January 8, 2019

# Acquisition Financing Year in Review: From Break-Neck to Brakes-On

The credit bull market finally exhibited signs of fragility in the fourth quarter of 2018, putting the brakes on what had seemed poised to be another banner year for corporate borrowers. The skies may yet clear, but for savvy borrowers the New Year is a good time to prepare for turbulence. Looking ahead to 2019, we contemplate strategies for M&A in choppy financing markets, the practical impact of credit rating downgrades, and the risks posed by the rise of "default activism" in the debt markets.

## The Financing Markets in 2018: A Sharp Transition

### *A Hot Start…*

Through its first three quarters, 2018 looked like a continuation of the recent credit bull market. The syndicated loan market went on a tear, with leveraged loan issuance in the first six months of 2018 falling just short of its first-half 2017 record. High-yield bonds followed suit, with the spread between "junk" bonds and U.S. treasuries touching a 10-year low. Investment grade issuance remained strong, and banks lined up to provide committed financing in support of major acquisitions by investment grade, levered and private equity buyers alike.

Corporate acquirors took notice and advantage: T-Mobile lined up $38.0 billion of financing commitments for its combination with Sprint; Cigna obtained $26.7 billion of bridge commitments and issued $20.0 billion of senior notes and $6.3 billion of bank facilities to fund its acquisition of Express Scripts; Broadcom tapped $20.3 billion of loan facilities for its acquisition of CA; and United Technologies obtained a $6.5 billion bridge and issued $11.0 billion of notes to support its acquisition of Rockwell Collins. Refinancings and repricings likewise surged, particularly in the white-hot leveraged lending realm.

### *…But a Cold Finish.*

Momentum stalled in Q4. The high-yield bond market ground to a halt, with zero dollars of new issuance in December, the first such month since 2008. Leveraged loan prices fell to their lowest levels in over two years, and multiple loan syndications were pulled from the market due to lack of demand. Investment grade bond issuance levels in December 2018 were the lowest of any December since 1995.

Acquisition Financing in Challenging Markets

While routine debt financing transactions can often wait until a sunny day, transformative M&A transactions can rarely be delayed on account of choppy financing markets. For acquirors looking to access the financing markets, we lay out some guidelines below:

*When lenders compete you win*. As we detailed in our recent memo, Financing the Deal in Volatile Markets, to obtain the best possible results in tough markets, borrowers should engage with multiple potential financing sources, balancing healthy competition among potential lenders against relationship, speed and confidentiality considerations. When markets are volatile, different lenders may deliver drastically different terms, depending on their other credit exposures, their market and industry outlooks, regulatory factors, and other considerations. Working with multiple potential financing providers keeps costs down, optimizes terms, and bolsters transaction certainty.

*Focus on the flex.* Many acquisition financing commitments provide that the underwriting bank can unilaterally "flex" critical economic terms – including interest rates, fees and covenants – to make such terms less favorable to borrowers and thus more marketable to debt investors in adverse debt markets. Also common in high-yield bridge commitments are "demand" provisions, which give financing commitment providers the right to demand that the borrower attempt to issue bonds on specified (and typically unpleasant) terms, and provide for a dramatic increase in commitment pricing if the issuance fails. When markets are volatile, the risk to borrowers of being flexed or subjected to a demand spikes, so it is essential for borrowers to model for a downside case that accounts for these provisions.

*Tackle tail risk.* At the peak of the financial crisis, financing failures – where financing sources walked away, or attempted to walk away, from their acquisition commitments – briefly became a not-uncommon occurrence. In an increasingly volatile financing environment, acquirors and sellers alike should give extra focus to the merger agreement provisions that allocate financing risk, including the acquiror's financing and the seller's financing cooperation covenants, conditionality provisions, termination rights, and termination consequences, if this tail risk again becomes reality.

Volatility creates opportunity, and well-prepared acquirors, working closely with their advisors, need not shy away from challenging financing markets. But they must play smart.

Ratings Risk in a Challenging Environment, and How to Prepare

In recent months, driven in part by reports from the Federal Reserve and the OCC, the financial press has focused on corporate debt levels generally (which are at an all-time high), and debt issued by "BBB"-rated companies in particular. Bonds rated "triple B," or the lowest investment grade tier, now constitute more than half of the $5 trillion U.S. investment grade bond market, up from about a third in 2008. The surge in BBB debt has led many observers to speculate that if the economy were to fall into recession, a wave of downgrades could push many BBB companies (and hundreds of billions of dollars of debt) out of the investment grade club entirely and potentially swamp the high-yield debt markets.

United States corporations are remarkably adaptive and flexible, and even in the depths of the financial crisis, most BBB issuers were able to retain their investment grade stature. But downgrades happen, and for companies that face the risk of becoming "fallen angels," planning ahead is critical, and we recommend focusing in particular on the following:

*Know your lien capacity.* Investment grade companies do not typically issue secured debt, but such debt is a critical (and the lowest-cost) part of the capital structure for high-yield companies. As a result, downgraded borrowers are likely to find themselves needing to borrow secured debt, in some cases for the first time. But typical investment grade debt documents include "lien covenants" that limit the issuer's ability to incur new secured debt. Scour these covenants now to understand their contours and carveouts, and think creatively with legal and financial advisers about ways in which new secured debt could be structured to comply with them.

*Disappearing financing sources*. Commercial paper is a favorite funding source for investment grade companies, but is not available to their high-yield counterparts. Similarly, investment grade companies with international subsidiaries frequently use "uncommitted" credit lines, but they dry up quickly when an issuer ceases to be rated investment grade. At-risk investment grade borrowers who rely on these sources should be ready with contingency plans to fill the gap, whether by way of traditional revolving facilities, factoring or securitization arrangements, or other sources.

*Non-lender creditors can still drive hard bargains*. Moving from investment grade to high-yield can result in a cascade of changes to a company's relationships with its non-lender creditors. Following a downgrade, commercial counterparties such as insurance companies and utilities may suddenly request deposits, letters of credit, or other forms of credit support. Borrowers on the cusp of a downgrade should assess where such potential liabilities and funding needs may lurk.

For companies stepping down from investment grade, addressing financing needs and funding gaps in advance will ensure a smoother landing.

Default Activism in a Downside Scenario

As detailed in our recent memos The Rise of the Net-Short Debt Activist and Default Activism in the Debt Markets, "Debt Default Activism" is an important and growing phenomenon, and market volatility may further fuel its expansion.

When debt prices decline, default activists can more easily buy debt at a discount and then seek to profit by demanding the debt be repaid (in some cases with premium) as a result of an alleged default. Market volatility also drives expansion of the credit default swap market, or "CDS," which can be jet fuel in the hands of a default activist. CDS contracts pay off when the underlying borrower defaults on its debt. While CDS usually serve important bona fide hedging purposes, a default activist can buy CDS, assert the occurrence of a default (often on the grounds of a complicated and years-old transaction), and seek to profit from the resulting chaos such assertion creates.

Companies with debt trading below par should stay particularly alert to the threat of default activism, just as companies that have endured short-term stock slumps should be wary of shareholder activism. For a borrower that is actively confronted by a default activist, it is critical to swiftly assemble a team of executives and advisors to lead the response, communicate closely with traditional "long-only" debt investors, and develop a comprehensive strategy for addressing the threat in real time.

Lightning Round: Other Developments to Monitor

The financing markets are never still, and there are always new trends and opportunities to monitor. Below is a lightning round of a few that we find interesting:

- *"Unrestricted Subsidiaries" unleashed*. Use of "unrestricted subsidiary" technology – which allows borrowers to "designate" a subsidiary as unrestricted, and to conduct transactions at the subsidiary that would otherwise be prohibited by the covenants in its debt documents – has matured. In recent years borrowers have employed this technology more than they did even at the height of the financial crisis, when such provisions were relatively new, often with litigation following. Use of such provisions can raise intricate covenant interpretation questions, so borrowers (and their advisors) should read carefully before diving in.

- *What leveraged lending guidance?* The target debt ceiling of 6x EBITDA on leveraged transactions imposed by U.S. federal bank regulators since 2013 feels like a fading memory. In 2018, almost three quarters of large LBOs were levered at 6x or higher; well over a third were levered 7x or higher. It appears that lender risk tolerance, as opposed to regulatory oversight, has become the limiting factor for leveraged deals (for now, at least).

- *Factor in for factoring*. Once mostly the domain of European companies, "factoring" accounts receivable (*i.e.*, selling them to financing counterparties at a slight discount) is growing swiftly Stateside. Increasingly, large companies are giving suppliers a binary choice: "participate in our factoring program and we'll pay you in 60 days, or don't and we'll pay you in 6 months." Since debt facilities often restrict factoring activity, considering trends in this space well in advance is recommended.

- *Demise of the "deemed dividend."* As we discussed in our recent memo, Proposed Treasury Regulations Would Limit the "Deemed Dividend" Rule of Section 956 and May Impact Guarantee and Collateral Packages of U.S. Corporate Borrowers, proposed changes to existing Treasury regulations may, in many cases, eliminate the adverse U.S. tax consequences of having foreign subsidiaries guarantee or secure debt of their U.S. parents. Borrowers should closely monitor these tax changes, but should think carefully before agreeing to provide non-U.S. credit support, as for many the cost (such as foreign counsel and filing fees) of doing so will still outweigh the benefits.

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

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