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Trends in Sponsor Acquisition Finance

By Andrew Colao, Tom Richards, Soo-Jin Shim, Tom Hashagen, Ondrej Rob, Charles Drisoll & Sean McClay

Introduction

The leveraged finance markets in the U.S. and Europe have historically contained more dissimilarities than similarities resulting from different norms, regulations and documentation. Recently there has been a trend toward an increased convergence of financing terms between the two markets, with European financial sponsors increasingly incorporating U.S. market concepts into their transactions. Additionally, financial sponsors continue to push to incorporate concepts into the leveraged loan market that were traditionally limited to the high-yield bond market in order to provide portfolio companies greater flexibility to operate their businesses, which has resulted in borrowers having an increased capacity to accumulate additional debt and fewer restrictions on new investment opportunities. The below table highlights several of the differences and similarities between the U.S. and European financing markets in greater detail. This article is not intended to detail all of the most favorable terms negotiated by sponsors/borrowers in the current market.

The Asian leveraged finance market is on the whole less active than the European and U.S. markets, but is rapidly expanding. The market is comprised of many different jurisdictions with local practices and therefore less consistent on terms across the region, so it is difficult to distil trends in loan covenants. Acquisition financings in Asia tend to be bank-only transactions with less leverage, more amortization and covenants than in the U.S. or Europe. Choice of law is often a consideration for lenders in the Asian market. Traditionally, Asian loan documents were largely governed by English law and follow the U.K. style of covenants, but there is an increasing trend toward taking a combination of terms from the European and U.S. markets. Particularly in connection with take-private transactions involving Chinese corporates listed in the U.S., the market has been showing a trend toward using U.S. style documentation. Also, with the increased volume of outbound acquisitions from Asia into the U.S. and Europe, Asian based borrowers are tapping the U.S. and European loan markets for better pricing and terms, following the relevant market standards in those regions, not Asia.

	Issue	United States	United Kingdom / Europe
A			
1.	Term Loan Types	Term B Loans with nominal quarterly or annual amortization payments and balloon payments at maturity are common in the leveraged finance market. Term A Loans with larger quarterly or annual amortization payments are uncommon, but are occasionally seen in smaller bank-driven financings.	Term B Loans with no amortization and bullet repayment at maturity common in large cap transactions. Amortizing Term A Loans are less popular although they still remain a feature of some lower mid-market deals.
B			
2.	Limited Closing Condition Representations and Warranties	SunGard clauses: The only representations that are conditions to closing are limited “Specified Representations” in the loan documentation and “Acquisition Agreement Representations” (i.e. the reps made by the target in the acquisition agreement that are material to the interests of the lenders and, if not accurate, would give the Buyer the right to not consummate the acquisition). Other SunGard provisions limit collateral to be delivered at closing to those types for which perfection that can be achieved by the filing of UCC filing statements and delivery of limited possessory collateral. Borrower-friendly commitment papers allow sponsors to push for more time post-closing to complete delivery of collateral. Acquisition agreements tend to have more limited “company MAC” clauses than loan agreements in order to ensure funding. The “company MAC” in acquisition agreements carves out, among other things, events or conditions that are broadly applicable to the target’s industry, the economy as a whole and geopolitical changes and is instead intended to focus on changes to the condition of the target specifically. The MAC condition to funding in the commitment papers for the financing is negotiated to match the MAC condition in the acquisition agreement so that there is no “daylight” in conditionality, as between the purchase agreement and the other debt documents.	“Certain Funds” requirement: Lenders’ firm commitment to fund on the closing date subject to only limited drawstops which are (i) “Major Events of Default” in relation to sponsor newcos only (i.e. the most important representations, covenants and events of default such as non-payment or insolvency/insolvency proceedings); (ii) illegality and (iii) change of control. Funding is also subject to a standard set of conditions precedent, which includes security over the holding/acquisition vehicles within the “bank group”. In competitive situations and to achieve a “strong certain funds bid”, sponsors tend to require confirmation from the arrangers that all such conditions precedent have been either satisfied or are in agreed form so that they can demonstrate that drawdown of the debt is fully within sponsor’s control. European SPAs (and therefore commitment papers) do not include any MAC conditionality.

	Issue	United States	United Kingdom / Europe
C	**Collateral**		
3.	Restrictions on Granting Security/Liens	"Deemed dividend" restrictions: controlled foreign corporations (CFC) guaranteeing U.S. borrower's obligations or providing security over its assets (or if U.S. owner pledges more than 2/3 of voting power)—"deemed dividend" to U.S. shareholders of lesser of earnings of CFC or amount of loan obligation guaranteed by CFC. Typically borrowers negotiate additional carve outs from the guaranty and collateral or perfection requirements. Common carve outs from the collateral package include owned real property below an agreed threshold, leased real property, motor vehicles, margin stock, interests in joint ventures or non-wholly owned subsidiaries and assets of immaterial subsidiaries and unrestricted subsidiaries.	Security restrictions and guarantee limitations differ dramatically between jurisdictions in Europe so local law advice is necessary in each such case. In particular, the value of any upstream credit support in jurisdictions such France, Germany, Italy or Spain can be considerably limited. With regards to English law restrictions: Unless model articles for limited liability companies impose other restrictions on granting security, a company has an implied power to grant security. <u>Corporate benefit restrictions</u>: grantor must receive adequate corporate benefit in order to grant guaranty/security. Any proposed transaction must be "likely to promote the success of the company as a whole" (a question of fact, determined on a case by case basis). For upstream guarantees and minimize the risk of challenge, a record of the board's approval of the company entering into the facility documentation should expressly set out the perceived benefits of the transaction for the group. Shareholder resolutions are also recommended to address any potential corporate benefit issues with regards to such upstream guarantees. <u>Financial assistance restrictions</u>: restrictions on: (i) granting security/guarantees for U.K. public companies for the purposes of acquisition of its shares on its parent's shares; (ii) U.K. private company for purposes of acquisition of shares of its parent which is a public company. Restrictions applicable to subsidiaries of public companies: Prohibition on giving guarantees or security for any type of acquisition funding in relation to an acquisition of a public company.
D			
4.	Restrictions on Indebtedness	Common to include incremental facilities/accordions that contain a fixed amount (typically equal to 100% of LTM EBITDA as of the closing date) with unlimited amounts permitted so long as the borrower maintains certain leverage levels (in the case of *pari passu* debt, usually equal to the closing date leverage). Often the incremental facility will also include the ability to incur both junior secured and unsecured debt at ratios at or greater than the applicable levels on the closing date. 50 bps MFN is common with respect to yield of *pari passu* term loan incremental facilities. Beginning to see push to 75 or 100 bps in large cap deals. Also see carve outs from MFN for "free and clear" incremental amount. Negative covenants typically include carve outs for corresponding "ratio debt" basket that match the applicable unlimited incurrence ratios in the incremental facility as well as other customary baskets. In mid and large cap transactions, ratio debt baskets often include "accretive prongs" permitting the borrower to incur debt so long as, on a pro forma basis, the applicable leverage level would not exceed such level as of the most recently ended fiscal quarter. Additionally, unsecured debt is often permitted if the interest coverage ratio of the borrower is at least 2x. Other baskets include an assumed indebtedness basket, an incurred acquisition debt basket and a basket for "contribution debt" permitting indebtedness equal to 100% to 200% of capital contributions.	Movement towards U.S. style permissions. Typically provides for senior secured, junior secured or unsecured (i) incremental facilities (additional term and RCF debt within the loan agreement); and (ii) incremental equivalent debt (outside the loan agreement), in each case subject to standard restrictions including an overall debt incurrence cap. Such additional debt capacity includes a fixed/"free-and-clear" amount (subject to a grower in top-tier sponsor deals) and separate unlimited amounts ("ratio debt") permitted if within pre-agreed leverage levels (usually set at closing date levels, possibly with flex to reduce by a small amount). 100 bps MFN subject to a 6 or 12 months sunset is also standard with respect to pricing of *pari passu* term loan incremental facilities (this is generally by reference to 'yield' but sometimes limited only to 'margin'). Large cap transactions see aggressive sponsors loosening the additional debt incurrence flexibility by converging traditional European loan style baskets with U.S. style and high-yield bond style incurrence-based debt incurrence flexibility to achieve a 2x fixed charge cover test for incurrence of junior secured or unsecured ratio debt.

	Issue	United States	United Kingdom / Europe
5.	Restrictions on Investment	Permitted Acquisitions: In large or mid-cap deals, borrowers usually have unlimited ability to consummate acquisitions of entities that become guarantors or assets that are acquired by the borrower or a guarantor. Acquisitions of entities that do not become guarantors or assets not owned by the borrower or a guarantor are often subject to a cap. Borrowers are often permitted to make unlimited investments subject only to being in pro forma compliance with a specific leverage ratio. Beginning to see incorporation of high-yield bond construct allowing for unlimited permitted acquisitions as long as borrower is acquiring a restricted subsidiary.	Traditionally, Permitted Acquisitions have been subject to overall value cap and a number of restrictions including a financial covenant test on a pro forma basis, no event of default, positive EBITDA, target not in a sanctioned jurisdiction or acquired business being complementary to the business of the group. Borrowers have been recently successful in achieving loosening of such restrictions focusing on regulating: (i) debt that is assumed in connection with an acquisition; and (ii) debt that is incurred to consummate an acquisition. Typically, borrowers are only permitted to incur additional debt through the accordion / additional facility (and other baskets) with no separate permission for acquisition debt. Acquired debt (and related guarantees / security) are usually permitted but have to be discharged within 3 - 4 months. In certain recent transactions, there is also the option to retain acquired debt provided the company is in compliance with a leverage test and subject to certain other conditions. Borrowers are sometimes successful in negotiating an “accretive” prong for acquisition-related debt (e.g. the leverage ratio is no worse pro forma for the acquisition).
6.	Restricted Payments	In large cap and middle market deals, borrowers have been permitted to make unlimited restricted payments subject only to being in pro forma compliance with a specified leverage ratio. Other common baskets include a general restricted payment basket and, after an IPO, a basket permitting restricted payments of up to 6.00% per annum of the IPO proceeds. In top-tier deals, the post-IPO basket permits additional restricted payments in an amount not to exceed a percentage of the market capitalization of the borrower.	In recent large cap and middle market deals, borrowers have been permitted to make unlimited restricted payments subject only to being in pro forma compliance with a specified leverage ratio. In addition, some recent large cap transactions also permit payments from the Available Amount subject only to a 2x fixed charge coverage test.
7.	Prepayments of Junior Debt	In large cap and middle market deals, borrowers have been permitted to make unlimited payments of junior debt subject only to being in pro forma compliance with a specified leverage ratio.	Recent top-tier sponsor deals follow the U.S. practice with the leverage test being half a turn or one turn higher than in the case of the unlimited restricted payment restrictions.
8.	Available Amount Basket	Common to have basket that may be used for restricted payments, prepayments of junior debt or investments that builds off of the excess cash flow that is not required to prepay the debt or 50% of consolidated net income.	Recent large-cap deals include the Available Amount flexibility within the parameters of the flexibility as standard in the U.S. market.
9.	Financial Covenants	Common to have springing financial covenants (“covenant-lite”) where the financial covenant is only tested when revolver usage is above a certain threshold (often 30% or 35% of overall revolving commitments). Increasingly, borrowings on the closing date are being carved out of the calculation of the revolver usage for a period after closing. Financial covenant levels are commonly set at a cushion (often 30 or 35%) to the sponsor model without any stepdowns in maximum leverage level. Covenant levels (and other ratios) are often adjusted to reflect any increase in leverage resulting from the exercise of any flex. Typically, borrowers are allowed unlimited cash netting, but sometimes subject to an agreed upon cap.	Traditionally, European lenders require ongoing financial maintenance covenants but since 2014, the U.K. and European market has become more accepting of covenant-lite deal structures even for upper middle market deals. Testing trigger for the springing covenant could be as high as 35 or 40% of commitments with up to 40% headroom. No cap on cash netting.

	Issue	United States	United Kingdom / Europe
10.	Equity Cures of Financial Covenants	Majority of sponsor deals provide equity cures—however, with restrictions on the frequency and absolute number of equity cures.	Large cap deals are not dissimilar to U.S. Traditional reluctance of European lenders to allow for EBITDA equity cures has been eroded and these are now common. Often no cap on overcures.
11.	Unrestricted Subsidiaries	Middle and large cap financings typically allow the borrower to designate certain subsidiaries as "Unrestricted" and exclude such subsidiaries from the restrictions in the negative covenants and financial covenant.	Remains a feature of large cap deals, but slowly becoming standard on top-tier sponsor transactions whether large cap or middle market.
E			
12.	Call Protection	"Soft call" protection applicable to voluntary prepayments or amendments as a result of a "repricing transaction" in which the primary purpose of the transaction is to lower all-in-yield of the debt are subject to a 1% prepayment premium for 6 or 12 months after the closing. Common carve outs from the "soft call" include material acquisitions, investments or asset sales, "change of control" transactions, IPOs, dividend recapitalizations and other transformative events. "Hard call" prepayment premiums are rare in first lien/senior secured financings, but are common in second lien financings.	"Soft call" protections have been originally introduced in European loans that are structured to be sold or syndicated in the U.S. Such protections are now relatively standard on large-cap deals and follow the U.S. standard, usually 6-12 months soft call at 1%. "Hard call" prepayment premiums are rare in first lien/senior secured financings, but are common in junior financings.
13.	Mandatory Prepayments For Asset Sales	Increasingly, allowance for greater flexibility for borrowers by (i) carving out more types of dispositions from the definition of asset sale, (ii) expanding the duration and scope of reinvestment rights, (iii) increasing the threshold amount under which the borrower need not use the proceeds to prepay, (iv) allowing the borrower to use asset sale proceeds to ratably repay *pari passu* debt and (v) leverage based stepdowns in the asset sale prepayment requirement.	Traditionally rigid regime of mandatory prepayments of any material assets which allowed only for ordinary course disposals has been eroded. Increasingly, ratio based permissions and "cash consideration" exceptions are being included. The proceeds of non-ordinary course disposals are generally required to be applied in prepayment of the facilities unless the relevant disposal falls within one of the exceptions or if the proceeds are applied in reinvestment in new assets. With the erosion of this covenant protection, lenders focus on ensuring holdco structural integrity is preserved via the change of control protections and / or change of ownership event of default (if included) to avoid disposals at those levels.
14.	Mandatory Prepayments for ECF	Typically prepayment is required for 50% of excess cash flow with leveraged based stepdowns to 25% and 0%. Increasingly seeing de minimis excess cash flow threshold below which mandatory prepayment not required. Typically mandatory prepayments are not required in respect of non-US cash to the extent that repatriation of such cash would violate applicable law or would cause a material adverse tax liability. Borrowers must use commercially reasonable efforts to take actions to repatriate such cash without violating applicable law or incurring such tax liability, but borrowers have often been successful limiting such obligations to one year after the event or calculation giving rise to such repatriation requirement, after which time the mandatory prepayment obligation falls away.	ECF remains a standard feature and follows the U.S. standard with regard to percentage applied in prepayment tied to leveraged based stepdowns.
15.	Change of Control; Portability	Change of control is typically an event of default rather than an event giving rise to a mandatory prepayment obligation. Portability provisions are uncommon and would be specifically negotiated between parties based on circumstances.	Traditionally, a change of control triggers mandatory prepayment although this is now largely modified by lenders having a put right to request being taken out at par on change of control. European market is still relatively hesitant around accepting portability as such, although there have been a few particular examples where sponsors succeeded in achieving portability subject to very strict parameters and based on relatively specific circumstances.

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16.	Borrower/Guarantor Buybacks	Typically in the form of a reverse "Dutch Auction" or purchase by a sponsor/affiliate through non-pro rata open market purchases. Usually debt bought back by the borrower or a guarantor must then be canceled.	Debt Purchase Transaction provisions included in LMA. Two alternative debt purchase transaction provisions include (i) prohibition on debt buybacks by a borrower and (ii) permitting debt buybacks, but only in certain specific conditions. Disenfranchisement provisions usually complement standard buy-back provisions.
17.	Sponsor Buybacks	Generally the sponsor and its affiliates can purchase the term loans (but usually not revolving loans), but are subject to an aggregate cap of the overall term loans. A typical cap is 25%. Bona fide debt fund affiliates of the sponsor are not subject to the cap on sponsor buybacks, but are typically limited to 49.9% of any vote in respect of amendments, consents or other modifications.	General ability to purchase subject to the standard disenfranchisement provisions.
F			
18.	Voting Thresholds	Typical amendments: 50.1% of lenders by commitment size/loan holdings. Unanimous decisions: 100%, but only of affected lenders. Unanimity required for "fundamental matters". Class votes are common for votes on matters affecting only certain classes of lenders. In credit agreements with springing financial covenants, only revolving lenders vote with respect to amendments to financial covenants. Generally, only revolving credit lenders vote on amendments to conditions precedent to borrowing under the revolver.	Non-unanimous issues: 66.67% of lenders by commitment size (although a number of large-cap deals include 50.1% majority). Super-majority issues (e.g. changing the scope of or releasing security/guarantees) require 80-85% content levels. List of decisions requiring unanimity reduced to include the most fundamental ones (e.g. voting provisions, order of priority/subordination, transfer provisions, governing law or changes to the borrowers, etc.). Most deals now include "Structural Change" concept requiring consent of each affected lender and simple majority lenders and usually includes: (i) extension of payment date, (ii) incurrence of additional debt, (iii) reduction in the margin or the amount of any payment of principal, interest, fees or commission payable, (iv) change to the currency of any payments due under the Finance Documents, (iv) redenomination of a Commitment into another currency, (v) re-tranching of any or all of the Facilities.
19.	Yank-a-Bank Provisions	Yes – allows borrower to remove lender from syndicate under certain circumstances (for example, if lender refuses to agree to action requiring unanimous consent if "Required Lenders" (50+% lenders by commitment/loan holdings) have consented).	Yes, but threshold vote for "required lenders" normally at least 66.67% (as opposed to 51%). A number of recent large-cap top-tier deals include reduced simple majority vote (i.e. at 50.1%) and yank available for other than simple majority votes.
20.	Snooze-You-Lose (lender's vote or applicable % discounted from total if no response w/in certain time)	Not included.	Included as a standard and usually set at 10-15 business days.
21.	Transfers and Assignments	Assignments to "disqualified institutions" are prohibited. "Disqualified institution" lists often include (i) persons identified in writing to the arrangers prior to the signing of the commitment letter and affiliates of such persons reasonably identifiable by name (and other affiliates of such persons identified in writing to the lead arrangers or, after closing, the agent), (ii)(A) competitors of the target or its subsidiaries and their affiliates identified to the lead arrangers prior to signing of the commitment letter and (B) affiliates of such competitors reasonably identifiable by name (and other affiliates of such persons identified in writing to the lead arrangers or, after the closing date, the agent) and (iii) persons engaged primarily in private equity, mezzanine financing or venture capital.	Borrowers/Sponsors have been recently successful in restricting any transfers without borrower's consent prior to funding even between lenders themselves or their affiliates. After the funding, general restriction on transfers applies with carve outs for transfers (i) to affiliates and other lenders; (ii) to entities on a white list (i.e. a list of pre-agreed lenders) and (iv) whilst an event of default is continuing (or now often limited to specific events of default in respect of non-payment, insolvency and possibly a financial covenant breach). Top-tier sponsor deals often include absolute restrictions on transfers to industrial competitors, loan-to-own investors or defaulting lenders which may include carve-outs allowing for transfers to any affiliated independent debt funds or whilst certain events of default are continuing.

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If you would like more information about the contents of this issue, or about Weil's Private Equity practice, please contact your relationship partner at Weil, or one of the authors below:

Editors:

Marco Compagnoni (London)	View Bio	marco.compagnoni@weil.com	+44 20 7903 1547
Doug Warner (New York)	View Bio	doug.warner@weil.com	+1 212 310 8751

Contributing Authors:

Andrew Colao (New York)	View Bio	andrew.colao@weil.com	+1 (212) 310 8830
Tom Hashagen (New York)	View Bio	tom.hashagen@weil.com	+1 (212) 310 8075
Charles Driscoll (New York)	*Not yet admitted*	charles.driscoll@weil.com	+1 (212) 310 8395
Sean McClay (New York)	*Not yet admitted*	sean.mcclay@weil.com	+1 (212) 310 8561
Tom Richards (London)	View Bio	tom.richards@weil.com	+44 (20) 7903 1086
Ondrej Rob (London)	View Bio	ondrej.rob@weil.com	+44 (20) 7903 1523
Soo-Jin Shim (Hong Kong)	View Bio	soo-jin.shim@weil.com	+ 852 3476 9108