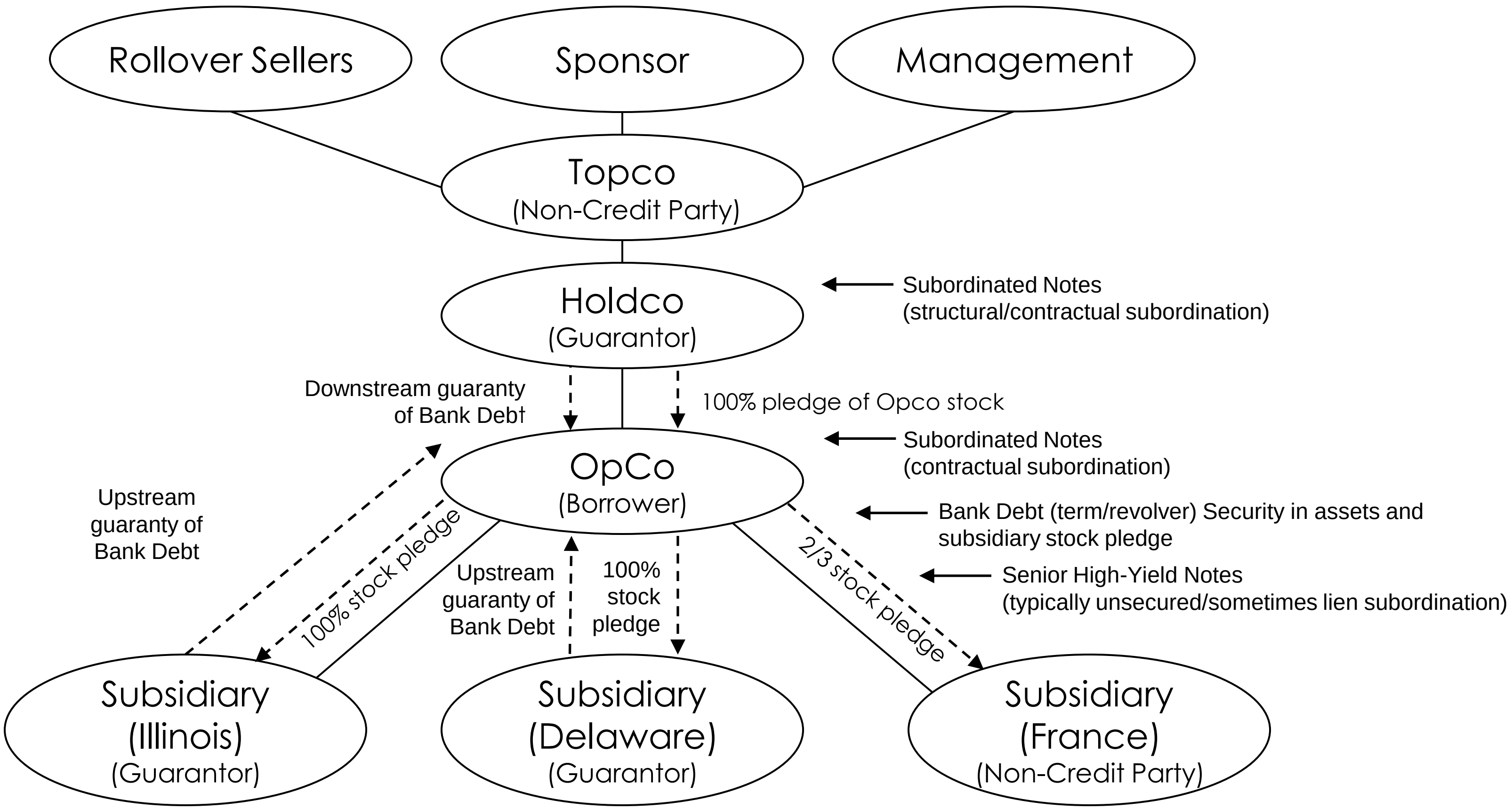
Leveraged Buyout Financing – Typical Structure



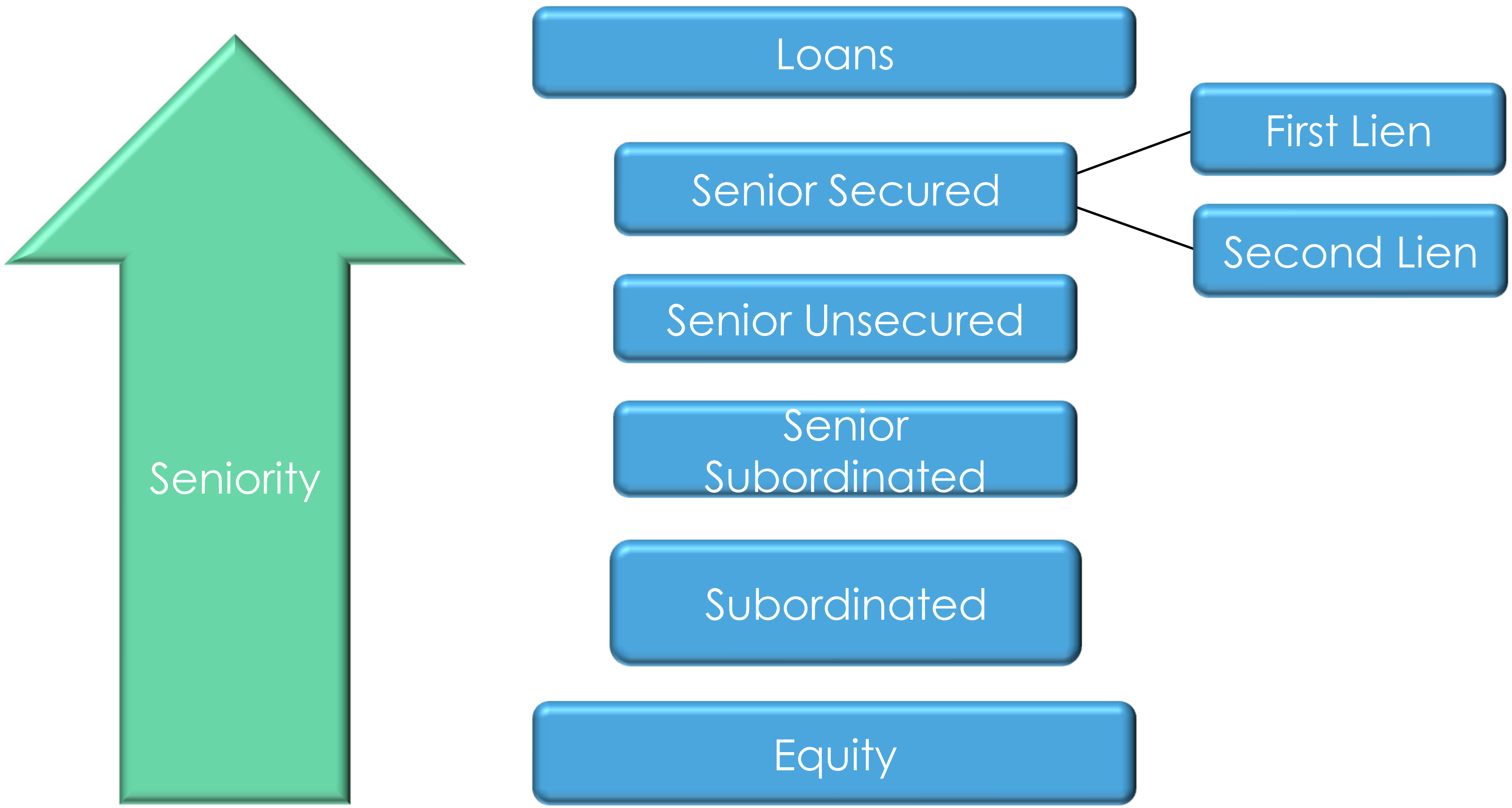
ASSETS of Holdco (if any) and STOCK of Opco pledged by Holdco in support of Holdco downstream GUARANTY

ASSETS of Opco and STOCK of Subsidiaries pledged in support of borrowings under CREDIT AGREEMENT by Opco

ASSETS of domestic subsidiaries pledged in support of upstream GUARANTIES by such Subsidiaries

Types of Credit Facilities

A Typology of Loans



Senior Credit Facilities

- Term Loans
  - Closing Date Term Loans
  - Delayed Draw Term Loans
- Revolving Loans
  - Letters of Credit
  - Swingline
- Incremental Facilities ("Accordions")
  - Advantage: No Lender consent required
  - Most Favored Nation (MFN) Pricing typically applies
  - Types: Fixed vs. Unlimited

Unitranche Facilities

What is Unitranche?

Senior secured debt on the borrower's capital structure

Lenders separately agree among themselves to create first and last out tranches

One Credit Agreement

- All lenders party to one Credit Agreement
- One class of loans/ one blended interest rate for all lenders (as far as borrower is concerned)
- One set of covenants and defaults
- Voting subject to majority (or supermajority)

Advantages of Unitranche Facilities

Second Lien Loans

- Loans secured by a second priority lien on the assets of the Borrower and Guarantors
- Typically agree to be subordinated with respect only to lien priorities and not payment priorities
- May be cross-defaulted (subject to cure/grace period) to First Lien loans or cross-accelerated to First Lien Loans
- Generally no amortization required and prepayments only made to the extent First Lien prepayment requirements have been satisfied or First Lien Lenders decline payments
- Maturity date is typically 6 months to 1 year beyond First Lien maturity

Second Lien Loans

- Often subject to prepayment premiums for repayments within a certain timeframe after closing
  - Market is moving toward just requiring premiums in connection with Repricing Transactions
    - Repricing Transactions are:
      - Prepayments made with the proceeds of any indebtedness with an interest rate below the rate charged on the existing debt; or
      - Amendments to the existing debt which have the effect of reducing pricing on the existing loan

Mezzanine Loans

- Traditional mezzanine loans are borrowed by the holding company/parent of the senior loan borrower
  - Generally preferred by senior lenders because it results in structural subordination
- Current market practice has the mezzanine loans borrowed by same borrower as senior loan borrower
- Mezzanine loans are typically unsecured and subject to express subordination agreements (resulting in contractual subordination)

Mezzanine Loans

- Common terms
  - Mezzanine loan pricing is significantly higher than senior loan pricing given the greater risk incurred by unsecured creditors, although rates have trended downward
  - Often a fixed rate of interest rather than a floating LIBOR linked loan
  - A portion of the interest on mezzanine loans is often payable in kind at Borrower’s option
    - Note that PIK interest presents AHYDO issues if the term of the mezzanine loan exceeds 5 years
  - Term of mezzanine loans typically set at 6 months to 1 year beyond the maturity date of senior loans
  - Generally subject to prepayment premiums; sometimes make-whole premiums, although prepayment premiums have been reduced recently
  - Trend towards carve-outs for change of control and "transformative transactions"
  - Mezzanine lenders often given equity and/or sometimes warrants in borrower
  - Mezzanine lenders often receive non-voting board observer rights

Incremental/Refinancing Tranches

- Most large cap deals and many mid-market facilities permit borrowers to incur incremental and/or refinancing indebtedness as existing facility increases or new tranches of debt that are pari passu, senior secured, unsecured, or high yield note issuances
- Form of intercreditor at closing is often negotiated to allow for additional tranches and types of debt to be added

Equity Contributions

- Lenders typically require at least 40% of capital structure to be contributed in the form of cash equity by the Sponsor
  - Management equity rollover often included for purposes of calculating such 40%
- Lenders generally have approval rights over:
  - The terms of any preferred equity invested at closing
    - Note – cannot have any mandatory redemption rights other than as a result of a change of control or asset sale
  - The identify of any non-affiliate/non-management equity co-investor at closing

Structuring Guarantees

- Important to identify early on in the debt financing process which entities in the corporate structure will provide guarantees and collateral for the credit facility
- Consider tax implications, particularly in the case of foreign subsidiaries. For US income tax purposes, a guarantee by a foreign subsidiary or a pledge of more than 65% of the voting equity interests of a foreign subsidiary may cause the earnings of such foreign subsidiary to be deemed to be paid as a dividend to the US parent (thereby potentially increasing US tax obligations by the amount of the deemed dividend although it never actually occurred)
- Consider regulatory issues that would restrict guarantees (such as prohibitions on PCs guaranteeing obligations in a healthcare deal and captive insurance subsidiaries being restricted from providing guarantees)
- Consider other company specific issues and operational restrictions that may prevent guarantees

Unrestricted Subsidiaries

What Entities are Subject to the Covenants, Events of Default and Representations and Warranties?

- Restricted Subsidiaries/Unrestricted Subsidiaries
  - Consider excluding “Immaterial Subsidiaries”: i.e., individually less than 5% CTA or 5% Total Revenues and collectively less than 10% of CTA and Total Revenues
  - Consider excluding “Unrestricted Subsidiaries”:
    - Entities on a schedule to the Credit Agreement at Closing
    - Other entities identified by Borrower from time to time, provided after giving effect to designation, would otherwise be in compliance with covenants (financial covenants, permitted investments, etc…)
    - Company may want to engage in unrelated businesses
    - Way to minimize impact of negative EBITDA attributable to entities

Structuring Collateral Package

- Most loans are secured by "substantially all" of the personal property of the applicable credit parties (including equity interests and promissory notes)
- Loans may also be secured by owned real property
- Depending on the importance of certain leased locations, lenders may also require leasehold mortgages, although not customary
- Typical exceptions to the collateral package (or perfection requirements) include:
  - Payroll, employee benefits, trust and escrow accounts; deposit accounts with a de minimus value
  - Assets the pledge of which would violate applicable law, regulation or contractual restriction
  - Motor vehicles and other equipment subject to certificates of title
  - Owned real estate with a de minimus value
  - Other assets deemed to be immaterial in the discretion of the Administrative Agent

Acquisition Financing Timeline

Acquisition financings can run from a few weeks to several months. This timeline assumes that this is a broadly syndicated deal (instead of a "club deal") and a period of 8 weeks from the commencement of the transaction through the closing. Timeline is also subject to any necessary regulatory approval.

Initiation (Weeks 1-3)

Sponsor approaches financial institutions to fund an acquisition

Sponsor chooses administrative agent and arranger to provide commitments and to conduct the syndication process.

Sponsor provides financial information and due diligence material to financial institutions after signing a non-disclosure agreement.

Administrative agent and its counsel sign off on the diligence.

Acquisition Financing Timeline (cont'd.)

Acquisition Documentation and Commitment Paper Documentation (Weeks 2-3)

Administrative agent's counsel and sponsor's counsel negotiate commitment papers concurrently with the negotiation of the acquisition agreement.

Administrative agent, arrangers and sponsor or its acquisition vehicle sign commitment papers simultaneously with the signing of the acquisition agreement.

Syndication Process (Weeks 3-8+)

Sponsor and target provide information so that the arrangers can prepare an information memorandum.

Arranger prepares information memorandum.

Arrangers go on "road show" to discuss information memorandum with potential lenders.

Acquisition Financing Timeline (cont'd.)

Loan Documents and Satisfying the Conditions to Fund and for the Acquisition (Weeks 3-8)

Administrative agent's counsel and sponsor's counsel negotiate the loan documents.

Administrative agent post documents for syndicate lenders.

Lenders provide any comments.

Loan documents are finalized and the conditions to fund and for consummation of the acquisition are satisfied except for execution and delivery of the final loan documents.

Closing/Signing (Week 8)

The loan documents are executed and delivered and all conditions to the funding and the acquisition are satisfied.

Funding occurs and the acquisition is consummated.

Acquisition Financing Timeline (cont'd.)

Post-Closing

Borrower and administrative agent work collaboratively to satisfy any post-closing conditions.

Arrangers continue to syndicate loans (if not fully syndicated).

Evolution of Loan Terms

Covenant Convergence → High-yield Style Covenants in Term B Loans → Builder Baskets and Grower Baskets → Debt Incurrence → Restricted Payments → Investments → Acquisitions

Acquisition Financing → SunGard Conditionality → Precaps

Terms Borrowed from High Yield Bond Indentures

- Unrestricted Subsidiaries
- Incurrence Flexibility
- Ratio debt: leverage ratio vs. coverage ratio
- Build Baskets: Cumulative unswept excess cash flow vs. 50% of cumulative consolidated net income
- Acquisitions permitted with no dollar cap (except non-Loan Party acquisitions)
- Accounting definitions
- Grower baskets (greater of dollar amount and a percentage of total assets or Consolidated EBITDA)
- Increasing conformity of credit facility covenants with high yield covenants

Trends - Financial Covenants

- Covenant Lite
  - Term Loan B: No financial maintenance covenants
  - Revolver: Springing covenant (total or first lien secured net leverage ratio)
    - Triggered based on Revolver usage (20-33%)
    - Treatment of Letters of Credit (exclusion of cash collateralized, inclusion of L/Cs over $ threshold)
    - Testing
  - No Term Loan default based on Financial Covenant (unless revolver accelerates)
- Fewer Covenants
- Cushions increasing
- Equity Cures
  - Increased cap
  - Credit for deleveraging in some or subsequent quarters

Trends - Acquisition Financing Conditionality

- Limited Specified Conditions
- Synching of Financing Conditions with Acquisition Agreement
  - Sungard
    - Reps limited to Acquisition Agreement reps that give Sponsor right to terminate and Specified Reps (list has become standardized); no “no default” condition
    - Limited Collateral Deliveries (UCC financing statements, certificated securities)
    - Application for financings of add-on acquisitions
  - Company MAC
  - Approval of Acquisition Agreement
  - Financial Information Deliveries
  - Termination Date
  - No separate acquisition-related conditions
  - Marketing Period

Trends – Commitment Papers

- Sponsor Precedent/Documentation Principles
  - Specified precedent agreement
  - Loan documents to be negotiated in good faith; changes to reflect operational and strategic requirements, size, industry of Borrower

Migration of Large-Cap Terms to Middle Market Deals

- Large cap terms appearing in middle market commitment letters include:
  - Limitations on expense reimbursement
    - Contingent on closing
    - Fee estimate or cap
  - The specification that sponsor's counsel will be responsible for drafting the loan documentation
    - Use of sponsor precedent
  - Looser "SunGard" conditionality
    - The types of collateral required to be delivered at closing are becoming more limited (i.e., UCC collateral and stock certificates)
- Becoming more common for middle market sponsors to draft the initial commitment papers

Migration of Large-Cap Terms to Middle Market Deals

- Large-cap terms that are now appearing in middle market loan agreements include:
  - Financial performance measurements
    - EBITDA
      - Inclusion of pro forma costs savings, synergies, optimization expenses projected by borrower (modified S-X standard), but generally capped at percentage of adjusted EBITDA
    - Net Debt
      - Unrestricted cash
      - No cap vs. caps
    - The percentages of ECF required to prepay loans and the related step-downs based on financial ratio tests are negotiated
    - No cap ex covenant
  - Incremental facilities
    - Conditions include:
      - Pro forma compliance with financial covenants

Migration of Large-Cap Terms to Middle Market Deals

- Size of incremental facility generally (but not always) capped in lower middle market
- Uncapped incremental facilities subject to ratio based limiter
- No Default – subject to SunGard conditionality for acquisitions
- MFN protection
  - 50 bps standard
  - Sunset (sometimes)
  - yield formulas for calculation

– Equity cure rights (terms have become standardized)

- Limited number of cures & limited number of quarters in any year
- Limited to amount needed to cure financial covenant default

– Amend & extend provisions

- Ability to extend maturity and change economic terms of any facility with consent of just extending lenders

– Ratio/incurrence based debt and restricted payment (including repayment of second lien and/or subordinated debt) flexibility

Migration of Large-Cap Terms to Middle Market Deals

- Sponsor affiliate loan assignments
  - generally capped at 20-30% of aggregate amount of term loans at time of purchase
  - voting rights (other than issues that unfairly impact sponsor lender) limited
  - numerosity issues in a bankruptcy
- Borrower debt buybacks/Dutch auctions
  - repurchase debt at below par prices
  - avoids pro rata sharing among lenders
  - Sometimes "open-market" repurchases permitted
- Builder baskets
  - used for additional restricted payments, permitted acquisitions, prepayments of second lien and/or sub debt, investments and capital expenditures
  - sometimes a “starter” basket
  - typically based on % of retained ECF or % of CNI plus increase in value of investments and/or sale of investments purchased with builder baskets

Migration of Large-Cap Terms to Middle Market Deals

- Grower baskets
  - used for additional restricted payments, permitted acquisitions, prepayments of second lien and/or sub debt, investments and capital expenditures
  - typically based off of a calculation of revenue, total assets of EBITDA
- Lender/competitor blacklists
- Refinancing facilities
  - Ability to refinance any facility in whole or in part with new debt issuances

Continued and Increased Presence of Alternative Lenders Helps Drive Middle Market Activity

- Customization of financing structures
- More flexibility for different structures and features
  - Unitranche, low or no amort, PIK interest, complex collateral issues
- With committed facilities, challenges include getting same degree of "SunGard" conditionality and hence more attention needs to be paid to the M&A dynamic and interplay (e.g., required financial conditions to closing)
- Alternative lenders often require equity co-invest
- We often see multiple alternative lenders competing for deals