Harvard Law School Forum on Corporate Governance

Financing Year in Review: A Robust Recovery

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Tags: **Banks**, **Covenants**, **Cryptocurrency**, **Debt**, **Debt contracts**, **Financial institutions**, **Financial regulation**, **Leveraged acquisitions**, **LIBOR**
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Booming debt markets throughout 2021 helped drive a record-breaking year of deal-making activity. Borrowers across industries, geographies and credit ratings maintained access to financing on historically attractive terms. We mark the New Year by looking at developments driven by the roaring debt markets, and considering what lies ahead as the calendar turns.

The Financing Markets in 2021: Record Breaking

Undeterred by the second year of the pandemic, 2021 was a record breaker for financing markets. New issuance volumes for both high-yield bonds and loans set full-year records before Thanksgiving, and those record high volumes were accompanied by record low yields. Investment grade bond issuance levels were the second highest on record, eclipsed only by levels reached in 2020.

The attractive financing available in 2021 supported dealmaking at an all-time record pace, including M&A transactions such as Salesforce.com's $27.7 billion acquisition of Slack; Jazz Pharmaceuticals' $7.2 billion acquisition of GW Pharmaceuticals; ii-vi's $7.0 billion acquisition of Coherent; IAC's $2.7 billion acquisition of Meredith Corporation's National Media Group; Herman Miller's

$1.8 billion acquisition of Knoll; and Siris Capital's innovative $1.5 billion double-acquisition of Equiniti Group and American Stock Transfer & Trust Company. The financing markets also supported other types of M&A activity, including XPO Logistics' $7.8 billion spin-off of GXO Logistics and the $9.3 billion "Reverse Morris Trust" transaction between 3M's food safety business and Neogen.

Refinancings were fast and frequent as well, and companies in sectors that faced headwinds at the initial peak of the Covid crisis, including Expedia and Gap, reset their capital structures on enviable terms.

Covenant Evolution

The strong markets drove two trends of note in the covenant space: first, the rise of investment grade covenant packages for *non*-investment grade borrowers, and second, expanded covenant flexibility for borrowers generally. While these trends have been years in the making, they've greatly accelerated, and CFOs, treasurers and financing-focused dealmakers alike will want to take note.

Investment grade covenants for non-investment grade companies

Investment grade covenant packages have recently become increasingly available to select BB-rated issuers. Traditionally, investment grade issuers have only been subject to a narrow set of covenants (typically, limits on lien

incurrence, sale-and-leaseback transactions, mergers and changes of control), while issuers of high-yield debt have been subject to a significantly broader set of restrictions that also includes limits on debt, dividends/share buybacks, investments, asset dispositions and affiliate transactions. This dichotomy has begun to blur.

In some recent bond deals, certain BB-rated issuers—including Gap, Edgewell, Nielsen and Angi—have enjoyed the more limited covenant packages that previously were available only to IG issuers. And perhaps counterintuitively, these instruments sometimes offer even more favorable covenants than traditional IG debt with respect to lien capacity, as BB-rated issuers have sought and obtained enhanced flexibility to incur secured debt within IG-style covenant packages. This is a trend that even true IG issuers may want to monitor, as the cutting edge in IG-style covenant packages may actually be developing in the BB-rated space.

Expanded flexibility generally

While some non-investment grade issuers may be able to place debt with limited covenants in certain situations, the market still generally expects most issuers of high-yield debt to agree to the traditional full suite of negative covenants. But the exceptions to those covenants, and the means of calculating compliance therewith, are evolving rapidly. For instance, "revenue synergies," or adjustments to EBITDA to reflect the expected positive impact on sales of operational actions which a borrower has taken only recently, or only determined to take (such as price increases), while rare in 2020, became increasingly frequent sights in 2021. Ditto for uncapped EBITDA add-backs for cost savings expected to be realized at any future time. Likewise, "multi-purpose" baskets available for use as exceptions to multiple covenants at the borrower's discretion are on the rise. On their own, such revisions may seem technical. But their aggregate impact can be powerful, particularly when a company faces headwinds and needs flexibility to raise capital and weather the storm.

For some time, various market observers have expressed concerns about "deterioration" (from the lender perspective) in covenants. However, flexibility in downtimes can be a blessing, even for lenders. Many companies that relied on enhanced covenant flexibility to stay afloat in 2020 became well-performing credits in 2021 as the economy stabilized. In any case, borrowers should carefully consider the potential availability of increased covenant flexibility with their advisors, and negotiate accordingly depending on then-current market conditions.

Direct Lending: Niche No Longer

In our **2019 memo**, we discussed how direct lending was leaving its mark. In 2021, that trend kicked into a new gear. Direct lenders have become the lenders of choice for financings by "software as a service" ("SaaS") companies, and have played increasingly large parts in financing LBOs generally, in some cases providing multi-billion dollar commitments that were once solely the purview of traditional banks.

Borrowers may want to consider deepening their relationships with significant direct lenders, just as they do with traditional banks. And in acquisition contexts, sponsors and other leveraged issuers may want to involve direct lenders in initial competitive bidding processes for their loan commitments. Even in deals where direct lenders do not outbid traditional banks, direct lenders may later take an "anchor" position in the syndicated debt, helping to drive terms and de-risk the commitment.

Lighting Round: Other Developments to Monitor

New developments and opportunities in financing markets are always on the horizon. Below are several that we find most interesting:

- *The LIBOR transition is here … yet its shape remains unclear*. U.S. regulators have instructed banks not to provide new LIBOR-based loans, and as of this writing, many new financings are being placed with a replacement rate and LIBOR-based borrowings in certain foreign currencies are no longer available. Nevertheless, markets have yet to converge on a consensus rate to replace LIBOR. While U.S. regulators have signaled their preference for the Secured Overnight Financing Rate ("SOFR") and state legislatures have begun to enact statutes establishing SOFR as the default fall-back benchmark rate, certain banks continue to prefer the Bloomberg Short-Term Bank Yield Index. Beyond rate selection, the questions of whether and how to adjust credit spreads to account for

differences between LIBOR and SOFR remain unsettled. Borrowers should consult with their advisors and proceed thoughtfully.

- *Should "unanimous consent" amendments instead be "nearly unanimous"?* Traditionally, debt agreements in the U.S. have required the consent of a majority of creditors for most modifications, but *unanimous* consent for "sacred rights" amendments (such as those affecting maturities, principal amount, interest payments and sometimes collateral/guarantees). These 100%-vote provisions encourage holdout tactics and gamesmanship, even in situations where the vast majority of creditors support the transaction. In light of the prevalence of such strategies —which, in some cases, can even lead to bankruptcy filings that might otherwise be handled completely out-of-court—it may be time to look across the Atlantic to the United Kingdom, where high supermajority consent thresholds are standard for "sacred rights" amendments. Such a shift would undercut holdouts and be beneficial to stakeholders generally.
- *ESG developments*. Last year, **we noted** that investors were increasingly demanding ESG disclosures alongside traditional financial metrics. In 2021, the ESG trend surged, led by multi-billion dollar ESG-linked bond issuances by blue chip companies such as Amazon and Salesforce. The total volume of loan instruments with interest rates tied to ESG metrics grew nearly tenfold over the past year, from approximately $13.8 billion in 2020 to over $133 billion in 2021. We expect both the volume of ESG-linked debt instruments and the pricing impact of ESG risk to increase in coming years.
- *SEC targets opportunistic credit strategies.* We have written much about debt default activism (see **here**, **here** and **here**), and **noted** regulators' increasing concerns posed by opportunistic credit strategies. In December, the SEC proposed new rules for the securities-based swaps market, which could deter credit default swaps buyers and sellers from inducing or forestalling credit events in order to profit from their CDS position. As **we** **noted**, regulatory risk must be considered by those who would employ debt default or other activist strategies using securities-based
- *What to do about cryptocurrency?* The treatment of crypto-based assets in loan agreements is still in flux. Companies that hold, or may hold, crypto-based assets should consider seeking targeted covenant exceptions to avoid unexpected restrictions on this increasingly common activity.

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The New Year will bring new challenges, but whatever they may be—further Covid variants, increasing inflationary pressures, or challenges yet unseen—borrowers who remain informed and prepared will be equipped to make the best of it.

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