

June 2016

Q2 2016 CORPORATE BORROWER UPDATE



INTRODUCTION

Welcome to the Q2 2016 edition of the Addleshaw Goddard Corporate Borrower Update.

As we approach the halfway point in the calendar year (where did H1 go?!), it is perhaps an opportune moment to assess where the market is in terms of legal documentation. The leveraged market has been characterised by high levels of liquidity for some time now, with the increased supply of lending options being accompanied by pressure on both pricing and documentary terms. A question often posed to us by our corporate clients is whether they can expect the loosening of leveraged documentation to cross over into the corporate borrower market. We take a close look at these issues from page 2 onwards.

Another key topic at the moment is the UK private placement (UKPP) market as an alternative source of liquidity for corporate borrowers. It's a fast moving area in which I'm proud to say that AG has become one of the dominant advisers, so our closer analysis of the current UKPP market at page 4 onwards will hopefully be of interest.

Do not hesitate to contact any member of the team (see page 6 onwards) if you have any questions on the topics covered. We look forward to working with you soon.

In the meantime, have a great summer!



Amanda Gray – Head of Corporate Banking

020 7160 3433

07720 544070

amanda.gray@addleshawgoddard.com

BORROWER FRIENDLY TERMS

Introduction

The UK leveraged finance market is once again experiencing a period of greater flexibility and a loosening of loan agreement terms to the benefit of both borrowers and sponsors.

Commentators point to the competition between US and EU loan providers, together with the influence of US loan market practices, for the rise in borrower and sponsor friendly terms and all the indications are that this trend is likely to continue for the foreseeable future.

In this article, we consider the borrower friendly trends seen within the sponsor-led leveraged finance market (such as covenant light loan agreements ("**cov-lite**"), covenant loose loan agreements ("**cov-loose**") and equity cures, as well as grower baskets) and the extent to which such trends are permeating the non-sponsor corporate borrower market.

Background: Borrowing from US market practices

Cov-lite loans and equity cures (see explanation below) are nothing new, both being prominent features in the UK leveraged market prior to the credit crunch. As with many borrower-friendly terms, they were less prominent post-2008 but are now on the rise, with some estimating that cov-lite loans constitute 45% of all institutional loan agreements to date this year.

What changed? The availability of traditional bank loans declined following the credit crunch and borrowers looked to different avenues of finance, particularly from the high yield bonds market, where US style cov-lite loans are prevalent. The introduction of new investors providing alternative forms of finance to compete with traditional bank offerings meant that borrowers had greater choice and, in turn, transacted on less restrictive terms. Improving market conditions have shifted the balance of power in favour of borrowers and sponsors.

The influence of the US and availability of funding from US dollar lending sources has led to a convergence of EU and US loan market terms, causing a move towards borrower friendly terms. The borrower's preference for terms used in high yield type financings and exposure to cov-lite has led to such practices being imported into leveraged finance documents, which traditionally have tended to be covenant heavy and pro-lender.

Cov-lite loans

The main feature of cov-lite loans is that the financial covenants are less restrictive in comparison to those in traditional loan agreements.

Some of the recent trends in cov-lite loans are as follows:

- **Number of covenants** - Prior to the financial crisis there were, on average, 3 or 4 covenants but in cov-lite loans there are typically two or three, and in some cases, just one financial covenant. Furthermore, this may be tested on an 'incurrence' rather than 'maintenance' basis (see below).
- **Additional headroom** - Borrowers have more flexibility to negotiate generous headroom for the financial covenant ratios; we have seen headroom of 35% or more on leveraged deals, compared to the previous maximum level of 25%.
- **Incurrence vs. maintenance covenants** - There has been a move towards the testing of covenants at the time of specific events defined in the loan agreement (such as acquisitions), instead of being tested at regular points during the life of the facilities. Where financial covenants are tested on a routine basis, this may be semi-annually or even annually, rather than on a monthly or quarterly basis.
- **Springing leverage covenant** - The covenant is only tested when the borrower has drawn a certain percentage of the total commitments or is only for the benefit of the RCF lender and only upon drawdown of the RCF.
- **Negative covenants** - There has been a move away from the concept of a permitted financial indebtedness basket, seen in traditional loan documentation, and a shift towards the idea of a leverage-based permitted debt basket, along with a separate general debt basket.

The less restrictive nature of cov-lite loans is likely to be attractive to borrowers in some instances. It is worth noting that the use of cov-lite loans is still not as prevalent in the UK as it is in the US. For example, with regard to the assessment of covenants, it is still more common for covenants to be maintenance covenants, with quarterly testing being a common feature, as opposed to incurrence covenants.

Cov-loose

A reduction in the number of covenants has meant that it is more common for loan agreements to contain one or two financial covenants or a springing leveraged covenant. Where there is a single financial covenant used, it tends to be the leverage covenant. However, it is also common to see the leverage covenant used alongside either the cash flow covenant or the interest cover covenant, with the latter being the lender's preferred addition.

Whilst the deal structure will ultimately determine which covenants should be applied, from the lender's perspective it may be seen as possible in some circumstances to adequately test the borrower's ability to pay using one financial covenant instead of requiring three or four covenants to test the same.

Equity cures

Equity cures are a ubiquitous feature of the leveraged market, allowing the sponsor to inject cash into a business to prevent the breach of a financial covenant. We have seen the emergence of equity cures into the non-sponsor corporate borrower market, especially where there is a large institutional investor/fund investor which is accustomed to investing in the sponsor-led market.

In what ways is the use of equity cures becoming more borrower friendly?

- **Number of cures** - four cures across the life of the facilities is now more common; previously three cures was the maximum.
- **Timing** - We have seen examples of equity cures being invoked in consecutive financial quarters.
- **Repayment** - Reduced or no obligation to prepay using the proceeds of the equity cure in some deals; lender friendly terms would require 50% - 100% repayment of the cure amount.
- **EBITDA** - Although rare, EBITDA cures (whereby the equity cure amount is deemed to increase EBITDA rather than reduce the total debt amount) are starting to creep back into term sheets. This has a leveraging effect, allowing the investor to inject a proportionately small amount of cash to achieve the same cure.
- **Overcure** - The ability to inject cash over and above the level actually required to cure the potential covenant breach. This is now a fairly standard request and is often conceded by lenders.

Grower baskets

In contrast to traditional loan agreements which include a fixed amount or hard cap basket, there is a trend towards soft baskets. An example of this is a "grower basket", which is calculated using the greater of a fixed amount and a proportion of a specified variable amount (i.e. the borrower group's total assets or EBITDA). Calculating a basket in this way is particularly beneficial to borrowers with acquisition focused strategies.

This trend is driven by a borrower's desire to receive rewards when the business is performing well. We typically see a maximum basket increase of 25% of EBITDA. The lender may insist on a two-way adjustment mechanism such that any increased baskets could similarly be reduced if EBITDA decreases over time, usually subject to a *de minimis* level of the original basket amount.

Conclusion

The trends outlined above are likely to continue and gain more prominence. The favourable economic conditions in Europe are attracting new investors to the market and in turn creating more liquidity. Additionally, the European Central Bank's pledge to continue with quantitative easing until March 2017 (and possibly beyond), as well as the general climate of low interest rates, is likely to preserve liquidity in the market and maintain demand for looser loan agreement terms. Our experience is that the trends outlined above are permeating the corporate borrower market only to a limited extent but as more lenders enter the sponsor market (especially unitranche providers) look at the corporate borrower market for viable investments, the conversation is likely to focus increasingly on whether the flexibility offered by such features may be made available to corporates.

AG contact

Addleshaw Goddard advises borrowers, management, sponsors, banks and alternative lenders across both the sponsor-backed and corporate borrower market.

If you require any assistance, or would like to discuss the above in more detail, please contact your usual Addleshaw Goddard contact or:



Laurie Keel
Partner
Laurie.keel@addleshawgoddard.com
020 7160 3063
07545 605640



Laura Moss
Associate
Laura.moss@addleshawgoddard.com
020 7160 3344
07709 332432

PRIVATE PLACEMENTS

Background

In our Q2 2015 update we published an article on developments within the UK private placement (**UKPP**) market. Since 2015, there have been some further regulatory and market changes which, coupled with the increasing capital costs for banks to lend, is helping the UKPP market gain increased traction as an alternative source of funding for corporate borrowers.

For those entities looking to maintain or establish a diversified capital structure, or those not able (or willing) to enter the public debt capital markets, a private placement (**PP**) is seen as a viable alternative source of capital for corporate borrowers.

What is a Private Placement?

A PP refers to the placement of debt with a small group of institutional investors (such as insurance and fund management companies). PPs are often attractive to borrowers looking for longer term and diversified credit portfolios.

Other notable features include:

- ▶ Can be issued in either note or loan form (largely dependent on investor preference)
- ▶ The debt instrument issued is usually (but not always) unrated
- ▶ The notes/loans are unlisted
- ▶ Representations, covenants and events of default may shadow any loan documentation that the borrower has in place
- ▶ Tenor is typically longer than ordinary term debt (average being 5-12 years)
- ▶ Investors seek to protect their position by requiring 'pari passu' ranking with a borrower's other debt (so called 'most-favoured nation' clause referred to in our Q2 2015 update)
- ▶ Interest on the debt instruments tends to be fixed, with no hedging
- ▶ Investors guard against early repayment by inclusion of a 'spens formula' or other 'make-whole' provision

Developments since Q2 2015

Withholding Tax

As anticipated in our Q2 2015 update, and in an attempt to help facilitate the development of the UKPP market, the UK government has introduced a withholding tax exemption on interest on PPs (Finance Act 2015, effective 1 January 2016). Under the exemption, tax is not deducted from interest payments on a 'qualifying' PP (being an unlisted security indicative of a loan), provided the following conditions are met:

- the borrower and the investor are not connected;
- the borrower holds a certificate from each investor that it is situated in a jurisdiction with UK double taxation rules in place;
- the term of the instrument does not exceed 50 years; and
- all securities comprising the placement have an aggregate minimum value of £10 million.

Price Setting

Borrowers are benefiting from an increasing trend to delay the time between price setting and funding, with the market showing a delay of between 3-6 months between pricing and funding. This trend is proving advantageous to borrowers who can lock in cheaper funding today, to use at some later date.

Standardisation of Documentation?

As discussed in our Q2 2015 update, the absence of market accepted standard form documents in Europe has been seen by many as obstructing the growth of the UKPP market. Current practice tends to be for each market to use its preferred form of documentation which is then tailored to the deal in question.

For UKPPs, the documents are often a hybrid between the American College of Investment Counsel (**US ACIC**) model form and Loan Market Association (**LMA**) standard form. English law can be chosen to govern US ACIC form documents or, where LMA form is used, then US investor requirements (e.g. sanctions and make whole provisions) can be incorporated from the US ACIC model.

Notwithstanding the introduction of LMA standard form pan-European private placement documents (**LMA PEPP Documents**), our experience is that US ACIC documentation remains the documentation of choice, especially where deals involve a competitive lender

process. This is largely due to the fact that institutional investors are familiar with the US ACIC documentation and many borrowers are concerned that the use of LMA documents may reduce their lender pool. Such documentation can, of course, be English-law governed – indeed this is what we see on 95% of UKPP deals.

It could therefore be said that, although the introduction of LMA PEPP Documentation was expected to assist in the standardisation of documentation and therefore facilitate the growth of the UKPP market, experience so far shows that the market itself has moved to standardise US ACIC documentation used in the UK, giving rise to a standardised form of documentation with which investors are familiar.

LOOKING AHEAD

Whilst challenges to the market remain, UKPPs are gaining real and tangible momentum. Whilst the nature of UKPPs as a private new issue market that is buy-to-hold presents challenges to both investors and borrowers, notably due to the lack of reliable performance reporting making it difficult for borrowers to demonstrate their attractiveness to the market, it is also true that increased liquidity has led to many borrowers seeing this market as a viable alternative to a public debt issuance (and without the rating/reporting downsides of the public market). Increased standardisation of documentation in the last 12 months has clearly assisted the UKPP market in achieving impetus and the next few months promise to see further growth in the UKPP market with both borrowers and investors rooting for it to succeed.

AG Contact

Addleshaw Goddard is a leading adviser in the UKPP market, with Lee Shankland, Steve Mackie and Gary Grigor (whose details are below) advising on over 30 secured PPs by UK corporates in recent years ranging in size from £25m to £325m. They are well known to many City based institutional PP desks (PP arrangers), debt advisors and the wider investor community who could be interested in investing in your business.

Lee, Steve and Gary work closely with our wider corporate borrower team, so if you require any advice or have any questions in relation to private placements, please do not hesitate to speak to any of them or your usual Addleshaw Goddard contact.



Lee Shankland
Partner
Joint Head of Banking Group (with Amanda Gray)
Lee.shankland@addleshawgoddard.com
0113 209 7676 / 0207 160 3315
07793 306028



Steve Mackie
Partner
Steve.mackie@addleshawgoddard.com
0207 160 3269
07921 417457



Gary Grigor
Managing Associate
Gary.grigor@addleshawgoddard.com
0113 209 2435
07714 391446

SENIOR TEAM CONTACTS

We advise corporate clients on the full range of financing matters. If you would like to discuss your financing, or any of the issues raised in this update, please contact any of the Addleshaw Goddard individuals listed below.

London

firstname.surname@addleshawgoddard.com

AMANDA GRAY

Partner

0207 160 3433
07720 544070



ALEX DUMPHY

Partner

0207 160 3221
07709 332374



STEVE MACKIE

Partner

0207 160 3269
07921 417457



MIKE DAVISON

Partner

0207 160 3458
07738 023412



ANGUS GILL

Partner

0207 160 3432
07802 719687



LAURIE KEEL

Partner

0207 160 3063
07545 605640



RONAN ARMSTRONG

Managing Associate

0207 160 3320
07921 284445



RICHARD STANBROOK

Managing Associate

0207 160 3362
07738 023334



SARAH STOKES

Managing Associate

0207 160 3147
07789 070218



London (continued)

firstname.surname@addleshawgoddard.com

JAMES TARLETON

Managing Associate

0207 160 3461
07809 594153



LAURA MOSS

Associate

0207 160 3344
07709 332432



CERYS POOLIS

Associate

0207 160 3450
07912 395353



"I admire them for their sector product knowledge. They seem to have a huge depth of resources to assist with all the connected issues we might have."

CHAMBERS UK 2016

Leeds

firstname.surname@addleshawgoddard.com

DAVID HANDY

Partner

0113 209 2432

07720 350326



ROSALIND MASON

Partner

0113 209 2046

07834 570309



MICHAEL KIDD

Managing Associate

0113 209 2684

07725 734912



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CHAMBERS UK 2016

Manchester

firstname.surname@addleshawgoddard.com

MARTIN O'SHEA

Partner

0161 934 6403
07775 586372



ANDREW MASKILL

Partner

0161 934 6343
07775 586375



RICHARD OMAN

Partner

0161 934 6739
07709 332429



SIMON PRENDERGAST

Partner

0161 934 6027
07912 395312



REBECCA WILLIAMS

Partner

0161 934 6291
07809 594262



RICHARD CHANDLER

Legal Director

0161 934 6352
07738 144072



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Manchester continued

firstname.surname@addleshawgoddard.com

PETER JONES

Legal Director

0161 934 6346
07872 675592



LOUISE JONES

Managing Associate

0161 934 6316
07720 999789



CAROLINE GRAY

Managing Associate

0161 934 6695
07841 080565



NATALIE HEWITT

Managing Associate

0161 934 6311
07725 732068



BEN EDWARDS

Managing Associate

0161 934 6745
07710 857891



BEN TRAYNOR

Managing Associate

0161 934 6773
07725 353110



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