Experts' View

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Stephen is a partner in the firm's Corporate Department. His practice involves advising financial institutions and corporate clients in a wide variety of matters, including syndicated loan transactions, capital markets transactions and mergers and acquisitions.

Michael and Stephen share their thoughts on current issues in leveraged lending:

Given the leverage limits contained in the Leveraged Lending Guidance, what is happening in negotiations of EBITDA add-backs in loan agreements?

The definition of EBITDA and the scope of add-backs to EBITDA in loan agreements have been the subject of significant focus and negotiation between borrowers and lenders in leveraged loan transactions for many years. As "leverage" for these purposes is generally defined as the ratio of "total debt" to trailing four-quarter EBITDA, any definitional change that has the effect of increasing EBITDA has a multiplier effect when used for purposes of measuring or regulating debt capacity. The concerns over high leverage contained in the Leveraged Lending Guidance, and the regulators' admonition that definitional "enhancements" to EBITDA will be criticized if they do not have reasonable support, have further increased the attention that these provisions receive in the negotiation of loan agreements.

While we have not seen fundamental changes in EBITDA definitions in loan agreements over the past year, certain common add-backs to EBITDA have been subject to additional scrutiny by both borrowers and lenders. While add-backs for actual costs and expenses (such as transaction fees and expenses, restructuring and integration costs, and certain other non-recurring costs and expenses) continue to be commonly included without significant change from historical practice, add-backs for projected improvements in operating results (such as anticipated synergies and cost savings) are now frequently the subject of greater discussion and negotiation between borrowers and lenders.

Borrowers continue to negotiate for significant flexibility with respect to both the amount of cost savings and synergies that are permitted to be added back to EBITDA, as well as the period of time during which projected amounts may be added back before they are required either to be realized or dropped from the EBITDA calculation.

Lenders, on the other hand, are increasingly looking to shorten time periods for realization and to introduce caps on amounts that can be added back (which are often expressed as a percentage of unadjusted EBITDA). In our experience, these caps vary widely and range from 5% to 25% of unadjusted EBITDA. In the context of acquisition financings, borrowers are frequently asking to include a schedule of specific add-backs for periods after the closing of the transaction, which are often based on quality of earnings reports or projections prepared by the borrower or the related financial sponsor and made available to the private lenders during the syndication of the loans.

Finally, we have seen an increasing focus on the determination of closing date leverage, particularly in leveraged acquisitions. This is generally accomplished by the borrower and the lenders agreeing on historical EBITDA (adjusted as per the model) for the most recent four quarters ended prior to the closing of the transaction. These "deemed" EBITDA amounts are used to determine the borrower's closing date leverage for purposes of the loan agreement. Historically, the deemed EBITDA numbers were most important for determining compliance with financial maintenance covenants during the first year after closing. They are now, however, more important for setting closing date leverage levels that are often used as the ceiling for the borrower's ability to incur incremental or additional debt after the closing date, a concept that is a direct response to the Leveraged Lending Guidance's increased focus on leverage levels in the market.

So far in 2015, loans financing M&A activity have been largely concentrated in the investment grade space. Do you anticipate leveraged loan M&A activity picking up in the second half of the year?

We have seen a number of large loan transactions during the first half of 2015 to support M&A activity. Two recent examples are Heinz's $60 billion merger with Kraft and the $66 billion acquisition by Actavis plc of Allergan, Inc. Both of these transactions were in the investment grade space and there have been numerous similar transactions consummated or announced since the end of 2014. We expect to see more of these types of transactions this year.

On the leveraged side, we are continuing to see some M&A activity, but the last six months have been slower in this area than in comparable time periods in recent years. The deterrent effect of the Leveraged Lending Guidance has certainly contributed to this slowdown in activity, as both financial sponsors and arranger banks evaluate new transactions in light of the regulators' published concerns.

Financial sponsors, in particular, appear to be adjusting to the regulatory environment and finding new ways to finance leveraged acquisitions. This includes seeking financing from unregulated institutions and changing deal structures to allow the regulated institutions to participate. All of these factors are likely to lead to an increase in leveraged loan M&A activity in the second half of the year, although we do not believe the activity will approach recent historic levels.

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