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Direct Lending Terms and Documentation: Leverage Covenants, Incremental Financing, Guaranty Provisions

THURSDAY, MAY 6, 2021

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Alon M. Goldberger, Partner, **Stroock & Stroock & Lavan**, New York

Milap Patel, Counsel, **Ropes & Gray**, Boston

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Direct Lending Terms and Documentation

Leverage Covenants, Incremental Financing, Guaranty Provisions

Alex Cota
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Alon Goldberger
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YOUR PRESENTERS

ALEX COTA, Stroock & Stroock & Lavan

Alex Cota is a debt finance partner practicing in Stroock's Financial Restructuring Group, and serves as the leader of its "Debt Finance" Business Unit. He advises and represents banks, private equity and hedge funds, business development companies, alternative capital providers, other financial institutions and private companies on a variety of complex financing transactions across a broad variety of industries and in all levels of the capital structure, both lender-side and borrower-side (including administrative agent and arranger representations).

ALON GOLDBERGER, Stroock & Stroock & Lavan

Alon Goldberger focuses his practice on a variety of complex finance transactions. He represents agents, lenders, public and private borrowers, private equity sponsors and their portfolio companies, business development companies and other providers (bank and non-bank) of senior and subordinated debt financing. Alon also advises clients on a broad range of financing transactions, including first and second lien revolving and term loan credit facilities, asset-based and cash-flow based lending, acquisition financing, unitranche credit facilities, refinancings, recapitalizations and both in-court and out-of-court restructurings.

MILAP PATEL, Ropes & Gray

Milap advises lenders, private equity sponsors and their portfolio companies on leveraged finance transactions, including syndicated credit facilities, mezzanine and subordinated financings, high yield offerings, and debt restructurings. He has also represented companies in public and private securities offerings and general corporate advisory matters.

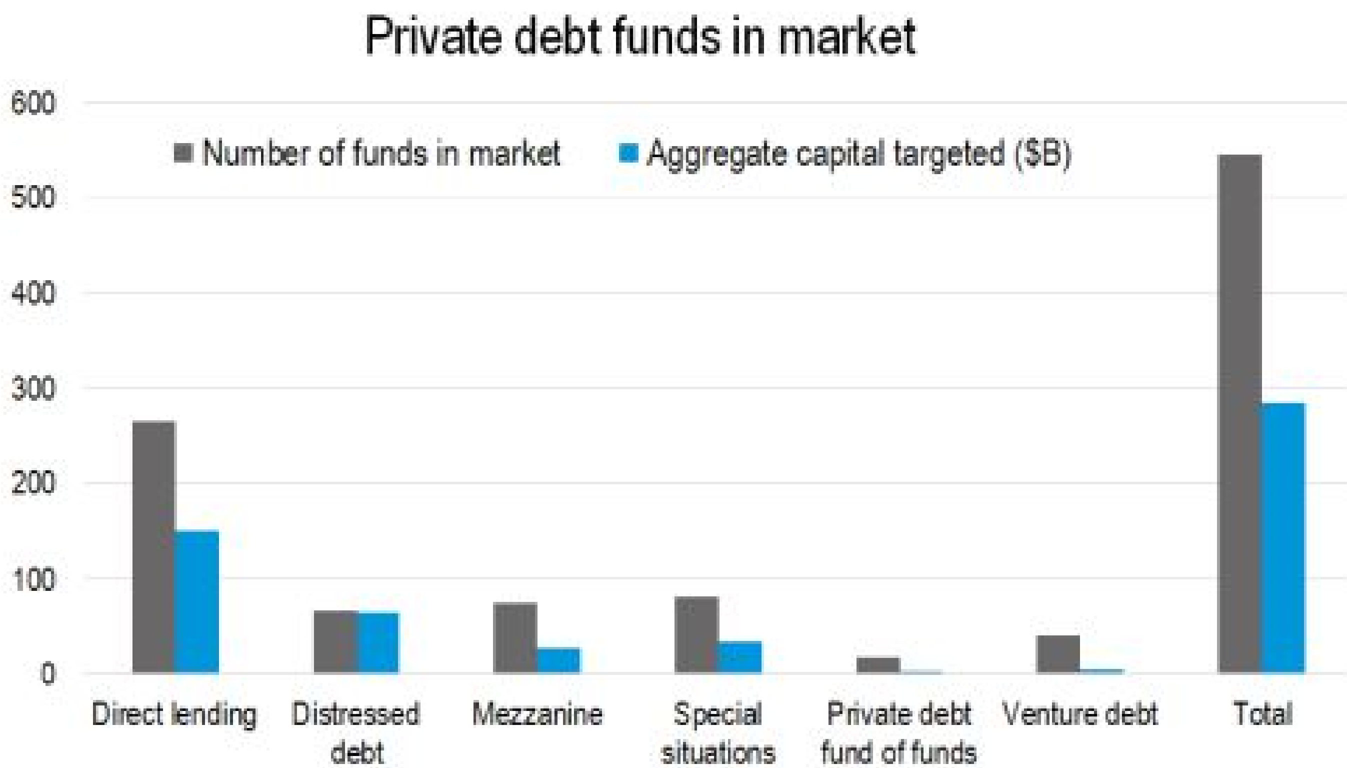
WHAT IS DIRECT LENDING?

- Private debt funded by **direct lenders** rather than money-center traditional banks
  - Direct lenders are often the credit-strategy arms of private equity funds, pensions, endowments, business development companies, asset management firms or wealthy individuals
    - Direct lending funds raise capital from investors
  - Direct lenders are generally unregulated and do not have to conform to the OCC regs, including leveraged lending guidelines which restrain traditional banks
- Primarily occurs in the **small to middle-market**, although trending toward larger scale transactions as well over the past 5 years
  - Banks scaled back on middle market lending after the 2008 global financial crisis due to credit risk and leveraged lending guidelines and direct lending started by filling the gap (but has now grown on its own)

WHAT IS DIRECT LENDING?

- There is **limited or no syndication**
  - Club deals are prevalent, but most arrangers keep most, if not all, exposure on-balance sheet
- Becoming a larger part of the **debt market** overall
  - Private debt is projected to increase 11.4% annually, to $1.46 trillion at the end of 2025, from $848 billion at the end of 2020" – prediction from S&P Global in September 2019
    - "Private debt" is a broad term – includes direct lending, mezzanine, distressed, special situations and venture debt funds

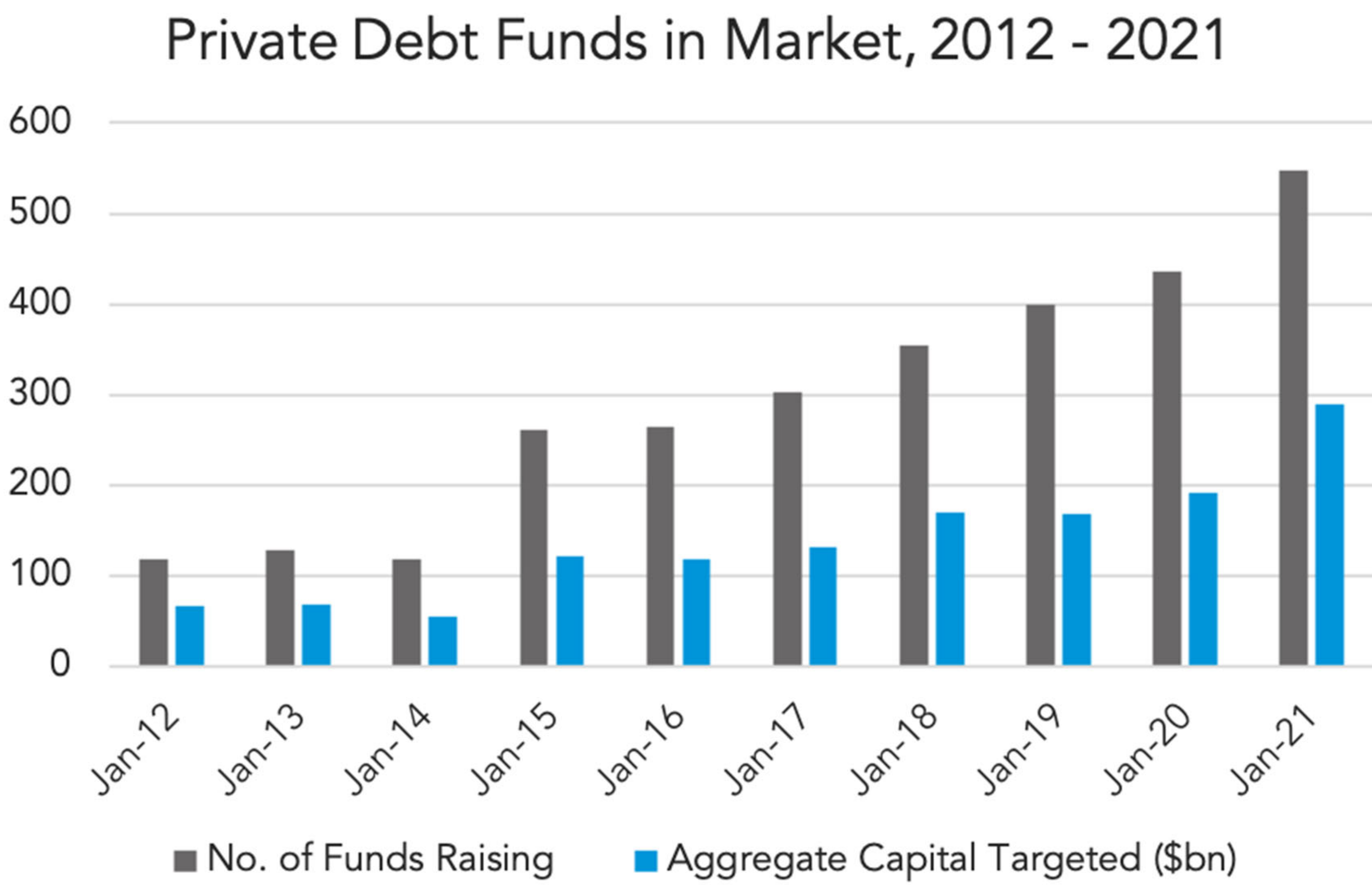
WHAT IS DIRECT LENDING?



Data as of Jan. 25, 2021.

Source: Preqin

WHAT IS DIRECT LENDING?



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PRIVATE EQUITY FUNDS AS LENDERS

- Limited Partners are pressuring **private equity managers** to deploy excess dry powder
  - $1.45 trillion dry powder globally as of June 2020 according to Preqin Ltd.
- Direct lending makes **private equity funds agile** because they can invest via both debt and equity
- Natural expansion area into direct lending as an avenue to **produce additional ROI**
  - The same diligence required to analyze a target company is what is required to determine the potential value of a credit
  - As interest rates fall, the demand for loans is increasing, creating more room for PE funds to enter
    - Leveraged lending market has increased to more than $2 trillion (80% increase over 8 years)

FEATURES OF DIRECT LENDING AND EFFECT ON DOCUMENTATION – General

- **Main overview:** “Typically illiquid, senior secured loans with 5-7-year maturities and floating coupon rates and returns expectations are in the high single digits to low double digits” – Mergers and Inquisitions
  - Typically more significant due diligence on the front end
  - No syndication → few trades, if any
  - Documents are not tailored toward marketability/syndication. Little to no flex in commitment terms.
- Flexibility to lend to **unusual or complex borrowers**
  - Direct lending funds are unregulated, so they can take on deals with higher risk than traditional banks
  - Limits borrower trade secret information from being shared broadly with syndicated lenders
- Some borrowers prefer the idea of having a **lender “partner”** to discuss business decisions more closely (as opposed to an admin agent who has to go collect lender consents)
- The Agent is typically one of the lenders, so they are personally invested in the credit

FEATURES OF DIRECT LENDING AND EFFECT ON DOCUMENTATION – General

- **Flexible financing structures**
  - Unitranche structures are available when necessary to combine first and second lien loans into one facility
  - FILO (first-in, last-out) structures also available to squeeze more juice out of borrowing bases
  - Direct lending documentation can be negotiated and executed on a shorter timetable vs. syndicated deals
  - Amendments to direct lending deals can potentially be easier to obtain
- **Customized interest payments**
  - How interest is paid depends on the deal, capital structure and cash flows of an underlying borrower
  - Flexibility for PIK payments for certain periods of time (or for some portion of the interest rate) to allow enhanced liquidity for the Borrower

FEATURES OF DIRECT LENDING AND EFFECT ON DOCUMENTATION – Guarantors

- **Guarantors**
  - Structured to maximize the guarantor/credit party group
  - Materiality thresholds for unrestricted subsidiaries are generally lower to capture the most guarantors
  - Provisions allowing release of guarantors are tighter
  - Foreign guarantors
    - More likely to be included as loan parties than in general syndicated deals, especially given the tax law change in May 2019 (Section 956 of the Internal Revenue Code (IRC))
    - Allows for borrowers with foreign subsidiaries to potentially pledge 100% of that foreign equity as collateral (rather than 65% as previously capped)
- **Investments**
  - Mindful of "trap door" capacity (i.e. the ability to move assets to a foreign subsidiary or unrestricted subsidiary), and ways to close that avenue
  - May include a basket for investments to be made in unrestricted subsidiaries

FEATURES OF DIRECT LENDING AND EFFECT ON DOCUMENTATION – Certain Covenants

- Typically limit or prohibit:
  - Transaction with affiliates – related-party transactions in the general course of business, which can lead to value leakage to third party entities
  - Asset Sales – amount of assets a borrower can sell, transfer or lease, usually within a calendar year, in order to protect the core assets within the credit group to maintain the value of such credit group
  - Restricted Payments, often including:
    - Payment of junior debt, and sometimes *pari passu* debt
    - Dividend payments
    - Payment of management fees to a private equity sponsor
  - Debt / Liens - typical exclusions include:
    - Debt/liens existing at the time of the financing
    - Intercompany indebtedness
    - General baskets up to a negotiated cap

FEATURES OF DIRECT LENDING AND EFFECT ON DOCUMENTATION – Fin Covs

- Enhanced **financial maintenance** covenants
  - EBITDA is a heavily negotiated, carefully crafted calculation that is based upon direct lender's diligence of the company
    - Add-backs and caps are more tailored to business-specific needs
  - Secured leverage ratios – often broader than just "Collateral" to include debt secured by any assets of the loan parties, rather than just debt secured by Collateral
    - Helps avoid leakage
    - Truer approximation of collateral coverage
  - Other financial covenants – NAV, minimum liquidity, FCCR
  - Step-downs sometimes incorporated
  - One of the more "regulated" aspects of direct lending, in that direct lenders may have internal requirements
  - Delivery of quarterly and/or monthly financials
  - Equity cure provisions allow a sponsor to inject additional capital into the group to cure a financial covenant breach so that the breach does not trigger an event of default
  - Direct lenders are moving towards **covenant lite structures** without maintenance covenants

FEATURES OF DIRECT LENDING AND EFFECT ON DOCUMENTATION – Delayed Draw

- Delayed draws **post-closing**
  - Price is fixed and funding is committed, which allows certainty despite a changing market
    - Allows for ongoing relationship between parties to be baked into the deal at closing rather than requiring additional funding to be renegotiated – speaks to more intimate relationship between borrowers and direct lenders
  - More common and for longer commitment periods than found in traditional, syndicated lending
    - Up to two years in some instances
  - Usually requires customary bringdowns of reps and warranties at each funding

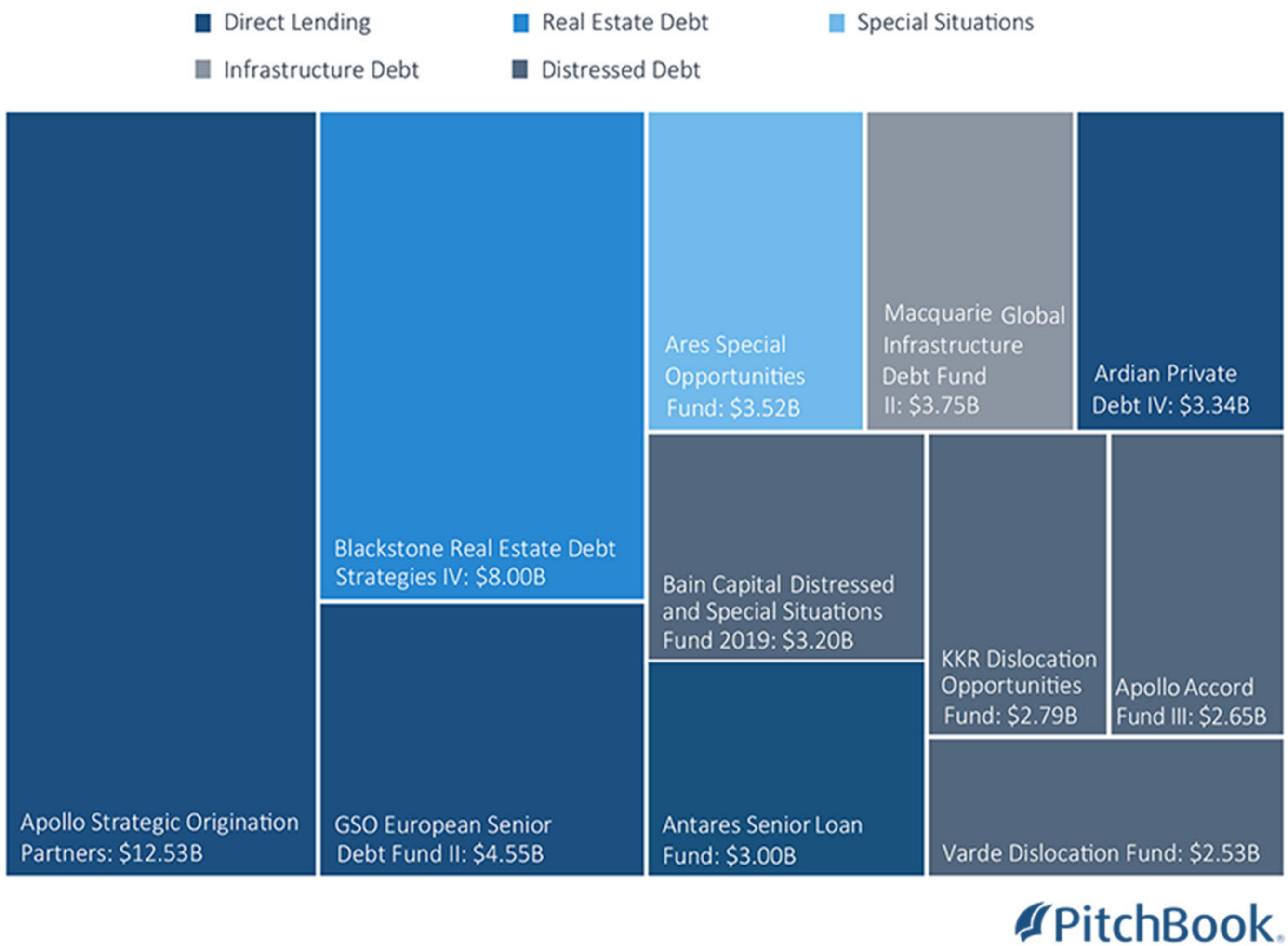
FEATURES OF DIRECT LENDING AND EFFECT ON DOCUMENTATION – Other Features

- Collateral / Perfection
  - Deposit and Securities Account Control Agreements
- Board Observer Rights
  - Direct Lenders may require board observer rights
- Equity/Warrants
  - Some direct lending deals include the issuance of penny warrants to provide lenders with equity upside

FEATURES OF DIRECT LENDING AND EFFECT ON DOCUMENTATION – Other Terms

- **Fees**
  - Direct lenders often charge administrative and collateral agency fees
    - There was a downward trend for fee rates during 2020 due to COVID-19
- **Equity Cures**
  - Issuance and sale of additional equity may be required to fund mandatory prepayment
- **Voting**
  - Negotiated threshold for "Required Lenders" depending on deal
- **Other Covenants**
  - Informational Requirements
    - Lender calls at a frequency negotiated with the Borrower
    - Board Observation rights
    - KPIs
  - MFN clauses are often included
    - With respect to both pricing and loan tenor

10 LARGEST PRIVATE DEBT FUNDS 2020



Source: PitchBook

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THANK YOU!

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