

## ROUNDTABLE



## GLOBAL LEVERAGED FINANCING

The leveraged finance market has experienced explosive growth around the world over the last four years. M&A activity has led to borrower-friendly terms and pricing for debt types across the capital structure. This may continue as long as the private equity boom rolls on, although there are recent signs of a pullback on credit terms. Advisers arranging financing packages in today's market need to consider investor enthusiasm for new deals, legal frameworks around the globe and long-term challenges facing the underlying business. In this competitive field, shrewd decisions will separate long-term players from short-term opportunists.

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**Over the last few years the leveraged finance market has witnessed explosive growth. What factors are contributing to the increasing appetite of lenders to provide capital to the buyout market?**

**Smith:** There has been a global wave of liquidity with investors from around the globe seeking higher returns. This capital has led to the unprecedented formation of CLOs and CDOs that account for a very significant percentage of new issuance purchases for leveraged finance. The creation of LCDS and CDS markets and the related indexes have also allowed risk to be spread very efficiently and has encouraged lenders to take increasing levels of risk. With so much demand for yield, spreads have, until very recently, compressed to historic lows to treasuries. The pendulum is clearly moving in the other direction at the moment but the fact remains that there is still much capital that needs to be deployed.

**Walsh:** There has been substantially increased liquidity in the market generally, both from traditional bank lenders in the UK and European markets but also increasingly from the US and the Far East and new sources of finance, such as hedge funds and the investor community. The increased size of transactions and the increased frequency with which the original buyout finance is then refinanced have led to additional opportunities for lenders to provide capital. Also, the tax treatment of equity investments has made debt a much more attractive asset class for investors like pension funds.

**Stefanowski:** A number of factors are contributing to the appetite. There is search for yield across the board. Returns and volumes from sponsor equity liquidity have been at all time highs, encouraging a number of new lenders, particularly institutions, into the space. CLOs have supplemented and, in some cases, even replaced the bank lenders. A very active and liquid secondary market has created confidence for lenders to enter and exit the market. Standardisation of credit default swap terms enables lenders to better manage risk exposure. Finally, though, some CLOs do less fundamental risk analysis than the banks, so if the market tilts the wrong way then they could be stuck with a risky asset. The instability of the market in early July has shown how institutional appetite remains higher than that of the banks, as syndicate desks have had to work harder to get pro-rata pieces of new deals away.

**Hourican:** A number of developments have resulted in the moon, the sun and the stars lining up in the leveraged finance market. First, we have a very low interest rate environment. Second, the creation of the Euro in the late 90s paved the way for a significant market in which companies in Europe could operate across Europe. That in turn has created a deeply liquid, diversified and transparent market for both loans and bonds and a more dynamic buyout market across Europe. Third, the institutional market has become an important mainstay to the bullet structures in the centre of the capital structure, and also to second lien products. Without the institutional markets, we would not have the liquidity to execute the size of deals completed over the last few years.

**Eisenbiegler:** Buy-side appetite for leveraged loans has been driven by a number of factors. Institutional investors and hedge

funds have been seeking high yield with the benefits of collateral and (in some cases) covenants. Default rates (aided by abundant sources of rescue financing at even higher rates) and interest rates have been low. Liquidity in this asset class that has never been better. The development of the LCDS market has allowed lenders to manage risk effectively and to take on more risk. The explosive growth of second lien loans has added a new high yield product, which the market has embraced. Another factor is the increased contribution of sponsored financings, perceived advantages of which include professional management, availability of additional junior capital, and a focus on achieving a short to medium term liquidity event.

**Joachim:** One of the biggest factors that has led to the increasing appetite of lenders to provide capital for the buyout market has been the explosive growth of hedge funds and CLOs in the market place. Competition has increased as hedge funds and CLOs are under constant pressure from their investors to put capital to work. Over the last few years, a clever place to put that money has been at various points in the capital structure on LBO and M&A transactions. Second liens in particular present an alternative to unsecured debt in need of a mezzanine or sub-debt structure, by offering secured debt with obvious protections. From a borrower's perspective, second lien is still cheaper than going to the public markets, so it is a win-win formula.

**Legge:** The key factor that I see contributing to the increasing appetite of lenders to provide capital is the evolution in the structures that are available to lenders. By the early 2000s, the growth in the second lien marketplace brought the need for intercreditor rights for those lenders, such as relatively short standstill periods. That improved the risk/return profile on second lien lending from the days when it was extremely junior. From there, more hybrid structures evolved to the point where the market comprises senior lenders, second lien lenders, mezzanine lenders and junior lenders. There is simply more capital throughout the spectrum and lenders can come in at any level. As the market matured, syndication opportunities also opened up, which has significantly increased lending in the marketplace.

**In what ways are local markets converging to create a truly global leveraged finance market?**

**Joachim:** For starters, many of the top equity sponsors are going global in search of new opportunities. An obvious way of trying to break through and find less competition is to look beyond domestic borders for more deals. Also, many of the large credit transactions include foreign borrowing capacity in ways they have not previously, including multi-currency layer credit facilities. Firms doing deals overseas will be in increasing contact with local banks, and bringing them in to be lead players on a foreign borrowing silo or take up local tranches.

**Eisenbiegler:** In the last 2-3 years, I have seen significant convergence around US-style norms for leveraged financings. Significant differences remain, however, between US and European markets in structure and terms for second lien and mezzanine financings. Another significant difference between US and European markets ►►

is that European banks seem more comfortable using their balance sheets for leveraged loans.

**Stefanowski:** There are local banks and sponsors looking at every deal in the market and any new trend in pricing or structures is picked up across the market. That said, larger deals still tend to migrate to the proven financial centres, such as London, to complete the syndication. Trends from the US also make their way over here, but with a clear time lag as European firms judge when and how to adapt them to local markets.

**Smith:** We see an increasing number of deals that are being marketed globally with multiple tranches in different currencies. With increasingly sophisticated swap and hedge strategies, I think we will see issuers continue to try to take advantage of purchasing power throughout the globe to minimise their borrowing costs.

**Hourican:** As an arranging bank, we need to think about our business in terms of currencies rather than countries. It is important to identify where the liquidity is likely to be and in which currency it is most likely to be raised. Origination is a relatively local activity, supported by global distribution. Depending on the cash profile or the earnings profile of a company, the idea is to access liquidity in whichever currency best matches the company's ability to repay it. In Asian markets, however, where local currency is a big requirement, the ability to create a deeply liquid distribution pool is inhibited. When dealing in Taiwan, Korea, Thailand or Singapore, for example, the ability of banks to deliver local currency and also to distribute local currency to a wide spectrum of investors is held back because these are not yet mature markets.

**Walsh:** The UK market is now heavily influenced by developments in the US markets and by the requirements of US investors, such as second lien tranches, non-amortising senior tranches, covenant-lite structures and incurrence covenants by which the leveraged loan market has taken on some features of the bond or

note market, as well as the extensive use of structural subordination of junior debt.

**Legge:** From a Canadian perspective, the market tracks the US marketplace fairly closely. For example, in the personal property area, some of the Canadian provinces have recently adopted security transfer legislation that mirrors UCC Article 8 in the US, while personal property security legislation in Canada generally followed UCC Article 9. So while there will always be local differences in security, throughout the global market some markets provide a leadership role that leads to convergence.

**What recent innovations have you witnessed in debt structures or components?**

**Hourican:** The market, due to its transparency, liquidity and number of players, is changing daily. All we have to do is look at the last 10 days to note that spreads have widened and elements of structures that disappeared a few months ago have been re-introduced. Flex has become a more important consideration for arranging banks, for example. Following the syndication and allocation of a deal, the deeply liquid secondary market provides an instant gauge of whether the primary price of the deal was right or wrong. There is a responsive feedback from all of the markets across the globe on whether deal structures are working or not, and whether investors are accepting or pushing back on individual characteristics of certain deals. In this way, the European market has become almost as transparent as the US market, while the Asian market remains more opaque.

**Walsh:** All senior debt packages, often with only a bullet repayment, are commonplace. Mezzanine tranches are less common, with the second lien tranche being stretched so as to encroach upon what was traditional mezzanine territory. Where there is a mezzanine tranche the cash pay element is being reduced and you may see a 'mezz toggle' by which the borrower has the right to vary the split between the cash pay and the non-cash pay elements of the mezzanine margin. There have also recently been 'covenant-lite' structures by which some or all of the traditional maintenance financial covenants have been replaced by incurrence style covenants.

**Smith:** The most recent innovations are almost notorious at this point in the cycle: covenant-lite structures and PIK toggle notes. These are the innovations that clearly received the most resistance from new issue buyers over the past few weeks and have become highly challenging, if not impossible, to sell through today.

**Eisenbiegler:** One innovation that has been embraced by both lenders and sponsors in certain middle market deals is the 'uni-tranche' structure. Under this structure, the arranger commits to provide the entire debt financing, on a senior secured basis. The various tranches of financing (for example: revolver, term loan A, term loan B, delayed draw term loan) bear interest at a uniform interest rate which is similar to the all-in blended interest rates for a senior/mezzanine deal or a first lien/second lien deal. The total leverage is also similar. The credit facilities are provided pursuant to a single credit agreement, with limited class voting rights. The ►►

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STEVEN D. SMITH

borrower benefits from the single credit agreement, the limited class voting rights and the ability to amortise or prepay relatively high yielding debt. Unitranche financings are often provided by funds or BDCs. These providers will often retain a large block of the credit facilities and retain effective control over matters requiring approval of the 'required lenders'. These providers may also create (through mechanisms that may or may not be visible to the borrower) a 'first out' facility within the credit facilities, with lower pricing in exchange for payment or collateral proceeds priority, and 'skim' interest paid on the first out facility in excess of the lower rate agreed to by the first out lenders.

**Stefanowski:** Not really innovations as such, but we're seeing an increase in the use of ABL and securitisation in deal structures as ways to optimise financing solutions, particularly in cross-border deals.

**Joachim:** The marketplace is dominated by relatively unregulated entities like hedge funds, private equity funds and CLOs, as opposed to regulated public companies and banks. The individuals at these firms are smart and creative. They put in place more innovative structures to fit particular transactions, as opposed to the stringent, off-the-shelf approach frequently seen at money centre banks and public companies. Perhaps the biggest innovation in the last 7-10 years has been the explosion in the second lien market. An enormous amount of capital is being put in at a more senior position in the capital structure compared to when the mezzanine market was hot. Over the next few years, whenever the cycle turns, it will be interesting to see how this enormous amount of secured debt will affect restructuring negotiations, particularly in credits where the second lien ends up as the fulcrum security.

**What are some of the key points in documentation regarding terms, conditions, security, covenants, flexibility and so on?**

**Legge:** There has been an increase in the number of leveraged acquisitions carried out through auction. As a result, much of the financing that leads to a commitment is being done with little time for due diligence and limited access to management. That makes it a lot more difficult for borrowers to know what they will be living with in the long term. Those responsible for negotiating the credit facility may have little access to management, even though management may be staying in place after the takeover and their input is often crucial to determining whether the credit facility works for their business. This can create tension. Timeframes continue to grow shorter, driven by the pace of an acquisition. Buyers want their transactions wrapped within 2-4 weeks, but the credit or leveraged side can often take longer. The loan agreement will be live for a number of years, but once the acquisition transaction closes, the business is bought and the purchase documentation is essentially done. That puts considerable pressure on those structuring the loan documentation to ensure it is appropriate despite the short timeframes. Regarding key points within the documents, pre-payment fees continue to be hotly negotiated and increasingly important as borrowers may wish to extricate themselves from loan documentation that has been put together too hastily and does not work for their business. Another bugbear is control over cash and blocked account agreements, which involve third party

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JENNIFER G. LEGGE

players that have little or no interest in the transaction.

**Joachim:** Myriad borrower friendly provisions are included in debt deals these days. These include the loosening of conditionality, closing date reps that are watered down and heavily MAC-qualified, delivery of collateral post-closing, covenant-lite deals, 'equity cure' provisions, PIK toggle, and bond-like incurrence tests on debt, lien and investment covenants. The most recent innovations over the last three or four years have all been borrower-friendly. As the press have documented recently, we may be reaching the end of that cycle, but it remains to be seen.

**Stefanowski:** The loosening of documentation and covenants is evidence that this has been very much a borrowers' market. Interestingly, terms and conditions have tightened up immediately when the market 'wobbled' in early July as investors pushed back on the more aggressive documentation.

**Walsh:** The Loan Market Association (LMA) leveraged finance agreement which first appeared in 2004 and which is, in its basic form, a very lender friendly document, is now routinely amended significantly by sponsors. Sponsor modifications to basic LMA documents which are now regularly accepted in the market include: equity cure of any financial covenant breach, 'yank the bank' to take out non-consenting lenders, 'snooze and lose' by which lenders who do not respond to requests within an agreed timescale are disqualified from voting, a substantial narrowing of the definition of 'material adverse effect', restrictions on transferability of debt by lenders and considerable influence or control over primary syndication, reduced bank majorities, carry forward and carry back of unused baskets of certain permitted transactions, a reduction in the scope of repeating representations and events of default and reverse flex arrangements by which if syndication is over-subscribed, margins can be reduced.

**Smith:** Some of the key areas of contention will be overall leverage levels, how to structure new covenant packages (one covenant ►►

or a full set of maintenance covenants), how to calibrate covenant levels (how much cushion to base operating plan will be allowed), whether any PIK feature will be included, will an equity cure be permitted or any other type of ‘mulligan’ and finally, and from an underwriter’s perspective, the critical issue of how much flex in terms of caps and structure will be included in the deal.

**Eisenbiegler:** Financial covenants are one battleground. Borrowers continue to press for fewer financial maintenance covenants or (until very recently) for covenant-lite deals which have none. Where lenders do have financial maintenance covenants, sponsors uniformly want equity-cure rights. Sponsors also want ‘incurance’ based debt covenants and large baskets for sponsor debt, seller debt and earn outs. Sponsors also press for lots of flexibility to permit acquisitions and distributions. Definitions of EBITDA and Excess Cash Flow have become very complex and are highly negotiated. In acquisition financings, sponsors want the full array of ‘Sun Guard’ provisions, even in middle market deals. That means, among other things, financing commitments with very limited conditionality, including limited or no due diligence outs, elimination (in some cases) of ‘market MACs’, business MACs conforming precisely to the acquisition agreement and a definitive listing of conditions precedent, covenants and events of default.

**How much longer will borrowers be able to receive concessions on loan terms?**

**Stefanowski:** Essentially, borrowers will keep receiving concessions until the market says ‘no more’. This could be driven by a number of factors including reduced market liquidity, too many restrictions imposed on transfers in the secondary market and covenants becoming so relaxed the deal does not make business sense. In a tightening market, relaxed covenants may mean that businesses end up in a difficult situation as lenders will not get an early indication of underperformance and, therefore, cannot develop a turnaround plan fast enough.

**Probably the greatest surprise in recent times has been the emergence of covenant-lite structures in loan facilities, which emerged in the early part of this year.**

JEREMY WALSH

**Hourican:** It’s entirely about supply and demand, in terms of what people can get for their money. The one thing that has held up in the leveraged loan market – which cannot be said of virtually every other form of asset financing across the world over the last five years – has been the pricing. The pricing has stayed up because the institutional synthetic funds, mostly CLOs, have return requirements that do not allow them to participate below a certain hurdle. The result is that rather than move on price, the market has been allowing greater flexibility or tenure and package. An arranging bank needs to access liquidity across all currencies in the world. This means it must react to the sentiment of investors and ensure that it structures, prices and covenants the debt according to what investors will accept.

**Eisenbiegler:** The market has become more lender-friendly. There is developing momentum away from covenant-lite loans, and PIK-toggles appear to be gone. Investors in CLOs (who purchase roughly 60 percent of new issue leveraged loans) have been pressuring fund managers to decrease exposure to covenant-lite loans. This pressure may be fuelled by Standard & Poor’s criteria for rating CLOs holding these loans. Arrangers have been adding covenants and increasing pricing in many deals to clear market. Recent examples include Tower Automotive and Myer Industries.

**Joachim:** There is a lot of lender fatigue. Banks are still doing the deals but they are frustrated at the level of borrower-friendliness they need to build into deals. We are approaching a critical mass whereby the pendulum will swing back the other way. Whether that is happening right now is obviously up for debate, but it is being discussed more intensely. The losses at Bear Sterns may have been a tipping point, but perhaps the market will adjust to that development as well. In a macro sense, what is happening now is a big game of chicken. Equity sponsors are trying to hold onto this favourable marketplace while lenders are trying to push back, encouraged by the funds to which they syndicate. At the end of the day, what will decide the issue is market liquidity. If liquidity keeps pouring into the market and interest rates stay relatively low, the continued pressure to put capital to work, equity firms will continue to demand certain terms and win the game.

**Smith:** Unless we see a dramatic shift in sentiment from the past couple of weeks, borrowers appear to be asserting that the days of ever increasing concessions have ended. We may look back at the era of covenant-lite/PIK toggle as representing the high water mark of the credit cycle. I should also add that supply/demand dynamics are clearly at work here as we have so many of the mega-LBOs back up in the market – many tens of billions of dollars must clear over the next few months. It is possible that after the market digests this bulge in the snake, that the more aggressive structures reappear.

**Walsh:** This is likely to depend in large measure upon the continued extent of liquidity in the market in that arrangers have generally made concessions in circumstances where they have had to compete for the mandate. Probably the greatest surprise in recent times has been the emergence of covenant-lite structures in loan facilities, which emerged in the early part of this year. So far relatively few covenant-lite deals have been entered into, mostly ►►

larger deals and in the light of recent market developments they might be regarded as a passing phase.

**How has the ability of lenders to syndicate changed the leveraged finance market? What are the recent trends in syndication, and where are they headed?**

**Eisenbiegler:** One change is the dramatic increased liquidity of middle market leveraged loans. This has allowed institutional investors greater access to the higher yields (and risk) in this segment of the market. It has also increased the number of lenders in middle market deals, making waivers, amendments and restructurings more challenging. Recent trends in syndications are in the direction of increasing pricing and adding structural features and covenants to clear market.

**Walsh:** The ability of lenders to syndicate is of primary importance on leveraged transactions. In quite a number of cases, the lenders' credit decision can appear secondary to the advice from the lender's syndication or distribution team as to the likely ability to sell down the debt. Sponsors also now have a much greater role in agreeing the syndication strategy with the arrangers, including agreeing a list of which banks or funds may be approached with a view to participation in primary syndication. On some deals, lenders have agreed to transfer only with the consent of the borrower (not to be unreasonably withheld or delayed) ahead of any continuing event of default.

**Stefanowski:** On a basic level, syndication allows lenders to finance much larger LBOs than they would normally be prepared to. In addition, it also allows lenders to participate in specific deals, or asset classes, without leading the deal. The increasing role of institutional investors in the market means that banks can find it difficult to secure allocations. Increasingly, we're seeing more 'Revolver/B' structures replacing the historical Revolver/A, B and C tranches. Also, second lien and mezzanine have come under pressure from increased B loan tranches with PIK notes completing the structure.

**Joachim:** Ten years ago, the same money centre banks booked the deals, arranged the deals and reached out to call a hundred potential players in the debt markets for potential syndication. Now, between hedge funds and CLOs, there are literally thousands of potential players with whom to place debt. Some of the newer entrants to the market are effectively buying up senior secured debt in a way that the prop desk of an investment bank or fund would buy a bond. They are buying it is kind of a security, rather than a negotiated document, with the expectation that the fluid market will provide their exit. If they have a problem, they can sell out and as long as there is liquidity in the market, just as one would do when buying a bond or an equity security. A decade ago, people would look at bank debt as a document that can be negotiated and changed with relatively passive lenders. Today, if a deal is oversubscribed, there is no need to make changes requested by a particular lender because others are lining up to take their place. Yet there are signs that CLOs are starting to step back and question why they are buying slugs of debt with watered-down covenants, when the exit strategy may involve an insolvency situation where

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## **Lenders that have built long-term access to the market will continue to access liquidity, albeit with changes in tenure, leverage and covenants applied to the debt that are appropriate for investors to take at a particular time.**

JOHN HOURICAN

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a trade out or debt for equity swap is necessary. This is affecting the syndication market. Some recent deals have experienced syndication problems because lenders were delving into the fundamentals of the deal more than they have in the past.

**Smith:** Banks today are all in the transport business as opposed to the warehouse business. It has allowed much larger deals to get done and to distribute the risk into a much larger group of holders, magnified by the impact of CLOs/CDOs, and thereby spreading risk much more broadly than we have historically seen in the leveraged finance market.

**Legge:** The development in the multi-level structures and much greater syndication at each level has significantly changed the leveraged marketplace – there is more capital and more documentation as a result, with rights, restrictions and conditions imposed by each.

**Hourican:** Lenders that have built long-term access to the market will continue to access liquidity, albeit with changes in tenure, leverage and covenants applied to the debt that are appropriate for investors to take at a particular time. Leading players need to hold their nerve and provide liquidity and structure to the market, even when it becomes choppy.

**What key issues are arising in intercreditor agreements and negotiations among senior, second lien, mezzanine and junior lenders?**

**Legge:** The key issues with intercreditor agreements are not surprising as they have historically been the key issues, although they are more refined now that there are different levels of debt. The pre-eminent issue is standstills – they govern how long the junior or second lien lenders have to wait before they qualify for a seat at the table, to have a say in whether to preserve value in the business and influence the plan of action. Second lien standstills are certainly far better than what juniors had ever seen. Juniors ►►

likely expect a period in excess of 120 days, unless it's equity-like junior debt, in which case the standstill may be infinite. Second lien lenders on the other hand can typically negotiate a standstill somewhere between 30 and 90 days. Another key issue is whether there is a cap on the amount of senior debt in the deal. Second lien lenders do not want senior lenders ratcheting up the credit limit without having a say on the maximum level, since any additional debt will be ahead of them in the capital structure. Whereas senior lenders want the flexibility to deal with emergency situations by potentially injecting cash if it is required by a deteriorating business, the second lien lenders want to put limits on that flexibility. Sometimes there will be no restrictions, but depending on their bargaining strength, second liens have been known to insist on some form of restriction. Also heavily negotiated is whether the junior lien lenders are able to retain rights to control their claim and vote in a bankruptcy process. Senior lenders want juniors to be fully subordinated and have a complete power of attorney over the juniors' rights in order to control the show without juniors interfering in the process. One compromise is imposing a timeframe in which juniors can exercise those rights, after which their rights may be exercised by the seniors.

**Hourican:** When structuring it is crucial to understand the intercreditor arrangements between the various pieces of the capital structure. Given that debt is much more widely distributed now than it was seven or eight years ago, acting as a single voice will be far more challenging. The dynamics of any downturn in the market will be specific to individual deals, but there is no doubt that the process will be different if it involves a syndicate of 80 players versus a historic syndicate of six banks.

**Joachim:** Over the last 10 years or so, second liens have evolved from last out components of asset-based lending deals to full, separate tranches with their own rights and documents. There have been significant changes, and the market has swung back and forth at various points in time between second lien-favourable and first

lien-favourable. I think now it has settled at a level of fairness, after both sides have compromised in the last couple of years. First lien lenders are starting to think seriously about bankruptcy rights and waivers because observers are predicting a change in the cycle towards more defaults, certainly in certain industries. Lenders are wondering how these agreements will hold up in a bankruptcy and how they will apply in practice. Private equity firms are also rethinking their position. It used to be that equity sponsors were almost completely absent from intercreditor discussions. Now they become actively involved to make sure of two things: first, that the deal closes in an orderly and efficient fashion, and second, that the deal has been structured in a way that does not give the second lien-holders – which might be the fulcrum security – too much leverage. Ideally, they want the second lien silent. Since first lien lenders are likely to get out in full, equity sponsors have realised that they bear the risk of second lien lenders having too much power. It creates an interesting alignment of interests between equity sponsors and first lien lenders.

**Stefanowski:** A key issue is the ability to increase senior debt without mezzanine lender consent. Also, the concept of structural or facility change – the ability to increase senior debt by a limited amount with majority senior lender consent only – is now widely accepted in market. We also see issues surrounding the ability to change the order of priority and subordination, including for mandatory prepayments. It is not unusual to see structuring where all levels of debt (senior, second lien, mezz and junior) are put into the same entity and thereby the same level. Finally, there is a desire to include senior headroom in intercreditor agreements, to exclude capitalised interest.

**Walsh:** These include the circumstances if any in which a subordinated lender may be able to take or require enforcement action and/or may have any permitted payments to it blocked. However, in the current environment where there have been very few defaults, the intercreditor arrangements have not yet really been tested and it remains to be seen how the tensions between the different creditor constituencies (and within each of those constituencies) will play out in any restructuring.

**Over the last 10 years or so, second liens have evolved from last out components of asset-based lending deals to full, separate tranches with their own rights and documents.**

MARK JOACHIM

**Eisenbiegler:** Key intercreditor issues in first lien/second lien financings include the following. First, the cap on first lien debt and what obligations are included in first lien debt. Second, the length of standstill on exercise collateral remedies by second lien lenders. Third, terms of the advance consent by second lien lenders to debtor in possession financing provided or approved by first lien lenders, including the maximum amount of the DIP financing and whether a 'roll-up' of prepetition first lien debt into the DIP facility is permitted. Fourth, conditions for application of the collateral proceeds 'waterfall'. Fifth, terms under which second liens are released prior to and in bankruptcy. Sixth, retention by second lien lenders of all rights of unsecured creditors. Seventh, waiver of rights of second lien lenders to seek adequate protection in bankruptcy. Finally, terms of the option of second lien lenders to purchase first lien debt. As for senior/mezzanine leveraged financings, key subordination terms include the cap on senior debt and what obligations are included in senior debt. They also include the length of the payment blockage period and ►►

the remedy blockage period (if a private deal), and how many payment blockage notices may be given. Other considerations are what events will terminate the remedy blockage period, what obligations are subordinated, and what 'reorganization securities' may be issued in bankruptcy in exchange for subordination debt.

**Smith:** The most interesting battleground that has largely been untested in restructurings will be the provisions that govern the relationship between first and second lien security holders. When the next restructuring cycle happens, that will be one of the most hotly contested intercreditor issues. The relationship between secured debt and subordinated, unsecured debt has not been dramatically altered by the recent innovations in the leveraged finance market.

**What impact do regulations have on the international market, from jurisdictional security over assets to Basel II issues?**

**Walsh:** The impact of regulation can be felt as regards the particular lender's cost of funds and therefore how competitive the lender can be on pricing. As regards jurisdictional security, there is an increased recognition, through 'agreed security principles', of the cost, practicality and local law restrictions on the giving of guarantees and security.

**Legge:** Regulations will always have relevance as local jurisdictions assert their own right to make property law and impose corporate restrictions on the ability to borrow money or guarantee/give security in some instances. In Canada we see restrictions from some provinces, and this is a capsule reflection of what happens globally.

**Stefanowski:** Restrictions on security or guarantees vary across European jurisdictions: There are stricter corporate benefit tests in some countries and financial assistance rules will vary across European jurisdictions. Also, licence requirements vary across Europe, which limits the ability of unregulated lenders to participate in certain syndicates. Grey areas also exist, such as whether it is possible to lend into certain jurisdictions as a participant without a licence.

**Hourican:** Basel II is a more complicated capital regime than Basel I, which was an effective yet unsophisticated, level paying field. Basel II has three different regimes with two or three introductory timetables across different geographies. There is arbitrage in terms of the regime in which a bank operates, the investors to whom it sells debt and the timeframe in which the bank applies Basel I versus Basel II. Given that the leveraged lending market will generally have a lower risk/return on the capital attached to a leveraged loan under the Basel II regime, banks need to understand the implications. Basel II is a new capital regime that all banks must embrace; the issue is whether it creates competitive disadvantage for some and competitive advantage for others.

**Do you believe debt multiples have reached their peak or do they have the potential to climb even higher?**

**Stefanowski:** Even with the recent market turbulence, in certain

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**There are stricter corporate benefit tests in some countries and financial assistance rules will vary across European jurisdictions.**

BOB STEFANOWSKI

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sectors – healthcare or media, for example – it is possible to see multiples rising. Structures such as Opco/Propco also allow multiples to be stretched in specific areas. It also depends on the business model of the target; if proven growth strategies are in place, lenders will lend at greater multiples, while highly cyclical businesses will command less leverage. Having a lender with a good understanding of the business model of the borrower is essential to size a financing properly, so industrial expertise can be a real benefit for sponsors, borrowers and syndicate members alike.

**Walsh:** It may well be the case that debt multiples are reaching their peak, particularly in the very large deals and in circumstances where we may be moving to a sustained period of interest rates at a level which is higher than have been enjoyed during the last few years. That said, some limitation on debt multiples might be welcome for purchasers in that it may cause vendors to become less aggressive in the prices they are seeking.

**Smith:** They have certainly reached a peak for the time being. Unless the supply/demand balance changes significantly, we are going to be seeing ever higher debt multiples. This credit cycle has resulted in some of the highest multiples ever and economically I don't see how they can go much higher unless we have much lower interest rates and spreads, which seems unlikely. There is a limit after capex as to how much debt a company can service.

**Hourican:** We don't see debt multiples moving out much further. The market has stretched tenures and amortisation to long dated and bullet structures, so it will be difficult to stretch leverage further other than through quasi-equity instruments, which then involve the use of equity rather than debt. It should be noted, however, that there is a wide spectrum of leveraged multiples across the market. One industry will be leveraged differently to another, and any remarks on multiples should take into account the type of industry, the degree of regulation and the volatility in business earnings. Arranging banks need to assess each opportunity separately and try to structure what the market can accept. ►

**Joachim:** Allowing a high-debt multiple is really just another borrower-friendly provision. Banks are feeling the same frustration with respect to covenant-lite loans as they are with high debt multiples. So the question is how long will banks tolerate such borrower-friendly provisions, and when will they start insisting on more traditional EBITDA calculations. Rising debt multiples is a game of musical chairs, where players can continue to make huge returns by selling at even higher multiples, until the music stops.

**Is there a real danger that risks may surface for companies that become over-leveraged?**

**Walsh:** Yes there is. If we are moving to a period of consistently higher interest rates, there is a risk that companies may be unable to service their debt without hindering the companies' operations or growth strategies. If there is a more general economic downturn, this may lead to financial covenant breaches and, possibly, payment defaults.

**Eisenbiegler:** There is definitely a real danger. The concern for lenders in covenant-lite leveraged financings is that the first default may well be a payment default. With most leveraged loans having little amortisation, that will likely be a time of significant financial distress. Having little leverage prior to that time will likely adversely affect recovery prospects.

**Smith:** The risks to the over-levered company are real and well known. The over-levered company may become resource constrained and not have the ability to invest in its businesses or respond to competitive assaults. When this happens, a spiral ensues that can lead to default and eventually bankruptcy. The interesting feature of the covenant-lite structure is that a business might theoretically languish for quite some time in that so long as it makes interest payments (which is made easier by the PIK toggle feature common to many covenant-lite deals) there is no

way creditors can force a restructuring. They might be forced to sit on the sidelines for quite a long time before being able to exercise any of their debt remedies.

**Stefanowski:** It is now a widely-held view that we're at the top of the credit cycle and businesses will be under increasing stress to pay back the outstanding debt. Some companies will be over-leveraged. However, the relaxation of covenants and lower fundamental credit analysis means problems may only surface late in the process. With the market looking 'choppy', now is a good time for sponsors to be selecting a proven lender for the long term.

**Hourican:** In general, most companies are quite fully leveraged. That said, any company with a lot of debt that ends up in difficulty becomes over-levered by definition. If a company that is expecting to grow fails to do so, and the burden of its repayments are unaltered, it becomes over-levered through underperformance rather than having the wrong debt structure from the original deal. It is also important to note that the financial risk in these deals tends to be hedged against the interest rate cycle, to ensure a fixed cost of debt rather than fluctuations with LIBOR.

**Joachim:** Sponsors can keep on increasing the leverage on their businesses through several cycles until the market tires of it. But we may be entering that part of the cycle where more attention is paid to financial covenants. Whether or not a company is over-leveraged, with or without a controlling covenant, sponsors may soon find it difficult to refinance or sell their companies into a different market with a suitable return.

**In preparation for the next downturn, and the inevitable rise in corporate defaults, how important is it for financial sponsors to assess the nature of the lender with whom a relationship will be formed, rather than automatically selecting the cheapest debt offer on the table?**

**Hourican:** A good lender will work closely with the owners of underperforming businesses. The starting point is to remember that if the bank is losing money, the owners have already lost all of theirs, so it is never in their interest to not work with the banks to improve recovery. The bank has no incentive to do anything that offends a core income stream. That results in a symbiotic relationship between financial sponsors and arranging banks in particular, because this is a business, not just a transaction.

**Legge:** Choosing the relationship lender (or arranger/administrative agent) is a critically important aspect of assessing the debt options available to a company. We see many different relationships and what happens when those relationships do not go well. Borrowers need to understand the lender and their track record when it comes to dealing with borrowers that default. They should know whether the lender is capable of working things out or whether they are likely to exit as soon as the deal turns south by selling off their debt to the highest bidder, who might cause additional problems for the borrower. The sophistication of the lender, in terms of their understanding the ups and downs of the borrower's sector, and whether seasonality is causing the problem, is also important. Typically, restructuring is extremely expensive for a ►►

**With most leveraged loans having little amortisation, that will likely be a time of significant financial distress.**

RICK EISENBIEGLER

company as well as for a lender, since they do not usually receive 100 cents on the dollar, which is incentive for everyone to work things out. This is not always possible, of course, but if the relationship is built on a strong foundation, there is a greater chance of success down the line than if the borrower simply opts for the cheapest lender offer. If you do, you might get what you pay for, which is frequently a lender who will be quick to flip the debt.

**Smith:** The syndication process that spreads debt broadly among a variety of holders, with the underwriting syndicate holding very little debt in the end, leads financial sponsors to the conclusion that the cost of capital is the most important factor rather than the nature of the lender. By the time a default would occur, the original lender will not be much of a factor. Moreover, the secondary trading of loans has become much more efficient, such that by the time debt is trading at distressed levels it has largely passed from new issue purchasers to distressed hedge funds that specialise in troubled loans. For financial sponsors who find themselves with portfolio companies in default, these distressed investors are the ones they will be looking at across the negotiating table.

**Eisenbiegler:** This is certainly a consideration, but sponsors can only do so much. Sponsors can (and do) negotiate prohibitions on assignments to specific lenders with whom they are uncomfortable and to competitors of the borrower. Sponsors also typically retain the right to consent to assignments if no event of default is continuing. The liquidity in the leveraged loan market, however, means that distressed loans will trade into the hands of distressed debt investors, who clearly have agendas different than par investors.

**Stefanowski:** Sponsors should seriously consider what a lender will be like, and how they will behave as a partner, when the cycle turns and a transaction starts to under perform. It is also important for sponsors that lead banks continue to hold a significant portion of the deal, rather than selling down to zero through the secondary markets. Agents of transactions, particularly in times of stress, have much more influence over the remaining bank members if they continue to have significant interest in the transaction. These factors should be considered when selecting lenders to lead transactions.

**Walsh:** Borrowers, particularly in the mid-market, having been going to great lengths to select the lenders who would participate in primary syndications. Thereafter, the borrower will sometimes have the right to veto subsequent transfers of debt (such consent not to be unreasonably withheld). However, even then, this restriction will almost invariably fall away if an event of default occurs and is continuing. The likelihood is therefore that if the company does get into financial difficulties and an event of default occurs, the debt will be freely transferable and the creditor constituencies may well rapidly become comprised partly or mainly of debt traders.

**How much longer do you think banks and investors will maintain their appetite to supply capital for leveraging companies? Are there any signs that support may have started to wane?**

**Joachim:** Liquidity will not dry up anytime soon, although much depends on how syndicates choose to apply their excess liquidity. This summer has provided some interesting test cases, as a number of deals in the market are threatening to hang their agent banks on the borrower-friendly terms that syndicates say they are uncomfortable with. Syndicates are pushing back on covenant-lite provisions and PIK toggles, for example. Yet banks and funds are not going to stop providing capital; they are just going to stop providing capital under the current structures. In fact, the top debt funds in the market are eagerly anticipating the next phase of the cycle, when the 'dumb money' falls out and they will be able to negotiate on distressed debt sold by CLOs and others. It is an opportunity to make money not only on yield but also on big fees for DIPs, exit financings or rescue financings. There will be less competition in a smart money market, and funds can better insulate themselves against deal risk, add more conditionality to their terms and demand higher fees upfront.

**Stefanowski:** LBOs are here to stay. This is a well-defined asset class from a debt and equity standpoint and lenders will continue to invest where it makes economic sense and the risks do not outweigh the returns. There are no real signs of support waning. There may be a few examples of over-exuberance and CLO market failures to come, but this is likely to mean the market becomes more rational, with lenders, sponsors and businesses in alignment.

**Smith:** To a certain extent, that support has already begun to wane. However, there is still a significant amount of equity capital that must be deployed and a large pool of debt capital that is willing to support deals that are correctly structured and priced. Until that liquidity evaporates, we can expect deals to continue to flow.

**Walsh:** The appetite of banks and investors to supply capital for leverage in companies will depend upon market conditions generally, the degree of competition available for deals and the likely availability and returns that could be achieved by lending or investing elsewhere. There is some evidence that support may have started to wane, at least on the very large transactions, in the face of the current US sub-prime shock and of a possibly sustained rise in interest rates.

**Hourican:** There remains a strong and buoyant market for high yield debt and other parts of the capital structure. The liquidity pools to which we have access are not diminishing. In the last couple of weeks, however, investors have taken a more discerning and demanding approach to the protections that exist around the debt through covenants or pricing, but this is a feature of the market that changes with sentiment. We expect this market to remain strong albeit that the current environment is challenging. ■