WEIL GOTSHAL

Private Equity Alert

July 2008

Weil News

- Weil Gotshal advised the consortium of Teachers Private Capital, Providence Equity Partners, Madison Dearborn Partners and Merrill Lynch Global Private Equity in the successful negotiation of the $34 billion debt financing for the acquisition of BCE Inc., the largest LBO financing in history
- Weil Gotshal advised NBC Universal, Inc. in connection with the $3.5 billion acquisition of The Weather Channel by NBC Universal, Inc., The Blackstone Group and Bain Capital
- Weil Gotshal advised Advent International Corp. in connection with its acquisition of specialist health care provider Craegmoor Healthcare Group from Legal & General Group plc
- Weil Gotshal advised Diamond Castle Holdings in connection with the acquisition of label and packaging company York Label from Wind Point Partners
- Weil Gotshal advised Diamond Castle Holdings in connection with the $320 million sale of wind farm developer Catamount Energy Corp. to Duke Energy Corp.
- Weil Gotshal advised American Capital Strategies in connection with its sale of robotics company PaR Systems Inc. to MML Capital Partners
- Weil Gotshal advised DLJ Merchant Banking Partners in the $386 million secondary offering of shares of Rockwood Holdings, Inc.

Happy Birthday Mr. Borrower

By Doug Warner (doug.warner@weil.com), Stuart Hills (stuart.hills@weil.com), Michael Nicklin (michael.nicklin@weil.com) and Paul Libretta (paul.libretta@weil.com)

It goes without saying that the leveraged finance markets have become a nastier, more brutish place for private equity sponsors in the year since the beginning of the credit bust. However, it appears that the more things change the more things stay the same. Although some of the familiar features of leveraged buyouts in the last few years, such as generous leverage ratios, stapled financing, equity bridges, covenant-lite loans, PIK toggle notes and liberal equity cures, are gone from the current market, much of what remains is similar to the heady days of the first half of 2007. This article summarizes what has changed and what remains the same in the leveraged finance markets in the United States and Europe one year into the credit crunch.

United States

An oddity of the current leveraged finance market in the U.S. is that the most significant declines in the leveraged loan pipeline have resulted from busted deals rather than successful syndications. The inability to syndicate by lenders has largely been driven by an overall decrease in demand and the economic terms of the credit boom loans and certain of their structural features, such as PIK toggle, the lack of any financial covenants or the lack of any financial covenants with teeth. As a result, the primary changes we have seen in the leveraged finance markets have been to the economic terms and structure of the loans rather than the conditions to providing them.

The primary changes we have seen in the leveraged finance markets have been to the economic terms and structure of the loans rather than the conditions to providing them.

What Has Changed

- **Who The Lenders Are** – It is an old adage on Wall Street that investment banks are in the moving business rather than the storage business. To make the moving business work in leveraged finance you need demand for the leveraged loans originated by the banks. The first thing to dry up in the credit crunch was demand which left the banks with substantial amounts of unsold inventory and a reluctance to make significant new commitments. This has resulted in private equity sponsors seeking out financing from new entrants in the market, including from European and Asian banks with historically little exposure to U.S. leveraged finance credits, from traditional mezzanine lenders and directly from hedge funds and other institutional investors. Similarly, it is much rarer for sell-side advisors to offer stapled financing in connection with a sale of the business

and senior lenders have little appetite for equity bridges.

- **Not As Much Debt Is Being Offered** – Lenders are no longer giving money away. The amount of debt that lenders are providing as a multiple of EBITDA has decreased significantly from the first half of 2007. Similarly, there has been a material increase in lender requirements of equity contributions to capitalization. Equity contributions in some recent deals have been as high as 50% or more of total capitalization.
- **Debt Is More Expensive For Borrowers Who Can Obtain It** – Interest rate spreads over LIBOR have increased significantly from the first half of 2007. In addition, LIBOR floors have also been introduced in response to the current low LIBOR levels. Loans are also being issued with OID (thereby reducing proceeds to borrowers) to further juice yields for lenders. Arrangement and commitment fees have also risen.
- **Lenders Are Demanding More Onerous Market Flex Terms** – Market flex provisions have become much more onerous to sponsors allowing lenders to more materially alter the pricing and terms of commitments to ensure a successful syndication.
- **Covenant-Lite Loans Are Dead** – Lenders have returned to requiring financial covenants in loan documents which provide them with early warning triggers on the health of the borrower. Similarly, the cushions in the covenants over sponsors' base case plans are less generous than in the past. Lenders have also tightened up on the ability of a borrower to cure covenant defaults through a contribution of additional equity.
- **PIK Toggle Is Dead** – Lenders are generally no longer agreeing to structure tranches of loans where borrowers can elect to defer cash payments in favor of issuing additional loans.
- **Devil Is In The Details** – Sponsors are increasingly asking up-front for detailed terms of the credit agreement or the minutiae of the financial covenants prior to signing the acquisition agreement in order to minimize the risk that a disagreement on terms with the lenders could jeopardize or delay their financing. Lenders, on the other hand, will often resist providing such detail in their commitment documentation unless they retain the ability to alter such terms in their market flex provisions.
- **Sponsor Precedent Is Dead** – Lenders are generally no longer agreeing to use "sponsor precedent" as the starting point for loan documentation.

What Has Remained the Same

- **Financing Outs Are Still Out** – Despite speculation to the contrary at the beginning of the credit bust, most deals still do not have a financing out as a condition to closing. This has required sponsors to ensure that their debt commitment papers are as tight as they were pre-credit crunch, particularly where they don't have the ability to bridge the entire purchase price with equity in the event that the lenders are unwilling to fund at closing.
- **Time To Market** – Although Sellers are generally unwilling to agree to a financing out, they will frequently allow sponsors and lenders a marketing period to allow them the opportunity to attempt to syndicate the debt prior to closing.
- **Debt Commitment Conditions Have Not Changed Substantially** – Surprisingly, lenders have generally not meaningfully increased the conditionality of their commitments. They have generally been unsuccessful in tightening up business MACs, obtaining market MACs or "no new adverse information conditions" in commitment papers. Similarly, the Sungard approach of conditioning the initial closing on only limited "Specified Representations" in the credit agreement remains common (although the scope of these representations has been expanded in certain instances).
- **No Mandatory "Sue The Bank" Provisions** – Despite speculation to the contrary, sellers have not been insisting on "sue the bank" provisions in their acquisition agreement which compel buyers to sue the bank in the event of an alleged breach of its obligations to provide funding.
- **Specific Performance Exclusions And Caps On Damages Still Not Common** – Despite speculation to the contrary in the wake of the Clear Channel litigation, banks have generally not been inserting in their commitment papers an express waiver by the borrower of specific performance as a remedy or a cap on damages of the reverse termination fee.
- **Sponsors Can Still Obtain Limited Transfer Restrictions** – Lenders are, in many cases, still willing to agree to limit transfers of their loans to certain "disqualified lenders" agreed in advance with the sponsor.

Europe

The effect of the "crunch" in Europe in many ways mirrors the experience in the United States. However,

dealing with the backlog of deals awaiting syndication in Europe has proved a little more stubborn. For whatever reason, whether it be the maturity of the secondary market, the culture of the institutions or the sheer uncertainty on the value of existing loans, European banks have not been as active as their US counterparts in unblocking the "hung credits".

From a market perspective, there appears to be a willing return to relationship-style banking, second lien has disappeared along with covenant-lite loans and PIK toggle, the mezzanine market is, not surprisingly, buoyant and alternative funding sources, such as sovereign wealth funds, are considering entering the debt markets.

European loan documentation has traditionally not expressly prohibited the borrower or its affiliates from buying back its own debt. Some borrowers and sponsors are choosing to take advantage of the fact that their debt is trading below par (in many cases unconnected to the strength of the underlying credit) and are considering buying it back. The debate surrounding the effect of such transactions (in particular, regarding voting rights and whether the buyback constitutes a prepayment that should be shared pro-rata among the lenders and their impact on the syndicated loan market generally) is ongoing, and it is not too surprising what camps banks and sponsors are falling into (and clearly there is a divergence of views in the lenders structuring these transactions who are anxious to get the debt off their balance sheet and the other lenders in such transactions who would like to participate in the buyback).

What Has Changed

- **Timing Of Transactions** – Deal timetables have extended as banks have focused more closely on due diligence before committing to finance a transaction.
- **Club Deals** – Many lenders are insisting on being part of a club of lenders prior to underwriting mid-market transactions where they would previously have fought hard to obtain the sole underwriting mandate. In addition to impacting the timing of transactions, the differing institutional concerns of lenders have, in some instances, resulted in financing commitments being offered on the basis of the lowest common denominator.
- **Pricing Is Up And Leverage Is Down** – Deals are still being done but they are requiring a larger equity contribution. In addition, there are reports that LIBOR floors are beginning to be seen in Europe.
- **Capital Structures Have Changed** – Second lien has disappeared and mezzanine has reemerged. Non-amortizing Term B only debt facilities have been replaced by more traditional A/B/C term facilities (with the typical amortizing Term A tranche) and there has been an increasing trend towards vendor debt to bridge the financing gap. Accordion facilities (*i.e.*, the flexibility of an uncommitted facility) have also become harder to obtain.
- **Greater Market Flex** – Sponsors had been successful in limiting the changes a lead arranger could make to a transaction in order to ensure a successful syndication. Flex terms have now greatly increased, not just in the pricing but also in the structural changes and, in some cases, other terms of the facilities that can now be imposed. The introduction of original issue discount is just one new development.
- **Equity Cure Rights Are More Limited** – Lenders are restricting the ability of sponsors to use equity cures in respect of covenant defaults as well as the frequency with which they can be used.
- **Tighter Prepayment Conditions Apply** – Lenders are imposing greater restrictions on the use by borrowers of excess cash through increased sweeps of excess cash flow and more limited ability to repay junior debt before the senior debt is fully repaid.
- **Greater Call Protection** – Lenders are demanding greater call protection on their loans (with no-call provisions now regularly seen in mezzanine loans for the first year or two after closing).
- **Basket Carryforward Provisions** – Basket carryforward provisions (which were previously applicable to permitted acquisitions, joint-ventures, disposals and capital expenditure) are now generally limited to the capital expenditure covenant only.
- **Annual Clean Down** – Lender requirements for an annual clean down of the revolving facility are now generally required (particularly in transactions where the revolver is drawn at closing).

What Has Remained the Same

- **Certain Funds On Private Acquisitions** – Lenders are still accepting UK public-to-private style certain funds provisions that require the lenders to fund except in very limited circumstances (which are within the control of the borrower). In this regard, interim facilities (or exploding bridges) are still available to avoid a "documentation out" in the commitment papers. However, the length of the commitment is subject to much more scrutiny and

"real" reasons, such as antitrust and regulatory approvals, are required for a lengthy commitment rather than simply a desire for flexibility in the timing of closing.

- **Transfer Rights/Restrictions Are Still Being Accepted** – Lenders are still accepting some restrictions on who they can transfer commitments to just not to the same degree as previously (*e.g.*, blacklists and consultation rights rather than consent rights). Consent to transfers prior to closing is still seen as a key component to a buyer ensuring that "certain funds" will be there at closing.
- **Yank-a-Bank and Snooze-and-Lose** – Yank-a-Bank (*i.e.*, the ability to remove a non-consenting lender from a syndicate) and Snooze-and-Lose (*i.e.*, excluding a lender from voting on a particular matter due to its delay in voting) provisions still apply although there is more debate as to whether the relevant threshold for yank-a-bank should be 66-2/3% or 85%.
- **MAC Provisions Largely Unchanged** – The definition of material adverse effect in loan agreements has not materially changed since the beginning of the credit crunch.
- **Guarantees And Security** – It is still usual for the only guarantees and collateral to be granted at closing to be from the newcos incorporated for the acquisition (including a pledge over the shares in the target). Guarantees and collateral from the target group are granted, subject to agreed security principles, post-closing (typically somewhere between 45 to 90 days after closing).
- **Warrantless Mezzanine** – Despite speculation to the contrary, the mezzanine market appears to have accepted that, generally, European mezzanine debt will be warrantless.
- **Clean-up Periods** – It is still market for the borrower to have a period of time (typically 90 to 120 days after closing) to clean-up breaches of representations and warranties, undertakings and events of default attributable to members of the target group, subject to certain key customary exceptions.

Conclusion

Both in the United States and Europe lenders are still dealing with a backlog of unsold loans and weaker demand for new loans. Predictably, this has adversely impacted the ability of private equity sponsors to obtain adequate debt financing and has significantly increased the cost of that capital. However, when debt financing is available, many of the terms of the pre-credit bust 2007 leveraged financing markets, such as limited funding conditions and limited MAC outs, still remains which give sponsors the ability to compete for companies when sellers are only willing to sell on a no-financing out basis.

Back Issues of Private Equity Alert are available online at www.weil.com

Recent Articles:

China's Private Equity Landscape

In the PIPEline

SPACs – Exit Opportunities for Private Equity Sponsors?

District Court Dismisses Antitrust Suit Against Private Equity Bidders

Ignorance of the FCPA Is No Excuse

PBGC Ruling Extends Control Group Liability to Private Equity Fund

Private Equity Market – The Good, the Bad and the ?

144A Equity Offerings – Potential New Liquidity Option for Sponsors

Recent Securities Law Amendments May Increase Sponsor Liquidity

Shopping for Distressed Companies

Sir David Walker Publishes Guidelines for Disclosure and Transparency in Private Equity

A Rock and a Hard Place

The Pre-Budget Report – The UK Private Equity Industry Heaves a Collective Sigh of Relief

Opportunistic Purchases of Portfolio Company Debt

Qualifying as an Excluded Party in a Go-Shop – Can You Wake Up Late But Still Say You Were On Time?

Congress Turns its Attention to the Taxation of Investment Funds and Sponsors

Going Semi-Private

The Great Pushback

Winning Management's Vote – Alternative Approaches to Equity Compensation

FTC Heightens Antitrust Scrutiny of Private Equity Investments in Overlapping Companies

Private Equity in Brazil: Opportunities and Challenges for Foreign Investors

Private Equity Alert is published by the Private Equity Group of Weil, Gotshal & Manges LLP, 767 Fifth Avenue, New York, NY 10153, +1-212-310-8000. The Private Equity Group's practice includes the formation of private equity funds and the execution of domestic and cross-border acquisition and investment transactions. Our fund formation practice includes the representation of private equity fund sponsors in organizing a wide variety of private equity funds, including buyout, venture capital, distressed debt and real estate opportunity funds, and the representation of large institutional investors making investments in those funds. Our transaction execution practice includes the representation of private equity fund sponsors and their portfolio companies in a broad range of transactions, including leveraged buyouts, merger and acquisition transactions, strategic investments, recapitalizations, minority equity investments, venture capital investments and restructurings.

Editor: Douglas Warner (doug.warner@weil.com), +1-212-310-8751
Deputy Editor: Michael Weisser (michael.weisser@weil.com), +1-212-310-8249

©2008. All rights reserved. Quotation with attribution is permitted. This publication provides general information and should not be used or taken as legal advice for specific situations that depend on the evaluation of precise factual circumstances. The views expressed in these articles reflect those of the authors and not necessarily the views of Weil, Gotshal & Manges LLP. If you would like to add a colleague to our mailing list or if you need to change or remove your name from our mailing list, please log on to http://www.weil.com/weil/subscribe.html, e-mail subscriptions@weil.com, or call +1-646-728-4056.

Beijing
Steven Xiang
+86-10-8515-0558

Boston
James Westra
+1-617-772-8377

Budapest
David Dederick
+1-361-302-9100

Dallas
Glenn West
+1-214-746-7780

Frankfurt
Gerhard Schmidt
+49-69-21659-700

Hong Kong
Akiko Mikumo
+852-3476-9008

Peter Feist
+852-3476-9100

London
Michael Francies
+44-20-7903-1170

Marco Compagnoni
+44-20-7903-1547

Munich
Gerhard Schmidt
+49-89-242430

New York
Thomas Roberts
+1-212-310-8479

Barry Wolf
+1-212-310-8209

Doug Warner
+1-212-310-8751

Paris
David Aknin
+331-44-21-9797

Prague
Karel Muzikar
+420-2-2140-7300

Providence
David Duffell
+1-401-278-4700

Shanghai
Steven Xiang
+86-21-6288-1855

Silicon Valley
Craig Adas
+1-650-802-3020

Warsaw
Pawel Rymarz
+48-22-520-4000

Washington, DC
Robert Odle
+1-202-682-7180

Wilmington
E. Norman Veasey
+1-302-656-6600

www.weil.com