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Encouraging Signs For Leveraged Loans In 2013

Law360, New York (January 28, 2013, 5:30 PM ET) -- The U.S. leveraged loan market flourished in 2012, as borrowers took advantage of favorable pricing and terms amid strong investor demand. S&P Capital IQ Leveraged Commentary and Data (LCD) tracked $465 billion of leveraged loan issuance (up 24 percent from 2011), while Thomson Reuters LPC calculated $664 billion (up 17 percent from 2011).[1] This makes 2012 the third-highest year in volume of primary leveraged loan issuance, behind only 2006 and 2007.[2] The fourth quarter of 2012 was especially robust with $136 billion of loan issuance, the most since the post-credit crunch high of $141 billion in the first quarter of 2011.[3]

Unlike 2006 and 2007, when mega-LBO deals drove the market, the 2012 market was driven primarily by opportunistic financings such as repricings, refinancings and dividend recaps. In fact, refinancings and repricings accounted for more than 50 percent of large syndicated institutional deal volume[4], as borrowers took advantage of favorable market conditions throughout the year to loosen covenants, reduce interest rate margins, add new tranches of loans and extend maturity dates. LBO volume was moderate and weighted toward smaller deals than those that were prevalent during the height of the market in 2006 and 2007.

Dividend-related loan volume reached a record high of $56.4 billion for the year[5], as private equity sponsors took advantage of issuer-friendly terms and strong EBITDA growth. Potential changes in dividend tax treatment added urgency to completing dividend recaps by year-end. Second-lien loan issuance also was strong: 2012 second-lien volume more than doubled to $17.1 billion, from $6.8 billion in 2011.[6]

One of the main factors contributing to positive market conditions in 2012 was the increased number of investors in both the primary and secondary loan markets. With an unexpectedly strong collateralized loan obligation (CLO) issuance in 2012 — topping the combined total of the past four years — structured finance vehicles rapidly increased their share of the primary institutional term loan market.

According to Fitch Ratings, CLOs represent approximately 45 percent of the current leveraged loan buyer base through primary loan issuance and refinancings.[7] With more cash to put to work, and with secondary prices rallying and margins narrowing, CLOs pursued riskier wider-margin opportunities and thus participated more aggressively in lower-quality deals. Coupled with steady demand from banks and with loan mutual funds, pension funds and other institutional accounts enlarging their participations, borrowers took advantage of strong liquidity to push for more generous structure and terms. Given the unwavering investor demand for loans in late 2012, we expect borrower-favorable trends to continue in 2013.

Covenant-Lite Loans

Covenant-lite loans were increasingly available to borrowers in 2012, in particular those

backed by private equity sponsors. Covenant-lite loans do not contain financial maintenance covenants that are tested regularly, although a financial maintenance covenant that "springs" into effect under certain conditions often is included solely for the benefit of the revolving lenders when applicable.

A springing financial maintenance covenant generally is tested on a quarterly basis as well as when revolving loans are drawn, but only when the aggregate outstanding amount of revolving loans exceeds a negotiated threshold. Waivers of and amendments to springing financial maintenance covenants generally can be accomplished solely with the consent of a majority of the revolving lenders.

While covenant-lite loans almost disappeared from the market during the credit crisis, they have made a dramatic comeback over the last two years. In fact, covenant-lite deals comprised 29 percent of overall institutional loan volume in 2012, exceeding 2007's prior record of 25 percent.[8] The current popularity of covenant-lite loans can be attributed in large part to the predominance of CLOs, as well as the increasing influence of hedge funds, high-yield investors and other relative value investors who are familiar with the incurrence -test-only world of bonds.

First-Out Revolvers

First-out revolving credit facilities provide revolving lenders with structural priority over term lenders that share a lien on common collateral. These facilities have developed and are becoming more prevalent in response to the limited number of lenders willing to provide revolving credit facilities due to their lower economic returns (as they are drawn for shorter periods of time than term loans and often not to their full commitment).

The scope of "first-out" rights afforded to revolving lenders is not standard and continues to evolve in the market. While some deals simply provide that revolving lenders are paid first with the proceeds of collateral, others provide revolving lenders with payment priority with respect to proceeds of asset sales and other mandatory prepayments and even upon the occurrence of certain events of default. Revolving lenders' ability to control enforcement remedies as well as their rights in a bankruptcy often are highly negotiated and frequently depend on their leverage in any particular deal.

Amend-and-Extend Provisions

Amend-and-extend provisions allow borrowers to request that individual lenders extend the maturity date of their loans, generally in exchange for higher margins and other attractive terms that are applicable solely to the extended loans. Initially developed as a solution to address the limited ability of borrowers to refinance maturing debt during the credit crisis, amend-and-extend provisions have become a common feature of leveraged loans.

Borrowers may implement amend-and-extend provisions by making an extension offer to all lenders of a particular tranche of loans. Lenders are not obligated to extend the maturity of their loans and may choose to accept or reject any such offer. If an extension offer is accepted, the maturity of the loans of the accepting lender is extended and the terms of such loans are modified in accordance with the extension offer, without the need for the consent of other lenders.

Uncapped Incremental Facilities

Incremental facilities (sometimes called "accordion" facilities) have been a common feature of leveraged loans for many years. They provide borrowers with the ability to upsize their credit facilities without the need for lender consent. Traditionally, the size of these facilities

was capped at a fixed amount. While many leveraged loans continue to include a fixed cap, a large number of deals in 2012 included an incurrence-based test that permits an unlimited amount of new incremental loans subject only to pro forma compliance with a specified leverage ratio. It will be interesting to see if these incurrence-based incremental facilities continue to gain traction in 2013.

Loan Buyback Provisions

Prior to the financial crisis, leveraged loans generally restricted the ability of borrowers and their affiliates to purchase outstanding loans made to such borrowers. These restrictions, however, began to be lifted during the financial crisis when practically all leveraged loans were trading at a substantial discount to par in the secondary market. Many credit agreements now permit borrowers, their sponsors and other affiliates to buy loans from some or all lenders, subject to certain common limitations.

For example, in most cases, loans purchased by borrowers automatically are deemed to be repaid and canceled. In addition, borrowers generally have been required to conduct loan purchases through reverse Dutch auctions in order to provide all lenders with an equal opportunity to participate in such purchases. However, a number of deals in 2012 permitted borrowers to make individual open-market loan purchases from lenders and this trend may continue to grow in 2013.

Sponsors and other affiliates typically are permitted to conduct loan buybacks through open-market purchases with individual lenders. However, after they purchase loans and become lenders, they are not afforded the same treatment as other lenders. For example, the voting rights of most affiliate lenders generally are quite limited, as is their ability to receive lender-only information and attend meetings of lenders. Ownership by sponsors and other affiliates usually is limited to no greater than 25 percent of outstanding loans, although such limitation often does not apply to affiliates that are bona fide debt funds investing in loans and other long-term debt in the ordinary course of business. Often, these debt funds are subject to less stringent voting and information restrictions.

Call Protection

As interest rates have fallen and lenders attempt to preserve a portion of their anticipated rate of return, call protection has become a common feature of leveraged loans. Many new first-lien leveraged loans now include a “soft call” — a common term for a premium that is payable when a borrower refinances or amends a loan for the purpose of lowering interest rates. A soft call premium of 1 percent on the amounts refinanced or amended during the first year of a loan is most common. More onerous prepayment premiums continue to be included in most second-lien loans, where multiyear call premiums typically apply to most loan prepayments.

Precap Provisions

“Precapitalized” or “precap” provisions permit the sale of a borrower to a qualified purchaser without triggering a change-of-control defaulting event. These provisions were included in a handful of deals in 2012 and may become more common in 2013, as borrowers of syndicated loans continue to enjoy more flexibility in altering their capital structure without the need to refinance.

Qualified purchasers generally are limited to sophisticated private equity purchasers that invest a minimum amount of equity in connection with the acquisition. Other requirements include minimum credit metrics with respect to the health and/or credit ratings of the loan parties following the transaction, and pro forma compliance with leverage ratio covenants. An increase in interest rate margins or payment of fees also may be required in connection

with the change of control.

The inclusion of precap provisions may be the next step in the evolution of documentation flexibility in leveraged loans. Time will tell if precap provisions will join amend-and-extend provisions, loan buybacks and increased refinancing flexibility as common features of leveraged loans.

European Borrowers

One of the key themes of 2012 was the influx of European borrowers into the U.S. loan markets due to the weakness in the European lending market. In 2012, European borrowers issued $28.4 billion in leveraged loans in the U.S., a significant increase from $8.8 billion issued in 2011.[9] This includes the October refinancing for Fresenius Medical Care in the amount of $3.2 billion (€2.5 billion), the largest U.S. loan for a European borrower since the 2009 debtor-in-possession facilities for LyondellBasell.

U.S. loan transactions with European borrowers may raise various structural and documentation issues due to distinctions between the European and U.S. markets. For example, to increase deal certainty many European deals employ the concept of "certain funds" in acquisition financings requiring diligence to be completed and most loan documentation to be agreed upon before the acquisition agreement is signed. In addition, U.S. and European guaranty and collateral packages differ, and local laws governing secured transactions in European jurisdictions may present guaranty or collateral limitations not present in the U.S.

Regulatory Considerations

The flood of new regulations applicable to banks and the lending market — Basel III, the Foreign Account Tax Compliance Act (FATCA), risk retention, leveraged lending guidance, the Volcker Rule and Federal Deposit Insurance Corporation (FDIC) assessment rules — already has affected and likely will continue to affect the loan market for years to come.

Upon implementation, certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act and Basel III will compel banks and certain other financial institutions to raise and maintain additional capital to satisfy stricter capital requirements, which may increase a lender's cost of funding or reduce its rate of return. Loan agreements traditionally have enabled lenders to pass on to the borrower increased costs resulting from changes in law implemented after the closing of the facility. Such provisions may cover the future implementation of the Dodd-Frank Act and Basel III.

Given that Dodd-Frank already has been enacted and Basel III has been adopted (although the implementations of rules still are pending in the United States), it has become common for yield protection provisions to expressly allocate to the borrower the risk of any increased costs arising from enactment of Dodd-Frank and Basel III. As Dodd-Frank and Basel III continue to be implemented, loan agreements likely will continue to evolve.

In light of the London Interbank Offered Rate (Libor) manipulation scandal last summer, the Wheatley Review, released in September by Her Majesty's Treasury, recommended a 10-point plan for the comprehensive reform of Libor, but did not propose abandoning it altogether. Although the Wheatley Review questioned the use of Libor for products such as variable-rate mortgages, it seemed to accept its usage in the syndicated loan market.

As a result of the proposed reforms, the British Bankers Association (BBA) no longer would have a role in setting Libor. Even though the scandal may have dealt a critical blow to Libor's credibility, it does not appear to have diminished the usage of Libor in the loan market. Whether regulatory reforms impact the usage or calculation of Libor remains to be

seen.

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[1] Source: S&P/Capital IQ/LCD, Thomson Reuters LPC.

[2] LCD, Dec. 21, 2012.

[3] Id.

[4] Debtwire Analytics, 2Q12 Review.

[5] LCD, Dec. 21, 2012.

[6] Id.

[7] Fitch Ratings, Nov. 26, 2012.

[8] LCD, Dec. 21, 2012.

[9] LCD, Dec. 21, 2012.

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