
Stephen M. Kessing

Market Trends: Leveraged Finance

by Stephen M. Kessing and Randall F. Limberg, Cravath, Swaine & Moore LLP

Overview

The leveraged finance market in 2016 continued to be influenced by trends of the last several years. Coming out of 2015, most analysts predicted that the principal issues borrowers and lenders would face in 2016 would be further evolution of the leveraged lending guidelines initially published in 2013, the prospect of rising interest rates, and the outcome of the U.S. presidential election. Now, looking back from 2017, it is clear that these issues significantly influenced much of the activity in the leveraged finance market over the past year.

As in prior recent years, the activities of regulated financial institutions in the leveraged finance market in 2016 continued to be affected by the March 21, 2013 "Interagency Guidance on Leveraged Lending" (the Guidance) issued by the Board of Governors of the Federal Reserve System (the Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC). In the fourth year since the Guidance was published, established market practices under these regulations continued to evolve. As the bounds of acceptable practices became further defined, unregulated entities and newer market entrants have and will continue to fill gaps in proposed transactions that may be inconsistent with the regulations.

More broadly, two key economic and political issues were the focus of 2016, in each case with resolutions coming only very late in the year. First, lenders and borrowers spent much of 2016 anticipating a rise in the Federal Reserve's target for short-term interest rates, which finally materialized in December of 2016 when the Federal Reserve raised this key rate to 0.50% to 0.75%. Second, the market awaited the outcome of the U.S. elections, which resulted in President Donald Trump's election on November 8, 2016. Still, even after the Federal Reserve's announcement and the electoral votes had been counted, some uncertainty in the leveraged finance market persisted. In early 2017, the Federal Reserve signaled and ultimately followed through with a follow-up interest rate hike, this time to 0.75% to 1.00%. Further rate hikes in 2017 remain possible. And, while many experts are optimistic that the Trump presidency will have positive impacts on the financing markets, the regime change's ramifications for the market are only just coming into focus.

In line with the continuation of prior trends, leveraged finance transaction volume for the year 2016 generally remained on par with 2015. The slowness that marked the tail-end of 2015 carried into 2016, but activity ramped up by the end of the year, particularly in the leveraged loan market. While global syndicated lending reached only about $4 trillion, a 10% decrease from the prior year, leveraged lending ultimately accounted for about $1 trillion in connection with approximately 2,500 deals, representing little change from 2015. By industry, the technology, healthcare, and retail sectors were the most active markets. Average leverage levels hovered around 6 times earnings before interest, taxes, depreciation, and amortization (EBITDA) for broadly syndicated leveraged buyout (LBO) transactions and 5.3 times EBITDA for institutional middle market LBOs.

Among the most notable trends in leveraged finance in 2016 was a sharp spike in refinancing activity, particularly in the latter half of the year. This spike led loan refinancing volume to overtake new money volume by the fourth quarter of 2016, as new money financings remained stagnant during the same period. In part, the fall in new money financings resulted from an 18% decline in the acquisition finance market after the all-time highs of the 2015 mergers and acquisitions (M&A) market, including a 29% decline specific to non-LBO financing transactions.

With respect to the bond market, while the investment grade bond market continued to smash volume records, high yield bond issuance was slow in 2016. High yield issuances fell over 10%, reaching just around a quarter trillion dollars in spite of the investment grade bond market topping 2015's record highs by over a percent at more than $1.3 trillion. The bulk of the high yield bond activity was focused on refinancing, with about two-thirds of high yield bond deals mentioning refinancing as a use of proceeds. This volume was skewed toward mid-range B rated bonds, with only about 13% of issuances below such ratings. The consumer and health care sectors were among the most active industries in high yield bonds.

The remainder of this article will focus on some notable deals of 2016, current practices with respect to deal structure and process, deal terms that are currently among the most heavily negotiated, legal and regulatory trends, and the outlook for 2017.

Notable Transactions

The year 2016 was marked by notable deals in several areas within the leveraged finance space. As in years past, acquisition financing made up a significant portion of the leveraged finance market in 2016, especially in the technology industry. The semiconductor firm Avago Technologies, for example, arranged loans through five banks in connection with a $37 billion acquisition of chip manufacturer Broadcom Corp., with a total of $15.5 billion of financing split between $9 billion to finance the acquisition and $6.5 billion to refinance existing facilities. Tech-giant Dell, in connection with its record $67 billion take-over of VMWare owner EMC, secured over $50 billion of financing from both investment grade and leveraged sources, using both loans and bonds in its financing mix.

Refinancing activity was particularly heavy in 2016 given historically low interest rates coupled with signals from the Federal Reserve that rate hikes were on the horizon. Dollar Tree, for instance, undertook a repricing of $4.2 billion in secured credit facilities, and XPO Logistics, as part of a several step plan to reduce its debt load and increase cash flows, also repriced and refinanced $2.6 billion of notes and term loans.

Financing related to spinoffs was more prevalent than usual in 2016. The largest of these deals was Yum Brands, owner of fast food chains KFC, Pizza Hut, and Taco Bell, which secured a total of approximately $3.5 billion of financing related to a spinoff of a portion of its Chinese operations to Primavera Capital, a Beijing-based investment firm. Hertz, the rental company, raised about $2.6 billion through a term loan and revolving line of credit for the spinoff of its equipment rental business, now known as HERC Rentals Inc., which also secured a $1.8 billion revolving credit facility as part of the deal. Other 2016 deals included Alcoa's $1.5 billion credit facilities related to its spinoff from Arconic, Valvoline Finco One LLC's $875 million term loan and $450 million revolving line of credit related to its spinoff from Ashland, and Conduent Inc.'s nearly $3 billion financings related to its spinoff from Xerox Corporation.

There were fewer notable deals in the slower high yield bond market. French telecom company Numericable-SFR, however, made one of the largest single-tranche debt sales in the history of the junk bond market, pricing $5.2 billion of 10-year notes. Alternative and unregulated lending institutions continued to gain market share in 2016 and early 2017, recording multiple deals reaching ten figures. These included alternative lenders Antares, Jefferies, Nomura, and Macquarie, as well as the financing branches of several prominent private equity shops. KKR's lending branch completed several notable deals, and an Ares Capital-led club provided $1.1 billion in financing to Thoma Bravo in connection with its buyout of Qlik.

Deal Structure and Process

Leveraged finance transactions can generally be categorized as either committed financings or best efforts financings.

Committed Financings

In a committed financing, financial institutions commit to provide the desired financing on agreed terms and subject to customary conditions. In most cases, the borrower or issuer agrees to the basic terms, including pricing and covenants, in advance subject to certain specific changes to the extent necessary for the financial institutions to successfully syndicate or market the debt.

For high yield bonds, in lieu of providing a forward underwriting of securities, the financial institutions typically provide a committed bridge facility, which would only be drawn if the high yield bonds cannot be successfully placed in the market.

Committed financings are typically used in M&A transactions where the borrower/issuer needs certainty of funding prior to entering into a transaction that is not conditioned upon obtaining financing. The borrower or issuer will commonly enter into a commitment letter with the banks or other financial institutions providing the financing. The commitment letter includes detailed term sheets describing the key terms of the financing. The arrangers of the financing take the risk of being able to syndicate or market the financing, but are compensated through the payment of commitment or arrangement fees on the amount of the committed financing. Depending upon the complexity of the transaction, the size of the debt facilities, and the details included in the term sheet, the timeline for negotiating and executing the commitment letter could extend for several weeks. The time period between the signing of the commitment letter and the closing of the transaction is driven by the timing of the underlying acquisition or other transaction and can range from four or six weeks to longer than one year.

Best Efforts Financings

In contrast to a committed financing, most refinancing transactions involving leveraged loans and high yield bonds are done on a best efforts basis. This means that the financial institutions that arrange the financing will enter into an agreement with the borrower or issuer to syndicate or market the financing, but do not commit to provide the financing on any specific terms. The successful outcome of the financing will depend on the willingness of the market to participate, and the financial institutions do not risk their own capital if the financing cannot be placed in the market. Commensurate with this structure, the financial institution will not earn any fees if the financing does not close. The timeline for these transactions tends to be shorter as the commitment letter is replaced with an engagement letter that is typically less detailed, and the time between signing the engagement letter and closing of the transaction can be as short as one or two weeks.

Deal Terms

In 2016, many borrower and issuer friendly terms continued to become more prevalent in leveraged finance transactions.

Leveraged Loans

Within the leveraged loan market, terms related to incremental facilities continued to evolve in a borrower favorable direction. Incremental facility provisions permit a borrower to incur additional debt in the future, either in the form of additional term loans under a credit agreement or in the form of other indebtedness. The most common formulation permits a borrower to incur a fixed dollar amount of additional debt, and then higher amounts depending upon a financial ratio. Many 2016 leveraged loan deals provided borrowers greater flexibility through growing fixed dollar baskets and variations of the ratio based components designed to provide more capacity. For example, many recent credit agreements permit ratio calculations based on the borrower's choice of various types of ratios. They may also permit the borrower to reclassify debt incurred under a fixed dollar basket to be deemed incurred under a ratio basket if the borrower's leverage profile improves. The most-favored nation pricing protections, which can limit the ability to price future debt with higher interest rate spreads, also continued to weaken, with exceptions increasingly made based on time elapsed since the original deal, amount, type of incurrence (i.e., fixed dollar or ratio), currency, and financing sources.

Another area of focus for borrowers relates to mandatory prepayment provisions in credit agreements. Borrowers commonly obtained exceptions to the "soft call" repricing protections (which require a fee, usually 1%, to be paid in connection with any repricing transaction) for initial public offerings, certain other transformative transactions, and certain types of triggering debt. Other common exceptions to mandatory prepayment provisions included step-down thresholds for asset sales and de minimis exceptions for excess cash flow prepayments.

In addition, in 2016 there were further exceptions to investment and restricted payment covenants as well as additional flexibility with respect to financial covenants. In sponsor backed leveraged loan transactions, the norm continued to be springing financial covenants, which are tested only when amounts borrowed under a revolving facility exceed a certain threshold. These covenants increasingly provide cushion levels such that a decrease in EBITDA of less than 30-35% would not breach the covenant. In contrast, step-downs, which tighten financial covenants over time, have become less common.

High Yield Bonds

There have been fewer market changes in the high yield market in 2016, due primarily to the slower high yield bond market as compared to the leveraged loan market. The market trends in 2016 have been focused on increased flexibility with respect to covenant suspension provisions and dilution of the change of control protections for bond holders. There has also been further flexibility with respect to future debt incurrence, restricted payments, and mandatory prepayments in response to some of the changes in the leveraged loan market described above.

Legal and Regulatory Trends

In 2017, there have been legal and regulatory developments in both the loan and bond markets.

Leveraged Loans

2016 represented, and 2017 likely will continue to represent, the evolution of the Guidance. The Guidance was aimed at preventing future losses of the sort faced by many banks in the wake of the 2007 economic downturn. Losses by lenders at that time were exacerbated by risky, over-levered lending practices, with financings routinely provided at debt to EBITDA ratios of 7:1, 8:1, or even greater. Viewed by regulators as a systemic issue worsening the recession that occurred in the latter half of the 2000s, the Federal Reserve, FDIC, and OCC collectively issued the Guidance in an effort to cap the amount of risk that lenders are permitted to absorb.

The Guidance focused on four factors used to identify over-levered deals:

- Proceeds used for buyouts, acquisitions, or capital distributions
- Financial metric tests, particularly whether a borrower's debt to EBITDA ratio exceeds 4:1 (or 3:1 with respect to senior debt only)
- Borrowers recognized as highly leveraged firms
- Industry comparisons made on a pro forma basis

In the years following the issuance of the Guidance, lenders faced uncertainty regarding its implementation. This uncertainty chilled the financing activity of some lenders who then faced a disadvantage in the market compared to those who interpreted the Guidance less conservatively. Recognizing the need to tighten up the market's understanding of the Guidance, the Federal Reserve, FDIC, and OCC provided further clarity in two steps. First, the regulators issued a November 2014 Frequently Asked Questions publication (FAQ memo), and second, the regulators participated in a February 2015 conference call (the red flags conference call) sharing what they determined to be red flags in leveraged lending. These red flags included debt to EBITDA ratios in excess of 6:1, overly optimistic cash flow projections, large percentage EBITDA adjustments, and other EBITDA adjustments lacking third party diligence. In addition, during this same period, the regulators began to enforce the Guidance through monetary penalties and other sanctions.

Today, it has been roughly four years since the initial release of the Guidance and over two years since the red flags conference call held by the regulators, suggesting the regulators feel the post-Guidance lending market has reached a more appropriate equilibrium. The OCC went so far as to change its characterization of leveraged lending from a "key risk" to an "issue warranting continued monitoring" in its semi-annual risk report for the fall of 2016. In turn, lenders have consistently made an effort to stay within the largely accepted boundaries established since the red flags conference call.

This effort by regulated financial institutions in the market to avoid deals that arguably constitute the sort of risky, levered lending described in the Guidance has provided space for alternative lenders to gain market share. Among these alternative lenders that focus on leveraged loans not regulated by the Federal Reserve, FDIC, or OCC, the most notable are Antares, Jefferies, Nomura, and Macquarie. These institutions' share of the market continues to rise as they fill a space left by regulated banks' refusal to engage in certain transactions. Seeing an opportunity to participate in this growing market, certain private equity funds have also begun increasing their lending operations.

Outside of the United States, the European Central Bank (the ECB) published draft guidance in November largely mirroring that of the Guidance. The ECB draft guidance focuses on many of the same factors as the Guidance, FAQ memo, and red flags conference call, with particular focus on a debt to EBITDA ratio of 6:1 or more, though other qualitative factors from the Guidance are repeated as well. The impact of any finalized regulation in Europe should be less dramatic than what was experienced in the United States. For one, it is unclear how effectively the ECB guidance will be enforced, with some European countries (e.g., the United Kingdom) not falling within the ambit of the Single Supervisory Mechanism of the ECB. Even if the route to enforcement were clearer, more prominent European banks are already shying away from the types of all-time high leverage ratios experienced in the United States during the financial boom, so many institutions are likely already in compliance with much of the draft guidance.

High Yield Bonds

The most important legal development in the bond market in 2016 concerned the decision in, and the subsequent market reaction to, Wilmington Sav. Fund Soc'y v. Cash Am. Int'l, Inc. (Cash America), No. 15-CV-5027 (JMF), 2016 U.S. Dist. LEXIS 127421 (S.D.N.Y. Sep. 19, 2016). In Cash America, the issuer consummated a spinoff that was determined to have violated the indenture, and a federal district court held that the bondholders were entitled to monetary damages equal to par plus the applicable make-whole premium, rather than merely the face amount of the bond. The court expressly declined to decide whether the issuer had defaulted in bad faith or with the intent to avoid the payment of the make-whole premium. This disrupted the expectations of some in the market that, based on a prior court decision, such a finding would be required to award the make-whole premium in the context of a monetary damages award for violation of a covenant. Shortly following Cash America, several bond offerings were marketed with language providing that the make-whole premium would be payable only in a voluntary optional redemption and would not be payable upon a violation of a covenant. This prompted an outcry from the buy-side community that specifically overriding the court's decision in Cash America would leave bondholders with limited tools to discourage intentional defaults and would make protective covenants essentially toothless. While a few deals included this language, the market ultimately rejected its inclusion in indentures. It remains to be seen to what extent future courts follow Cash America's reasoning or how they clarify in which situations the make-whole premium will be awarded upon violation of a covenant.

The other most significant legal development in the 2016 bond market was Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Fin. Corp. (Marblegate), 846 F.3d 1 (2d Cir. 2017). In Marblegate, the Second Circuit court overturned the previous District Court decision and clarified the interpretation of Section 316(b) of the Trust Indenture Act (the TIA) in the context of an out-of-court restructuring. In Marblegate and a similar ruling in the Caesar's Entertainment Corp. restructuring, the U.S. District Court for the Southern District of New York had cast doubt on the ability of issuers to conduct out-of-court restructurings that are binding on dissenting noteholders. In those cases, the District Court interpreted Section 316(b) of the TIA to prohibit out-of-court restructurings that harm noteholders' practical ability to receive payment without the consent of all noteholders. The Second Circuit overturned this interpretation, holding that Section 316(b) of the TIA was intended only to prohibit formal modifications to core payment terms, such as principal amount, interest rate, and maturity date, without the consent of all noteholders. Therefore, out-of-court restructurings that do not amend the indenture's core payment terms are permitted under Section 316(b) of the TIA, regardless of whether the restructuring adversely impacts a noteholder's practical ability to be repaid. The Second Circuit's ruling in Marblegate provides certainty to issuers seeking to restructure outstanding debt securities, clarifying that issuers offering to exchange outstanding debt securities for new securities can incentivize holders to accept the exchange by coupling the exchange offer with a consent solicitation that removes noncore terms from the indenture of the holders who reject the change.

Market Outlook

As of the end of February 2017, leveraged loan issuances have kept pace with 2016 volumes at approximately $250 billion year-to-date. Also, as in 2016, technology and retail continue to be particularly active sectors, with telecom also landing among the top three hottest industries for leveraged financing. Consistent with the fourth quarter of 2016, refinancings continue to outpace new money issuances as borrowers seek to lock in lower interest rates in anticipation of further target interest rate hikes by the Federal Reserve, with some estimates suggesting refinancings have thus far represented over 75% of 2017 leveraged loan issuances. Of the new money that has been issued, about $30 billion relates to M&A activity, with a relatively even split between LBO and non-LBO acquisitions.

As of March 2017, the high yield bond market also appears steady, with around $100 billion of volume.

Current trends are expected to continue in the remainder of 2017, though not without some wrinkles specific to the year. Four factors are generally expected to impact the leveraged lending market in 2017:

- It is expected that the demand for leveraged loans and high yield bonds will continue to grow, particularly from loan mutual funds as their assets under management continue to increase.
- The new administration appointed by President Trump seems likely to loosen regulatory review, both on the banking side and elsewhere. The appointment of Steven Mnuchin as Treasury Secretary grabbed headlines early, but the President will also nominate leaders of the FDIC and OCC. Other agency personnel changes could indirectly impact the leveraged lending market, including, for example, the direction new Department of Justice and Federal Trade Commission nominees take with respect to antitrust review of large M&A deals.
- The continued above-average performance of the market, and the related prospect that the Federal Reserve will raise interest rates, should lead to continued refinancing activity until borrowers no longer perceive that interest rates are at all-time lows.
- Changes in securities and banking regulation could play a role in 2017. In particular, President Trump has suggested he would like to overhaul the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act). While most experts are doubtful that any dramatic changes will make it through Congress, given the importance of the Act to the loan and securities market, even marginal tweaks will have an impact in 2017.