Market Trends 2019: LBO Leveraged Finance

A Lexis Practice Advisor® Practice Note by
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This practice note addresses how sponsors, underwriters, and investors have responded to a financing market in flux in 2019 by examining (1) the state of the leveraged finance market, (2) the state of leveraged buyouts (LBOs) and LBO leveraged financings, (3) key deal terms advanced and points of recent focus in 2019, and (4) three buyout financings that typify this year's mixed story. On the whole, choppiness within the leveraged finance market has contributed to continuing sponsor-favorable documentation trends for higher-quality buyouts and investor pushback to lower-quality credits.

For additional resources on acquisition financing, see Acquisition Finance Resource Kit. See Leveraged Buyouts – Introduction for an overview of LBO transactions.

State of the Leveraged Finance Market

The leveraged finance market in 2019 has been characterized by three principal trends: bifurcation of the market based on borrower quality, a shift towards bonds, and a narrow balance between supply and demand. These trends have contributed to a year marked by resilience, after significant stress in the fourth quarter of 2018.

These trends have been driven by global macroeconomic and geopolitical uncertainties that have caused periodic stress and undermined investor confidence. Key issues include concerns about the end of the economic cycle (including signs of slowing economic growth, such as the yield curve inversion) and geopolitical tensions, particularly in respect of trade. Low interest rates globally—the Federal Reserve made three 25 basis point cuts this year, and rates in Europe continued into negative territory—have driven investors to continue to seek yield, sometimes at the expense of documentation.

A Bifurcated Market

Lower-quality borrowers have suffered from these uncertainties due not only to jittery investors seeking safer harbors, but also to changes in the composition of the buy-side market. Retail investors have fled leveraged loans due to market choppiness and decreasing interest rates, with only one week of net inflows and $26.6 billion of total net outflows through October 23 (as compared to approximately $10.2 billion of net inflows in 2018). Simultaneously, collateralized loan obligation (CLO) funds have continued strong fundraising despite headwinds, raising $89 billion in the United States through September 30 and increasing their share of the loan market to a record 72% due to the retail investor flight. The increasing primacy of CLOs as buyers coincides with continued poor credit quality in the market: loans rated single-B or worse constituted 64% of the market at the end of September, and debt-to-EBITDA) ratios remain at cycle peaks, with an increasing percentage of high ratios (>7x). Because CLOs often face limits on holding loans rated CCC or worse and prefer double-B ratings, the confluence of these trends has bifurcated the market for borrowers—demand flows disproportionately towards better credits.

Lower-quality borrowers have been forced to increase yields and move to more lender-favorable documentation. As an example, the B-rated Teneo Holdings buyout increased pricing and included a host of documentation changes after struggling in syndication. On the other hand, strong credits or weaker credits with strong narratives have been oversubscribed and have been able to extract aggressive terms. In terms of pricing, the difference in weighted average bids between U.S. double-B and single-B loans at the end of September was 241 basis points, 190 basis points wider than in 2018.

While bonds have not had to face CLOs as marginal buyers, the bond market has been similarly discriminatory due to global uncertainties. Only $1.7 billion of bonds rated CCC or worse were issued in the third quarter of 2019 (2.6% of high-yield issuances), as compared to $5.2 billion in 2018 (12%). Through the third quarter, U.S. B-rated bonds issued with a yield-to-maturity that was 202 basis points wider than BB-ratings, and CCC-rated bonds a further 271 basis points wider.

The Bond Market

On the other hand, bonds as a whole have been buoyed by a market shift from floating-rate loans to fixed-rate bonds. The Federal Reserve turned more dovish this year, and European rates continue to sink below zero, driving money into bonds on both the buy-side and sell-side. In particular, sponsors have been keen to lock in these low interest rates with a fixed-rate bond. High-yield bond issuances were up 29% compared to 2018 through the third quarter, and bonds enjoyed a historically hot September—$434 billion in total globally. Meanwhile, net inflows of retail investors to high-yield bond funds have totaled $16.9 billion this year through October 23.

A Balanced Market

Finally, market dynamics have been shaped by a narrow balance between supply and demand. Uncharacteristically short supply has buoyed seller leverage and offset market weaknesses, particularly in the loan market where CLO fundraising has kept pace with new issues. As a result, stronger sellers have been able to achieve pricing and deal terms like those of the headier 2018 market despite the adverse trends.

The depressed fourth quarter of 2018 fed into a soft first quarter down 20% year-over-year in total volumes, due primarily to the ginger reintroduction of deals to the market and a light M&A pipeline from the winter slowdown. Deal supply remained low in the second quarter despite improving market fundamentals, with loan volumes sinking 49% versus the same period in 2018. The banner September for bonds mentioned above provides the exception that proves the rule, as the rally was led by investment grade issuers—$72 billion in the first week alone—and opportunistic high-yield financings.

Yet, this supply-demand balancing act means that stress in the market hits borrowers, particularly lower-quality borrowers, particularly hard. In August, market choppiness led multiple deals to be pulled even though issuances overall remained resilient. Likewise, trade tensions and economic concerns at the beginning of October reportedly forced the arranging banks to several weaker financings to hold onto over $2 billion of loans in aggregate even after pricing and documentation sweeteners.

Looking forward, the leveraged finance market may continue to face worsening macroeconomic and geopolitical trends. Loans remain under duress. With expectations of further interest rate cuts by the Federal Reserve, the share of loans trading below 90 cents grew from 4% of the market to 11% from September 2018 to September 2019, and loans trading below 80 cents grew from 2% to 6%. This market weakness may continue to undermine lower-quality borrowers in documentation, while strengthening the leverage of higher-quality borrowers.

LBO Leveraged Financings

The market outlook for LBO financings hinges on the quality of supply from the LBO market and the state of the leveraged finance market previously discussed—the quality and quantity of competing leveraged financings and the buy-side appetite. This section discusses the LBO market and reflections of the broader leveraged finance market in LBO financings.

LBO Market

Global uncertainty (particularly relating to trade and other geopolitical tensions) has weighed on M&A in 2019, with global volume down 11.4% through the third quarter and 21.2% in the third quarter as compared to 2018. At the same time, the equity bull market has contributed to a growth in average deal value to record levels (approximately $425 million).

Private equity has tracked these broader trends even as sponsors hold historically high levels of dry powder. Disclosed buyout volume was down 13.9% through the third quarter and 21.4% in the third quarter as compared to 2018. Moreover, buyout volume constituted the smallest share of M&A since 2016, at 15.8% globally and 20.3% in the U.S. At the same time, quality is under duress as deal valuations remain high. Through the third quarter, the median enterprise value to EBITDA multiple for U.S. buyouts was 12.9x (as compared to 11.5x in 2018).

Looking forward, market watchers expect M&A activity to be impacted by deepened trade tensions, uncertainty from the U.S. presidential election and worsening economic forecasts. On the other hand, any depression or volatility in valuations could lead to private equity bargain hunting with dry powder.

LBO Leveraged Finance Market

The nexus of stress in both the LBO and leveraged financed markets has contributed to a choppy, but overall robust financing market for buyouts.

Through the third quarter, LBO-related loan and bond issuances in the U.S. were up 2.1% by volume. The year-to-date comparison was depressed by the lowest third-quarter issuance ($44.1 billion) since 2016 and a contrast with the banner third quarter of 2018. Notable completed buyout financings with substantial loan and bond tranches included Power Solutions ($7.71 billion loans, $3.74 billion bonds); Merlin Entertainments ($2.81 billion loans, $821 million bonds); and Dun & Bradstreet ($3.13 billion loans, $1.45 billion bonds).

Tracking the broader market, sponsors have had a strong appetite for bonds. The volume of U.S. bond issuances through the third quarter grew 10.5% compared to the prior year, versus a growth of 1.3% for loans. Sponsors have also relied more frequently on secured bonds to offset weaker credits. In an example of both trends, Thomas H. Lee downsized its loan tranche for a secured bond issuance in connection with its buyout of Dun & Bradstreet. Even so, loans remain the largest source of LBO financing ($122.8 billion in loans versus $10.6 billion in bonds through the third quarter in the U.S.).

As elsewhere in the market, financings for buyouts with lower ratings have struggled. During September, sponsors outpaced the broader market in accepting buyer-favorable flex terms for loans, although their aggressive initial positions meant final terms remained more borrower-favorable than the market. At the beginning of the fourth quarter, investor resistance reportedly forced the arranging banks in the Shutterfly buyout to retain at least some of their loan tranches even after pricing and documentation sweeteners. In Kantar and Inmarsat, investor feedback resulted in improvements to documentation.

However, adverse market trends have not stopped the expansion of sponsor-favorable financings, with Merlin (based on Refinitiv's documentation) and Power Solutions notable instances of offerings whose deal terms would have been at the edge of the market even in the hot third quarter of 2018.

The market outlook for LBO leveraged financings remains subject to market uncertainties in the LBO and leveraged finance markets generally. Key LBOs signed in the third quarter include Brookfield's buyout of Genesee & Wyoming ($6.38 billion equity value), Tallgrass Energy ($3.06 billion) by Blackstone, Cambrex ($2.02 billion) by Permira, and Presidio ($1.37 billion) by BC Partners.

Deal Terms

This section discusses market trends in (1) acquisition regulatory risk allocation, (2) net short disenfranchisement and default sunsets, (3) restricted payments, (4) EBITDA add-backs, and (5) asset sale sweep step-downs in bonds.

As discussed previously, documentation quality has followed borrower quality. Stronger credits continue to push the envelope on loose terms. The Merlin buyout expanded on the Refinitiv terms that caused so much buy-side alarm last year (all references to Merlin are to its preliminary documentation), and sponsors introduced or extended a series of aggressive provisions. On the other hand, weaker borrowers have been forced to roll back aggressive preliminary terms.

Loan terms continue to converge with bonds as sponsors demand flexibility irrespective the capital. In many deals, pari loans and bonds issued at the same time have very similar covenant packages. While the discussion below occasionally highlights bonds versus loans, most of these provisions apply with equal force in each debt type.

As always, the highly interrelated nature of debt documents supercharges each loosening of a covenant. As an example, increasingly flexible EBITDA add-backs may inflate the benchmark metric for asset sale sweep step-downs, recently introduced in sponsor bonds. Accordingly, the covenant package continues to leave sponsors with more protection, and creditors less, than would appear from the sum of the individual provisions.

Acquisition Regulatory Risk Allocation

Acquisitions have faced not only growing regulatory scrutiny, but also growing regulatory uncertainty. Merger regulation across the globe increasingly serves domestic and international political and national security objectives rather than running strictly anticompetitive analyses. This has led to more significant delays in merger review and more significant ex ante uncertainty about the time line and success of the review. Moreover, it has increased the regulatory risk for LBOs, which infrequently raise anticompetitive concerns but more often attract political scrutiny—such as a review by the British government of Advent's buyout of the British aerospace and defense firm Cobham. See Merger Review Antitrust Fundamentals; see also Hart-Scott-Rodino (HSR) Act Filings.

Regulatory uncertainty impacts committed acquisition financing in several ways, including driving a longer commitment period, additional time-based fees (such as ticking fees and rate step-ups), and special mandatory redemption (SMR) provisions in escrow bond deals.

Although LBOs typically have a relatively smooth path to achieving regulatory approvals, for some transactions—especially transactions in sensitive industries or with a foreign buyer—there may be enhanced regulatory scrutiny. In addition, bolt-on acquisitions by portfolio companies may now raise antitrust scrutiny typically reserved for strategic transactions. As acquisition agreements provide for more time to complete an acquisition, commitment length must also lengthen. This shifts the time line risks to the commitment parties because they are forced to hold commitments (with associated capital requirements) on their balance sheets for longer periods of time.

To mitigate this risk, underwriters may require ticking fees, which are additional fees that begin to accrue after a certain date (e.g., 90 days from signing) if the commitment has not been drawn and may step up after further delays (e.g., every 90 days thereafter). In addition, the documentation may provide that interest rates and caps step up over time, which provides the underwriters with some protection against being exposed to market risk for a longer period.

Finally, acquisition-related bond offerings closing into escrow remain common. In these escrow deals, an SMR feature provides that the issuer must redeem the bonds if the acquisition is terminated or does not close by a given outside date. This structure enables offerings in advance of an uncertain deal completion. However, it exposes bondholders to completion risk that is difficult to value due to its opacity both ex ante and while the buyer and seller engage with regulators. In several instances, bonds have traded significantly above the redemption price before a surprising regulatory block.

Customarily, SMRs have been set at the issue price for sponsor transactions (as compared to par or 101%), plus accrued and unpaid interest to the redemption date. This formulation is the most sponsor-friendly way to set the redemption price because it does not require the sponsor to spend additional funds (other than accrued interest) if the transaction does not close. In particular, the selection of issue price rather than par decreases the redemption price by the amount of any original issue discount. However, a potential sign that investors may be looking for more compensation for committing to an uncertain deal is the Kantar buyout, which split the baby on the SMR and set the price at the issue price for nine months, and 101% of principal thereafter.

As political concerns continue to grow as a facet of regulatory review of acquisitions (e.g., CFIUS's expanded scope under recently enacted legislation), the acquisition financing market may continue to focus on mechanisms to mitigate and allocate regulatory risk prior to completion. See Proposed CFIUS Regulations: Client Alert Digest.

Net Short Debt Activism – Disenfranchisement and Default Sunsets

A federal court captured the attention of the leveraged finance world this February when it ruled against Windstream Holdings, Inc. in a covenant breach claim. U.S. Bank Nat'l Ass'n v. Windstream Servs., LLC), 2019 U.S. Dist LEXIS 26129 (S.D.N.Y. Feb. 15, 2019). Market watchers believe that plaintiff Aurelius Capital Management held a net short position in Windstream's bonds, explaining why they would devalue their own holdings by inducing a bankruptcy. The prospect of hedge funds coming after borrowers based on technical or old defaults rippled through the market, as even most creditors of Windstream were harmed by the litigation and resulting bankruptcy. The market quickly introduced a two-pronged response to defang this so-called net short debt activism.

First, net short disenfranchisement removes certain rights of creditors who are net short. Sponsors have deployed the provision in more aggressive financings, including Sirius Computers and Merlin. However, it has not achieved universal acceptance. For instance, neither the Shutterfly nor the TruckPro bonds went to market with disenfranchisement, while the Inmarsat and Kantar bonds stripped it out after marketing.

Disenfranchisement has varied within the market and between loans and bonds but follows a typical framework.

- Bonds typically cover submitting a notice of default and, in some instances, voting; while loans often also include waivers, modifications, amendments, and any other request, notice, or demand.
- Upon taking a covered action, creditors must affirmatively represent that they are not net short or, in some examples, are deemed to have made such a representation. Only creditors who are not net short can take a covered action.

Disenfranchisement gains more teeth when paired with a second innovation: a sunset on defaults. Here, creditors—irrespective long/short status—cannot submit a notice of default or acceleration based on facts that were publicly known for a certain duration, typically two years.

As the litigators' aphorism goes, bad facts make bad law. The market's rapid response to Windstream has led to provisions tailored to its facts and thus unfinished, sweeping both overinclusive and underinclusive to the risks of creditors holding perverse economic incentives. Looking ahead, expect further iterations of disenfranchisement and default sunsets and further innovations to address creditor perverse incentives.

Looser Restricted Payments

Sponsor pressure on restricted payment covenants continued apace in 2019. With recession risks growing, sponsors have sought greater flexibility to withdraw capital from portfolio companies to secure their return. In addition to uncharacteristically large basket sizes, sponsors have been pressing the envelope on a series of mechanisms that loosen the covenant.

Most aggressively, a series of LBO bonds have abandoned the ratio debt test when accessing the builder basket. Ubiquitous in bonds, this test requires issuers to be able to incur ratio debt (typically set at a ratio of adjusted EBITDA to consolidated fixed charges, a measure of financial health) before using the builder basket for restricted payments. Some of the most aggressive bonds of 2018—the Refinitiv and Envision buyouts—originated this deletion, but the winter market stress and a comparatively subdued 2019 have not arrested the trend.

Finally, sponsors have continued to roll back the event of default blocker, including by permitting restricted payments so long as no insolvency or payment event of default only (as opposed to any) had occurred and is continuing.

As the likelihood of a recession increases, sponsors are likely to continue to prioritize looser restricted payment covenants while the buy-side may give a heightened priority to curtailing restricted payment capacity over fears of low recoveries if sponsors are able to strip cash out before an event of default.

EBITDA Add-Backs

With deal valuations high, borrowers and creditors have faced pressure to justify significant leverage in marketing (regulators have cautioned about 6x or worse), and borrowers have demanded achievable EBITDA-based tests to make restricted payments, incur indebtedness, and satisfy other covenants. As a result, sponsor documents have incorporated liberal add-backs for calculating EBITDA. In particular, synergy add-backs have become entrenched in the market, despite estimates being widely recognized as aspirational.

Cutting edge buyout documentation has introduced synergy add-backs that encompass more transactions or that are difficult to define and thus subject to significant management discretion. For example, Power Solutions included the effects of increased pricing in customer contracts and contract renegotiation.

Sponsors have also increased their flexibility through synergy add-backs that are sometimes uncapped, have longer periods during which actions that result in synergies must be taken, and sometimes have unlimited periods during which the synergies must be realized. Certain sponsor bonds have cleared the market without caps or limits on when synergies must be realized. However, investors have resisted the evolution: after marketing, Power Solutions lowered its cap, and Kantar added one. Sponsors have also increasingly obtained uncapped synergy add-backs in loans.

Aggressive add-backs disconnect the borrower's business fundamentals from EBITDA-based covenant tests. For creditors, this undermines the tests' purpose: to loosen covenants because improving business performance made them less salient for preserving the credit. Indeed, resistance commonly results in at least some tightening of EBITDA add-backs after marketing. Even so, sponsors will undoubtedly continue to test creditors' appetite for add-backs.

Asset Sale Sweep Step-Downs in Bonds

Because sponsors often sell divisions after a buyout, the asset sale covenant continues to receive pressure. In particular, sponsors have begun incorporating step-downs into asset sale sweeps in the more aggressive bonds, including Merlin and Power Solutions. Common in loans, the step-down (based on leverage ratio) reduces the amount of sale proceeds subject to restricted uses, including debt repayment and certain reinvestments. However, this evolution is not without investor resistance—Power Solutions reduced the step-down ratios after marketing. Looking forward, sponsors are likely to continue to seek step-downs into bond asset sale sweeps in order to preserve proceeds for other purposes, such as dividends.

Notable Transactions

Power Solutions, Shutterfly, and Merlin Entertainments characterize the highs and lows of the 2019 market.

Power Solutions

Coming to market in March with the largest financing and most aggressive covenant package since Refinitiv, Power Solutions set the tone for the year: a strong borrower could perform in line with pre-winter expectations.

In November 2018, Johnson Controls agreed to a $13.2 billion sale of its Power Solutions business to Brookfield Business Partners LP. Debt financing was completed in April with $7.71 billion in loans and $3.74 billion in bonds (both secured and unsecured), each with both dollar- and euro-denominated tranches.

Investors substantially oversubscribed the financing, driving pricing below initial indications. Moody's rated each of the tranches Ba3, except for a B3 rating of the unsecured bonds. Though low, these ratings were sufficient along with a sound business case for the independent company to place Power Solutions in the favorable half of the market bifurcation. Investor appetite was not diminished by a covenant package that was aggressive by third quarter of 2018 standards and wildly so in relation to its first quarter peers. Investor resistance resulted in only limited tightening, especially of the restricted payments and debt covenants, in the final documentation.

Shutterfly

In contrast, the marketing struggles of Shutterfly amidst the historically hot September show that the market remains weak for the weakest borrowers.

In June, Apollo Global Management agreed to acquire Shutterfly and Snapfish. Debt financing entered the market in September and completed after a rough marketing period. Final debt for the acquisition included $1 billion in loans, approximately $785 million in secured bonds and a $300 million unsecured bond tranche.

A combination of poor ratings and poor investment narrative undermined the financing, and its struggles landed in The Wall Street Journal. Moody's rated the loan and secured bonds B1, while the unsecured bonds received a Caa1. Keeping the financing on the unfavorable side of the market bifurcation, investors also balked at the narrative of a declining photoprint business with low barriers of entry.

Reports indicated that, to clear the market, Apollo retained the poorly rated unsecured bonds, the unsecured bonds were upsized by approximately $250 million (downsizing the loan), the underwriters cut the loan price to 95% and, in the end, the underwriters kept $255 million of the loans.

Merlin

The recently priced financing of the Merlin Entertainments buyout affirmed the story of 2019: for higher-quality borrowers, the financing market has recovered from its slump, and they can resume testing the ceiling on aggressive deal terms.

In June, a consortium including Blackstone and the controlling family of The LEGO Group agreed to acquire Merlin, a European entertainment company. As is typical, the consortium flexed its muscles at the commitment stage: obtaining Refinitiv as the documentation precedent and taking nearly half of the underwriting commitments (and fees). Debt financing priced in October with $2.81 billion of loans and $821 million of bonds, both with dollar- and euro-denominated tranches, in addition to a revolving credit facility.

While market watchers raised alarms about documentation, the financing priced favorably—4.5% for the euro-denominated bonds and 6.625% for the dollar-denominated bonds—and cleared with aggressive documentation that expanded on the market-leading Refinitiv. Paralleling Power Solutions, Moody's rated the loans Ba3 and the unsecured bonds B3. Moreover, Merlin had a strong investment narrative: Blackstone and The LEGO Group family were previous owners and the consortium contributed a large equity tranche (almost half of total debt).

Market Outlook

The availability of favorable pricing and documentation in the leveraged finance market will remain a crucial factor in sponsor buyouts. The course of 2019 LBO financings contains a promise and a warning for sponsors amid worsening macroeconomic and geopolitical uncertainties. Buyouts with favorable ratings and strong investment narratives (such as Merlin) have not yet reached their high-water mark in terms of pricing or documentation. On the other hand, continued stress, and occasional failures, among lower-quality borrowers portend greater obstacles for ill-conceived or highly levered buyouts. Going forward, sponsors, underwriters, and their advisors will need to give increasing attention to the quality of the underlying acquisition as the determinant of marketing success and, thus, the appropriate posture for documentation.

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