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Acquisition Financing: the Year Behind and the Year Ahead

If 2008 through 2010 were years of tumult and recession in U.S. financing markets, and 2011 through 2015 years of recovery and growth, marked by ever-lower yields and record-setting financing activity even in the face of new compliance regimes, 2016 felt like a tipping point. After hitting record lows in the first half of the year, interest rates at last experienced a sustained rise, and the U.S. election results opened the door to major regulatory and legislative changes, including the potential roll-back of portions of Dodd-Frank and the potential roll-out of consensus-fueled fiscal stimulus.

During the course of a year marked by change, favorable issuance windows opened and closed multiple times, particularly for high-yield borrowers. Ultimately, investment grade corporate bond volumes hit a new U.S. record for their sixth consecutive year while high yield corporate bond volumes fell to their lowest level since 2009. Syndicated lending volumes in the U.S. matched 2015, with leveraged bank lending up and investment grade loans slightly down. But in spite of the inconsistency, well-prepared borrowers of varying credit levels were able to achieve many highly successful results. Major financing commitments and permanent financings were obtained in connection with investment grade acquisitions (including Bayer's $57 billion syndicated bridge loan in connection with its pending acquisition of Monsanto; Abbott Laboratories' $17.2 billion of financing commitments and $15 billion notes offering in connection with its acquisition of St. Jude Medical; and Danone S.A's $13.1 billion bridge commitment in connection with its acquisition of The WhiteWave Foods Company), spinoffs (such as Adient's $5 billion bank and bond transactions), high yield leveraged deals (including CenturyLink's $22 billion of financing commitments in connection with its pending acquisition of Level 3 Communications and Lions Gate's $4.5 billion bank and bond transactions in connection with its acquisition of Starz), and opportunistic high yield refinancings (such as Dollar Tree's repricing of its $4.2 billion secured credit facilities and XPO Logistics' repricing and refinancing of $2.6 billion of notes and term loans).

Though "uncertainty" remains the buzzword of the day, should 2017 bring continued rate rises and meaningful regulatory and legislative changes, the impact on acquisition financing markets will likely be profound. Times may change, but borrowers can, and should, stay nimble.

Regulatory and Legislative Activity

Potential changes to the corporate tax code, from lowering tax rates to loosening restrictions on U.S. companies' ability to repatriate cash from overseas, could have a major impact on acquisition financing activity in 2017. Throughout the M&A boom of the last half-decade, many U.S. acquirers faced limits on putting their significant stockpiles of overseas cash (which some experts estimate to exceed $2 trillion) to use due to tax impediments on repatriating that cash. As a result, many cash-rich acquirers elected to finance their transactions by issuing new indebtedness in the U.S. (often at historically low rates) rather than repatriate those funds. To the extent that U.S. tax law changes to reduce friction on cash repatriations, some U.S. companies, particularly in the technology and pharmaceutical sectors, may find themselves with new war chests to fuel M&A activity, freeing them of the requirement to seek as much, or any, third-party financing. Various other tax proposals floated by the President-elect and Congressional leadership, if enacted, could counteract this effect or compound it (for example, some proposals would condition or otherwise limit the deductibility of interest expense, with the Congressional plan expressly intended to equalize tax treatment on debt and equity financing).

In addition, potentially significant regulatory changes (the President-elect spoke at times during the campaign of "dismantling" the Dodd-Frank Act and stated more generally that "70% of regulations can go") could open, or reopen, certain financing opportunities for high yield acquirers. For instance, to the extent that the new administration adjusts regulatory constraints on lending or relaxes enforcement of such constraints—in particular the leveraged lending "guidance" jointly issued by U.S. federal bank regulatory agencies in 2013—U.S. banks may find themselves able to underwrite or arrange highly leveraged acquisition financings in the manner to which they were accustomed prior to the publication of the guidance. Similarly, if Dodd-Frank's risk retention rules (which require CLO fund managers to own a portion of the risk of the CLOs they manage) are relaxed or removed, CLO issuance, which was predicted to remain flat in 2017 (and significantly down from 2015), could take off, providing yet more liquidity into the debt markets.

Whether, when and how any of these changes (or others) will occur remains highly uncertain, but each of them has the potential to affect acquisition financing markets materially. The uncertainty as to the "what and when" of reform may well induce borrowers to seek both new and re-financings in the near term, lest circumstances shift unfavorably.

Interest Rates

Anticipated by investors for a number of years, higher interest rates finally arrived in late 2016, with USD LIBOR rates for all major durations currently at 7-year highs, the 10-year Treasury rate hovering near a 2-year high, and the Federal Reserve closing the year with a long-expected increase of the Fed Funds Rate and the announcement that more increases are likely to follow. These developments represent a stark contrast to the record lows seen in the first half of 2016, including an all-time low for 10-year Treasuries of 1.36%.

To illustrate the interest rate whipsaw, consider a 2016-vintage credit agreement and take a look at the unglamorous floating rate "floor" provision. With the first part of the year marked by near-zero and negative interest rates in many markets worldwide, bank lenders prevailed in instituting 0% LIBOR floors across the full spectrum of loan categories, including revolving and investment grade facilities that, unlike leveraged term loan B financings, had not typically included a LIBOR floor, as protection against the risks of sub-zero interbank rates to the returns of their cost-plus financings. Yet with three-month LIBOR at 1.0% for the first time since the financial crisis (and six-month LIBOR well above it), even the now-standard 1.0% LIBOR floor on term B loans may soon become an anachronism.

Beyond the obvious implications of higher costs of borrowing, companies should focus on several other key considerations in a rising rate environment. Borrowers should be mindful of compliance with maintenance and incurrence covenants in their credit facilities that are based upon interest expense, such as minimum fixed charge coverage ratio or interest coverage ratio tests. Because rates have been so low for so many years, many borrowers have paid little attention to these covenants; with rates rising, they may start to have bite. Additionally, borrowers may see a growing demand for their floating-rate paper, as a hedge by investors against rising interest rates, lead to reduced spreads (for instance, spreads in 4Q16 for B-rated loans were down 1.5% from the levels reached in 1Q16). Borrowers should continue to explore opportunities to capitalize on this trend by repricing their existing bank debt; while in new money financings, borrowers should carefully weigh the benefits of reduced spreads on floating rate debt against the virtues of locking in fixed rate debt, and should model for situations where interest rates continue to rise. Lastly, if interest rates continue to rise and stocks remain at or near record highs, we wonder whether equity will become a more desirable acquisition currency than it has been in recent years, changing the consideration mix offered by acquirers in deals to come.

Market Developments

The well-publicized 2015 decisions in *Marblegate Asset Management v. Education Management Corp.* (which remains under appeal and awaiting a decision from the Second Circuit Court of Appeals) and involving Caesars Entertainment Corp. (see our previous memo) continue to cast a shadow over certain aspects of the financing markets. These decisions, which called into question the ability of issuers of registered debt securities to consummate out-of-court restructurings without the consent of all affected noteholders, have had significant impact not only on the market for and practice of liability management transactions, but also on primary issuances of debt securities. These cases highlighted the risk that unexpected judicial interpretations of the Trust Indenture Act (even beyond the scope of these specific decisions) might have adverse and unforeseen effects on an issuer's ability to take certain actions in compliance with the terms of its debt agreements. To avoid this risk, we expect more and more issuers to insist on issuing debt securities in transactions exempt from registration, either through 144A-for-life offerings or otherwise. This approach has become commonplace in the high-yield space across both strategic and sponsor-backed issuers; one wonders whether it will spread to the investment-grade markets in the coming years.

It is also worth noting that, with increasing frequency throughout 2016, lenders have required that many acquisition-related bank and bond financings, particularly in the context of transactions with a long time period between signing and closing, be executed and funded far in advance of the closing of the transaction. Pre-funding in this way de-risks the commitment both for the underwriting banks and for the borrower, but brings a potentially significant cost to the borrower in the form of interest expense during the pre-closing period and breakage fees in the event the acquisition does not close. In the face of increasing uncertainty in 2017, we expect this trend to continue, and with interest rates on the rise, the proposition may become a more expensive one for acquirers.

Finally, borrowers with global businesses and debt issued in multiple currencies should focus on unique debt-related risks posed by the Dollar strengthening against other major currencies. For example, many debt instruments with leverage ratio and other financial covenants require that Euro- or Sterling-denominated debt and cash flows be converted to Dollars before being included in the calculations of debt or EBITDA, and significant currency swings may present unexpected challenges in this regard.

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In all, we expect 2017 to be a year of change, both potential and actual, of a type that the financing and deal-making markets have not experienced for many years. Interest rate increases, along with potential regulatory, legislative and market developments, will continue to merit special attention as critical drivers of change in the coming year and, as in years past, for both acquisition financings and refinancing transactions, borrowers should be prepared to seize upon open market windows and momentary improvements in the financing markets. Advance planning and early preparation for anticipated financing transactions may be increasingly important in the face of less predictability in markets and politics.

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