Paul|Weiss

Private Equity Digest

2013 Snapshot

January 2014, Issue 4

Deal Activity

2013 proved to be a mixed year for U.S. private equity deal activity. Global and U.S. sponsor-related M&A activity as measured by the number of deals was significantly down as compared to 2011 and 2012. Total deal volume was up, however, with U.S. PE M&A volume being particularly strong, increasing 17% over 2012, as compared to only 8% globally.

U.S. sponsor-backed exits declined overall, but equity markets pulled through, with IPOs increasing significantly in 2013 by both dollar volume and by number over both 2012 and 2011 figures. Investor money similarly flowed on the fundraising side, as U.S. PE fundraising continued to grow in 2013, increasing by almost 40% over 2012 as measured by the dollars raised.

Given recent reports of continued improvement in the U.S. financial markets, we look forward to a more consistently positive 2014.

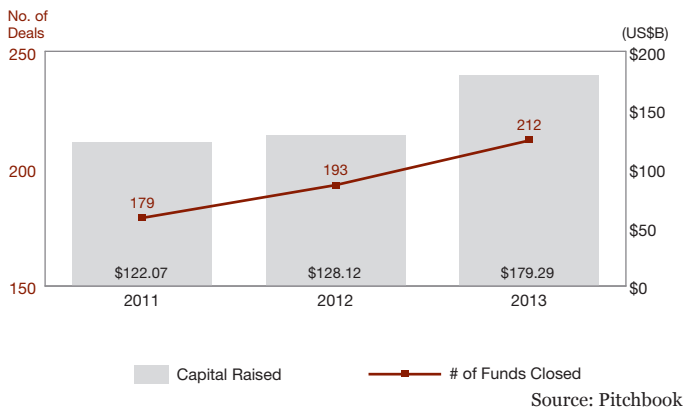
Sponsor Financing Trends

The syndicated loan market has made a dramatic comeback since the global credit crunch, and borrowers are now achieving some of the terms that were available at the height of the economic boom prior to the financial crisis. Private equity sponsors and their portfolio companies are reaping the benefits of this borrowers' market, fueled by an oversupply of capital in the debt markets. The protracted low interest rate environment has led more debt investors to seek higher yields in the syndicated loan market, but leveraged M&A activity has not kept pace with investor demand. As a result, 2013 witnessed the highest volume of U.S. syndicated loan issuance on record, but the vast majority of this activity consisted of refinancing transactions. Most sponsor-led financings now tend to be opportunistic, taking advantage of low interest margins and the other favorable terms available in today's market. The following is an overview of some of the key macro trends in recent sponsored leveraged financing transactions.

Covenant-Lite Resurgence. Despite market watchers' predictions that it would be many years before we saw the return of covenant-lite loans, the volume of covenant-lite loan issuances in recent quarters has actually surpassed pre-credit crunch levels. Credit facilities for companies backed by large private equity sponsors, and in some cases even middle market transactions, are now more likely than not to have covenant-lite features. Large sponsors are generally obtaining credit facilities that not only lack financial maintenance covenants, but also enjoy high-yield bond style incurrence tests. Other covenant-lite loans, particularly for middle market borrowers, are limited to the absence of financial maintenance covenants but otherwise resemble traditional loan facilities.

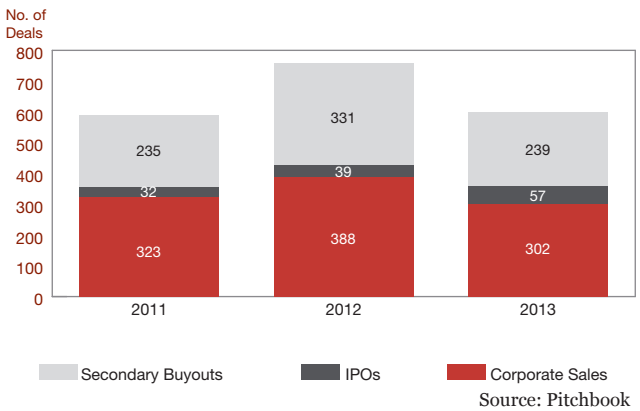
Lenders are increasingly reluctant to provide cash-flow based revolving credit facilities in covenant-lite deals. Instead, asset-based loan (ABL) structures are becoming more common, with a stand-alone term loan lacking financial maintenance covenants and a separate ABL facility subject to a "springing" fixed charge coverage ratio tested only if borrowing availability falls below a specified threshold.

U.S. Private Equity Fundraising



Source: Pitchbook

U.S. Sponsor-Backed Exits By Number



Source: Pitchbook

Recent deals have loosened the springing covenant's testing trigger, including by excluding outstanding letters of credit in the calculation. When the split term loan/ABL structure is used, the term loan often has a cross-acceleration (instead of a cross-default) to the ABL to prevent the term loan lenders from indirectly benefiting from the ABL's financial covenant. This allows the borrower to work out an ABL financial covenant violation without interference from the term loan lenders.

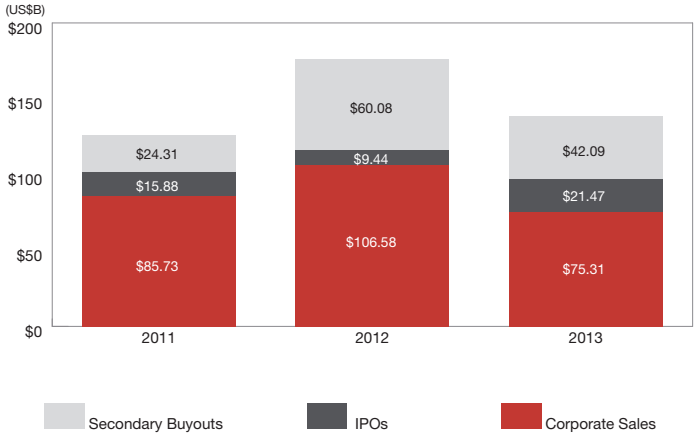
When a cash flow revolver is still used, one or more financial maintenance covenants typically apply to the revolver but not the term loan (even if both facilities are governed by a single credit agreement), giving revolving lenders the exclusive ability to exercise remedies in respect of a financial covenant default. Some cash flow revolvers, like their ABL counterparts, contain financial covenants that are springing in nature. In these deals, the covenants are typically tested only if the borrower makes draw downs in excess of a specified percentage of the total revolving facility.

Covenant-Loose Emergence. Even when true covenant-lite terms are not available, transactions with relaxed financial maintenance covenants are emerging in a trend known as "covenant-loose." These deals impose financial maintenance covenants on the borrower but may include fewer of them than traditional loan agreements and set the testing levels at higher cushions over the sponsor's financial model, making them less likely to be triggered. The overall covenant package may also be less restrictive than conventional facilities, giving the borrower more flexibility in conducting its operations.

Second Lien Financings. Like covenant-lite loans, second lien loan issuances increased dramatically over the past year. Second lien documentation continues to substantially mirror that of the first lien, but covenant levels are commonly set with a higher cushion over their first lien counterparts. Cushion levels are trending towards 20%, as opposed to the traditional 10% in prior years. Intercreditor issues continue to be the focus of negotiations in second lien transactions. It is common for second lien lenders to be subject to a standstill period (often 90-180 days) following a default, during which the first lien lenders have the exclusive ability to exercise rights against the borrower and the collateral.

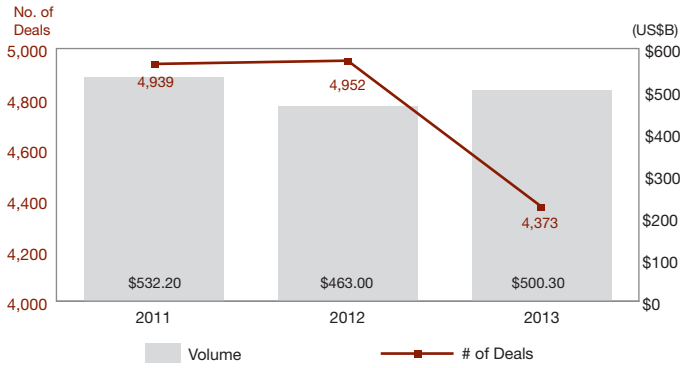
Refinancing Facilities. In addition to so-called "accordions" permitting incremental loan facilities, credit agreements in most large-cap sponsored financings now include "refinancing facilities" as well. This feature permits the borrower to refinance a portion of the credit facility using either new tranches of loans incurred under the credit agreement or additional debt incurred outside the credit agreement. In either case, the additional debt may be secured by the same collateral securing the initial loans, either on a *pari passu* or a junior basis. In this manner, the

U.S. Sponsor-Backed Exits By Dollar Volume



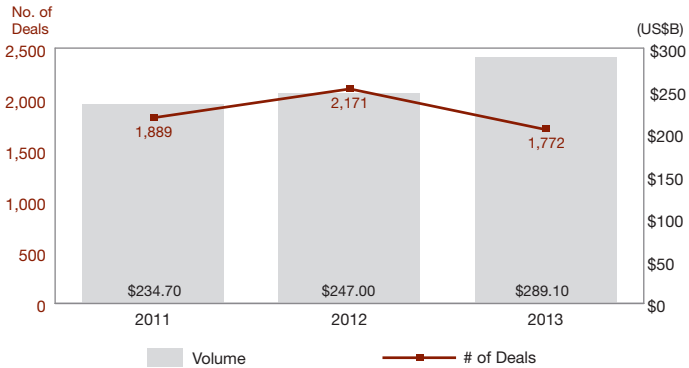
Source: Pitchbook

Global Sponsor-Related M&A Activity



Source: Dealogic

U.S. Sponsor-Related M&A Activity



Source: Dealogic

borrower has the flexibility to refinance a portion of its credit facility with debt obtained from other sources and secured by the same collateral, without needing to pay off the entire facility or seek lender consent. Unlike with incremental facilities, there is typically no "most favored nations" provision affecting pricing; the borrower is free to negotiate for the most favorable interest rates the market will bear without impacting the pricing of the remaining original loans.

Soft Call Protection. If a prepayment premium is included in a term loan facility, it now tends to be "soft call" payable only under specific limited circumstances (particularly for large private equity sponsors). Often, the premium is payable only if there is a "repricing event," defined as a refinancing of the facility at a lower interest rate or an amendment that results in a reduced interest rate. This soft call protection is most commonly set at 1% of the amount refinanced or repriced and usually applies during a window of six months to one year following incurrence of the loan. Some deals contain an exception for refinancings where the primary purpose of the transaction is not a reduction of interest rates (even where the transaction in fact results in a reduction of interest rates), such as a refinancing consummated in connection with a change of control transaction or a qualifying IPO.

Debt Buybacks. Debt buyback provisions continue to evolve in recent credit agreements. Originally developed during the financial crisis to allow sponsors and borrowers to capitalize on depressed loan trading prices, buyback mechanics permit either the borrower itself or the sponsor or another affiliate to purchase outstanding loans at a discount to par. Many sponsored financing transactions continue to include this flexibility. Some deals allow unlimited debt repurchases conducted via Dutch auction procedures, while open market purchases are typically subject to a cap. Customary restrictions on voting rights and access to syndicate information remain standard lender protections for sponsor buybacks, but in recent deals some sponsors have been successful in eliminating the troublesome requirement to represent that the sponsor possesses no material non-public information at the time of the buyback. In any event, when trading while in possession of material, non-public information, consideration should always be given to potential legal implications in consultation with legal counsel.

"Precap" Provisions. A handful of recent credit agreements contained "precapitalized" or "precap" provisions allowing the borrower to undergo a change of control without triggering an event of default. Ordinarily, a borrower being acquired by a third party would need to pay off a credit facility or obtain lender consent. This feature allows a qualifying purchaser to leave the borrower's credit facility in place after the acquisition, which can make the borrower a more appealing acquisition target (particularly if the credit markets tighten after the credit facility was put in place). In order to exercise this feature, the change of control needs to satisfy specified criteria. These can include conditions relating to the identity of the purchaser (for example, the purchaser may need to be a private equity sponsor having assets under management exceeding a specified threshold) and the consequences of the transaction (for example, the credit rating of the borrower and/or the loan may need to be maintained after giving effect to the transaction). So far, very few deals have come to market with this feature. In all of the reported examples, it appears the borrower was controlled by a private equity sponsor, the credit facility was incurred for the purpose of a dividend recapitalization, and a potential exit transaction was on the near horizon.

It is difficult to predict where the syndicated loan market is headed in the coming months, but it seems likely that the current borrowers' market will continue for at least the immediate future. Lenders are competing for every dollar and private equity sponsors continue to push the envelope in pursuing aggressive terms. The loan market is poised to accommodate an uptick in leveraged M&A activity, and it may take significant changes in supply and demand dynamics to see a reversal of current trends.

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