

Select terms in recent mega-cap broadly syndicated loans

Davis Polk partner and co-head of finance practice [Jason Kyrwood](#) and partner [Scott Herrig](#) discuss some of the latest broadly syndicated term loan B trends

Notwithstanding a pause during the second quarter of 2020, strong market conditions in the past few years have enabled private equity sponsors and borrowers to include significant flexibility in documentation for broadly syndicated term loan B (BSL) transactions. A recent series of mega-cap leveraged buyouts (LBOs) may represent a high watermark for these borrower-friendly terms.

Below is an overview of some of the most recent market terms – some new, and some which, while once considered aggressive, have now become commonplace – organised around the key concepts of leakage and leverage.

Leakage

The term “leakage” as used in this article refers to assets (including cash) being transferred outside of the borrower and guarantor (or loan-party) group, such that they are no longer subject to a direct lien in favour of or claim by the secured lenders; and, in many cases, are no longer even available to support repayment of the loans. Leakage may be achieved by a borrower (i) making investments (whether in the form of loans, advances or equity contributions) in non-loan party restricted subsidiaries or unrestricted subsidiaries, (ii) paying dividends to, or repurchasing equity held by, equity holders (restricted payments or RPs), (iii) prepaying junior debt owed to third parties or (iv) selling or otherwise disposing assets in a manner that results in net value leaving the loan party group. Many of these transactions have legitimate business purposes that are supported by loan market participants. However, in recent BSL transactions, the traditional limitations or guardrails on these transactions have been scaled back, in some cases dramatically.

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Investments, RPs and junior debt prepayments

Many BSL transactions permit unlimited investments, RPs and junior debt prepayments, subject to the satisfaction of a leverage ratio-based test. Rather than testing more traditional total net leverage ratios, certain recent BSL transactions permit these baskets to be tested against first lien net leverage ratios, which is a more limited test of the borrower's leverage profile and typically affords it greater flexibility. We have also seen these leverage ratios require less deleveraging from closing date levels for restricted payments, or no deleveraging at all in the case of investments. There are also ratio-based tests, most frequently limited to investments, that either require that the leverage ratio be not worse than prior to the applicable transaction or, in lieu of a leverage-based test, require pro forma compliance with an interest coverage ratio test, set either at 1.75x or 2.00x (or, in some cases, an interest coverage ratio not worse than prior). Further, this basket is often either not subject to the traditional condition that there be no event of default at the applicable time, or, in many cases

subject to a more limited requirement, such as the absence of a payment or bankruptcy event of default. Taken as a whole, these provisions afford borrowers with significant flexibility to make investments, including in unrestricted subsidiaries, which may be utilised in a distressed or highly leveraged scenario.

In addition to more permissive ratio-based baskets, many recent BSL transactions permit significant investments, RPs and junior debt prepayments under fixed or other baskets that are not tied to compliance with a financial ratio. A number of recent developments related to these baskets (above and beyond the growing size of many of these fixed baskets) are as follows.

BSL transactions commonly permit uncapped investments in, or acquisitions of, non-guarantor restricted subsidiaries, including foreign subsidiaries. This has long been the case for bonds and is viewed by borrowers as an important flexibility, particularly for those that have significant non-US operations. From the lenders' perspective, this understandable desire for operating flexibility needs to be weighed against the risk of material value being moved from the loan parties to non-US or

other non-loan party restricted subsidiaries, against which the lenders do not typically have a direct lien or claim. In an attempt to strike a balance between permitting a borrower to make ongoing investments in non-US operations and limiting the likelihood of leakage of a material portion of a borrower's business from the loan party group for liability management or similar purposes, some deals impose a fixed cap on investments in non-guarantor restricted subsidiaries under this basket, unless the investment is in the form of cash or cash equivalents and made in the ordinary course of business.

Investors' focus on fixed basket capacity has been amplified in recent transactions by provisions that explicitly allow capacity under general baskets for investments, junior debt prepayments and restricted payments to be reallocated amongst those baskets (in some deals, this reallocation construct applies more broadly to any baskets under the applicable covenants). The reallocation of unused capacity from investments and/or junior debt prepayments to restricted payments often receives the most attention from the

market in light of the resulting increase in dividend capacity, but the impact of reallocating unused capacity to investments (including investments in unrestricted subsidiaries) should also be assessed carefully. This is especially true in those transactions that permit reallocation from restricted payments to investments baskets on a 2x basis, which would mean that rather than making a \$1 dividend to shareholders, the borrower could make a \$2 investment in, for example, unrestricted subsidiaries.

Borrowers often argue that an investment, even in an unrestricted subsidiary, is accretive to the business (through the residual value in an unrestricted subsidiary) and, therefore, more beneficial to lenders than a restricted payment to equity holders. While that argument has some merit, lenders have increasingly focused on capacity for investments in unrestricted subsidiaries as a result of the recent surge in drop-down liability management transactions, in which assets of loan parties are transferred to an unrestricted subsidiary (or, in some cases, a non-guarantor restricted subsidiary) using investment capacity and,

thereafter, pledged to support incremental and structurally senior leverage. Many deals seek to address this type of transaction by identifying categories of particularly important assets, usually material intellectual property, and placing additional limitations on the transfer of those assets outside of the restricted party group (or, in some cases, the loan party group). However, these protections have been omitted in certain BSL transactions, depending on market feedback. A separate focus of lenders related to unrestricted subsidiaries is the ability to dividend or distribute the equity interests of unrestricted subsidiaries, which effectively converts investment capacity into RP capacity (so-called two-step dividend capacity). In many BSL transactions, a partial protection is accomplished by not allowing the dividend or distribution of an unrestricted subsidiary that is a cash box (i.e., whose primary assets are cash and/or cash equivalents).

In addition to ratio and basket capacity, another major source of leakage in BSL transactions is the available amount basket, which can be used for restricted payments, junior debt prepayments or investments.

Here again, there have been a number of important borrower-friendly developments. The available amount basket is now typically set as the sum of (i) a starter component (which can be set as high as 50-100% of EBITDA as of the closing), (ii) an EBITDA-based builder component and (iii) other customary adjustments. It can typically be used without satisfaction of any ratio test, and its use is subject to only limited no-default tests (if any). In BSL transactions, it is not uncommon for the builder component of the available amount to be the greatest of: (a) retained excess cash flow, (b) 50% of cumulative consolidated net income and (c) 100% of cumulative EBITDA minus 1.4-1.5x cumulative fixed charges. Traditionally, retained excess cash flow was viewed as the most lender-friendly formulation. However, as the list of items that are deducted from the ECF sweep, rather than the definition of excess cash flow, has continued to grow, the result is an excess cash flow amount that is artificially high, but an amount swept that is artificially low, resulting, for the purpose of the available amount calculation, in a larger-than-expected retained excess cash flow amount.

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Asset sales

Leakage from the business through asset sales was traditionally limited by restricting the scope of permitted asset sales by requiring material, non-ordinary-course sales to be made in cash and at fair market value (FMV), as well as requiring the cash sale proceeds to be swept to prepay the term loans – or, alternatively, to be reinvested in the business. More recently, exceptions to both the sweep and the asset sale negative covenant have expanded materially, with the combined result that asset sales should now be considered a potential source of leakage in assessing a covenant package.

Starting with the asset sale negative covenant, there have been a number of changes in recent years to the key exception to this covenant, i.e., the 75% cash consideration basket, which allows unlimited asset sales, so long as the sale is for FMV and not less than 75% of the consideration received is in the form of cash or cash equivalents. These developments include the increasing prevalence of a 50%, rather than a 75%, cash consideration prong – which often, though not always, requires that the related cash proceeds be applied to prepay the term loans, with no reinvestment rights. Over the past few years, there have been a number of BSL transactions in which borrowers have negotiated the flexibility to make significant asset sales subject to satisfying an agreed leverage test, rather than relying on – and complying with – the 75% cash consideration basket. In its earliest iterations, this leverage-based basket was often tailored to a specific identified asset sale and required the cash proceeds to be used to prepay the term loans (and/or make RPs) according to an agreed formula. In recent BSL transactions, however, this fairly tailored exception has been expanded to permit unlimited asset sales, untethered to any contemplated sale, subject to satisfying a specified total net leverage ratio. In addition, BSL transactions sometimes exclude from the asset sale negative covenant the disposition of non-collateral assets. For a company that has a large portion of its assets in non-guarantors (e.g., foreign subsidiaries), this can create significant flexibility to dispose of a material portion of the business. One point that may be overlooked is that non-collateral assets – in addition to covering all non-US assets in a typical US-based

BSL – will include assets of and equity in unrestricted subsidiaries. Limits on designating, investing in, and divesting or distributing unrestricted subsidiaries are often carefully negotiated in other covenants, but this non-collateral asset disposition exception may not receive the same focus, thereby undermining the negotiated protections.

With respect to the asset sale sweep, increasingly, a mandatory prepayment is triggered under the sweep only if a sale is made pursuant to the 75% cash consideration basket. In these cases, proceeds from sales made under any other basket – including the non-collateral basket described above and, where applicable, the ratio-based basket – would not be subject to the sweep. Sometimes, the asset sale sweep itself applies only to sales of collateral; in other cases, sales of non-collateral are effectively excluded from the sweep as the negative covenant separately permits the sale of non-collateral assets without any sweep. As has been the case for many years, the asset sale sweep is sometimes subject to step-downs to 50% and 0% of the net proceeds received if the borrower deleverages a sufficient amount from closing date levels. Some credit agreements also permit borrowers to net the asset sale proceeds against the principal amount of indebtedness for purposes of calculating the leverage ratio-based step-downs, increasing the likelihood that the net leverage falls below one or both of the step-down triggers.

Even if a given asset sale falls within the limited scope of the asset sale sweep, the borrower has an increasingly robust right to reinvest the cash proceeds in the business rather than making a prepayment. The reinvestment right may be accessed by the borrower for up to 24 months (or sometimes even longer) and will often allow the borrower to retroactively deem certain expenditures made before the receipt of asset sale proceeds to be a valid reinvestment of those proceeds. Combined with the broad scope of assets in which cash proceeds may be reinvested, this feature makes it even less likely that asset sale proceeds are ever actually applied to make a mandatory prepayment.

So how do increasingly flexible asset sale baskets and narrowing asset sale sweep requirements result in leakage? For credit agreements that include leveraged-based step-downs, available amount capacity is typically increased by the amount of asset

sale proceeds not required to be swept as a result of these step-downs. This general concept, traditionally limited to deals that include step-downs, has been expanded in many recent credit agreements to permit the available amount to be increased by any asset sale proceeds not required to be swept for any reason, which in many cases would pick up any asset sale made pursuant to a basket other than the 75% cash consideration basket (and, where so excluded, would pick up all sale of non-collateral assets). In addition, there are recent examples of BSL transactions that permit proceeds from asset sales made pursuant to the 75% cash consideration basket to be used to make restricted payments that are otherwise permitted in lieu of being reinvested in the business. Although this does not create additional RP capacity, it does appear to complete the years-long drift away from any requirement to prepay the term loans or reinvest in assets useful for the business. Lastly, and as noted above, in some credit agreements that include a leverage-based asset sale basket, proceeds from asset sales using that basket can be distributed to equity holders according to an agreed formula.

Leverage

The general structure of debt incurrence limitations in BSL transactions has remained relatively consistent over the years and permits incremental debt under the credit agreement up to an agreed dollar amount (with a corresponding EBITDA grower) plus unlimited additional amounts subject to satisfying a first lien, total secured or total leverage ratio, depending on the type of debt being incurred. In addition, BSLs allow debt to be incurred outside of the credit agreement on essentially the same basis and also include additional dollar-based baskets. Borrowers have continued to seek increased flexibility in areas that are not new through (i) not-worse-than (or accretive) tests that allow debt incurrence regardless of the pro forma leverage level so long as the relevant leverage ratio is not worse than prior to the incurrence, (ii) the push to permit junior lien and sometimes even *pari passu* debt to be incurred based on an interest or fixed charge coverage test, rather than a leverage test and (iii) the inclusion of provisions, which are now standard, allowing reclassification from dollar baskets to ratio baskets.

There are, however, other developments

that have gained traction in recent BSL transactions. In particular, an increasing number of transactions seek to eliminate, or create large basket exceptions to, the requirement that any incremental debt mature outside of, and have a longer weighted average life to maturity than, the existing term loans. This position is frequently justified by analogy to high-yield bonds, which have never had such a limitation. Permitting material amounts of debt to mature ahead of the term loans in the BSL context, however, may be contrary to the expectations of secured lenders who view their first lien term loan as the most senior (including as to maturity and scheduled amortisation) tranche of a borrower's capital structure – and price it accordingly.

Relatedly, incremental loans and incremental equivalent debt were traditionally permitted to be incurred and guaranteed only by loan parties and secured only by the collateral that secured the term loans. These prohibitions are intended to limit the amount of structurally senior debt that can be incurred by a borrower. Now, it is not uncommon for BSL transactions to include a dollar-based carveout to this prohibition, which permits incremental debt up to a dollar-capped amount to be incurred by non-loan parties and/or secured by non-collateral. Moreover, in recent BSL transactions, ratio debt and incurred acquisition debt generally have not included limitations on non-loan party obligors and collateral, at least in initially marketed terms.

However, the development that perhaps has attracted the most attention is the ability to utilise restricted payment capacity for debt incurrence. In many BSL transactions, this debt can be incurred on a secured basis and, often, in an amount that is 2x the amount of the relevant restricted payment capacity. In some cases, the term “restricted payment” in this context refers not only to dividends, but also to investments and junior debt prepayments. Moreover, some of these deals provide that any baskets and exceptions permitting restricted payments may be used to incur debt, rather than being expressly limited to specific dollar baskets and to the available amount. The result of combining increasingly permissive RP and investment capacity with debt capacity is to provide for leverage capacity on the closing date that is often several turns of EBITDA above the closing-date level.

Calculation of financial ratios

To the extent that leverage and leakage are regulated by financial ratios, borrowers also seek greater flexibility by limiting the type of debt that is included in the numerator of leverage ratios and/or increasing EBITDA in the denominator through expanded EBITDA adjustments.

Frequently, only debt for borrowed money is included in leverage ratios, and the ratios more or less explicitly exclude capital leases, revolving debt (either entirely or to the extent used for working capital purposes) and sometimes payment-subordinated debt. Understanding what is or is not included in the debt calculation, and ensuring it matches the lenders' model and expectations, therefore becomes very important.

It is equally important to understand how EBITDA is calculated. Investors are accustomed to addbacks for run-rate cost savings or synergies, which are not new and may or may not be subject to aggregate caps and maximum look-forward periods. However, it has become more common to also include revenue-based synergies and addbacks. These addbacks take several forms – as generic as revenue synergies, or more targeted, such as deemed or pro-forma EBITDA, for new stores or projects or incremental revenue from new or amended contracts or specified pricing initiatives. To understand their impact, these addbacks require a close analysis of how they operate in the context of a given borrower's business. There are also a range of other borrower-friendly EBITDA adjustments that are increasingly included in BSL transactions, including adjustments to EBITDA for positive changes in deferred revenue (without a corresponding deduction for decreases in deferred revenue), COVID-19-specific adjustments (in some circumstances including lost revenue), an increasingly broad restructuring cost addback and a growing list of “extraordinary or unusual” items (including any one-time, infrequent or similar items) that will be added back.

It is common to set ratio tests by reference to closing date leverage – with a set-back or cushion, as appropriate. In setting those closing date leverage ratio levels, some recent BSL transactions are formulated as the greater of (i) a hardwired ratio (usually set on a gross basis, ignoring balance sheet cash) and (ii)

the actual leverage ratio as of the closing date. Where actual (gross) closing date leverage ends up being the same as or lower than the hardwired ratio – which would happen when financeable EBITDA at signing is lower than actual EBITDA at closing – all applicable ratio tests will be set at the higher, hardwired ratio level and will result in additional debt incurrence capacity at closing. Where actual closing date leverage ends up being higher than the hardwired prong – which could happen if there is a long period between signing and closing and the target business deteriorates – all ratio tests will be set at the higher, actual level, thereby providing the borrower with greater credit under various ratio-based tests for any subsequent, post-closing deleveraging than would be provided under the pre-agreed, hardwired prongs.

Finally, borrowers are starting to seek to apply this general high-watermark concept to EBITDA growers too, by providing that the grower component of any applicable basket at any time will be the greater of (i) the pro-forma EBITDA at such time and (ii) the highest previously reported EBITDA during the life of the credit agreement. This creates a one-way ratchet, such that all baskets are automatically increased to, and remain at, the highest four-quarter EBITDA reported during the term of the credit facility, even when the performance of the business and EBITDA have materially deteriorated at a later test date.

Acknowledgments

The authors would like to thank Meyer Dworkin for his invaluable assistance in the preparation of this chapter. Meyer is a partner in Davis Polk's Finance Group. He advises lenders and borrowers on a wide range of finance transactions, including leveraged financings, NAV facilities, and back-leverage and derivatives transactions.



Jason Kyrwood
partner and co-head of
finance practice, Davis Polk



Scott Herrig
partner, Davis Polk