

“Covenant Lite”: The High-Water Mark of the LBO Market?

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Editor’s Note: Are we in a supernova of liquidity? The latest financing trend to hit Europe from the United States is covenant lite leveraged loans. True covenant lite deals remain rare, but “hybrid covenant lite” deals (where financial covenants are restricted just to the leveraged ratio) are increasingly becoming the norm. Economic Darwinism suggests that a number of the recent high-debt multiple deals will require some form of restructuring. However, the erosion of the traditional early-warning system based on quarterly tested financial covenants could turn out to be something of a poisoned pill for fundamentally distressed corporates. If there are no covenant breaches to signal to management that there is a problem requiring lender support and no contractual breaches to force them to the table, seasoned workout bankers risk being left impotent and unable to engage with the borrower in times of trading difficulties.

There have now been several “covenant lite” senior financing deals in the European market. The first of these, World Directories, has been oversubscribed in syndication, confirming that while some banks are reluctant to participate in such deals, there is strong demand from institutions and funds. Some arrangers of LBO loans might be wary of the underwriting risk associated with such facilities, but they are all under increasing pressure from their large PE clients to offer such financings. On several recent deals, arrangers have been asked to pitch a covenant lite option as well as a conventional LBO financing.



Adam Gallagher

This development in the market shows every sign of continuing. If one looks at the U.S. market as a trendsetter (“what the United States does today, Europe will do tomorrow...”), credit committees at the large arranging banks are going to have to put on a brave

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face and approve and underwrite such facilities for their key clients. According to Standard & Poor’s Leveraged Commentary and Data, 34 percent of overall U.S. activity for this year to the end of April was covenant lite, up from 8 percent of overall activity for the comparable period last year.



Chris Howard

Covenant lite deals were initially expected to be confined to relatively strong leveraged credits, i.e., stable credits with strong cash flow and low capex requirements, operating in noncyclical industries and at less-than-

“maintenance covenants” found in most mainstream LBO deals, which require a corporate group to maintain a certain credit position—in particular by complying with financial covenants (e.g., leverage, interest cover) on a periodic basis. Previously in European LBOs, incurrence-based covenants had been seen only in high-yield financings and, more recently, in subordinated levels of the capital structure, particularly in PIK financings (though more recently these covenants have been seen in second-lien facilities such as Versatel and Schieder Möbel). Covenant lite senior facilities can therefore be seen as part of the evolution of the European LBO market.



Christopher Davis

In many ways, the European LBO market is still responding to the challenges of covenant lite deals, and in certain cases we are seeing “semi-lite” deals or “hybrid” covenant lite deals. These hybrid deals vary, but often

maintenance covenants are preserved, perhaps with only a single financial

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maximum leverage. Media assets and directories businesses were thought to be ideal candidates, but the perception now is that we will see these deals in a diverse range of sectors. While market conditions are favorable, sponsors are increasingly challenging their lenders to provide such facilities at higher leverage multiples.

Incurrence-based negative covenants are a key feature of “true” or “total” covenant lite deals, and such covenants originate from the high-yield market. The drafting is standardised but complex. Typically, incurrence covenants seek to control both borrower and “restricted subsidiary” activity (see below) and therefore prevent the transfer of value out of this “controlled group.” These negative covenants will only bite when certain corporate actions are undertaken, e.g. when debt is “incurred” or dividends paid (see further below). They differ from the

covenant in the form of a leverage ratio. This article, however, is primarily concerned with true or total covenant lite deals where the senior debt (both term and revolving) has only incurrence-based covenants and no maintenance financial covenants.

Key Terms

Below is a brief summary of the key terms of true covenant lite facility agreements.

- Non-amortising term facility. (Conventional LBOs still involve a slice of amortising term debt, though completely non-amortising facilities have become more common.)
- Super senior revolving facility. (In a conventional LBO facility, the revolving/working capital facility would rank in *pari passu* with other senior debt. The reason for elevation

to super senior status in covenant lite deals is to provide an incentive for clearing banks (best placed to provide revolving facilities) to participate in the revolving facility. These banks might otherwise be reluctant to participate, because of the lack of maintenance covenants.)

- As with a conventional LBO, the interest rate will be floating and the margin will ratchet down if leverage decreases.

- The credit agreement contains the concepts of obligors, material companies, unrestricted subsidiaries and restricted subsidiaries.

- The definitions of obligors and material subsidiaries follow those that are customary in conventional LBO credit agreements.

- A “restricted subsidiary” is any subsidiary of the key holding company or “parent” that is not designated as an unrestricted subsidiary, and an “unrestricted subsidiary” is any subsidiary of the company that the board of directors has designated (subject to certain constraints) to be an unrestricted subsidiary along with any subsidiaries of that unrestricted subsidiary.

- “Unrestricted subsidiaries” are ring-fenced and do not form part of the controlled group that is the underlying credit. Accordingly, incurrence covenants and events of default set out in the credit agreement do not apply to unrestricted subsidiaries. Similarly, debt and earnings of unrestricted subsidiaries are not included in the calculation of the consolidated leverage ratio (see below). As such, the company could use these subsidiaries to carry on activities that the restricted subsidiaries are prohibited from undertaking.

- The “negative covenants” involve the parent and its restricted subsidiaries agreeing to refrain from certain acts. They place restrictions on, among others, the ability of the parent and its restricted subsidiaries to:

- incur additional debt;
- make “restricted payments” (in summary, distributions and other returns of capital in respect of the company’s shares, investments in noncontrolled entities and repayments of subordinated debt);
- enter into transactions with affiliates (*e.g.*, the private equity

sponsor of the deal or other investments owned by it);

- issue guarantees of debt (other than debt of members of the controlled group);

- grant liens;

- make sales of assets and subsidiary stock;

- enter into transactions that would result in a change of control of the company;

- enter into mergers or consolidations or sell substantially all the parent’s or a guarantor’s assets;

- enter into consensual restrictions that limit distributions and transfers of assets around the controlled group; and

- modify the intercompany loans forming part of the capital structure or the terms on which the intercompany borrowers can issue other intercompany debt.

The negative covenants generally have three elements:

1. the definition of the activity that is prohibited, such as the incurrence of additional indebtedness;

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2. the conditions that must be satisfied for the controlled group to be permitted to engage in the prohibited activity. So in relation to the prohibition on the incurrence of indebtedness, a “leverage ratio” test (essentially, the ratio of consolidated net debt to consolidated EBITDA) will be specified that will need to be satisfied after giving *pro forma* effect to the incurrence of the additional indebtedness;

3. certain types of transactions that are exempt from the requirements of the negative covenant (these may be included in the covenant itself or the definitions), such as specified ordinary-course borrowings, hedging transactions or qualified refinancings that may be incurred or undertaken without having to meet the leverage ratio test.

- In common with conventional LBO financings, the controlled group’s ability to engage in certain corporate transactions, such as making restricted payments, will, in some cases, depend on the capacity represented by “baskets.” “Basket” is a term used to define the quantum of certain permissions in the facility agreement—for example, the amount that the company can pay out as a restricted payment (such as a dividend) at any time. In the case of restricted payments, the size of the basket (and thus the company’s capacity to make restricted payments) is built up over time by a series of factors based on, most importantly, consolidated net income. The basket is reduced or depleted over time by the amount of restricted payments actually made.

- “Provision for incremental facilities” is a mechanism that allows additional debt (subject to a limit) to be spliced into the facilities such that the new lenders share the security and guarantee package.

- The “credit agreement” requires a percentage (typically 50 percent, dropping to 25 percent and then zero percent as leverage decreases) of “excess cash flow” to be applied in prepayment of the facilities. (This form of mandatory prepayment,

referred to as a “cash sweep,” is also common in conventional LBO financings.)

- Unlike most conventional LBO facilities, a covenant lite facility is unlikely to contain a restriction on capital expenditure.

- Mandatory prepayment is required from net proceeds from disposals, insurance proceeds, proceeds from receivables financing and from reports recoveries. In each case, prepayment is only required where the relevant proceeds exceed a specified threshold and there are broad re-investment rights.

- Upon the occurrence of a change of control the facilities must be prepaid in full.

- There are no prepayment fees payable upon prepayment of the facilities.

- The representations and warranties are made in relation to the obligors and material companies and are largely as one would expect to see in a conventional LBO facility agreement.

- In a standard LBO credit agreement, one would generally expect to see interest cover, cashflow cover and a leverage ratio as the triple cocktail of financial covenants. The only financial ratio that appears in a true covenant lite facility is the leverage ratio test (in the context described above) (unless, as is the case in certain U.S.-style covenant lite deals, there is a separate financial covenant in the revolver). As indicated above, in standard LBO credit agreements, financial ratios are tested periodically. They provide an “early warning” to lenders. This is because the ratios can be breached by a downturn in trading alone, so they present an opportunity for lenders to take action (they get their “seat at the table”). In a covenant lite facility, the leverage ratio is not tested periodically, but rather only when the company or a restricted subsidiary wishes to take certain specified actions, including:

- to put in place an incremental facility;
- to incur additional indebtedness; and
- to make restricted payments.

Such actions will only be permitted if the threshold for the leverage ratio will not be breached. However, if the company does not wish or need to take any of these actions, the leverage ratio will not protect the lenders: no default is triggered if there is a downturn in the borrowers performance.

- The information undertakings are as would be seen in a conventional LBO credit agreement. The only major difference in the covenant lite credit agreement is that because there are no periodically tested financial covenants, the only financial ratio set out in the compliance certificate is the leverage ratio for the purposes of determining the appropriate margin for the facilities.

- The events of default are as one would expect to see in a conventional LBO credit agreement—save that grace periods are often longer, thresholds for cross defaults, etc. tend to be larger and there is usually no material adverse change event of default.

- The security and guarantee package for a covenant lite facility is typically similar to that granted for a conventional LBO credit agreement and will be subject to the same structural constraints.

- Lenders under covenant lite deals generally have full liquidity, *i.e.*, the ability to transfer without borrower consent. This was the traditional position under European LBO credit agreements, but more recently in conventional deals some stronger sponsors have obtained control over lender transfers. Bankers argue strongly that full liquidity is necessary to reflect the bond-like characteristics of covenant lite deals and that it is a requirement of the institutional investor base that buys covenant lite deals.

A High-Water Mark for the European LBO Market?

The advent of European covenant lite facilities has led to press speculation that excess liquidity and lack of quality LBO loan assets have prompted a loss of credit control and discipline. The truth is much more difficult to discern. Thus far,

