ROPES & GRAY

SUMMER 2021 UPDATE

U.S. FINANCING MARKETS

MID-YEAR MARKET REFLECTION

In this document, we outline the key trends and developments in the U.S. financing markets as we approach the end of summer and offer an update on selected hot topics in the financing world.

U.S. FINANCING MARKETS – Staying Hot

- The U.S. leveraged loan and high yield bond market continued their strong momentum in the first half of 2021 in tandem with the rollout of vaccines and growing consumer demand. High yield issuance in the first half of 2021 set a record of $286.3 billion, 35% over the same period in 2020. The $38.4 billion of U.S. syndicated LBO volume in the second quarter of 2021 is the fourth highest quarterly level since the 2008 recession.
- As an indication of debt markets continuing to favor sponsors and borrowers, of syndicated deals with pricing flex in the first half of 2021, about 82% resulted in tighter pricing.
- As a sign of demand, the U.S. CLO market set a record of $76.9 billion of new issuances in the first half of the year.
- While activity was largely driven by refinancings and repricings in the first quarter of 2021, the second quarter saw an increase in M&A-driven activity in both the loan and bond markets, which is expected to continue into the third quarter.
- Driven by this active M&A market, as well as shrinking auction timelines, sponsors have been seeking larger DDTLs to fund future add-on acquisitions, and both direct lenders and lenders in the syndicated market have been willing to accommodate them.

SELECTED TOPICS

Sustainability Linked Debt

- The volume of leveraged loans and high yield bonds with a sustainability component has been accelerating since the second half of 2020. While most of that momentum remains centered in Europe, it is picking up speed in the United States as well, which saw $860 billion in ESG (environmental, social and governance)-related bond and loan issuance in the first half of 2021, compared to $766.2 billion in all of 2020.
- Sustainable debt traditionally meant “green bonds” and “green loans,” i.e., instruments whose proceeds were required to be used for an environmentally positive purpose. However, as market participants are under increasing pressure from investors and, in Europe, regulators to make ESG-positive investments, much of this proliferation of ESG-related debt has been in the form of sustainability-linked bonds (SLBs) and sustainability-linked loans (SLLs).
- The proceeds of SLBs and SLLs are not restricted for a sustainable purpose. Instead, these instruments incentivize companies to make a positive ESG-related impact through an interest rate adjustment.
- Borrowers and underwriters, often with the help of a “sustainability coordinator” (typically an arranger with ESG expertise), select Sustainability Performance Targets (SPTs) that are measured by key performance indicators (KPIs) for the issuer or borrower to achieve.
- SPTs and KPIs are selected on a case-by-case basis, but some common examples include a reduction in carbon emissions, increasing diversity in boards of directors, achievement of a particular ESG rating from a third party, and sustainability targets relevant to a particular company’s industry (such as, in the case of a producer of wood-based products, increased use of recycled wood).
- SLBs typically feature a coupon step-up (often 25 bps) at a pre-determined date unless the issuer has met the SPTs.
  - Since SPTs in SLBs are only tested once, they require minimal additional reporting by the issuer, if any. The issuer is usually

required to deliver a notice or certificate to the trustee that the SPTs have been met and that it has received an assurance letter to that effect from a third-party verifier (which is sometimes, but not always, required to be delivered to the trustee). The trustee is usually entitled to conclusively rely on the notice or certificate without further inquiry.

  - While the issuer may state an intention to report on its SPTs and KPIs periodically, it is not obligated to do so under the notes documents.

- SLLs function similarly in that they also feature a margin adjustment tied to the achievement of SPTs. However, SLLs more typically feature multiple SPTs, each tied to a separate margin adjustment. The overall margin adjustment is usually more modest than in bonds (often around 10 bps giving effect to achievement of all SPTs). SLLs are also more likely to include either a margin step-down if the SPT is achieved or a two-way margin adjustment so that the borrower is rewarded by a margin step-down for achieving SPTs and penalized for failing to meet the SPTs with a margin step-up.
  - Since SPTs are tested periodically in SLLs, they involve additional reporting, though the detail and extent varies by loan agreement and depends on the KPIs being used.

- In both SLBs and SLLs, the only consequence from failing to meet the SPTs is the margin adjustment rather than any default.

- There are currently numerous frameworks and standards that market participants may use as guides to select SPTs and KPIs (including the International Capital Markets Association's Sustainability-Linked Bonds Principles and the LSTA's Sustainability Linked Loan Principles), and the extent of disclosure and role of third-party verifiers to review selection and achievement of SPTs and KPIs (if any) vary widely. Market participants expect that there will eventually be a convergence around a standard set of frameworks, metrics, and disclosure and verification standards (though likely not in the near term).

Serta Variations

- In the first half of 2021, lenders in both the direct and syndicated debt spaces continued their push to include "Serta" protections, which typically require the consent of each adversely affected lender for the borrower to subordinate its obligations under a credit facility to new obligations (instead of only requiring the consent of majority lenders). These provisions may be included in credit agreements at the outset of a deal or through the exercise of market flex.

- While this push gained increasing traction in the first half of 2021, not all Serta provisions are the same, and many sponsors have been successful in softening their impact, including through the following:
  - Requiring consent only of adversely affected lenders who have not been offered an opportunity to participate in the priming transaction.
  - Limiting the affected-lender vote to new debt that would subordinate the credit obligations in right of payment, but not with respect to lien priority.
  - In rare cases, carving out super-priority revolvers and/or asset-based facilities from the Serta provision.
  - Carving out pre-existing permitted debt baskets.

LIBOR Update

- On March 5, 2021, the ICE Benchmark Administration (IBA) announced that it will cease the publication of overnight as well as 1-, 3-, 6- and 12-month USD LIBOR settings after June 30, 2023, and all other LIBOR settings after December 31, 2021.

- The announcement constitutes a "Benchmark Transition Event" under the hardwired LIBOR transition approach recommended by the Alternate Reference Rates Committee (ARRC) that has been used increasingly in newly originated credit facilities since the second half of 2020.

- As a result, after June 30, 2023, loan agreements that use the ARRC hardwired approach will automatically transition to the first replacement index included in the waterfall of potential replacements in that provision—usually Term SOFR, which is expected to become available for use in corporate loans in August 2021. Alternatively, the administrative agent and the borrower may elect to opt in early to switch to a new benchmark index once a specified number of loans in the market use it.

- Loan agreements that use the amendment approach will need to be amended in order to incorporate a new rate. Usually, these amendments can be implemented by the Administrative Agent and the Borrower, subject to a negative consent right of majority lenders.

- Concerns about Term SOFR's lack of credit sensitivity have given rise to competing options, such as the Bloomberg Short Term Bank Yield Index (BSBY) and AMERIBOR. Nevertheless, market participants increasingly expect that Term SOFR will become the standard replacement index for leveraged loans.

- Term SOFR is not expected to be used for over-the-counter derivative products, which are set to transition to SOFR Compounded in Arrears. However, Term SOFR-based hedges are expected to become available on a bilateral basis to borrowers who wish to achieve a perfect hedge with respect to their Term SOFR-based loans.

Surety Bonds

- Private equity sponsors are increasingly targeting investments in companies that provide infrastructure-related services. Many such companies serve governmental entities or other customers that require contractors to provide surety bonds in support of their projects. In the context of a highly levered capital structure, surety bonds can present unique issues for a borrower to address with respect to its principal debt facilities and its surety bond providers.
- In a typical surety bond arrangement, a principal (the company) has a contract to perform services for a client that is supported by a bond provided by a surety guaranteeing that the obligations under the contract will be met. The company, in turn, grants the surety a lien over certain of its assets in order to secure any reimbursement or indemnification that it may owe to the surety if the bond is ever called. While sureties typically do not perfect these liens, competing liens over the same assets, including liens in favor of secured parties under the principal's loan documents, may nevertheless be subject to equitable subordination to the surety's liens in a bankruptcy scenario under common law.
- From the borrower's perspective, surety bonds, like undrawn letters of credit or other contingent obligations, should not count in the calculation of incurrence ratios unless any related reimbursement or indemnification obligations have not been satisfied after becoming due and payable. In addition, a company should generally not be restricted in its ability to obtain surety bonds, as these are often a key part of its business model.
- From the lenders' perspective, concerns arise with respect to (1) their rights in a bankruptcy scenario over the assets that the surety also has a claim over and (2) a potentially dramatic increase to leverage if its surety bonds, or a material portion of them, are called. On the other hand, the surety typically requires access to certain assets of the company over which it holds a lien in order to perform under the bonded contracts if it is ever required to. These concerns may be addressed in a variety of ways, including the following:
  - Lenders may require the borrower to provide the administrative agent with notices of material claims made by clients against a surety, claims of reimbursement or indemnification made by the surety against a loan party and/or a material default under surety bonds.
  - Lenders may also require disclosure as to the amount of surety bonds outstanding in the compliance certificate.
  - Lenders may take some comfort from narrowly drafted lien in favor of the surety such that it is limited to assets relating to the bonded contract (e.g., equipment and material on a project site, and/or rights in, and proceeds arising out of the contracts).
  - A surety may require the lenders to agree that, during an exercise of remedies under the loan documents, the surety may lease equipment and other assets that have been foreclosed on by the lenders and that are required to perform under the bonded contracts.
  - Lenders may request certain protections in the credit agreement with respect to liens granted to the surety —e.g., a moratorium on granting additional liens to sureties if, and for as long as, leverage exceeds a certain level.

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