New Year: New Terms for the Mid-Market?

TRENDS FROM THE EUROPEAN LARGE-CAP LEVERAGED DEBT SPACE AND THEIR EMERGENCE IN THE UK AND EUROPEAN MID-MARKET

DLA PIPER

Foreword

I am pleased to introduce our first Market Trends report, exploring the debt finance deal terms trending in the European large-cap market and their potential to develop and influence the UK and European mid-market over the coming period.

Covering the breadth of the market as it does, this report focuses on the issues that matter to both our lender and borrower clients and is based on the insights of our European finance group – which includes 80 partners and over 200 lawyers drawn from across our leveraged finance, capital markets and fund financing teams.

I hope that you will find this to be an useful resource and encourage you to get in touch with our team should you have any questions or comments.

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Introduction

Following a path well-trodden, flexible sponsor terms first conceived in the US TLB and HYB markets continue to find their way into large-cap European leveraged loan documents, before ultimately emerging in some shape or form in the UK and European mid-market.

Documentary convergence is by no means a new concept in the large and mid-sized European markets: the gradual infiltration of terms more traditionally associated with US-style TLBs or HYBs is a phenomenon with which investors in both the large-cap and mid-market loan spaces are extremely familiar. Over the last decade, this trickle-down effect has been responsible for the emergence of "cov-loose" and "cov-lite" structures, market acceptance of material adjustments to EBITDA and the introduction of EBITDA cures for leverage covenant breaches. It has also seen lenders in both the large and mid-markets accept a move toward tighter restrictions on facility transfers, and looser controls around debt incurrence, basket headroom and cash leakage, including via dividend payments to sponsors.

Of course, the mechanics and drafting of these sponsor technologies – and the degree of flexibility that they afford the borrower – varies materially across the UK and European large-cap and mid-markets. As a rule of thumb, the documentary terms seen in the mid-market remain significantly more conservative than at the larger end of the loans spectrum. However, concepts that have become entrenched in the latter space have a habit of appearing, and often ultimately becoming accepted, at the smaller end of the debt playing field.

Lenders and their legal advisors operating in the mid-market have therefore learned to keep one eye trained on the European large-cap horizon, for advance warning of the terms evolving there that may, sooner or later, appear in their own loan documentation.

Here, we take a look at some recent trends from the European large-cap leverage space, including in respect of the controls around further debt incurrence, basket flexibility, leakage and permitted adjustments to EBITDA. We also consider the potential for these trends to take root in the mid-market over the coming year.

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Incremental facilities

It is now well established for loan agreements in the mid-market to permit the incurrence of further *pari passu* ranking secured debt by way of incremental facilities. These are typically made available within the facilities agreement itself. Historically, the total debt potentially available as incremental facilities was subject to a hard cap. However, as is so often the case, the traditionally large-cap position of allowing incremental debt incurrence subject to *pro forma* compliance with a specified financial covenant – typically leverage based on adjusted figures – has found its way into the mid-market and is now a fairly standard sponsor expectation.

> *"Whilst controls around the incurrence of additional debt remain of most fundamental importance in the European mid-market, there has been a move toward more traditionally large-cap or HYB parameters, with leverage-ratio conditions replacing hard caps on the total incremental debt amount and, in some instances (albeit generally only in the upper mid-market), the emergence of 'freebie baskets' offering additional debt capacity outside of – and unregulated by – the applicable incurrence covenant."*
>
> — Neil Campbell, Partner, Debt Finance, UK

Other large-cap additional debt concepts that mid-market players may find themselves encountering more frequently include the following:

The freebie basket

A large-cap – originally US – concept that is already finding its way into the mid-market is the freebie basket. The freebie basket is a further amount of debt incurrence permitted in addition to, and outside of, the leverage covenant-controlled quantum described above.

The freebie basket can be hard-capped by reference to a specified amount or, more common in the large-cap space, soft-capped so that its upper limit is linked to the group's then current adjusted EBITDA (the greater of GBP/EUR X million and Y% Adjusted EBITDA).

In the European large-cap market, it is not uncommon to see the upper limit set by reference to one turn (100%) of adjusted EBITDA. This gives the borrower the ability, free and clear of the leverage-linked additional debt permission, to incur incremental debt, secured and ranking *pari passu* with the existing Lenders' facilities, in an amount up to 100% of the group's adjusted EBITDA figure. Traditionally seen as "aggressive" by lenders, albeit now often accepted in the large-cap space, the concept should be considered carefully in the context of the cov-lite nature of many European loans, where lenders do not benefit from the protection of a regularly tested maintenance financial covenant.

Even in the mid-market, where maintenance covenants generally remain a Lender expectation, given (i) that EBITDA can typically be inflated via a veritable shopping list of add-backs, adjustments and normalisations (more on this later), and (ii) the increasing headroom at which financial covenants are set, lenders should carefully evaluate the credit risks inherent in accepting an EBITDA-linked freebie basket on debt incurrence.

Permitted inside maturity

In the mid-market, it remains the expectation that incremental facilities mature no earlier than the existing facilities, to protect the existing lenders from refinancing risk and prevent what is known as tenor subordination, where another creditor's debt matures earlier than the lender's. In the larger-cap space, however, it is becoming more common for the documentation to permit a specified or capped amount of incremental debt to mature before the original facilities.

Erosion of MFN

The existence of an MFN in respect of incremental facilities remains a hallmark of both the mid- and large-cap market. At the larger end of the capital spectrum, however, the actual substance of the MFN protection is trending the same way as (dare we say it) baggy leverage maintenance covenants – a nice-to-have, at least optically, but lacking real teeth. Below are some borrower-driven exclusions and caveats that limit the practical value of the MFN to lenders, particularly when used in combination:

Sunset – while 12 (or even sometimes 18) month sunsets on MFN remain the norm in the mid-market, six-month sunsets are common in the larger-cap space.

De minimis – the MFN may contain a carve-out whereby it does not apply to incremental facilities unless the quantum of debt incurrence exceeds a specified threshold.

Margin only – it is important to consider what is being targeted by the MFN protection. Should it apply to all-in yield (ie margin + commission/ OID/ arrangement fees (including any deferred payment arrangements))? Or do, for example, the closing fees sit outside of the MFN, allowing incremental lenders to front-load their pricing?

Not all additional debt covered by the protection – MFNs may only apply to incremental facilities incurred under the leverage control and not to a freebie basket (where one is included). Or their application might exclude additional debt raised for a specified purpose e.g. an acquisition facility. Alternatively, additional facilities made available in different currencies to the original facilities or via sidecar arrangements (see below) may be excluded from the MFN protection.

Sidecars

The ability to incur additional debt via so-called sidecars (*pari passu* ranking debt instruments documented outside of the existing lenders' facilities agreement) is a feature of the large-cap debt markets. The mid-market and private credit space, however, remains generally reluctant to give up visibility on the rights and controls governing the debt arrangements of other *pari passu* ranking secured creditors. For now, the expectation in the mid-market is still that any additional debt sharing the existing lenders' priority and ranking in the capital structure will be provided under the terms of the existing lenders' facilities agreement.

"While we have seen a general loosening of the controls around additional debt incurrence, the mid-market currently continues to push back on allowing additional senior indebtedness via sidecars, with investors generally reluctant to 'fly blind' in terms of the rights and controls governing the debt arrangements of other pari passu ranking secured creditors."

— Max Mayer, Partner, Debt Finance, Netherlands

Basket flexibility

Permanent increases to baskets and thresholds

THE CONCEPT OF PERMANENT BASKET INCREASES

The use of soft-capped, grower baskets throughout the permitted definitions in a facilities agreement, so that each basket's upper limit is linked to the business's current adjusted EBITDA (the greater of GBP/EUR X million and Y% adjusted EBITDA) is well entrenched in the mid-market. The philosophy behind the concept is that, if a business is performing well and becoming more profitable, the original nominal basket quantums set at day one are no longer appropriate and should be increased in line with profitability. The day-one nominal value therefore features as the GBP/EUR X million "floor" of the grower basket, with the adjusted EBITDA limb of the basket tracking increases and decreases in the business's performance.

Permanent increase or "one-way grower basket" language takes this concept further. It specifies that, where the value of the % adjusted EBITDA limb exceeds the GBP/EUR X million amount of the basket, the GBP/EUR X million amount is permanently increased to that % adjusted EBITDA value. The lower limit or "floor" of the basket will therefore increase in line with adjusted EBITDA but will never subsequently decrease: it will always remain set at, or permanently scaled up to, the highest % EBITDA level the business has historically achieved, even if the business's performance subsequently deteriorates for any reason.

CONSIDERATIONS FOR LENDERS

The potential risks of accepting the concept of one-way grower baskets are clear for any threshold or permission. The degree of flexibility a borrower group is afforded to incur liabilities, grant guarantees or provide other credit support, dispose of assets or otherwise engage in transactions representing value leakage to entities outside the lenders' security net, is all credit-risk linked and carefully set by reference to the business's size and profitability. The inclusion of one-way grower baskets (i.e. baskets that can only ever go up in size) concept means those capped amounts may remain permanently set at increased levels, notwithstanding a subsequent fall in the group's EBITDA due to, for example, a decline in performance or a wider macroeconomic event.

However, potentially the most important considerations from a lender's perspective will be where a facilities agreement contains soft-capped, EBITDA-linked baskets in respect of either incremental debt or permitted payments. Here, the permanent increase effectively allows borrowers to bank enhanced debt incurrence or dividend/yield capacity for a future downturn, providing the opportunity for levering and/or cash extraction at a later date – see table below.

INCREMENTAL DEBT HEADROOM	DIVIDEND/YIELD CAPACITY
If any part of the indebtedness that can be incurred under an incremental facility is soft-capped or scalable by reference to adjusted EBITDA – or even where the baskets of the Permitted Financial Indebtedness definition are soft-capped in a similar fashion – the permanent-increase concept could provide headroom for companies to borrow their way out of a future downturn or liquidity decline. From a lender's perspective, this could potentially result in the business over-leveraging and, in the case of *pari passu* ranking incremental facilities, could mean the existing lenders' position in the capital structure is diluted at a credit-sensitive time.	Where permissions for shareholder distributions or subordinated debt yield are soft-capped or scalable by reference to adjusted EBITDA, allowing for a permanent increase in permitted payment capacity following a one-off / temporary increase in adjusted EBITDA could offer investors an opportunity at a later date to extract significant value from the business, notwithstanding a subsequent fall in profitability, shifting the stakeholder preference away from the secured creditors and toward the equity.

"The negotiation of appropriate adjustments to EBITDA now needs to take into account any grower baskets, where these are structured as a percentage of said EBITDA, since – depending on the nature of the borrower's business – EBITDA might be subject to high volatility. Where this is the case, market appetite for increased flexibility will need to be balanced against a Lender's requirement for caution when assessing what parameters and controls are necessary, in order to reach a satisfactory outcome."

— César Herrero Mazarío, Partner, Debt Finance, Spain

Reallocation of basket amounts

MID-MARKET BASKET RECLASSIFICATION

Where an amount or transaction meets the criteria of more than one of the baskets or permissions in a loan agreement, basket reclassification language allows the borrower to choose which basket or permission it allots that amount or transaction to – and the flexibility from time to time to reclassify that item to a different basket or permission. While the ability to classify and reclassify items at the borrower's discretion raises logistical questions regarding how measurable in practice the available headroom within such baskets is at any time, the concept is frequently seen in mid-market documentation.

LARGE-CAP CONVERSION OF RESTRICTED PAYMENT CAPACITY TO DEBT INCURRENCE HEADROOM

In the European large-cap space, transaction parameters are generally set on an incurrence basis. A borrower may, for example, incur unlimited amounts of debt, or make "restricted" payments such as dividends to shareholders, if – *pro forma* for that transaction – they would remain in compliance with a specified financial test. That incurrence capacity is often supplemented by further baskets and permissions, including a freebie basket that sits outside the incurrence covenant control (see above).

The ability for a borrower to convert available capacity under the restricted payment covenant into debt incurrence headroom is an originally US concept that has become a feature in the European debt market. While the concept provides valuable flexibility to the group and its sponsors, it can be challenging from a lender's perspective. In particular, where restricted payment headroom is reallocated to allow further debt incurrence at a time when the borrower doesn't actually have the liquidity to make a distribution, the construct allows that theoretical headroom to be used by the business to lever up and to potentially dilute the existing lenders' position in the debt structure. As the mid-market comes under increasing pressure to accept freebie baskets alongside incurrence-covenant controlled permissions for yield payments and incremental facilities, stakeholders should remain vigilant regarding headroom reallocation mechanisms of this type and their inevitable impact on the capital structure.

SUPPLEMENTING BASKET HEADROOM VIA ACCEPTABLE FUNDING SOURCES

A final note on the subject of baskets and incurrence: a mechanism has already emerged in the mid-market that allows borrowers to increase or supplement baskets and thresholds by the amount of any "Acceptable Funding Sources." What is captured by this definition varies between transactions, but generally includes non-operational cash items such as retained/excess cash, proceeds from disposals or other one-off occurrences not required to be applied in prepayment of the facilities, new shareholder injections and amounts of permitted financial indebtedness.

The ability to supplement basket headroom via Acceptable Funding Sources may apply generally across all baskets and thresholds in a facilities agreement or it may be limited to specific baskets. In either case, the consequence is that amounts that "have been through the wash-cycle" can be applied for the relevant controlled purpose, but outside of the basket cap, similar to a freebie. Parties should make sure they have considered the possible impact of such concept in terms of potential leakage.

> *"Basket flexibility and permeability continues to be a hot topic in the mid-market, with a growing number of term sheets requesting the ability for borrowers to supplement baskets and thresholds throughout the credit agreement with any amounts of acceptable funding sources (items that don't form part of the operational cash of the business), widening the scope for potential leakage."*
>
> — Richard Normington, Legal Director, Debt Finance, UK

EBITDA adjustments

It has been a number of years since the mid-market accepted that leverage covenants would be set by reference to adjusted, rather than "true" EBITDA. Such adjustments typically allow the borrower to include, subject to specified parameters, projected savings and synergies associated with certain types of transaction or events occurring in the relevant period. Such transactions or events may include acquisitions, disposals and "Group Initiatives," as well as new revenue streams, strategy decisions or other group and business optimisations. The debate – in both the large-cap and mid-market space – is no longer whether to permit adjustments when determining EBITDA, but what the parameters or controls should be around such adjustments.

> *"The suite of potential adjustments to EBITDA – particularly in the context of anticipated but unrealised synergies – remains the subject of negotiation, with market dynamics often dictating where parties land in terms of the degree of control around the type, maximum quantum, realisation timings and verification processes for synergies and cost savings that EBITDA can be adjusted for."*
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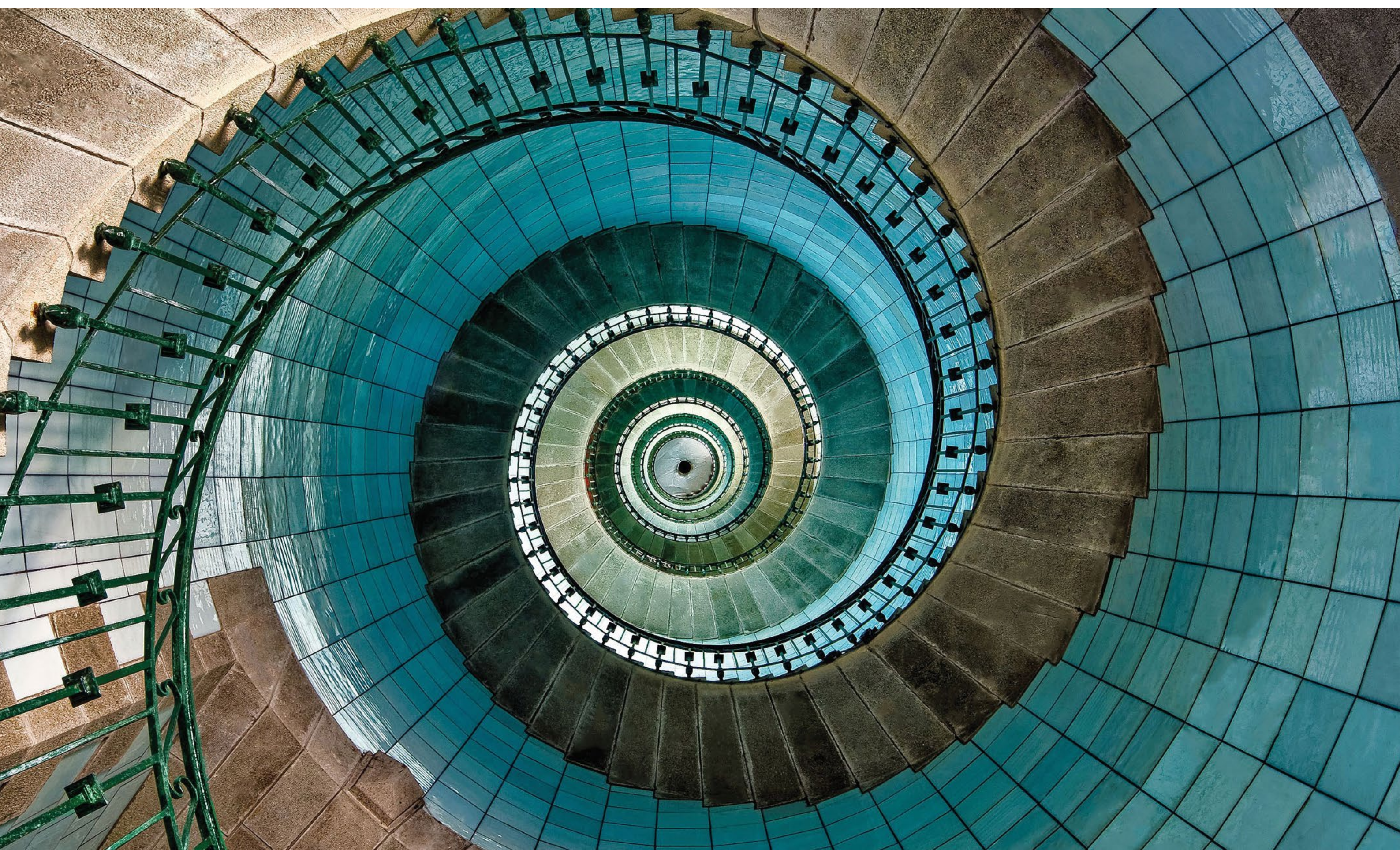
> — Dr Wolfram Distler, Partner, Debt Finance, Germany

Some pro forma adjustment trends from European larger-cap loan agreements which mid-market participants should continue to be cognisant of include:

- **Revenue synergies and operating improvements etc** – the mid-market continues to hold relatively firm on the exclusion of projected revenue synergies from permitted adjustments, on the basis that EBITDA should only be adjusted for unrealised amounts that constitute "true" cost savings and cost synergies. The large-cap market, however, frequently sees the types of unrealised amounts that can be used to adjust EBITDA expanded to include revenue synergies, operating improvements and similar profitability measures.
- **Loosening of cap** – the large-cap market continues to lead the charge in increasing the maximum quantum of *pro forma* adjustments that can be applied in any measurement period when determining EBITDA, with 25% EBITDA a commonly accepted aggregate cap (though please see below regarding the removal of the cap entirely).
- **Third-party verification –** adjustments have historically required certification by the CFO and, where above a certain quantum, by third-party diligence providers or industry specialists. Alongside the loosening of the overall cap, the certification requirements have also come under scrutiny. While CFO sign-off is operationally "easy" to obtain, independent verification is being increasingly considered by sponsors as unwelcome and overly burdensome and is therefore becoming more heavily resisted.
- **No cap** – leveraged transactions at the large end of the capital spectrum may allow *pro forma* adjustments to EBITDA on an uncapped basis.
- **Look-forward period –** unsurprisingly, large-cap documents are continuing to push out the length of the look-forward period for the realisation of synergies, with 18-24 months commonly agreed, versus the 12 to 18-month period that remains the norm in the mid-market. In addition, it is worth looking out for a shift in what the look-forward period relates to and how specific the event or result of that event (ie the synergy or saving) needs to be. For example, rather than the synergies or savings needing to be actually realised within the specified look-forward period, the document may instead require *actions expected to result in* the relevant synergies or savings to occur or be taken within the look-forward period – with no time restriction on the ultimate realisation of those synergies or savings. The point pits a borrower's requirement for flexibility – and their understandable inability to precisely prescribe the exact nature and timings of synergies yet to be realised – against a lender's desire for specificity and certainty, with market dynamics likely to determine the outcome.



Attrition of events of default

The move toward the acceptance of a more "US" or HYB style Events of Default package in the European large-cap loans market over recent years is notable and has arisen, at least in part, as a result of the acceptance of "high yield bond in disguise" terms within loan documents (see below for more). Here are some of the key trends:

- **Extensions to grace periods** – grace periods of 60 days or more for certain Events of Default are a common feature of large-cap documents. The longer remedy periods may be justifiable within the framework of US bankruptcy proceedings, but lenders may query whether the approach is appropriate in a European or UK context.
- **Cross acceleration rather than cross default** – traditionally a US position that has become prevalent in the European market, and one that the mid-market needs to remain alert to. While cross acceleration may make sense for certain types of debt in the structure, given the various enforcement and insolvency regimes in Europe and the UK, there is no one-size-fits-all approach and ensuring an early seat at the table for discussions in any distress scenario remains a key consideration for secured creditors.
- **Removal of certain Events of Default** – the curtain seems to have fallen at the larger end of the European loans market for audit qualification and MAC-driven Events of Default. Arguably, these may be unlikely triggers for lender acceleration on their own – the practical value of a MAC Event of Default, and the likelihood of a lender successfully enforcing solely off the back of the same, has long been debated. However, the wholesale removal of these concepts from large cap facilities agreements could represent the thin end of the wedge in terms of attrition of lenders' Event of Default protections more generally.

High Yield Bonds in disguise: continued form convergence

While some parties may argue otherwise, the majority of mid-market facilities agreements remain broadly (if occasionally somewhat distantly(!)) LMA-based or LMA-compliant in form and substance. The large-cap space, however, has seen a substantial shift towards a hybrid document structure, whereby the market norm is now for a loan document to wholesale incorporate information/financial reporting requirements, general undertakings – including restrictive covenants and related definitions – and Events of Default based on high-yield bond style terms. These may be included via schedules to the loan agreement expressed to be governed by New York law, similar to the long-established approach to documentation for super senior RCFs in the European HYB market.

Sponsors that operate in both the large-cap and mid-market space – an ever-expanding group due to the plethora of dry powder available in an increasingly competitive capital deployment market – will typically prefer debt instruments to be written on their "house" terms regardless of the transaction size or other parties involved. We therefore expect to see the mid-market come under pressure to accept hybrid forms of loan documentation, or loan agreements constituting "high yield bonds in disguise," over the coming years.

Key contacts

If you would like to discuss the insights in this report, or explore how DLA Piper can help you to navigate the debt finance space, please reach out to any of our contributors.

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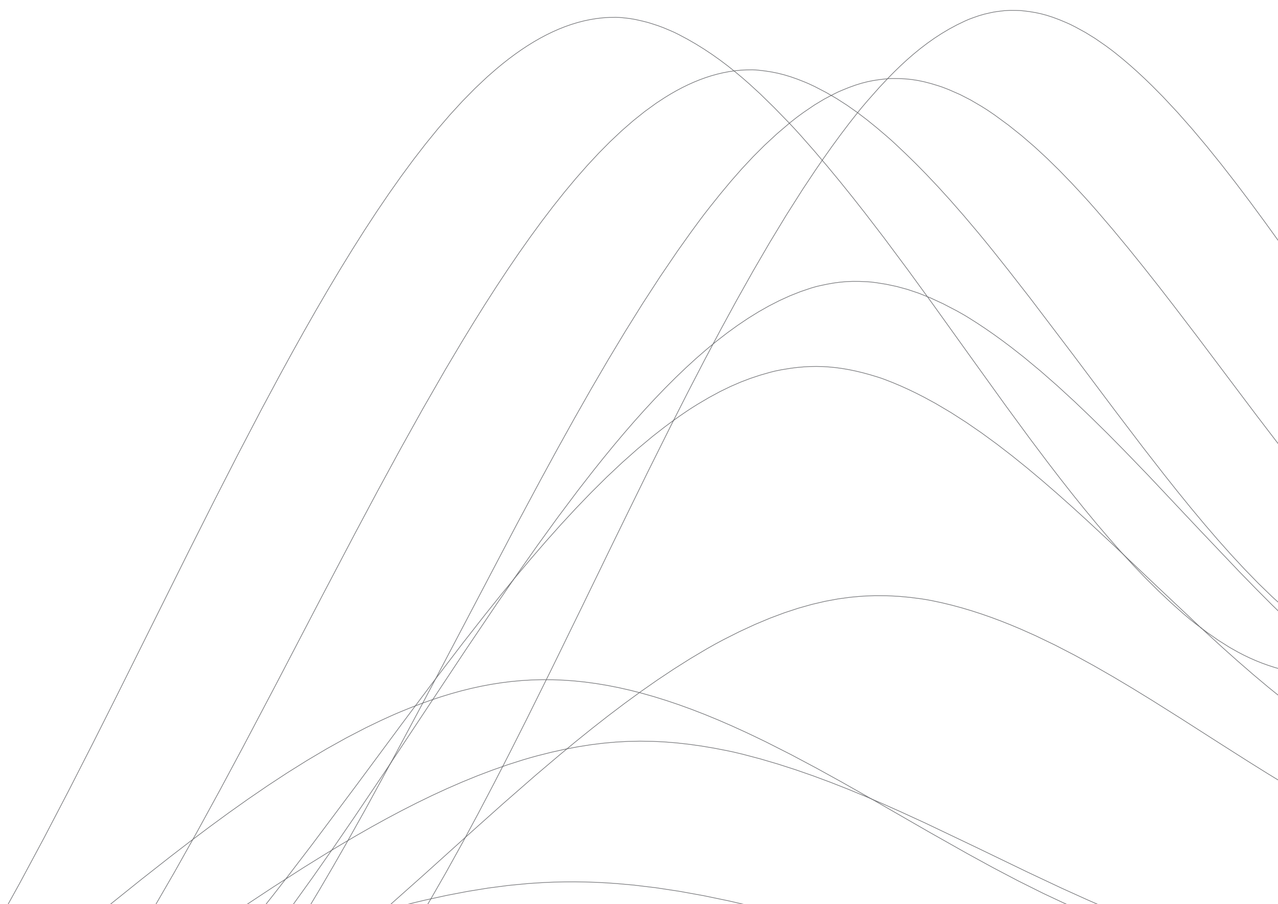

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