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Financing Year in Review: From Crisis to Comeback

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The Covid pandemic and fears of a global recession roiled financial markets around the world in March and April: U.S. investment grade risk premiums reached their highest levels since the Great Recession and investment grade bond and commercial paper markets briefly froze; the leveraged loan and high-yield bond markets seized shut; and the amount of U.S. distressed debt (bonds yielding at least 1,000 basis points more than treasuries and loans trading for less than 80 cents on the dollar) ballooned to nearly \$1 trillion.

Unlike in the Great Recession, global financial markets quickly stabilized, and markets and banks proved to be a source of strength for large and mid-sized companies of all credit profiles. Companies moved quickly to stockpile liquidity (first by drawing [existing lines of credit](#) and then by [exploring more creative options](#)) and secure temporary covenant relief. Some companies, such as Expedia and Gap, fully reconfigured their capital structures, moving swiftly and nimbly to strengthen their balance sheets and ride out the storm. Government stimulus programs and central bank activity—including the Federal Reserve's cut in interest rates to zero and intervention directly in credit markets by buying corporate debt and ETFs—buoyed markets and set the stage for this binge on new borrowings.

By December, the script had reversed: investment grade spreads neared record-tight levels; CCC-rated bonds reached their lowest yields in more than five years; and the amount of U.S. distressed debt fell below pre-Covid levels to \$184 billion. High-yield bond volumes reached their highest December level since 2006.

2021 brings new questions. Do companies have adequate liquidity to withstand the pandemic's current wave? As temporary financial covenant relief rolls off, will companies need further relief? When and how will companies begin addressing the seismic increase in corporate leverage, or are such levels simply another "new normal"? Relatedly, what do expanding central bank balance sheets and near-zero interest rates portend for future growth, inflation and the strength of the dollar, and how long can the low-rate environment hold?

The Acquisition Financing Markets in 2020

While debt-fueled mergers and acquisitions activity came to a screeching halt during the first several months of the Covid crisis, it came roaring back in the second half of 2020, as suspended deals were revived and new deals emerged, especially in the fourth quarter. Pfizer's wholly-owned subsidiary Upjohn Inc. raised approximately \$12 billion in permanent bank and bond financing related to its combination with Mylan N.V.; Salesforce obtained \$10 billion of bridge commitments to support its acquisition of Slack; Nasdaq obtained \$2.5 billion of bridge commitments to support its acquisition of Verafin; and PPG Industries raised \$2 billion of term loan commitments to support its acquisition of Tikkurila.

In the private equity space, near-zero interest rates propelled a remarkable, nearly 20% increase in 2020 deal activity over 2019 levels, to the highest levels since 2007.

2020 was a unique year in many ways, but it demonstrated a well-established maxim for deal-makers: windows can open as quickly as they shut, and the best strategy is to be the right mix of patient and prepared.

Financing Certainty in M&A Transactions

2020 brought several high profile disputes between buyers and sellers in pending mergers, focused on MAE provisions and alleged breaches of interim operating covenants. Unlike in the Great Recession, front page disputes have not centered on financing failures. Nevertheless, it remains critical for sellers to focus on buyer financial resources, including the strength and certainty of financing commitments. A lawsuit for damages or specific performance (and, in some circumstances, a capped “reverse termination fee”) against a buyer without the financial wherewithal to consummate the deal can be cold comfort to a seller and its shareholders.

Likewise, no matter how tight the commitment, the process of actually obtaining financing can be long and complicated, and often requires extensive cooperation from the seller. The seller’s cooperation obligations are typically reduced to a highly negotiated

“financing cooperation” provision in the transaction agreement that is intended to detail the assistance the buyer may (and may not) seek from the seller during its financing process. These provisions are another area remorseful buyers are likely to comb finely for potential breach arguments when looking to exit or renegotiate uneconomic transactions. Sellers should therefore negotiate these provisions carefully, thinking practically about what information and assistance they can and cannot provide (and the buyer truly needs). Rigor and attention will pay off if issues arise.

Anti-Debt Default Activism Trend Continues

Borrowers have increasingly sought to preempt the threat of debt default activism, detailed in our prior memos, [The Rise of the Net-Short Debt Activist](#), [Default Activism in the Debt Markets](#) and [Debt Default Activism: After Windstream, the Winds of Change](#), by including in new debt agreements provisions that undermine key activist strategies, including net-short strategies. The technology continues to evolve, with recent deals including hard voting caps for lenders regardless of their economic interests, limiting any one large lender’s power, and other limitations on the exercise of remedies designed to preclude unfriendly holders from accumulating large positions in the first place. Borrowers, particularly highly leveraged businesses, should understand these developments and consider which provisions might be advisable to include in their future financings.

Other Developments to Monitor

The financing markets never stop evolving, and each year brings new developments and new opportunities. Below is a lightning round of a few that we find interesting:

- *Convertible notes come to the fore ... for a while.* Attracted by lower interest rates and fewer operating restrictions than regular-way debt, and less dilution than straight equity offerings, many companies turned to convertible notes as the preferred capital-raising instrument during the Covid liquidity-building frenzy. However, as discussed in our memo, [Creating Liquidity during the COVID-19 Pandemic: Convertible Bonds](#), issuers and acquirors must beware of customary provisions in convertible notes and related derivatives products that can come back to haunt them in the event of a transformative transaction.
- *The LIBOR transition is nearly upon us.* The ICE Benchmark Administration Limited, the administrator of LIBOR, announced that subject to the outcome of a consultation period currently underway, it intends to cease publishing U.S. dollar LIBOR for certain tenors and foreign currency-denominated LIBOR for all tenors at the end of 2021, with other U.S. dollar LIBOR tenors receiving a stay of execution until the end of 2023. The Federal Reserve-backed Alternative Reference Rates Committee (the “ARRC”) has endorsed a Secured Overnight Financing Rate (or “SOFR”)-based benchmark as the preferred LIBOR replacement, and in June, the ARRC updated its recommended contractual language to provide for a “hardwired” fallback from LIBOR to SOFR. New credit

agreements include variations of the ARRC's "hardwired" roadmap; borrowers whose existing credit agreements do not contain such provisions should consult with their advisors well in advance of the transition that is set to begin by the end of the year.

- *ESG risk is credit risk.* Investors are seeking—and increasingly demanding, notwithstanding (or perhaps because of) the Covid pandemic—ESG disclosure alongside traditional financial metrics, with profound implications for corporate credit. Over time, we expect companies to find their cost of capital more directly tied to their ESG risk, which firms are lining up to help investors evaluate. See our prior memo, [ESG Performance and the Credit Markets](#) .

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