January 13, 2020

Acquisition Financing Year in Review: The Decade of Debt

2019 was another strong year for corporate borrowers, continuing a decade-long run marked by historically low interest rates and strong credit markets. Over the last 10 years, total U.S. corporate bonds outstanding rose from $6 trillion to nearly $10 trillion, while leveraged loans expanded to $1.2 trillion from $500 billion.

But even in the midst of this bull market, new opportunities and challenges arose. Two major trends from the last year stand out—the increased participation of "non-traditional lenders" as a financing source and the continued evolution of "debt default activism" as a material concern for borrowers.

The Acquisition Financing Markets in 2019

Though the credit markets looked shaky as 2018 came to a close, they roared back by early 2019, and corporate acquirers took full advantage. Global Payments raised $5.0 billion of credit facilities to finance its acquisition of Total System Services; United Technologies raised $6.0 billion of credit facilities to support its separation into three public companies and merger of its aerospace business with Raytheon; Broadcom obtained $15.5 billion of term loan facilities in connection with its acquisition of Symantec's enterprise security business; Upjohn obtained $12.0 billion in bridge commitments to support its pending Reverse Morris Trust transaction with Mylan; and Edgewell obtained $1.6 billion in high-yield commitments in connection with its pending acquisition of Harry's.

There were some exceptions to market bullishness—in particular, while credits rated BB or above received very strong receptions, some issuers rated single-B or below, particularly those in challenged industries, found the markets more discerning—but on the whole, the year was undeniably a strong one for borrowers.

Direct Lending Breaks Out of the Middle Market

2019 was the year that "direct lenders"—private investment funds that make large, concentrated debt investments and that have been an increasingly important force in middle-market deals in recent years—began to leave their mark on larger deals. Direct lenders funded larger M&A deals, including multiple billion-dollar commitments.

If your address changes or if you do not wish to continue receiving these memos, please send an e-mail to Publications@wlrk.com or call 212-403-1443.

W/3623595

The main trait that distinguishes direct lending from the high-yield bond and syndicated lending markets is the "direct" element. In the bond and syndicated lending markets, a traditional bank acts as the go-between (*i.e.*, as the "underwriter" or "arranger") between the borrower issuing debt and the investors that purchase it, working to achieve debt terms that "clear the market." The bank receives a fee for its services, and in most cases, it seeks to sell down all or a portion of its investment prior to, or simultaneously with, funding.

In contrast, direct lenders take a "buy-and-hold" approach, a strategy reminiscent of earlier decades, when the junk bond markets were new, and the corporate lending markets were largely dominated by banks like Manufacturers Hanover, Bankers Trust and Chemical Bank that would make, and hold, large loans.

The large and liquid syndicated loan and high-yield bond markets are likely to remain the primary financing sources for leveraged borrowers, but direct lenders offer a set of benefits and tradeoffs that may be of utility in some contexts.

Potential Benefits of Direct Lenders

No flex terms. Commitments from direct lenders, unlike traditional syndicated loan and bridge loan commitments, generally do not include "market flex" terms that allow the lenders to unilaterally impose changes in terms on the borrower if necessary for syndication. For borrowers seeking certainty of terms at signing, this is a meaningful benefit.

Minimal marketing. Because direct lenders do not broadly syndicate their holdings, there is no need for a marketing process (*i.e.*, creation of offering documents and related deliverables, and participation by the borrower in standard marketing presentations). For some borrowers this can be a material advantage and can enhance speed of execution.

Structural flexibility. Direct lenders, with their focus on ultimate returns, may be more willing to engage in structuring to address borrower needs, such as credit ratings treatment and covenants in existing debt documents, and for instance might be agnostic on taking a preferred stock instrument as compared to a subordinated debt instrument, so long as the economics work.

An option in tough markets. Even in years that generally are bullish, financing market "windows" can quickly shift between "open" and "shut" depending on macroeconomic and other factors. Direct lenders, with their committed capital acting as dry powder, can step in at a time when traditional debt

funds face outflows and underwritten bank commitments are more difficult to obtain. Though these circumstances may impact economics and terms, for acquirers and other borrowers for whom time is of the essence, the extra cost can be worthwhile.

Considerations Regarding Direct Lenders

Lender competition remains critical. To obtain the best terms, it is usually beneficial for borrowers to engage with multiple potential financing sources (including both traditional and non-traditional lenders) and to balance healthy competition among potential lenders against relationship, speed and confidentiality considerations. Many factors, from a lender's existing capital allocation to its bullishness on the terms of a specific investment, can impact its willingness to fight for a deal.

Striking a balance across multiple markets. Many borrowers of late have found a sweet spot between the traditional syndicated debt financing and direct lending, relying on the former to obtain low-cost "first lien" secured debt, and on the latter for junior financing. For borrowers, this combination can optimize cost of capital while enabling higher leverage.

Reverse diligence. Before accepting a commitment from a direct lender, borrowers must understand, among other things, the lender's funding ability, track record and general reputation.

Consider a downside situation. Direct lending in its current form is still a relatively recent phenomenon, and thus has not yet been tested in a major downturn. Direct lenders will create a new dynamic for borrowers that are under pressure and seeking lender concessions: across the negotiating table will be a concentrated holder (or club of holders), rather than a diffuse set of lenders with a traditional bank or financial advisor acting as a go-between. In some situations, this could be advantageous, in others, not. For borrowers, before signing on the dotted line, it's worth asking whether the direct lender is a counterparty they would be comfortable negotiating with should challenging times arise.

Debt Default Activism: Borrowers Respond

As discussed in our prior 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. 2019 saw the most prominent example of debt default activism yet come to a swift and striking conclusion, with telecommunications provider Windstream losing its much-watched litigation with the hedge fund

Aurelius Capital—which was widely believed to be "net-short" Windstream's debt—and subsequently entering bankruptcy.

As detailed in our recent memo, Debt Default Activism: After *Windstream*, the Winds of Change, borrowers have increasingly sought to preempt the threat of debt default activism by including drafting technology in new debt agreements that undermines key activist strategies, including net-short strategies. These provisions are evolving rapidly and are worthy of consideration for inclusion in new debt documents by all issuers, whether or not they have previously been subject to activist attacks.

However, with such provisions being new and untested—and, of course, completely absent from debt documents issued before 2019—debt default activism is not likely to subside in the near term. Companies with debt trading below par should stay particularly alert to the threat of default activism, especially when they are weighing covenant-implicating transactions. It is no longer sufficient for borrowers to consider only the "four corners" of a debt document when analyzing whether a transaction is permitted by its covenants, as activists have increasingly sought to meld arguments of breach-in-form with allegations of breach-in-substance. Obviously, major corporate transactions cannot simply be put on hold for fear of a spurious challenge. But before completing a transaction, it is worth assessing what arguments a creative activist could make against it. In many cases, there are proactive process and documentation steps that a borrower can take that will blunt the risk of such future arguments.

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:

- *Post-LIBOR landscape begins to take shape.* Regulators and market participants continue to progress towards replacing LIBOR. In summer 2017, UK regulators announced that they would no longer require banks to submit LIBOR rates after 2021. As such, the markets may now have less than two years to land on a replacement for the controversial, but widely used, floating rate benchmark. The Federal Reserve-backed Alternative Reference Rates Committee (the "ARRC") has endorsed a Secured Overnight Financing Rate (or "SOFR")-based benchmark, though there are several variations of potential SOFR rates that differ in key ways, and some market

observers have expressed concern about SOFR's potential volatility in certain circumstances. Borrowers entering into credit agreements or other floating rate instruments should pause to consider the issue and should be familiar with the ARRC's recently issued form SOFR provisions.

- *"Unrestricted Subsidiaries" under fire*. In several high-profile incidents, borrowers designated a subsidiary as "unrestricted" under their credit documents—thereby freeing such subsidiary from the restrictions of their debt covenants—and then used that freedom as a path to credit-negative transactions. As a result, this debt-agreement technology has now come under focus by investors, who have in some cases sought to place limits on its usage in new debt issued by B-rated issuers. Along with synergy and cost savings addbacks to EBITDA, unrestricted subsidiary provisions have become one of the most closely negotiated provisions in high-yield debt.

- *Emphasizing the "equity" in private equity deals*. In a number of deals this year, private equity buyers have signed up acquisition agreements *before* obtaining debt commitments, instead initially backing their buyout with an equity commitment for 100% of the purchase price. In competitive bidding processes, this tactic allows the PE buyer to move quickly and offer increased certainty of closing. Given the record levels of dry powder at PE funds and the fierce competition for prime assets, we may see more of this tactic in the year to come.

* * *

Eric M. Rosof
Josh A. Feltman
Gregory E. Pessin
Michael S. Benn
John R. Sobolewski
Emily D. Johnson
Neil M. Snyder
Sumita Ahuja