ROPES & GRAY

ALERT ▪ Leveraged Finance ▪ Private Equity

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U.S. Financing Markets Winter 2021 Update

1. U.S. Financing Markets – Forward Momentum

- Positive sentiment driven by the announcement of COVID-19 vaccine approvals buoyed the institutional markets in late 2020
- After pausing in early November for the US elections, activity resumed and has continued at a brisk pace into the first weeks of 2021, with repricings increasingly common as demand remains elevated (in some cases, despite the applicability of 1% soft call premiums)
- The high yield (HY) market remained red-hot and hit an annual volume record of $435B for 2020; as a marker of steady investor demand, January 19, 2021 recorded the highest single day volume ($9B) since 2014
- The institutional loan markets in Q4 maintained the elevated primary levels first seen in Q3, with supply increasingly driven by the recent uptick in M&A activity, and prices in the secondary have rallied in January to return to approximately pre-COVID levels; nevertheless, annual volume ($288B) in 2020 was down 7% from 2019, largely driven by the slowdown in Q2
- In a sign of resurgent investor appetite, the syndicated second lien loan market has again become attractive to borrowers (in lieu of privately-placed second lien loans)
- Overall, credit documentation terms have again increasingly started to resemble those from the early 2020 pre-COVID era
- On the other hand, companies in sectors particularly negatively affected by COVID-19 that obtained financial covenant relief in 2020 may require an extension later into 2021

2. Selected Topics

- Super Priority Revolvers – Agreement Among Lenders:
    - In unitranche / direct lender credit facilities, the inclusion of a "super priority" revolver provided by a 3rd party bank has become an increasingly prevalent feature
        - From the perspective of the borrower, the advantages of a super-priority revolver typically include:
            - A larger quantum, as the revolver is more attractive to a bank lender than to the institutional lenders that typically provide the term loan component of the credit facility
            - Lower pricing, as the revolver will be less risky because of its priority status ahead of the term loan
        - The revolver and term loan are documented under the same credit agreement, as with a customary cash flow credit facility, but also typically incorporate an "agreement among lenders" (AAL) that is solely for the benefit of the revolver and term lenders. Key features of the AAL typically include, among other things:

        - A payment waterfall documenting the "first-out" status of the revolver (which overrides the payment waterfall in the credit agreement)
        - Voting provisions that grant blocking rights to the revolver lenders over waivers/amendment of specified credit agreement provisions in certain cases (and/or vice versa to the term loan lenders)
            - In "covy-lite" facilities, where under the credit agreement a springing leverage covenant nominally only applies to the revolver, these voting provisions can often operate as a "back-door" mechanism for the term loan lenders to obtain the benefit of the financial covenant
        - A "cash dominion" right for the revolver lender, allowing it to exercise control over cash in controlled accounts upon the occurrence of certain triggering events
            - Revolver lenders sometimes seek to negotiate for additional rights to control remedies
        - A purchase option for the term loan lenders to buy out the revolver lender in certain circumstances
        - A right of first offer for the term loan lenders applicable to transfers of the revolver
    - Although the borrower is not a beneficiary under the AAL, it may have an interest in certain AAL provisions (particularly regarding voting rights) and should take into account the applicability of the AAL in certain scenarios that may occur over the life of the credit facility
        - A borrower may seek to insert itself into negotiation of the AAL; however, in many cases, especially where the revolver lender is brought into the facility by the term lenders, the AAL will be based on a form precedent between the revolver and term lenders and may not be subject to input from the borrower (and in any event, it may be amended post-closing by the lenders without notice to the borrower)
        - In some cases, components of the AAL may be included in the main credit agreement so as to provide the borrower with visibility and input into inter-lender provisions that would otherwise be in the AAL
    - Many recent credit agreements with "super priority" revolvers have placed strict limits on side-car pari passu facilities to restrict the ability of the borrower to incur debt that would subvert the "first-out" priority of the revolver

- Serta, Chewy and J. Crew Provisions:
    - Loan market participants have become increasingly focused on provisions in documentation that may permit a borrower to engage in transactions that have been viewed as controversial, such as those undertaken by Serta in 2020 and Chewy and J. Crew in prior years
        - While guardrails around such provisions are already a mainstay in unitranche / direct lender credit facilities, the syndicated loan market has begun to more stridently push for similar

protections, and it has become increasingly common for banks underwriting syndicated credit facilities to request "flex" to add such protections during syndication if necessary

- Preferred Equity:
  - An increasing number of auctions feature "staple" providers offering (or partnering with a 3rd party provider to offer) a preferred equity instrument to increase leverage available to potential buyers
  - The preferred equity is often structured in a manner that avoids the characterization of such instrument as debt for rating agency purposes, with features that can include:
    - Perpetual maturity
    - Scheduled pay-in-kind dividends, the rate for which is subject to increase upon certain triggers, which may include:
      - The occurrence of certain designated dates (for example, the 6th anniversary of the closing date and every 2nd year thereafter), and/or the failure to consummate an exit transaction (sale or IPO) after a designated time
      - The consummation of an exit transaction
      - The occurrence of certain events under the company's credit facilities (such as acceleration or payment default)
    - Call premium schedule usually resembling HY bonds
    - Board observer seat (may include director seats upon the occurrence of certain triggers)
    - Mandatory redemption only upon an exit transaction to the extent of available company funds
- LIBOR Replacement Update:
  - In November 2020, the authorities administrating LIBOR announced their intention to extend the availability of USD LIBOR tenors for legacy contracts until June 2023. The extension is helpful because it gives more time for existing LIBOR-based credit facilities to mature or be amended to incorporate proper fallback language (although it does not apply to LIBOR-based instruments in any currency other than US Dollars).
  - However, US banking regulators have effectively mandated that LIBOR not be used as a reference rate for new loan originations after 2021, and banks continue to press for the inclusion of the 'hardwired' Alternative Reference Rate Committee (ARRC) standardized provisions providing for the transition from LIBOR to SOFR without an amendment process. While most credit agreements still provide a consent right to the borrower with respect to the adoption of SOFR, the hardwired approach (or a variation thereof) has been accepted by borrowers in certain cases and will likely become more prevalent as the year progresses; however, parties do continue to negotiate the ARRC language even when using the hardwired approach, with borrowers pressing for more control over the transition to SOFR and corresponding changes to the loan documents, as well as the ability to adopt a Term SOFR structure should one become available in the future.