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# Acquisition Financing: A Banner Year Behind, and New Opportunities in the Year Ahead

The credit bull market charged through 2017, with many terrific outcomes for opportunistic borrowers. But even in the best of times, borrowers and their advisors should remain nimble and thoughtful, and 2018 brings much to consider, including the impact on the acquisition financing markets of the most significant business tax reform in a generation, and the continued rise of the net-short debt investor.

## 2017: A Good Year to Be a Borrower

2017 was another banner year for borrowers. Corporate debt yields were low, gross issuance of syndicated loans and investment grade bonds each hit new records, and high-yield bond issuance, though not record-breaking, remained strong.

The acquisition financing market remained ready, willing and able to assist buyers, including CenturyLink in its acquisition of Level 3 (approximately $10 billion of acquisition financing, including a $6 billion term loan B), Abbott Laboratories in its acquisitions of St. Jude ($17.2 billion of financing commitments) and Alere ($2.8 billion term loan A), United Technologies in its pending acquisition of Rockwell Collins ($6.5 billion of financing commitments), Thermo Fisher in its acquisition of Patheon ($7.3 billion of financing commitments), Amazon.com in its acquisition of Whole Foods ($13.7 billion of financing commitments) and Penn National Gaming in its pending acquisition of Pinnacle Entertainment ($2 billion of financing commitments).

Repricing and refinancing transactions came in waves, as well-prepared borrowers seized opportunities to extend maturities and reduce rates. High-yield issuers improved their capital structures with refinancing transactions, including Intelsat (a $1.5 billion new notes issuance to extend its most near-term maturity), Lions Gate (a $925 million term loan B repricing), Presidio (a $740 million bank repricing and refinancing) and Rayonier Advanced Materials (a $930 million bank refinancing in connection with its acquisition of Tembec). Investment grade issuers were not to be outdone, with a sea of new issuances, including remarkable issuances of "zero coupon" euro-denominated notes by issuers, including Johnson Controls.

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Tax Reform and the Financing Markets

December brought the passage of the Tax Cuts and Jobs Act (the "Act"), ushering in the most significant changes to business taxation in decades. Corporate borrowers generally, and highly levered acquirors in particular, will need to work closely with their legal and financial advisors to ensure they account for the Act's major changes. Though the Act makes numerous changes that will affect M&A and how deals are financed, it is worth briefly noting a few of the revisions that could have the most significant impact on the debt markets.

*Is debt now less appealing to acquirors?* In short, it depends. Changes included in the Act may make highly levered transactions less attractive to M&A buyers. In particular, the Act (1) reduces the corporate tax rate from 35% to 21%, making all tax deductions, including interest, less valuable relative to years past; and (2) caps deductions for net business interest expense at 30% of an amount that approximates EBITDA (and, beginning in 2022, EBIT), altering the calculus for financing highly levered deals. It is likely that these limits will affect return models for private equity buyers, given the significant leverage (often 6x EBITDA or higher; more on this topic below) of many PE deals in 2017. The changes, however, surely do not mean that PE buyers are out of the M&A market. We note that 2017 brought huge new private equity capital raises, with available PE capital to deploy currently at an all-time record. We would expect financial sponsors to quickly learn the intricacies of these deduction limits, and to find creative solutions to maximize value for their investors. It will also be interesting to see whether preferred equity, long an overlooked instrument in highly levered financings because preferred dividends are not tax deductible, is more frequently utilized as mezzanine financing as a result of these changes.

*Is debt less necessary for acquirors (at least in the near term)?* Investment grade acquirors may not have much concern about exceeding the interest deductibility cap. But many large U.S. multinationals — particularly those in tech and pharma that have accumulated substantial overseas cash balances over many years — may find it less necessary to raise new debt to fund deals or refinance their existing debt because the Act, with its move toward a "territorial" tax regime, allows them to have access to that overseas cash. Moreover, overseas cash of potential targets may look attractive to buyers as a means of funding an acquisition. Until those stockpiles are reduced (whether through debt repayments, acquisitions, buybacks, dividends or otherwise), these businesses may simply have limited need for the debt markets.

*Limits on deductibility of intercompany payments may lead to more U.S. borrowing by foreign multinationals*. The Act limits the deductibility of payments by a U.S. company to its non-U.S. affiliates, including interest payments that otherwise would not be subject to the general 30% cap described above. This could reduce the effectiveness of intercompany lending structures that foreign multinationals have historically used to maximize the deductibility of interest expense. These changes may lead foreign acquirers of U.S. entities to borrow directly at their U.S. subsidiary level (rather than at the foreign parent), and in any event will require multinational borrowers to closely assess optimal financing arrangements in the future.

*Rumors of the demise of the "deemed dividend" rule have been greatly exaggerated.* Both the House and Senate drafts of the Act eliminated the "deemed dividend" rule set forth in Section 956 of the tax code, pursuant to which a taxable "repatriation" may occur upon a guarantee or pledge of assets by a foreign subsidiary in support of debt of its U.S. parent entity. Surprisingly though, while the final version of the Act largely eliminated U.S. tax on *actual* dividends from controlled foreign corporations (or "CFCs") to their U.S. corporate parents, it preserved the deemed dividend rule, and borrowers should therefore retain provisions in their debt documents limiting their obligation to add foreign guarantors or pledge more than 65% of the voting stock of any CFCs. In fact, in certain circumstances, corporate entities that would not have constituted CFCs before the Act may constitute CFCs now. Borrowers should remain focused on this issue.

*The accounting cost of lower taxes*. For borrowers and issuers with net operating losses, or NOLs, one odd effect of the Act may be a sudden reduction in their balance sheet assets. With corporate taxes reduced, the value of those NOLs correspondingly declines. And while corporations may happily take that trade, those borrowers that have financial covenants or baskets directly or indirectly based on their total assets will want to ensure that they take into account any such NOL write-downs. Borrowers should also consider any impact of the Act's one-time deemed repatriation tax on their EBITDA definitions and financial ratio tests. Working in connection with the move toward a "territorial" tax regime, this one-time tax is imposed on certain U.S. taxpayers with respect to unrepatriated earnings of their foreign subsidiaries (generally at a rate of 15.5% or 8%, depending on whether such earnings were invested in cash or other assets) and may be paid in installments over eight years.

Attack of the Net-Short Debt Investor

In recent years, a new breed of debt investor has gained increased prominence. This investor buys debt not in the hope that the debt will perform, but in the hope that it will not. It takes a position in a traditional debt instrument (usually bonds) issued by a performing borrower, and takes other, more significant positions (usually CDS) that will pay off if that same borrower defaults on those same bonds. The economic result is that the investor is incentivized, net-net, to *want* its borrower to default. Once the net-short investor attacks, the results can be dramatic, with the borrower suddenly faced with the net-short investor's public letters arguing its case for a default, the issuance by the net-short investor of a formal default notice (using its long position), or both. Litigation can quickly follow.

To be prepared, and to reduce the risk of net-short investor action, borrowers — and high-yield and distressed borrowers in particular — should take preventive action and be ready to adapt, including:

- *Simplify covenants where possible*. Debt documents can be complex. Where possible, simplicity should reign: for example, reducing myriad notice and certificate delivery requirements, which can be challenging to track even for a well-organized borrower, can be helpful.

- *Monitor covenant compliance*. Debt agreements are living, breathing documents that continue to have implications for the borrower long after the initial draw. Implementing an efficient and understandable compliance process for ordinary course transactions, and consulting counsel when undertaking anything new or unusual, may go a long way toward limiting the interstitial spaces in which net-short investors have been breeding.

- *Cultivate a constructive relationship with traditional debtholders*. Borrowers should work to identify and maintain good relationships with traditional debt investors that are long its debt. When a net-short investor appears, traditional long debt investors, which often have little incentive to sit idly by while a net-short investor seeks to undermine their borrower, may be willing to provide consents, or to participate in tender or exchange offers, that undercut the default claims of the net-short investor.

- *Assemble a team*. Once it is confronted by the alleged default claims of a net-short investor, the borrower should assemble a small group of key officers plus a lawyer, investment banker and possibly a public relations firm. The group should be prepared to be creative, combing their documents for counterarguments and paths to cure any alleged default, and seeking natural allies (including not only traditional long debtholders, but also sellers of CDS protection).

Other Opportunities and Issues to Monitor

In the ever-evolving financing markets, there are always new trends and opportunities to monitor. Below is a lightning round of a few that we find interesting:

- *Leveraged lending guidance*. The target ceiling of 6x EBITDA on leveraged transactions imposed by U.S. federal bank regulators since 2013 showed signs of cracking in 2017. LBO leverage sharply rebounded last year, with the percentage of LBOs with at least 6x leverage coming in higher than at any time since 2007. Observers also noticed a rise in EBITDA add backs that resulted in borrowers coming in at or slightly below the 6x target. These trends may indicate that, under the current U.S. administration, regulators became more willing to curtail enforcement of the leveraged lending guidance. If so, the result in 2018 could be further increases in acquisition leverage levels (perhaps offset, though, by the tax changes described above), and a decrease in the competitive advantage that the guidance bestowed on nontraditional lenders.

- *New term loan technology*. "Covenant lite" is old news. Strong borrowers have been widely successful in eliminating leverage and other maintenance covenants from their term loan B agreements. But one recent trend is the increased use of leverage tests for the *benefit* of term loan B borrowers, including leverage-based interest rate step downs (long normal in term loan A facilities, but new to term loan B) and asset sale prepayment step-downs. Borrowers should consider whether such new leverage-based technology would make sense for them.

- *Who needs a commitment?* Perhaps emboldened by the strong financing markets, more investment grade borrowers have been relying on their revolvers or uncommitted best efforts financings to

fund their acquisitions, rather than paying for bridge commitments. Although investment grade companies, unlike their high-yield brethren, may be less susceptible to deteriorating financing markets, the financing plan should be carefully crafted before signing an acquisition agreement without having a "certain funds" bridge commitment.

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While financing markets may boom and bust, interest rates may rise and fall, and regulations and market practices may change and evolve, one thing remains constant: fortune favors the well-prepared borrower.

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