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Commercial Lending Deal Terms for the Middle Market: Borrower and Lender Perspectives

Negotiating Financial Covenants, Leverage Ratios, Equity Cures, EBITDA, IC Agreements and More

TUESDAY, APRIL 28, 2015

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Today's faculty features:

Paul W. Hespel, Partner, **Pepper Hamilton LLP**, New York

Joseph W. Price, Member, **Mintz, Levin, Cohn, Ferris, Glovsky and Popeo PC**, New York

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April 28, 2015

Joseph W. Price, Member
Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, PC
666 Third Avenue
New York, NY 10017
jwprice@mintz.com

Paul W. Hespel, Partner
Pepper Hamilton LLP
620 Eight Avenue
New York, NY 10018
hespelp@pepperlaw.com

Debt Finance Markets - Overview

- Increase in default rates, but mostly the result of 2006/2008 era credits that currently are/are anticipated to be in default.
- Increase in leverage multiples and, in the acquisition finance context, decrease of equity contribution requirements.
- Absence of problematic maturities.
- Borrowing costs anticipated to remain low and growth in EBITDA, which means coverage ratios have adequate headroom.
- Covenant-lite is the new normal in largely syndicated transactions.

Debt Finance Markets - Overview

- Implementation of changes in regulatory environment (risk retention rules; leveraged lending guidance).
- Geo-political and economic instability, especially overseas.
- Increase in interest rates earlier than anticipated ?

“Middle Market” Defined

- Definition based on size of borrower/issuer or size of financing
- As to deal terms, the identity of parties involved is more relevant, with key questions:
  - Is there an arranger involved who intends to widely syndicate its exposure, or is the deal a club deal?
  - Are lenders “buy to hold” investors?
  - Who is the sponsor/borrower/issuer? Sponsor generally intent on maintaining consistency in the precedent library irrespective of deal size

Interagency Guidance on Leveraged Lending

- Overview
  - Joint guidance issued by OCC, Federal Reserve and FDIC on March 21, 2013 (and Frequently Asked Questions (FAQ) on implementation of Guidelines released on November 7, 2014)
  - Replaces interagency standards issued in 2001
  - Not a set of mandatory requirements, but must be considered in all respects by all institutions that originate or sponsor leveraged transactions
  - Guidance on (i) defining leveraged lending, (ii) developing appropriate lending policy and clear underwriting standards, (iii) detailed leveraged lending reporting, (iv) the role of board and senior management, and (v) stress tests of leveraged loan portfolios.

Interagency Guidance on Leveraged Lending

Underwriting and Valuation Standards

- Underwriting Standards considerations include (among others):
  - Borrower's capacity to repay and ability to de-lever over reasonable period of time
    - Ability of borrower to repay 50% of total debt over a 5-7 year period is an example of adequate repayment capacity
  - Expectations for degree of support provided by sponsor
    - Should have documentation about sponsor's willingness and ability to pay
    - Should consider past practices and contractual obligations, history of borrower support, incentives and degree of support promised
  - Acceptable collateral types, loan-to-value guidelines, appropriate collateral valuation methodologies, and expectations for control and maintenance of collateral (e.g., lock boxes, inspections, regular reporting)
  - Credit agreement covenant protections, such as financial performance, reporting requirements, and compliance monitoring
    - Leverage level after planned asset sales in excess of 6X Total Debt/EBITDA "raises concern" – according to FAQ, this is not a "bright line" test

Interagency Guidance on Leveraged Lending

Enforcement and Effects

- Enforcement by Regulators
  - – Regulators have reportedly enforced guidelines by frequent contact with banks, extensive querying over compliance, verbal warnings and official letters demanding fixes
  - – The Fed has reportedly warned banks that making risky leveraged loans may affect the Fed's assessment of such banks' loan loss rates in their annual comprehensive capital analysis and review
- Potentially uneven enforcement
  - – The OCC is reportedly enforcing the guidelines more zealously than the Fed, which may put nationally chartered banks at a disadvantage to investment banking firms and foreign banks

Interagency Guidance on Leveraged Lending

Enforcement and Effects

- Effects on Banks
  - Reluctance to make leveraged loans
    - E.g. In May 2014, three longtime banks for leading private equity firm turned down a request for a buyout loan over regulatory concerns
    - Private Equity Funds might be seen as less competitive in M&A processes due to problems obtaining financing stemming from leveraged lending restrictions
  - Difficulties with certain syndications
    - Limits on number of non-compliant financings banks may enter create reduced incentive to use allowances on financings where banks are not acting as lead arranger
  - Seeking alternative lending arrangements to appease regulators
    - E.g. Investing in PIK notes issued by holding companies to avoid more debt on cash flow of operating companies

Participants in Middle Market Finance

- Banks and regulated financial institutions.
- Institutional investors.
- Structured finance vehicles (CLOs).
- Insurance companies.
- Alternative Capital Sources (hedge funds, mezzanine funds, Business Development Corporations (BDCs), Small Business Investment Companies (SBICs), etc.)

Types of Financing Products Provided by Alternative Capital Sources

- Unsecured Mezzanine debt
- “Silent Second” Mezzanine debt
- “Stretch” 1st Lien debt
- 2nd Lien debt
- “Cross Lien” financings
- “Unitranche” credit facilities
- Private High Yield debt
- Equity Kickers:
  - Warrants
  - Equity co-investments
  - Conversion rights

Evolution in Credit Agreement Provisions

- Convergence of Bond Market and Institutional Loan Market
  - Long evolution
  - Factors leading to convergence
  - Consequences

Borrower and Lender Perspectives

- The Challenge
  - Debt Financing Lives On; Restricts Company's Activities for Years
    - Credit documents must anticipate events and circumstances that will occur over several years in the future
- The Tension
  - Lenders want to minimize risk
    - Limit company's flexibility to spend money, expand or undertake new enterprises
    - Force company's cash flow to repay debt
    - Achieve highest possible returns on their capital

vs.

  - Company wants flexibility
    - Seeks freedom to expand, engage in different operations
    - Take advantage of business opportunities
    - Have discretion to spend money as it wants
    - Limit cost of capital

Typical Ranges of Rates and Spreads for Leveraged Deals

- 1st Lien Senior Secured Credit Facilities (non-Unitranche):
  - L + 3.50% - L + 5.50%
  - No LIBOR floor - 1.00% floor
  - Rates dependent on senior/total leverage profile
  - Grid based pricing step downs (typically limited to no more than three total pricing tiers) tied to total/senior leverage
  - Rates lower for asset based working capital facilities
- 2nd Lien Term Loans
  - L + 7.50% - L + 11.00%
  - Sometimes fixed rates not tied to LIBOR

Typical Ranges of Rates and Spreads for Leveraged Deals (cont'd)

- Senior Secured Unitranche Credit Facilities
  - L + 6.50% - L + 10.50%
  - No LIBOR floor - 1.00% Floor
  - Sometimes fixed rates not tied to LIBOR
  - Sometimes grid based pricing step-downs tied to total/senior leverage
  - Yield payable to individual lenders within facility depends on first-out/last-out positions
- Mezzanine Loans (contractually subordinated and unsecured)
  - 10.00% -15.00%
  - Sometimes LIBOR based
  - Often between 1-3% of coupon is paid-in-kind

Typical Maturity Dates and Amortization

- 1st Lien Senior Secured Credit Facilities (including Unitranche facilities)
  - 5 – 7 year maturities
    - Revolver often matures inside of term loan maturity date, unless 5 year deal
    - Common for larger "term loan B" facilities to have 1% per annum amortization for life of facility
    - Credit facilities with alternative lenders may have lower (or no) amortization in first year with amortization increasing during term of facility
- 2nd Lien and Mezzanine Facilities
  - Maturity typically 6 months (sometimes up to one year) following 1st lien/senior loan maturity date; cross acceleration to 1st lien/senior debt (as opposed to cross-default) and cross-payment default
  - No amortization

Prepayment Penalties

- More of less standard for senior term loans and mezzanine facilities
  - – No-calls and penalties in excess of 3/2/1 no longer typical; mezz. prepayment penalty periods have decreased
  - – 101% "soft calls" (refinancings with cheaper debt) becoming more prevalent for senior facilities
- Other negotiated exceptions include:
  - – "Transformative Transactions" – typically refinancings in connection with add-on acquisitions
  - – Change of Control transactions

Debt Restrictions

- Closing date total leverage ratios typically not more than 6.00x in the middle market (see discussion on leverage lending guidance)
- Like other traditionally high-yield style terms, ratio (leverage/coverage ratio) debt has emerged in credit agreements
  - May be used to incur subordinated debt, pari passu unsecured debt or second lien debt
  - Pro forma for incurrence, leverage ratios (i) not to exceed total leverage at closing or (ii) below a defined percentage of total leverage at closing
  - Lower middle market deals more likely to have hard $ cap on additional debt incurrence

Debt Restrictions (cont'd)

- Incremental Facilities
  - Generally pari passu in right of payment and lien priority with first lien credit facilities
  - Conditions include:
    - Pro forma compliance with financial covenants
      - Size of incremental facility generally (but not always) capped in lower middle market
      - Ratio based incurrence limiters
      - Larger facilities subject to "fee and clear" basket (outside of ratio based incurrence limiters)
    - Default blockers and accuracy of reps and warranties
      - Often subject to SunGard style conditionality
        - Reps and warranties limited to fundamental reps, and target based reps the failure of which triggers buyer termination rights
      - Default blocker condition limited to payment and bankruptcy

Debt Restrictions (cont'd)

– "Most Favored Nations" pricing protection in connection with incurrence of incremental facilities

- 50 bps standard
- Sunset (sometimes); between 12 – 18 months post closing
- Yield formulas for calculations

Restricted Payments

- Covenant encompasses dividends, distributions, payment of sponsor management fees and transaction fees and prepayments of second lien and/or subordinated debt.
- Universally permit:
  – Distributions for tax payments by members or unit holders in connection with ownership of flow through entities for tax purposes; sometimes subject to default blocker

  – Payment of sponsor management fees subject to a hard $ cap per annum or a percentage (negotiated at closing) of TTM EBITDA; typically subject to a default blocker; often subject to a subordination agreement

  – Employee stock repurchase program; subject to default blocker and hard $ cap

Restricted Payments (cont'd)

- Negotiated Exceptions:
  - – The payment of sponsor transaction fees post-closing; typically subject to default blocker; often subject to a subordination agreement
  - – Restricted Payments subject to leverage/coverage ratio
    - Pro forma for RPs, leverage ratios (i) not to exceed total leverage at closing or (ii) below a defined percentage of total leverage at closing
    - Lower middle market deals more likely to have hard $ cap on other RPs
  - – Builder/Grower Baskets
    - Builder Baskets - based on % of retained ECF or % of CNI <u>plus</u> proceeds of prior equity issuances <u>plus</u> increase in the value of investments and/or sale of investments purchased using the builder basket <u>plus</u> ECF which lenders have declined (sometimes)
    - Grower Baskets – based off of % of revenues, total assets or EBITDA

Permitted Acquisitions

- Middle market has typically required a hard $ cap on permitted acquisitions
- For acquisitive companies, trend towards ratio/incurrence based flexibility for acquisitions so long as:
  - Pro forma for acquisition, leverage ratios (i) not to exceed total leverage at closing or (ii) below a defined percentage of total leverage at closing
  - Acquired entities become credit parties and/or acquired assets are pledged
- Some Negotiated Exceptions:
  - Acquisition of foreign entities or assets (often subject to separate hard $ cap)
  - Acquisition of targets with historically negative EBITDA

Permitted Acquisitions (cont'd)

– Sungard conditionality (similar issues with incremental loan incurrence to fund acquisitions)

– Use of Builder/Grower Baskets for additional permitted acquisitions

Financial Covenants

- Continued trend towards fewer financial covenants in credit documents with significant cushion to sponsor/company projections
- Financial Covenants for Leveraged Deals:
  - Minimum Fixed Charged Coverage Ratio (typical)
  - Maximum Total Leverage Ratio/Senior Leverage Ratio/Secured Leverage Ratio (typical)
    - Negotiation of "Net Debt" (calculation of "net of unrestricted company cash") is common. Negotiation typically revolves around caps and thresholds with respect to cash which is netted from debt calculation
  - Minimum Interest Coverage Ratio (sometimes; also a substitute for FCCR)
  - Maximum Capital Expenditures (sometimes; this has become less common)

Financial Covenants (cont'd)

– Minimum EBITDA (sometimes; rarely seen other than lower middle market)

– "Covenant Lite" (sometimes; not as common as first half of 2014; typically only for large middle market deals)

- Term Loan B: No financial maintenance covenants applicable
- Revolver: Springing covenant (total or 1st lien secured "net" leverage ratio)
  - Trigger based on Revolver usage (20-33% of revolver commitment drawn)
  - Treatment of letters of credit (exclusion of cash collateralized LCs, inclusion of non-cash collateralized LCs over a certain $ threshold)
- No term loan default based on financial covenant breach unless revolver accelerates

Financial Covenants (cont'd)

- Financial Covenant for ABL Facilities
  - Generally limited to a "springing" Fixed Charge Coverage Ratio or Interest Coverage Ratio, tested only when revolving loan availability is less than a negotiated % of the revolving loan commitment (and/or the borrowing base)

Equity Cure Rights

- Ability of company to cure financial covenant default with proceeds of equity issuance is more or less the standard across the middle market
- Typical Negotiated Limitations:
  - Cap on number of cures during the term of the facility
    - Whether cures may be made in consecutive fiscal periods (cures typically limited to no more than 2 per fiscal year anyway)
    - Ability to cure with the issuance of subordinated debt (in addition to issuance of common stock or qualified preferred)
    - Whether the cure proceeds must be applied to prepay term loans (requirement more typical in the lower middle market)
- Used frequently?

EBITDA Calculation

- Add-backs are generally more permissive than they used to be, making financial covenants and ratio based tests in credit documents easier to comply with from a borrower perspective
- Typical Negotiated Add-Backs:
  – Caps on post closing deal fees, costs and expenses
  – Caps on other non-recurring items
  – Pro forma cost savings, synergies, optimization expenses
    - These are items projected by the company (modified S-X standard)
    - Projected adjustments generally capped at a percentage of Adjusted EBITDA (calculated prior to add-back for projected adjustments); sometimes exception to cap for reg. S-X compliance

Mandatory Prepayments

- Trend towards less sweeps, hard $ basket exceptions within sweeps and longer periods to reinvest/commit to reinvest proceeds
  - Excess Cash Flow Sweep
    - Percentage is negotiated, but typically start at 50% of retained ECF. Step-downs based on performance threshold standards built in.
    - Borrowers request that ECF sweep commence with completion of the first full fiscal year under the new credit facility.
    - Key to identify important deductions to sweep such as 100% credit for voluntary prepayments, deductions for acquisitions, investments and restricted payments.
    - Sometimes not applicable to 2nd lien term loans.
    - ECF that is not swept (including as a result of lenders declining proceeds) may sometimes increase "Builder Basket".

Mandatory Prepayments (cont'd)

- Debt Sweep
  - Typically 100% sweep. All debt permitted under the credit agreement should be carved out.
- Equity Sweep
  - Percentage is negotiated, but typically start at 50%. Many deals are done today without an equity sweep
  - Typical negotiated exceptions include: (i) sweep limited to IPO proceeds, (ii) exclusion of equity issued to fund permitted acquisitions and capital expenditures and (iii) exclusion of equity issued to sponsor, co-investors and management (including financial covenant equity cures to the extent proceeds are not required to prepay term loans)
- Asset Sale/Casualty Insurance and Condemnation Sweep
  - These typically do give the company the right to reinvest proceeds in assets used or useful in the business prior to requiring the prepayment of term loans with these proceeds. Reinvestment timeframes vary between 6-15 months (typically 360 days)
  - Minimum thresholds for application of sweep are typical
  - These sweeps should not include liability or business interruption insurance

Mandatory Prepayments (cont'd)

- Extraordinary Receipts
  - Sweep of net cash proceeds from tax refunds, purchase price adjustments (other than typical working capital adjustments), indemnification under purchase agreements and/or litigation/settlement related payments
  - Only typical in lower middle market transactions and subject to negotiation
  - Sweep should be net of proceeds required to be paid to third parties

Additional Commonly Negotiated Provisions

– Amend & extend provisions

  • Ability to extend maturity and change economic terms of any facility with consent of only extending lenders

  • Typically no MFN issues

– Refinancing Facilities

  • Ability to refinance any facility in whole or part with new debt issuances, whether under the Credit Agreement or stand alone ("Sidecar" facilities or notes), secured or unsecured

  • Required to have later maturity and weighted average life to maturity greater than debt being refinanced

  • Terms required to be "market" vs. not materially less favorable to company (other than pricing, redemption, call protection)

Additional Commonly Negotiated Provisions

– Sponsor affiliate loan assignments

  • generally capped at 20-30% of aggregate amount of term loans at time of purchase

  • voting rights (other than issues that unfairly impact sponsor lender) limited

  • numerosity issues in a bankruptcy

– Borrower debt buybacks/Dutch auctions

  • repurchase debt at below par prices

  • avoids pro rata sharing among lenders

  • sometimes "open-market" repurchases permitted

– Lender/competitor blacklists

  • generally issues with extent of entities on the list and whether the company is permitted to designate entities post closing

Some Key Subordination and Intercreditor Issues for Transactions with Senior and Mezzanine Facilities

- Unlimited sub. debt payment blockage during payment or bankruptcy EOD
- 120-180 day sub. debt payment blockage during non-payment EODs
  - Caps on expense reimbursements during this period
  - No more than 120-180 blockage days in any 360 consecutive day period
  - Limited number of blocks during term of agreement
- 120-180 day sub. debt remedy standstills
- Sub. Debt and Senior Debt caps

Some Key Subordination and Intercreditor Issues for Transactions with Senior and Mezzanine Facilities (cont'd)

- For senior loans with maturity dates longer than 5 years, whether AHYDO catch-up payments under the sub. debt will be permitted
- Whether senior debt allows sub. debt with a "silent second lien" (rare)