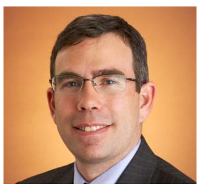
Market Trends 2018/19: Leveraged Finance

A Lexis Practice Advisor® Practice Note by Stephen M. Kessing and Emily C. Weiss, Cravath, Swaine & Moore LLP



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This article will provide an overview of the leveraged finance market in 2018 and focus on notable deals, current practices with respect to deal structure and process, deal terms that are currently among the most heavily negotiated, legal and regulatory trends, and the outlook for 2019. The year 2018 represented the third-highest total for leveraged issuances on record, continuing the trend of significant activity in the leveraged finance market in recent years, but the market exhibited some challenges during the year. In contrast to 2017, which saw record market growth driven by strong investor demand, 2018 experienced a significant slowdown in the third quarter, as well as a steep decline in secondary market bids. The leveraged loan market continued to be supported by high volumes of collateralized loan obligation (CLO) issuances and yield-seeking investors in the loan asset class, although December 2018 saw the lowest monthly total in new CLO issuances since January 2017.

The Board of Governors of the Federal Reserve System's (Federal Reserve's) target short-term interest rate hike cycle continued in a steady and predictable fashion in 2018, with the Federal Reserve remaining transparent in communicating its plans. This key rate was raised four times in 2018 (by 0.25% each time). However, in March and May 2019, the Federal Reserve voted to keep the short-term interest rate steady at 2.25%, and Chair Jerome Powell signaled that the Federal Reserve does not have plans to raise rates in 2019, citing global economic and financial developments and muted inflation pressures.

Nonetheless, there were a number of developments in 2018 which may impact the market in the years ahead—three of the most significant of which concern continued clarity regarding leveraged lending guidance, the eventual replacement of the London Interbank Offered Rate (LIBOR), and the effects of certain Internal Revenue Service (IRS) regulations regarding certain provisions modified under President Trump's tax reform plan.

In 2017, market practices became more established under the Interagency Guidance on Leveraged Lending (Guidance) issued in 2013 by the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC), as the bounds of acceptable practices became clearer. However, in October of 2017, the Government Accountability Office (GAO) determined that the Guidance was a rule, and not guidance, for purposes of the Congressional Review Act (CRA). Under the CRA, as a rule and not as guidance, the Guidance should have been subject to a 60-day congressional review period and because it was not, the current enforceability of the Guidance was called into question. In response to the resulting concern, the Federal Reserve, FDIC, and OCC suggested that they would consider reopening the Guidance for public comment and possible refinement. Although some banks pursued deals with more aggressive leverage levels against this backdrop, most adopted a wait-and-see approach, choosing to maintain leverage within the realm of the Guidance's established 6.0 times standard (i.e., ratio of debt to earnings before interest, taxes, depreciation, and amortization (EBITDA) of 6:1).

However, things continued to become clearer in 2018 when Joseph Otting of the OCC was reported to have noted at a conference presentation that institutions should have the right to do the leveraged lending they want, as long as they have the capital and personnel to manage that and it doesn't impact their safety and soundness. While the OCC has noted that financial institutions should participate in leveraged lending to the extent that their capital and personnel can support such activity, it should be noted that in the fourth quarter 2018 slowdown of the leveraged finance market, U.S. mergers and acquisitions (M&A) transactions with leverage ratios over 6.0 times fell from 36% in the third quarter to 32.6%, indicating that highly leveraged transactions may continue to decline, particularly during periods of market volatility.

Direct lending by unregulated entities continued to grow in 2018. In the years since 2013, direct lenders have become an important source of capital in the leveraged finance market, particularly for smaller corporate and mid-tier sponsors in proposed transactions that may have been inconsistent with the Guidance, and thus less palatable to financial institutions that are more tightly regulated and risk averse. Direct lenders are continuing to gain access to top-tier sponsors and even public companies as they further embed themselves as a source of capital in the loan market by offering favorable loan terms.

Another regulatory development that continues to garner attention is the response to the announcement in July 2017 by the United Kingdom's Financial Conduct Authority that banks would no longer be required to submit LIBOR quotes beginning in 2022. While banks agreed to continue to support LIBOR through 2021, borrowers and lenders have been actively reviewing their existing LIBOR fallback provisions and amendment provisions to ensure an alternative to LIBOR can be established if and when LIBOR ceases to be quoted. There is no market consensus yet on a replacement for LIBOR. However, the Alternative Reference Rates Committee (convened by the Board of Governors of the Federal Reserve System) identified the Secured Overnight Financing Rate (SOFR) as an alternative short-term U.S. dollar interest rate, which is based on overnight U.S. treasury repurchase transactions that had more than $700 billion in daily transactions last year. There are two challenges with transitioning to SOFR: (1) SOFR differs from LIBOR in that it is an overnight rate, while LIBOR is published across a number of maturity periods and (2) unlike LIBOR, SOFR does not contain an embedded credit risk premium. The development of market consensus on a replacement for LIBOR will continue in the coming years.

In December of 2017, President Trump's much-anticipated tax reform plan was enacted through a bill informally known as the Tax Cuts and Jobs Act (TCJA). Certain provisions of the TCJA that may affect leveraged lending transactions include the overhaul of the Section 956 deemed dividend rules, the 30% limitation on interest deductions, and the reduction of the corporate tax rate from 35% to 21%. Additionally, Section 163(j) was modified such that net business interest expenses generally can only be deducted up to 30% of the taxpayer's adjusted taxable income on a yearly basis. In November 2018, the IRS proposed regulations regarding the limitations on business interest deductions under the revised Section 163(j). Market participants continue to consider the implications of these new tax provisions and related regulations as they document and structure new deals. As detailed below, the limit on interest deductions will likely have an immediate effect on the financial performance of certain highly leveraged companies. In addition, in May of 2019, the IRS issued final regulations regarding Section 956 of the Code that generally follow the earlier proposed regulations. As a result of these newly published regulations, foreign subsidiaries generally can provide guarantees/pledges of debt issued by U.S. issuers (or become co-borrowers with U.S. issuers) without triggering the deemed dividend rules. This development may result in significant structural changes to leveraged finance transactions for U.S. issuers and borrowers that have significant foreign assets or operations, but it is too early to tell how significantly this will affect the leverage finance market.

Despite the above, 2018 was characterized by a strong first half followed by increased volatility that nevertheless resulted in significant leveraged loan volumes. Globally, syndicated lending reached $4.7 trillion, a 9% increase from the prior year, largely driven by $2.6 trillion of U.S. syndicated loans. U.S. leveraged lending decreased slightly to $1.24 trillion. This decrease in activity was driven by a drop in institutional loans from $919 billion (accounting for two-thirds of leveraged loan volume in 2017) to $730 billion in 2018. Of the $1.24 trillion total amount, refinancing activity accounted for $750 billion, a 20% decrease over the previous year, but issuers in the market were able to continue to get better terms in an overall borrower-friendly market. New money volume was 4% higher than in 2017 at $490 billion, accounting for nearly 40% of volume (33% in 2017). By industry, technology, oil and gas, financial services, and health care were the most active. In 2018, 44% of leveraged buyout (LBO) transactions were levered at or above 7.0x, the highest numbers since 2007 but slightly down as a percentage of the overall M&A market. In the fourth quarter of 2018, average leverage levels decreased to 6.4 times EBITDA for broadly syndicated LBO transactions and 5.4 times EBITDA for institutional middle market LBOs.

Unlike the year 2017, 2018 saw M&A and LBO volumes increase in the U.S. M&A loan volumes finished solidly with leveraged issuance increasing 23% to $381 billion, surpassing 2007's record. This volume was driven by $153 billion of LBO issuance, which is 21% higher than 2017 and only ranks behind 2007's record. Leveraged sponsored volume decreased slightly to $674 billion, a 4% drop from 2017.

CLO issuance broke records finishing 2018 with over $128 billion in volume, a 9% year-over-year increase. CLOs are the largest buyers of leveraged loans, and the strong demand from CLOs helped create market conditions favorable to refinancing transactions. However, the CLO market dropped significantly in December 2018, with only $5.7 billion in new issue, underscoring the market unease experienced in the fourth quarter.

The supply of leveraged loans dwarfed the high-yield bond market in 2018, continuing the trend in recent years of issuers' demonstrating a preference for loans. Although 2018 saw an increase in high-yield issuances, the high-yield bond market raised just over $168 billion, the lowest annual total since 2009, and a 40% decrease from 2017.

Notable Transactions

The year 2018 saw an increase in the M&A and LBO transactions that dominated the leveraged loan market (in contrast to 2017, during which refinancing activity was the primary driver). One of the most significant transactions of the year was the funding that supported Blackstone's 55% purchase of the Financial & Risk unit of Thomson Reuters, recently renamed Refinitiv. Two other significant leveraged transactions were the loans that funded the spin-off of Akzo Nobel and KKR's buyout of Envision Healthcare.

Due to suboptimal market conditions, a $1.275 billion financing for CoverageOne's buyout by CVC Capital Partners, originally scheduled for the fourth quarter 2018, was postponed until 2019 in the search for more favorable market conditions after year-end.

Deal Structure and Process

Leveraged finance transactions can generally be categorized as either committed financings or best efforts financings.

Committed Financings

In a committed financing, financial institutions commit to provide the desired financing on agreed terms and subject to customary conditions. In most cases, the borrower or issuer agrees to the basic terms, including pricing and covenants, in advance, subject to certain specific changes to the extent necessary for the financial institutions to successfully syndicate or market the debt.

For high-yield bonds, in lieu of providing a forward underwriting of securities, the financial institutions typically provide a committed bridge facility, which would only be drawn if the high-yield bonds cannot be successfully placed in the market.

Committed financings are typically used in M&A transactions where the borrower/issuer needs certainty of funding prior to entering into a transaction that is not conditioned upon obtaining financing. The borrower or issuer will commonly enter into a commitment letter with the banks or other financial institutions providing the financing. The commitment letter includes detailed term sheets describing the key terms of the financing. The arrangers of the financing take the risk of being able to syndicate or market the financing but are compensated through the payment of commitment or arrangement fees on the amount of the committed financing. Depending upon the complexity of the transaction, the size of the debt facilities, and the details included in the term sheet, the time line for negotiating and executing the commitment letter could extend for several weeks. The time period between the signing of the commitment letter and the closing of the transaction is driven by the timing of the underlying acquisition or other transaction and can range from four or six weeks to longer than one year.

Best Efforts Financings

In contrast to a committed financing, most refinancing transactions involving leveraged loans and high-yield bonds are done on a best-efforts basis. This means that the financial institutions that arrange the financing will enter into an agreement with the borrower or issuer to syndicate or market the financing, but do not commit to provide the financing on any specific terms. The successful outcome of the financing will depend on the willingness of the market to participate, and the financial institutions do not risk their own capital if the financing cannot be placed in the market.

Commensurate with this structure, the financial institution will not earn any fees if the financing does not close. The time line for these transactions tends to be shorter as the commitment letter is replaced with an engagement letter that is typically less detailed, and the time between signing the engagement letter and closing of the transaction can be as short as one or two weeks.

Deal Terms

In 2018, many borrower and issuer-friendly terms continued to become more prevalent in leveraged finance transactions.

Leveraged Loans

Within the leveraged loan market, terms related to incremental facilities continued to evolve in a borrower-favorable direction. Incremental facility provisions permit a borrower to incur additional debt in the future, either in the form of additional term loans under a credit agreement or in the form of other indebtedness. The most common formulation permits a borrower to incur a fixed-dollar amount of additional debt, and then higher amounts depending upon a financial ratio. A significant number of leveraged loan deals in 2018 provided borrowers greater flexibility through growing fixed dollar baskets and variations of the ratio-based components designed to provide more borrowing capacity. For example, leveraged credit agreements continue to include provisions that permit incremental debt to be incurred not based on absolute leverage levels but on a requirement that leverage not be worse than prior to the incurrence if used to fund acquisitions or other investments. They may also permit the borrower to reclassify debt incurred under a fixed-dollar basket to be deemed incurred under a ratio basket if the borrower's leverage profile improves. In addition, various provisions permit borrowers to combine baskets in order to provide additional debt capacity. The most-favored-nation pricing protections, which can limit the ability to price future debt with higher interest rate spreads, also continued to weaken, with exceptions increasingly made based on time elapsed since the original deal, amount, type of incurrence (i.e., fixed dollar or ratio), currency, and financing sources and movement from the historically standard 50-basis point differential to higher permitted differences.

Another area of focus for borrowers relates to mandatory prepayment provisions in credit agreements. Borrowers commonly obtained exceptions to the soft call repricing protections (which require a fee, usually 1%, to be paid in connection with any repricing transaction) for initial public offerings, certain other transformative transactions, and certain types of triggering debt. These provisions, which historically applied for up to 12 months after a deal closes, are now much more frequently applied only for six months. Other common exceptions to mandatory prepayment provisions included step-down thresholds for asset sales and de minimis exceptions for excess cash flow prepayments as well as other exclusions or deductions from the excess cash flow prepayment requirement.

In addition, in 2018, there were further exceptions to investment and restricted payment covenants as well as additional flexibility with respect to financial covenants. In sponsor-backed leveraged loan transactions, the norm continued to be springing financial covenants, which are tested only when amounts borrowed under a revolving facility exceed a certain threshold. These covenants increasingly provide cushion levels such that a decrease in EBITDA of less than 30%–35% would not breach the covenant. In contrast, step-downs, which tighten financial covenants over time, have become less common. However, the market slowdown in the fourth quarter of 2018 also saw loan covenants tighten, including a decline in EBITDA addbacks and adjustments, signaling that lenders reclaimed some lost ground with respect to financial covenants in difficult market conditions.

High-Yield Bonds

There have been fewer market changes in the high-yield market in 2018, due primarily to the slower high-yield market as compared to the leveraged loan market. As with 2017, the market trends in 2018 continued to be focused on increased flexibility with respect to covenant suspension provisions and dilution of the change of control protections for bond holders. There has also been further flexibility with respect to future debt incurrence, restricted payments, and mandatory prepayments in response to some of the changes in the leveraged loan market described above. The terms of high-yield bonds and leverage loans continue to converge.

Legal and Regulatory Trends

In 2018, there were legal and regulatory developments affecting both the loan and bond markets.

Leveraged Loans

In 2017—five years after the Guidance was first issued—just as the market began to fully understand how the Guidance would be implemented, the enforceability of the Guidance was called into question. In 2018, the Federal Reserve, FDIC, and OCC ultimately confirmed that the Guidance would not be enforced; however, many financial institutions have adopted the Guidance as best practice. The Guidance was aimed at preventing future losses of the sort faced by many banks in the wake of the 2007 economic downturn. Losses by lenders at that time were exacerbated by risky, over-levered lending practices, with financings routinely provided at debt to EBITDA ratios of 7:1, 8:1, or even greater. Viewed by regulators as a systemic issue worsening the recession that occurred in the latter half of the 2000s, the Federal Reserve, FDIC, and OCC collectively issued the Guidance in an effort to cap the amount of risk that lenders are permitted to absorb.

In the years following the issuance of the Guidance, lenders faced uncertainty regarding its implementation. This uncertainty chilled the financing activity of some lenders who then faced a disadvantage in the market compared to those who interpreted the Guidance less conservatively. Recognizing the need to tighten up the market's understanding of the Guidance, the Federal Reserve, FDIC, and OCC provided further clarity in two steps. First, the regulators issued a November 2014 Frequently Asked Questions publication (FAQ memo), and second, the regulators participated in a February 2015 conference call (red flags conference call) sharing what they determined to be red flags in leveraged lending. These red flags included debt to EBITDA ratios in excess of 6:1, overly optimistic cash flow projections, large percentage EBITDA adjustments, and other EBITDA adjustments lacking third-party diligence. In addition, during this same period, the regulators began to enforce the Guidance through monetary penalties and other sanctions. However, in 2018, the Guidance was determined to be unenforceable, although financial institutions have demonstrated their intentions to adhere relatively closely to the Guidance all the same.

Outside of the United States, the European Central Bank (ECB) released its final guidance on leveraged transactions (ECB Guidance), which took effect on November 16, 2017, and largely mirrored the Guidance. The ECB Guidance focuses on many of the same factors as the Guidance, the FAQ memo, and the red flags conference call, with particular focus on a debt to EBITDA ratio of 6:1 or more, though other qualitative factors from the Guidance are repeated as well. The impact of the ECB Guidance in Europe seems to have been less dramatic than what was experienced in the United States. Enforceability of the ECB Guidance remains unclear, with some European countries (e.g., the United Kingdom) not subject to the ECB. That said, more prominent European banks are already shying away from the types of all-time high-leverage ratios experienced in the United States during the financial boom, so many institutions are likely already in compliance with much of the ECB Guidance.

In the second half of 2018, key Wall Street regulators, in particular the Federal Reserve and the OCC, began to caution against increasingly risky transactions and the erosion of lender protections. In the OCC's Fall 2018 Semiannual Risk Perspective, the OCC signaled that it was reviewing transactions with increasing leverage, weaker capital structures, and looser credit agreements. The risks associated with leveraged lending have drawn greater scrutiny both among regulators globally, and among banks' credit committees. Thus, although the Guidance and ECB Guidance cannot, or may not, be enforced, they have already had the intended effect of alerting financial institutions to the risks associated with leveraged lending and encouraging financial institutions to consider such risks carefully before proceeding to fund these types of transactions.

High-Yield Bonds

An important development in the bond market in 2017 concerned the effects of certain provisions of the TCJA, particularly on highly levered companies. The TCJA lowered U.S. corporate tax rates from 35% to 21% and permitted companies to fully write off capital expenditures in the year spent for at least the next five years. However, through the revised Section 163(j), the TCJA also set forth a limit on the amount of interest expense that companies may deduct, which is now set at 30% of EBITDA, and beginning in 2022, will be 30% of earnings before interest and taxes (EBIT). Additionally, interest expense that cannot be deducted in the taxable year in which it is incurred can be carried forward indefinitely, subject to the 30% annual limitation in such years.

In November 2018, the IRS proposed a number of regulations regarding the new Section 163(j). For example, the regulations define "interest" broadly, meaning that any transaction that has the substance of a loan, regardless of form, can produce interest income or expense. The regulations also include a broad anti-avoidance provision, allowing the IRS to re-characterize transactions that it determines have been entered into in order to avoid the application of Section 163(j).

While most high-yield companies will benefit from a drop in the corporate tax rate, certain highly leveraged and lower-rated companies will likely experience the negative effects of the decreased interest deductibility immediately. The number of high-yield companies that will be unable to fully deduct their interest expense, and the overall effect this will have on the financial performance of these companies, remains to be seen. If lower-rated, high-yield companies do perform poorly as a result of the TCJA while higher-rated, high-yield companies perform better as a result of the TCJA, there could be a stratification within the high-yield market with investors keeping their exposure to more highly rated, high-yield bonds and moving away from lower-rated, high-yield bonds.

One of the high-yield bond spaces' most publicized events in 2018 was the litigation involving Windstream Holdings Inc. (including its subsidiaries, Windstream) and Aurelius Capital Management LP (Aurelius), which ultimately led to Windstream's declaring Chapter 11 bankruptcy. In 2015, Windstream completed a tax-free spin-off of its telecommunications network assets into Communications Sales and Leasing, Inc. a real estate investment trust now known as Uniti Group Inc. (Uniti). After completion of the spin-off, Windstream leased certain materials from Uniti, which was ultimately determined to be a sale-leaseback transaction that violated the covenants of certain of Windstream's outstanding bonds. Although Windstream sought to retroactively obtain consent from bondholders to enable them to proceed with the sale-leaseback arrangement, ultimately, Aurelius, which had since purchased a substantial portion of Windstream's 6.375% Senior Notes due 2023 (2023 Notes), sent a notice of default and pushed the trustee under the indenture governing the 2023 Notes (Indenture) to file suit in the Southern District of New York (SDNY). The SDNY determined that the sale-leaseback transaction was a default under the Indenture, thereby triggering defaults and accelerations under other Windstream indebtedness totaling approximately $5.8 billion and prompting Windstream to file for bankruptcy. The case also triggered criticism of Aurelius and other funds that identify technical defaults in issuers' outstanding indebtedness, purchase some of that indebtedness, engage in credit default swaps, and file suits to enforce the technical defaults, allowing them to profit handsomely from enforcement of the covenants that govern the indebtedness. The Windstream case could have significant implications for other companies contemplating restructuring or business combinations and the liabilities associated with covenant restrictions related to their outstanding indebtedness. The Windstream case has also caused some issuers to start to address net short investors in their credit documents by adopting provisions that limit voting rights of debtholders that hold CDS or other derivative instruments.

Market Outlook

Analysts are optimistic that leveraged loan issuances will recover in 2019 after the slowdown and volatility experienced at the end of 2018. However, syndicated loan volume, including both in the leveraged loan and investment grade markets, was down 40% year-over-year in the first quarter. Specifically, in the U.S., leveraged loan issuances were down 11% compared to the first quarter of 2018, with $152 billion in issuances, of which only $79 billion was new money, a 31% decrease over the same period in the previous year. Additionally, refinancings declined to $73 billion in the first quarter of 2019, compared to $148 billion in the fourth quarter of 2018 and $229 billion in the first quarter of that year. CLO issuance, in contrast, has remained relatively steady at $27 billion in the first quarter, signaling the potential for another strong year, although CLO managers have indicated that there is a lack of clarity on CLO volumes due to uncertainty with respect to outflows.

M&A, expected to be the primary driver of 2019 leveraged deal flow, has been off to an uneven start this year, as private equity sponsors have held onto their cash while they wait for the economy to stabilize before making their next moves. The pipeline for U.S. M&A-related loans was over $38 billion as of mid-April 2019, down 17.1% from 2018, when the level was approximately $46 billion. Investment banks are attributing the lack of M&A-related loans to the fact that acquisition multiples are too high, but the relatively steady M&A activity in the first quarter of 2019, combined with the Federal Reserve's decision to postpone rate increases, have provided optimism that the market will stabilize.

As of March 2019, high-yield volume is at $63 billion for the year, which is consistent with the first quarter of 2018. However, the market conditions that decimated the year for high-yield in 2018 seem to still be recovering in 2019. In addition, as stated above, many believe the M&A pipeline is strong, which may provide opportunities for increases in high-yield bond offerings into the second and third quarters of 2019.

Current trends are expected to continue for the remainder of 2019, although the possibility of renewed market volatility is ever-present. Factors that are expected to impact the leveraged lending market in 2019 include the following:

- It is expected that demand for leveraged loans will continue to grow, driven by CLOs and other loan mutual funds, as it was in 2018, and also driven by an increase in M&A activity. The high demand for CLOs, however, has created some cause for concern at the Federal Reserve. Randal Quarles, a member of the Board of the Federal Reserve and Chair of the Financial Stability Board, indicated that the Federal Reserve is watching for signs that CLOs could be threatened by investor runs. Although CLOs have not historically had this risk, the growing popularity of this product could give rise to new risks in this arena.

- The Financial Stability Oversight Council (FSOC) is continually evaluating whether the leveraged loan market has the potential to become a systemic risk. When asked recently about the risks associated with the leveraged loan market, Joseph Otting stated that he does not see the risks at levels that are systemic at this point. However, the FSOC's risk committee has considered the issue and will continue to monitor it in the future. Similar concerns have also been raised by the ECB and other international financial regulators.

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