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Europe Special Reports

Christine Tognoli
+44 (0)20 3741 1317

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2018 EUROPEAN LOAN TRENDS ROUND UP: PART II NEGATIVE COVENANTS

OVERVIEW

In this three-part Special Report, we explore key covenant trends and developments in the European leveraged loan market in 2018. In Part I of the series we looked at key trends relating to convergence of documentation and financial covenants. In Part III, to follow, we will consider economic terms and certain other features of interest to market participants.

In this Part II, we examine key figures and developments in negative covenant packages, in particular regarding debt incurrence, cash leakage and investments, and disposals.

European Leveraged Loan Covenants 2018 Key Trends
Part I – Overview & Financial Covenants Covering the convergence with HY bond and US loan markets, covenant-lite as the predominant deal structure, manipulation of financial ratios, and evolution of equity cures
Part II – Negative Covenants Covering trends in incremental debt capacity, increased flexibility in restricted payment builder baskets, and loosening of restrictions on acquisitions and asset sales
Part III – Pricing Protection and Other Notable Features Covering benchmark floors, standardisation of soft-call protection, increased flexibility in voting regimes, and increasingly restrictive transfer regimes

INDEBTEDNESS

It has become commonplace in the European leveraged loan market to permit an unlimited amount of debt subject only to a financial ratio test (leverage and/or a fixed charge coverage). This is achieved through incremental facilities permitted under the relevant SFA as well as, in many cases, incremental equivalent debt or ratio debt permitted to be incurred under a separate instrument. Various other permitted debt carve-outs are then available in addition (and regardless of a financial ratio).

Incremental Facilities

The vast majority of European SFAs permit incremental facilities: all but one of the 2018 SFAs reviewed by us provide for incremental facility capacity – and *all* of these permit the incurrence of such incremental debt without a monetary cap subject to meeting a leverage test[1]. Typically, the test is set at *actual* opening level, and this is consistent with the original concept of ratio-based incremental debt (a concept lenders should fight to preserve). However, we have seen numerous examples of 'rounding-up' for purposes of setting the leverage test which may build in some immediate capacity. Immediate capacity may also result where the incurrence test is ostensibly set at opening level, however marketing leverage includes certain debt items that would be excluded when calculating leverage as per covenant definitions.

Of 2018 SFAs with ratio-based incremental capacity, nearly 90% also provide for a 'freebie' or 'free and clear' amount, available in addition to the ratio-based permission and regardless of whether the ratio test could be met (such freebies were already common in 2017, at

[1] Usually a total net leverage or senior secured net leverage test (sometimes a 2x FCCR test applies where the debt to be incurred is unsecured, for example).

Christine Tognoli | Senior Covenant Analyst
Christine is an English and California qualified lawyer with over 12 years of qualification and experience in banking and finance law. She previously practiced at Paul Hastings and Clifford Chance.

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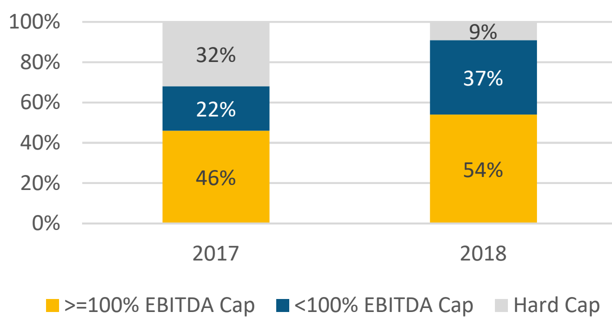
just over 80% of SFAs with ratio-based incremental capacity that year).

These 'freebie' baskets are now typically grower baskets, soft-capped by reference to a percentage of EBITDA. Over 90% of 'freebies' in 2018 SFAs were soft-capped[2], compared to 68% in 2017 (and 36% in 2016).



Interestingly, while overall 100% EBITDA freebies increased a bit in 2018, if we look at soft-capped (grower basket) freebies, the proportion that are soft-capped to (at least) 100% EBITDA decreased to 60% in 2018 as compared to 68% of grower basket freebies in 2017.[3] This was an area of notable lender pushback during 2018, with several deals reducing the freebie basket from 'greater of €[x] and 100% EBITDA' to 'greater of €[y] and 75% (or even 50%) of EBITDA' during primary syndication.

Inside Maturity Baskets

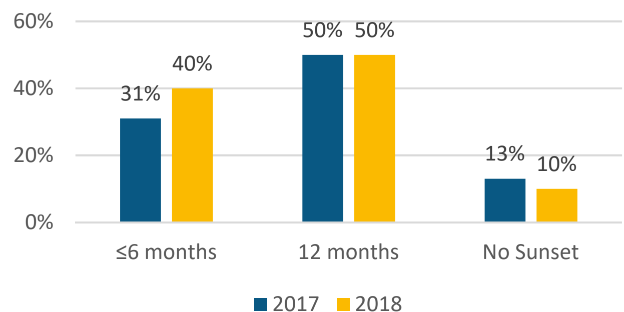
We occasionally observed 'inside maturity baskets' (i.e. a capped amount of incremental facility capacity permitted to have an earlier maturity than the original TLB) during 2018. However, this was another area where we saw pushback from lenders during syndication, in particular during the first half of the year. We subsequently saw these baskets wane in the second half.

MFN Protection

All 2018 SFAs (with incremental facility capacity) provided for MFN protection[4], and this continued to be an area of focus for lenders, with a number of deals needing to make changes during primary syndication to improve such protection.

Most deals set MFN at 100bps (80% of 2018 SFAs), with under 15% of 2018 SFAs adopting the customary US market position of 50bps.

Most (88% in 2018) MFN provisions are subject to a sunset, whereby the protection will cease to apply after a specified period. Half of the MFN sunsets in 2018 SFAs occur after 12 months, and 40% occur after 6 months.



Ultimately, there was little change in 2018 MFN statistics as compared to 2017. However, we continued to see borrowers and sponsors limit application of MFN protection beyond sunsets and other common exceptions:[5] for example, providing that MFN only applies

[2] In nearly all cases this was formulated as a grower basket being the greater of a fixed amount and a % of EBITDA; but in one SFA it was simply a % of EBITDA and in another the basket was soft-capped to a percentage of total assets rather than EBITDA.
[3] In one 2018 example the freebie was soft-capped to 115% EBITDA. We also note that in some cases where the freebie is hard-capped rather than a grower basket, the capped amount may equate to 100% of opening LTM/transaction EBITDA, but it will not grow over time in line with EBITDA growth.
[4] Pricing protection in the form of an MFN provision that caps the margin/yield differential between the existing lenders' loans and that of the new incremental loans.
[5] Typically, MFN only applies where the new debt is pari passu secured like-for-like loans, and often only where denominated in the same currency. It has also become common for MFN not to apply where the incremental debt matures a specified period of time later than the maturity of the existing loans.

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where the incremental debt is incurred under specific limbs of the incremental basket (e.g. the ratio-based limb and not the 'freebie') or in excess of a threshold amount. In a small handful of the most aggressive MFN provisions, MFN protection does not apply where incremental debt is raised to finance a permitted acquisition.

A number of 2018 SFAs, in particular a number of those that fall within the 'high yield bond in disguise' categorisation, do *not* extend MFN protection where the debt is incurred outside the SFA as incremental equivalent debt or pari secured ratio debt. This makes it easier for borrowers to circumvent MFN (to the extent it would otherwise apply) by incurring 'sidecar' debt under a separate instrument.

Incremental Equivalent / Ratio Debt Capacity

In addition to the ability to raise incremental facilities under an SFA, the vast majority of SFAs (over 80% of 2018 SFAs) permit pari passu secured incremental debt (loan or bond format) to be incurred outside the SFA, by way of "Permitted Alternative Debt", "Incremental Equivalent Debt", or other ratio-based debt, typically subject to compliance with the same ratio tests that apply for incurrence of incremental facilities within the SFA.[6]

Acquired and Acquisition Debt

An increasing number of SFAs include an express permission for the incurrence debt to fund an acquisition, or to be assumed in connection with an acquisition, rather than being reliant on debt capacity more generally. In many cases the test for acquired/acquisition debt is the same ratio test that applies for the incurrence of incremental and/or ratio debt (eg the same leverage test and/or 2x FCCR test). In some cases, the permission for acquired/acquisition debt is even more flexible, permitting the debt to be incurred so long as the relevant ratio is *not worsened* (i.e. no higher in the case of leverage and no lower in the case of FCCR).

51% of 2018 SFAs permit acquired/acquisition debt to be incurred so long as the leverage and/or FCCR levels pro forma for the incurrence and acquisition are *no worse than* pre-transaction, even if the ratio tests for incremental and/or ratio debt more generally are not met.

In a minority of the more aggressive deals (18% of 2018 SFAs) we saw a capped amount of acquired/acquisition debt permitted in addition to the ratio-based amount, akin to (and in addition to) the incremental facility freebie amount[7].

Contribution Debt

Contribution debt, whereby debt may be incurred up to a percentage (usually 100%, e.g. on a euro for euro basis) of the amount of net cash proceeds received by the borrower group following the closing date from the issuance or sale of capital stock or subordinated shareholder debt (or other equity contribution to the group), has also become more common in the European leverage loan market. 53% of 2018 SFAs contained a permission for contribution debt. Typically, such contribution debt is capable of being secured on a pari passu basis with the SFA facilities, without regard to any cap or leverage test.

In a very small handful of aggressive deals, contribution debt is permitted up to 200% of net cash proceeds of equity issuances or other equity contribution, a feature that is likewise aggressively off-market in the HY bond

[6] Plus, in many cases, the 'freebie' amount. In some agreements (eg in some 'high yield bond in disguise' SFAs), there is also the concept of 'ratio debt' that permits an unlimited amount of debt in compliance with a 2x fixed charge coverage test, which may be secured by the SFA collateral on a pari passu basis subject to meeting secured leverage tests (typically the same tests as required for incremental facilities). There are some additional examples in our sample that permit ratio-based debt to be incurred outside the SFA but only on an unsecured and/or junior basis to the SFA facilities (but these are not included in the ~80% figure above).
[7] This additional basket for acquired/acquisition debt is smaller than the 'freebie' basket available for incremental debt more generally. The size of these baskets for acquired/acquisition debt varied, but most were in the region of 10%-20% EBITDA.

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market. Only three 2018 SFAs reviewed by us permitted 200% contribution debt.[8]

Restricted Payment Capacity = Debt Capacity

A small number of recent deals permit debt capacity to be increased by certain amounts that would otherwise be available to make dividends and other Restricted Payments – allowing Restricted Payment capacity to instead be used to incur debt. Such flexibility is unusual, however, seen by us in around 10% of 2018 SFAs.

The most common construct we've seen is through the Contribution Debt permission, allowing that basket to be increased by the amount available for payments under the Restricted Payments covenant. In other cases, this is done through a separate debt permission allowing debt to be incurred up to the amount available under specified Restricted Payment baskets (including the general Restricted Payment basket).

The more aggressive of these permissions, including those that increase Contribution Debt by available Restricted Payment capacity, allow such debt to be pari passu secured, dilutive to lenders' collateral package, without regard to a senior secured leverage test.

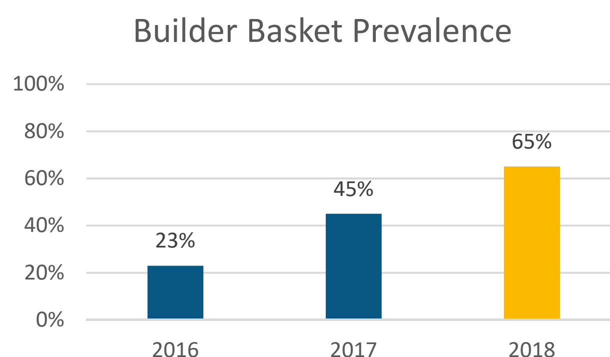
While presumably a sponsor will prefer to keep Restricted Payment capacity for dividends, the flexibility to convert Restricted Payment capacity to debt capacity could be useful for a borrower with Restricted Payment capacity but no cash available to fund a payment, or for a distressed borrower, who might benefit from greater debt capacity for ongoing operations (only a couple of examples in our sample expressly require, in addition to the RP capacity being available, that the payment *could actually be made* at the time debt is incurred instead (i.e. requiring both capacity and cash available for funding the RP at the relevant time)).

We will cover the ability to sacrifice RP capacity for debt incurrence capacity (in both the European HY bond and leveraged loan markets) in greater detail in a future Special Report.

RESTRICTED PAYMENT BUILDER BASKETS

Builder Baskets

HY bond (and US leveraged loan) style builder baskets had become relatively common in the European market in 2017, featuring in around 45% of 2017 SFAs reviewed by us. As expected, prevalence increased in 2018, to 65% of SFAs.



These baskets predominantly 'build up' with cumulative 50% consolidated net income[9] (plus other customary amounts, such as capital contributions, equity issuance proceeds, investment returns, declined prepayment proceeds), as was the case with 88% of builder baskets in 2018 SFAs. The remainder are generally based on the more traditional leveraged loan concept of permitting cash leakage from retained excess cash. These builder baskets are typically available for dividends and other restricted payments, investments and junior debt payments.

[8] We reviewed at least one other deal where 200% contribution debt was proposed but ultimately reduced to the typical 100% following pushback during syndication.

[9] CNI formulation will allow the borrower to manage down excess cashflow for purposes of the annual ECF sweep, while using a different measure to 'build up' the builder basket with income from operations. In addition, definitions of 'Consolidated Net Income' are including an ever-increasing number of add-backs, similar to those seen for EBITDA.

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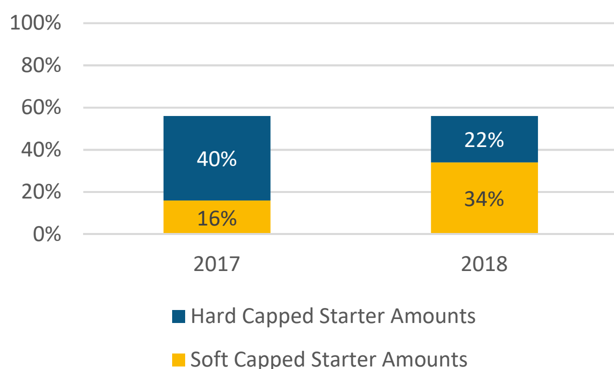
Starter Amounts

Builder basket 'starter amounts' (a capped amount available immediately regardless of accumulation of CNI or other amounts) are viewed by us as aggressive by both loan and HY bond standards, but continue to be observed in both markets. Prevalence in 2018 SFAs was flat on 2017: in both years starter amounts featured in a little over half of SFAs with builder baskets (56% in both years).

On the other hand, the portion of starter amounts that are soft-capped by reference to EBITDA more than doubled in 2018 to 61% of starter amounts, as compared to 2017 (when just under 30% of starter amounts were soft-capped). This remains an area where features in European leveraged loans have become more aggressive than their counterparts in the HY bond market.



As we have noted in prior reports, we regard these starter amounts as particularly inappropriate in the context of LBOs, as they could enable a near-term reduction of a sponsor's initial equity cheque.

Financial Ratio Test

The availability of a builder basket should be, and virtually always is, subject to a financial ratio test. However, in a small handful of highly aggressive permissions, the financial ratio test was omitted as a condition to use of the basket for some purposes. 12% of 2018 builder baskets may be used to fund investments *without* regard to a financial ratio test. However, only two 2018 SFAs permitted dividends and other restricted payments to be made from a builder basket without a ratio test condition, illustrating that this remains an off-market feature generally rejected by lenders.

Default Blockers

Cash leakage during the continuance of defaults under an SFA is generally viewed as sensitive, if not entirely inappropriate. However, this is an area where covenant protections have eroded over the last few years with, until recently, limited scrutiny. Material Restricted Payment carve-outs, such as the builder basket, general capped basket, unlimited ratio-based permission and similar, should all cease to be available upon any "Default", i.e. a breach of an SFA term that would be an actionable Event of Default but for the lapse of time and/or notice. However, the most common position in SFAs in the current market is to only block such Restricted Payments during *actual* Events of Default. By way of example, under 30% of RP builder baskets in 2018 SFAs cease to be available upon occurrence and continuance of Defaults (*potential* Events of Default). The remainder are only blocked once such Defaults mature into *actual* Events of Default.[10] Leakage during pendency of an unresolved Default (i.e. potential Event of Default) is never appropriate, in our view.

Additional 'Available Amount'

In addition to the (typically) CNI-based builder basket, we saw some 2018 deals include a further 'Available Amount' (or 'Acceptable Funding Sources') basket, available for dividends and other cash leakage, that accumulates certain net proceeds and other retained cash. Payments out of this basket are subject to a

[10] In one notably aggressive deal, the relevant Events of Default that would block payments out of the builder basket were also limited.

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financial ratio test (typically leverage[11]), but set higher than the leverage level required for unlimited ratio-based RP capacity more generally.

Having such an 'Available Amount' permission *in addition to* a 50% CNI-based builder basket is still relatively novel: we saw this in just under a quarter of 2018 SFAs with CNI-based builder baskets.

The amounts that may accrue in the Available Amount are often broadly and vaguely defined.[12] For example, 'Retained Cash' may include not only retained excess cashflow, disposal proceeds[13] and other proceeds not required in prepayment, but also items such as 'prepayments under contractual arrangements' (whatever they may be) and 'amounts received from outside the group to be used for the relevant expenditure' (broad enough to include new debt?). Sometimes proceeds of permitted debt are expressly included[14]. Returns on investments may also increase capacity under this basket, but drafting does not always require (though it should) that this be limited to returns on investments that were originally made using the Available Amount.

ACQUISITIONS AND DISPOSALS

Permitted Acquisitions

We have noted in our trends updates over the last couple of years the remarkable erosion of conditions to making Permitted Acquisitions.[15] *None* of the 2018 SFAs reviewed by us provided for any monetary cap on Permitted Acquisition capacity, and under 20% required any sort of financial ratio test (which in some cases is simply pro forma compliance with the financial covenant and may only apply where a consideration threshold is exceeded).[16]

47% of 2018 SFAs follow a high yield bond construct, permitting acquisitions without limit (or conditions) so long as the acquired person becomes part of the restricted group.

Asset Sales

High yield bond style asset sale regimes are also becoming the standard in European leveraged loans, even in SFAs that do not more generally follow a HY bond style covenant package. 70% of 2018 SFAs (compared to around a half of those in 2017) permit disposals of assets without cap, typically subject to fair market value and 75% cash or cash equivalent consideration[17] requirements (and subject to relevant prepayment and/or reinvestment requirements)[18].

Leverage based step-downs

Typically, any proceeds of asset sales (with customary, though often extensive, exceptions) that are not applied in reinvestment or pursuant to a menu of debt prepayment options should be offered to repay TLB loans. A mechanism by which the portion of asset sale proceeds required in mandatory prepayment steps down depending on leverage has become a common feature in the US leveraged loan market but remains off-market in the European leveraged loan market (and *even more so* in the European high yield bond market). However, such a feature has gained some ground in European SFAs,

[11] In a small number of deals, the leverage test for payments out of the Available Amount is around or even slightly above opening level. In some, the portion of the payment required to be made from the Available Amount reduces if a tighter leverage test is met, and then the remainder may be funded from any source.
[12] Sometimes items may be duplicative of items that also increase the CNI-based builder basket, and language should be included to prevent double counting.
[13] Particularly permissive when coupled with a leverage-based reduction in asset sale prepayment requirement.
[14] It is particularly objectionable to permit proceeds of new senior secured debt to be used to fund dividends.
[15] For purposes of these statistics we are looking at criteria for permitted acquisitions of a controlling stake, or of a business unit/division, and not minority acquisitions or investments more generally. In addition to the lack of caps/financial ratio tests, we continued to see the disappearance of other traditional conditions, such as cap on negative target EBITDA, no contingent liabilities, etc.
[16] We note there may be indirect regulation by virtue of an ongoing financial covenant or springing financial covenant, and where debt is incurred to finance an acquisition, relevant limits on the ability to incur such debt would, of course, apply.
[17] Certain items are deemed to be cash for this purpose, often including an agreed amount of 'designated non-cash consideration'.
[18] In a couple of examples, the 75% cash/equivalent consideration requirement was omitted, making the construct particularly aggressive.

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with just over a quarter of 2018 SFAs including leverage-based step-downs to asset sale mandatory prepayment requirements.

These features not only permit depletion of a borrower's asset base without commensurate reduction of its debt, in many cases the retained asset sale proceeds will increase baskets available for dividends and other cash leakage.

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