Private equity transactions

Selecting funding sources

Stephen Lucas, **Robert Ferguson** and **David Meredith** of **Weil, Gotshal & Manges** discuss the financing considerations for private equity sponsors and target management teams.

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Available sources for funding private equity transactions can vary over time. This depends, in particular, on the market and investor base appetite for leveraged loan instruments. From mid-2009, for example, the use of high yield bonds in sponsor-backed leveraged finance capital structures became increasingly widespread in Europe (*see box "Key terms"*).

Given the time, process and market risk, and the expense of launching a high yield bond issue, it is important to understand and assess upfront the relative benefits (of which there are potentially many) of raising high yield bond finance as compared to traditional bank debt (*see box "Recent examples of high yield issuances by sponsors"*).

This article compares and contrasts the two forms of finance, and sets out the key implications for private equity sponsors that are evaluating whether to introduce high yield bond debt into a leveraged capital structure:

- In the context of an auction scenario.
- When building the financing model.

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- When considering business expansion and target management.

- When anticipating a change in circumstances.

Key terms

High yield bonds. Bonds are publicly traded debt instruments. They typically have a credit rating (in other words, an indication of how risky they are). High yield bonds are bonds that are rated as sub-investment grade (in other words, with a rating below BBB-, in the case of Standard & Poor's, or below Baa3, in the case of Moody's). Given the low rating of high yield bonds (that is, the higher risk of default), the interest rate (or yield or coupon) is "high" relative to a bench mark issue of government bonds. High yield bonds tend to have a fixed interest rate with maturities of between seven to ten years. They are sometimes also known as junk bonds.

Leveraged finance. Leverage refers to the ratio of bank or bond debt to the amount of equity investment in the capital structure of a company. A highly-leveraged transaction will involve a proportionately large amount of bank or bond debt. De-leveraging is where a company reduces its financial leverage by paying off debt or increasing its EBITDA (earnings before interest, taxes, depreciation and amortisation).

Capital structure. The particular combination of debt, equity and other sources of finance that a sponsor uses to fund the acquisition of the target and provide for the on-going working capital requirements of the target business.

BANK LOAN vs HIGH YIELD DEBT

Traditional leveraged finance bank debt is raised through private market, broadly unregulated, loans that are underwritten by a group of banks at an early stage in the acquisition process.

Final documents can be agreed along an expedited timeline, with distribution or syndication to follow later. There is a focus on de-leveraging and prepayment, with pricing set to reflect risk (and as such, margins include a varying ratchet (up and down by reference to a leverage ratio)). The loan documents include tight financial and operational covenants, which are set according to a financial model, and by reference to an underlying operating business plan (*see box "Covenants"*).

Financial covenants are tested quarterly and levels of debt are set to require de-leveraging progressing over time (*see box "Key terms"*).

High yield bonds, on the other hand, are typically offered to institutional investors and closely follow the standards of securities disclosure expected in the US market, and are traded on the unregulated market of a European exchange (usually Luxembourg or Ireland). As such, there is no requirement for a Prospectus Directive-compliant prospectus.

The bond offering document therefore includes extensive disclosure by the bond issuer, including as to its financial performance (usually over at least the three most recent financial years and any subsequent interim financial period), and this significantly affects both timing and cost.

The bond investor base is typically widespread and is identified through a book-building process, before pricing and issuing the bond. As such, actual funding is only committed and underwritten on a certain funds basis at the very end of the issue process, and, until that time, is therefore subject to capital market conditions.

Bond investors focus more on yield and call protection than on de-leveraging and prepayment. Bond documents provide more flexible covenants, fewer prepayment triggers, but with protection around yield.

STEP 1: AUCTIONS

After the successful use of the high yield bond product in the refinancing context after the market re-opened in mid-2009, by late 2010, high yield bonds began to be used again by sponsors in auction situations. However, not all auction situations are suitable for bond financings.

Key considerations

In an auction situation, the availability and certainty of finance are critical. The use of bond finance can have material implications in this regard.

Bank debt can be underwritten and documented on a certain funds basis with a club of banks along an expedited timeline prior to the bid date. By contrast, high yield bond debt, and related final unconditional "certain funds" bond documents, will only be available after a more extensive legal due diligence exercise at the target/issuer, completion of a ratings process, and road shows across a wide investor base, all to be carried out in the "right" market conditions. These factors have implications for timing, funding risk and cost.

In this context, the key consideration is whether there is a so-called "financing condition" in the acquisition agreement. If there is, this means that the acquisition agreement includes a condition such that if the buyer/bidder finds that its financing is not available at closing, it is not obliged to complete the purchase and can just "walk away" from the deal.

This is a relatively unusual condition in European buyouts, as sellers want to ensure that buyers/bidders do not have grounds for walking away having signed an acquisition agreement (and, moreover, will probably require independent evidence that certain funds are, in fact, available before signing an acquisition agreement).

Recent examples of high yield issuances by sponsors

Issuer	Sponsor(s)	Size/Coupon/Maturity/Type	Date of Launch	Purpose
Priory	Advent	£206,000,000 7% Senior Secured Notes due 2018 (Tap) £425,000,000 7% Senior Secured Notes due 2018 £175,000,000 8.875% Senior Notes due 2019	4 April 2011 24 January 2011	Finance acquisition of Craegmoor Finance acquisition of Priory
Evonik Carbon Black	Rhone Capital Triton Partners	€355,000,000 10% Senior Secured Notes due 2018 $350,000,000 9.625% Senior Secured Notes due 2018	6 June 2011	Finance acquisition of Evonik Industries' carbon black business line
Kion	Goldman Sachs Capital Partners KKR	€325,000,000 7.875% Senior Secured Notes due 2018 €175,000,000 Senior Secured Floating Rate Notes due 2018	1 April 2011	Refinance existing indebtedness
Phones 4U	BC Partners	£430,000,000 9.5% Senior Secured Notes due 2018	18 March 2011	Finance acquisition of Phones4U
Sunrise	CVC	CHF 300 million 7% Senior Secured Notes due 2017 €371,000,000 7% Senior Secured Notes due 2017 €505,000,000 8.5% Senior Notes due 2018	4 October 2010	Finance acquisition of Sunrise

Bridging

Given the process and execution risk involved in raising high yield bond finance at a future point in time, if certainty of funding is required at the time of signing the acquisition agreement, this is usually ensured through a documented and unconditional loan market bridge facility. This is put in place to back-stop any risk on the bond issue.

Typically, the plan is to use the time period between signing the acquisition agreement and closing (in other words, funding) of the acquisition to issue a high yield bond so that the bridge facility is never actually funded. Funded bridge facilities can be expensive, particularly as margins step up over time, and the lenders have multiple refinancing rights, including the right to require a bond issue in an unfavourable market with limited control by the sponsor. The agreed bridge pricing cap (in other words, the maximum interest rate on the bridge) should be evaluated in the context of the financing model.

Timeline and process

It is important to understand the precise timeline and milestones of the high yield bond process for the following reasons:

- It is necessary to assess the risk and cost of the timing, process and launch in the context of the expected timeline for signing and closing the acquisition.

- While interim or bridge financing may be put in place at signing of the acquisition agreement, ideally, the high yield bond will be funded at closing of the acquisition, or put into escrow before closing.

- Careful and thoughtful briefing of management sets clear expectations and facilitates a smoother process.

- Early stage co-operation among the buyer's advisers, banks and rating agencies is essential to address particular requirements of bond financing in a timely manner.

Assistance

In all cases where a high yield bond issue is contemplated, sponsors should consider including in the acquisition agreement any obligations that the seller and the target should assume by way of assisting with the bond documents and issue process. For example, if due diligence is to be carried out on the target before closing the acquisition (in preparation for a bond issue), rights of access to, and assistance of, the target management team are critical.

Stapled financing

From a sell-side perspective, sellers often look to pre-package a target for sale by arranging for a stapled financing. This means that all bidders have access to a set of financing terms and debt that is pre-arranged by the seller in advance, and provides a "bottom line" for any other banks looking to finance a bid. Due to the nature of the high yield bond issue process (that is, where a firm underwriting is received only shortly before funding), it is challenging to set up a stapled high yield bond (as opposed to a stapled loan financing). However, the relevant due diligence and work on an offering memorandum can begin in advance.

STEP 2: FINANCIAL MODEL

When considering the suitability of a high yield bond debt in the context of a financial model, the principal commercial considerations will relate to the headline financial terms, including any impact on leverage multiples (the ratio of net debt to earnings for the last 12 months) and pricing.

However, there are other material financial implications for a sponsor that should be considered, including in relation to the nature of high yield bond debt, tenor (maturity or term), and the issuer's option to prepay before the maturity date (*see box "Bank vs bond debt: financial model considerations"*).

STEP 3: BUSINESS GROWTH AND TARGET MANAGEMENT

It is often noted that high yield bond incurrence covenants provide more operational flexibility for the issuer and its management team, as compared to bank maintenance covenants (*see box "Covenants"*). However, beyond this general principle, it is important to identify the specific instances where the additional flexibility offered by the high yield bond covenant package is material in the context of the operational business plan (*see also box "Covenant principles compared"*).

Furthermore, while the high yield bond covenant package is indeed "looser" by comparison with bank debt covenants, in terms of management time, it is important to balance this against potentially more detailed (but less frequent) reporting requirements. In addition, if there is also a bank debt layer in the capital structure, tighter bank covenants may apply to the business, in any event. However, only the consent of those banks will be needed to amend those covenants in circumstances already permitted by the high yield bond covenants (*see "Change in circumstances" below*).

Covenants

Covenants are the undertakings given by the borrower to the lenders. There are three main types:

Positive covenants. An obligation to do something; for example, obtain authorisations necessary to carry on the business.

Negative covenants. An obligation not to do something; for example, not to merge or dispose of assets, subject to agreed exceptions.

Financial covenants. These covenants are expressed to be either "maintenance" or "incurrence" in style:

- A maintenance covenant broadly sets out standards that a borrower must meet either permanently or at regular points in time (usually quarterly) during the term of the facilities. This type of covenant has customarily been included in bank debt facilities agreements in the UK and Europe.
- An incurrence covenant dictates criteria that must be met at the time of a specific event, which will be defined in the relevant finance document. This type of covenant has commonly been used in high yield bonds.

Planning for growth

When planning for growth, the following factors will weigh in favour of bond finance, as compared to a bank debt package, and so should be considered when preparing the documentation:

No restrictions on acquisitions. Bank debt includes a number of cumulative restrictions on acquisitions, including annual and total caps, leverage tests and limitations on the nature and place of business of the acquired company. By contrast, high yield bonds have no restrictions on acquisitions per se.

Greater ability to raise additional debt. Bank debt includes a fixed cap on the raising of debt, as well as financial covenants that also restrict debt levels based on the financial performance of the group. By contrast, high yield bonds provide greater opportunity to raise additional debt for the following reasons:

- Baskets (that is, exceptions to financial covenants) are set by reference to a financial ratio, so that the quantum of new debt that can be incurred can grow over time with growth in EBITDA (earnings before interest, taxes, depreciation and amortisation) in the business, rather than a strict cap.
- In a downside scenario, there is no financial covenant restriction that would otherwise have the effect of triggering a default due to a deterioration in the business (even if no additional new debt is incurred).
- As a practical matter, from a market, document and security perspective, the high yield bond product allows a greater ability to raise additional debt finance by way of taps (a sale of additional bonds that are interchangeable with past issues) or stand-alone issues, once a trading bench mark has been established.

Covenant principles compared

Principle	Bank debt	Bond finance
Positive covenants	Common.	Few positive covenants (those that do exist mostly relate to reporting requirements).
Financial covenants	Financial covenants are typically included and tested every quarter on a last 12 months basis (including on leverage, interest cover and fixed charge cover).	No equivalent. As such, if the business deteriorates, the high yield bond incurrence covenants may restrict the taking of specific actions from that time (for example, the ability to merge, the raising of new debt or the making of new restricted payments); however, no default per se will arise.
Maintenance/ incurrence covenants	Maintenance covenants apply at all times (and, in the case of financial covenants, are tested quarterly).	Incurrence covenants are only tested at the time that a restricted action is to be taken.
Baskets	Baskets (that is, exceptions) to the restrictive covenants in bank deals tend to be limited by a fixed capped amount.	Baskets in high yield bond covenants may be calculated on an annualised basis by reference to a financial test (for example, percentage of assets or leverage, or based on consolidated net income) and, therefore, these baskets will grow over time with the growth of the business.
Scope of restrictions	Restrict the entire group.	Permit specified subsidiaries to be carved out of the high yield bond covenants and stand alone on an operationally ring-fenced basis (that is, the so-called "unrestricted subsidiaries").

By contrast, the right to raise incremental or additional pari passu debt facilities in the context of a senior bank deal will be more restricted and/or subject to consents.

Funding capex. Unlike bank debt, high yield bonds do not prohibit or limit capital expenditure (capex) spend through a financial covenant that specifies an annual cap. However, high yield bonds are an imperfect debt instrument for providing the source of funding for that capex, as they must be fully drawn at close.

As high yield bond documents do not include the bank debt-style de-leveraging cash sweeps and prepayments, it is more likely that excess cash will remain in the business and be available to fund capex. Otherwise, if there are anticipated material capex needs over time, a bank debt facility may be required.

Other flexibility. High yield bond documents include further flexibility as compared to the bank debt position, including the following elements:

- Disposals and asset sales are controlled only by reference to the use and reinvestment of proceeds (rather than by an annual cap as in bank debt).

- Joint ventures, loans out from the group, guarantees and dividends are permitted collectively, subject to a financial ratio test and a single basket that builds up over time by reference to consolidated net income and certain specific cash inflows (rather than by reference to separate caps, or following substantial de-leveraging, as in bank debt).

- There are fewer events of default and no general cross-default provisions (other than for payment defaults).

Other factors

Other factors for sponsors to take into account include:

Management and reporting. For a target management team that may be unfamiliar with high yield bonds, the required disclosure exercise, the documents generally, the drafting and negotiation of the covenant exceptions, the road show process, and the reporting requirements can be daunting. As such, it is important for the sponsor team and their lawyers to work with management in this context, especially in terms of supporting the due diligence exercise and the covenant negotiations, taking into account the ongoing compliance and governance obligations (including the need to track the amounts available under the various (growing) baskets and the calculation of ratios).

In addition, management teams will be focused on any personal liability issues in relation to the high yield bond offering memorandum, particularly in the context of the US market and given that bonds are often issued out of a newco of which the only directors will be the managers.

Disclosure. As compared to bank debt, bonds require less frequent re-

Bank vs bond debt: financial model considerations

Consideration	Bank finance	Bond finance
Leverage	Leverage levels (and the amount of any sponsor equity contribution) vary considerably; in particular, by reference to target valuation multiples, industry sector and market conditions. Since the credit crunch, leverage levels have decreased materially, coupled with a requirement for larger equity contributions in the capital structure.	The bond markets provide an alternative source of funding liquidity. Although more susceptible to market conditions, at the "right" times, high yield bonds can be used together with loans to maximise leverage.
Tenor/ repayment dates	Senior bank debt maturities typically extend to six and seven years.	Where high yield bonds rank pari passu with senior bank debt in the capital structure, their maturity dates are typically set slightly beyond those of the bank debt (with the senior bank debt maturing first). Subordinated bonds are even longer dated.
Amortisation/ de-leveraging requirements	Bank debt will typically have features that require de-leveraging, including an amortising tranche (a portion of the debt that is required to be repaid in regular instalments), tightening financial covenants, restrictions on acquisitions based on leverage limits, mandatory prepayments with excess cash and other mandatory prepayment events.	Bond investors focus more on yield. As such, high yield bonds have a bullet repayment (one-off repayment at the end of the term) and no equivalent de-leveraging based restrictions. In fact, the incurrence-based growth baskets embedded in a high yield bond allow for additional borrowing that is scaled to the growth of the business.
Buybacks and liability management	The Loan Market Association has introduced a recommended process for debt buybacks in the loan market context, including in relation to price, equal treatment, and the right to vote and attend bank meetings following a buyback.	The bond market is less regulated, and buybacks by way of open market purchases are not restricted and do not attract call protection payments. Repurchases can be done on a non pro rata basis and the price is subject to negotiation on a trade-by-trade basis. Payments for waivers and consents by bondholders, however, are usually required by the terms and conditions to be on an equal basis among bondholders. More generally, the bond product is easier to manage and exchange from a liability perspective.
Pricing and interest rates	Bank debt pricing is always floating and typically includes a margin ratchet (a mechanism whereby the initial margin on a loan is reduced as and when the borrower achieves a better financial position, determined by reference to certain key financial ratios).	High yield bond pricing can be fixed or floating, but more commonly is fixed. Fixed-rate pricing avoids the need for interest rate hedging. However, senior high yield bond pricing is often higher than senior loan pricing. When comparing fixed-rate high yield bond pricing against floating-rate bank debt pricing, it is important to consider both the expected changes in the floating interest rate over the life of the loan, as well as related hedging costs during the period.

porting of financial and other information and do not include an obligation to deliver monthly accounts or annual budgets.

However, the high yield bonds will require the management team to prepare annual and quarterly reports, including an "operating and financial review" of financial performance, a description of the issuer's business and other information in substantially the same level of detail as was contained in the original high yield bond offering document, as well as publicly to disclose material events on a timely basis. This can be a significant ongoing work stream for management.

Confidentiality. Information provided to bank debt lenders by members of the group is required to be kept confidential through the parties entering into contractual confidentiality agreements. By contrast, high yield bonds require information to be more widely disseminated and extensive information to be available on the issuer's website, usually without password protection.

Bank debt. Businesses will often require (multi-currency) working capital, ancillary or capex lines, or seek the right to prepay some of their debt without penalty (in the case of the company outperforming the model).

Bank vs bond debt: financial model considerations (continued)

Consideration	Bank finance	Bond finance
Currencies	Bank debt can be made available in most freely available currencies, including with a right to switch currencies after closing or with a right to select so-called optional currencies for revolving facilities.	High yield bonds are raised typically in euros, US dollars or sterling. As such, if the business has fluctuating multi-currency requirements, these will need to be financed in the bank market.
Working capital, ancillary facility or capex	Any requirement for revolving debt (for example, for working capital); for other secured banking products (such as letters of credit or other ancillary facilities); or for longer term debt (for example, for capital expenditure (capex) spend over time), will need to be financed in the bank market, usually on a pari passu or super-senior (in other words, ranking ahead of the other senior secured debt) basis, or through an over-funding of the bond at close.	High yield bond finance is always fully funded at the close of the bond offering and therefore is not an ideal source for revolving credit requirements of a business (where the amount of debt requires changes over time). Although an additional "tap" of the bond can provide additional funds (maturing at the same time as the original issue of bonds), this is again more suited to funding one-off expenditure (rather than revolving credit requirements in multi-currencies).
Restrictions on right to redeem/repay	Bank debt is voluntarily prepayable at any time without penalty.	Consistent with the bond investors' search for yield, the right to redeem a bond is partially restricted by the call protection provisions. During the specified "non call period", any redemption (other than through open market repurchases) would require the making of a make-whole payment to provide the bondholders with the net present value of a number of interest payments. This non-call period is longer for subordinated bonds but significantly shorter for floating-rate bonds. If there is any additional bank debt layer in the capital structure, it is likely that the applicable intercreditor terms will include a further restriction on the redemption, or repurchase of all or part of the bonds subject to specified conditions.
Change of control	On a change of control, bank debt is typically required to be prepaid in full at par.	On a change of control, the issuer of a high yield bond must make an offer to repurchase the high yield bonds at 101% of their principal amount (that is, greater than par). In practice, this offer may be rejected by bondholders, especially if either the bonds are trading above 101%; or if bondholders believe that a consent will be required as a consequence of the acquisition/change of control, which may necessitate a redemption with a make-whole payment or payment of a consent fee that will exceed a 101% return. Trading prices of bonds in the secondary market will reflect market sentiment on this point.

These features cannot be provided by the bond product. As such, capital structures may include an element of pari passu or super-senior bank debt.

Senior term debt that ranks alongside a senior high yield bond will still typically include a full suite of bank covenants. These will, in practice, limit much of the flexibility that the high yield bond covenants otherwise permit. However, in the case of super-senior revolving debt, covenant packages sometimes preserve much of the flexibility that the high yield bond covenants deliver for the sponsor and management.

STEP 4: CHANGE IN CIRCUMSTANCES

As with any leveraged financing, circumstances can change. They can change for the better, where a business may then look to prepay debt, or look to make expansionary changes from the original business plan. Alternatively, they can change for the worse, giving rise to the need for a waiver to avoid a default, or for a more protracted restructuring.

In the context of the high yield bond documents, there are a number of points to consider.

Likelihood of need for consent

As mentioned above (*see "Business growth and target management"*),

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given the looser incurrence covenant package (and, in particular, the absence of financial covenants), it is less likely that a waiver will be required in a high yield bond deal as compared to a bank debt.

Acceleration threshold

The right to accelerate the redemption of a bond on an event of default is set at holders of 25% in aggregate principal amount of bonds outstanding. By contrast, there is a 66.6% threshold of all lenders for the acceleration of bank debt.

Consent thresholds

Save for a very limited number of key amendments relating to economic rights which require unanimity, most bank consent thresholds will be on a 66.6% basis, or otherwise effected through the structural change provisions. By contrast, for high yield bond deals, amendments can generally be made by holders of a simple majority of aggregate principal amount of bonds outstanding, save for a very limited number of key amendments relating to economic rights, which require 90% approval.

Waivers and consents

Unlike bank debt, there are no restrictions on transfers in high yield bond documents. As such, the bond investor/creditor base can be diverse, difficult to identify and may change quickly without control by the sponsor. This, of course, poses challenges in the context of seeking the relevant parties in order to obtain bondholder consent.

In terms of consent fees and the likelihood of obtaining a positive outcome, bond investors will often be driven by short-term returns, rather than by a strategic investment in a longer term story. As such, the price point for a bondholder consent will often depend on what bondholders believe they can extract from the issuer at a moment of maximum negotiating leverage.

Despite a lower consent threshold, from a practical point of view, it is therefore more challenging to obtain a bondholder consent and restructure a bond debt, due to the more widespread, public and diverse nature of the bond investor base and interests, as compared to bank lenders.

Given the lower thresholds for acceleration and consent, an activist investor needs to acquire a lower percentage of the bond issue to have control (in particular, where the debt may be trading significantly less than par).

Snooze and lose

If there is revolving or pari passu bank debt within a capital structure, intercreditor provisions often include a so-called "snooze-and-lose" provision, which sometimes applies equally to the bond and bank debt, that is, if a vote of any lender or bondholder is not exercised within, for example, 15 business days, that vote is not counted. This provision can be very helpful from a sponsor perspective when dealing with bondholders, in particular, due to the bond voting thresholds. It is, however, uncommon to have snooze-and-lose clauses in all-bond structures.

Intercreditor rights

Compared with the early deals of 2010, the overall intercreditor principles for bank and senior high yield bond deals are now broadly settled. There is, however, still room to negotiate many points of detail, or in relation to, say, hedging, that can be of significance for equity and debt holders. Sponsors should carefully consider with their lawyers the latest comparable deals when they are assessing the position to take on these points.

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