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Financing the Deal in Volatile Markets

After years of nearly uninterrupted strength, the credit markets have shown significant volatility and material signs of weakness in recent weeks. Among other things, according to Bloomberg, November saw investment grade bond spreads at their highest in nearly two years, the prices of leveraged loans fall to their lowest in two years and the biggest weekly jump in Euro high-yield spreads in almost seven years. As a result, many acquirers seeking to finance their M&A deals in the debt markets have faced challenges rarely seen in recent years. We cannot predict what the coming months will bring, but listed below are observations from our experiences in the current (and previous) choppy financing markets and our recommendations on best practices for borrowers seeking to play in them.

- **What's Market?** When markets are volatile, different financing sources may have markedly different views of the risk that any particular financing transaction presents—and as a result, may offer vastly different terms. Of course it is always the case that different financial institutions (and particularly different *types* of financial institutions—money-center commercial banks, investment banks or alternative lenders) have different risk tolerances, but recent volatility and unpredictability in the financing markets have resulted in greater differentiation in the terms that individual financing sources are willing to offer potential borrowers. Therefore, borrowers seeking to finance a transaction should test (and should ensure that engagement letters with their investment bankers provide them with sufficient flexibility to test) the market with multiple financial institutions of varied types to ensure that they are partnering with the lender(s) best suited to their transaction given the specific market conditions. Disclosing an M&A transaction to more potential financing providers prior to signing may expose a deal to greater leak risk, but a borrower can mitigate this risk and achieve substantial and offsetting benefits by properly managing and calibrating this process.

- **Here Today, Gone Tomorrow.** In markets like these, particular lenders' views on the terms upon which they are willing to lend may change rapidly and unpredictably. Because of each lender's unique institutional sensitivities and tolerances, market developments are likely

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to impact each potential financing source differently. Although the state of the markets on one day may be such that Lender A is the best positioned and most willing to provide the best terms to a specific borrower on that day, the changed state of the markets on the next day may make it such that Lender A has to walk back its proposed terms, leaving Lender B (which was far behind Lender A the day before) as the financing provider now offering the best terms. As a result, potential acquirers should match the cadence of their financing process closely with the broader M&A transaction timeline and should consider keeping multiple financial institutions "warm" up to the moment they sign commitment papers, to ensure that they choose the best financing fit at the critical moment of execution. Obtaining debt financing on favorable terms in volatile markets can be a tough and unpredictable game, and it pays to have a deep bench.

- **Hope for the Best, Prepare for the Worst.** When markets are choppy, lenders request broader "flex terms" in debt commitments—that is, terms (including structure, pricing, fees and covenants) that lenders can change in order to successfully syndicate the financing between signing and closing—as a mitigant to increased syndication risk. Potential borrowers must focus as much on the "fully flexed" terms of a proposed financing as on the headline, base-case committed terms. The lender's *true* commitment is to the fully flexed package of terms, and it is critical for a borrower to understand and model what living with those terms for an extended period following closing might mean.

- **Political Environment Exacerbates these Risks.** Political tensions around the globe, most prominently between the United States and China, have created new uncertainties over the timeline required to obtain regulatory clearance for major M&A transactions (for example, timing of approvals from either the Committee on Foreign Investment in the United States or the State Administration for Market Regulation of the People's Republic of China is often difficult to predict). In turn, acquirers and targets whose deals require such approvals are agreeing to longer and longer "outside" termination dates for such transactions just as their financing sources are becoming more skittish about syndication risk. In deals where such issues arise, acquirers should flag timing concerns to financing sources early in the M&A process and should work creatively with their advisors and lenders to mitigate the impact on their financing

plan, for instance by committing to syndicate or close financing well in advance of the acquisition, including into escrow.

Eric M. Rosof
Gregory E. Pessin
Michael S. Benn
John R. Sobolewski
Emily D. Johnson
Benjamin S. Arfa