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The International Comparative Legal Guide to:

Lending & Secured Finance 2015

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A practical cross-border insight into lending and secured finance

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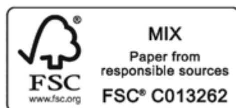

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Global Trends in Leveraged Lending

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The significant global trends in leveraged lending in 2014 were driven by a rise in M&A activity and new money deals, a changing regulatory environment and broad macro-economic and political developments, including a substantial drop in oil prices, fears of rising interest rates (coupled with the consequential pull-back in the fixed coupon bond market) and the long overdue rise of the U.S. dollar. The end of quantitative easing in the U.S. (and the start of QE in Europe), persistent speculation on rising U.S. interest rates and renewed regulatory clampdown on federally regulated entities (e.g., banks) contributed to an environment of volatility. Despite the fluctuation of sentiment and market stability, the leveraged finance market as an asset class performed well. We discuss below specific trends in leveraged lending from 2014.

1 Volatility Reigns

Leveraged loan issuance proved robust in the first two quarters of 2014 and was headed for a record-breaking year until issuance dropped significantly in Q3 (and then somewhat rebounded in Q4) – the quintessential archetype of market volatility. Geopolitical instability and the impact of regulation on banks contributed to the choppy nature of the market.

2014 was punctuated with marked challenges driven largely by government policies. The U.S. Federal Reserve finally ended its quantitative easing programme, while the ECB has just started rolling out theirs. Speculation mounted that the Fed would raise interest rates in the U.S., while in Europe, interest rates are expected to remain low for the foreseeable future. Oil prices suffered one of the largest declines since the 1980s. Tensions mounted between Russia and Ukraine, culminating in robust economic sanctions on Russian trade. The prospect of Greece defaulting on its debt continued to cause concern in Europe. The Swiss Franc was unpegged from the Euro causing a near 30 per cent. rise against the Euro, triggering large losses in the FX markets. Across markets, borrower costs rose and investor confidence oscillated.

The leveraged lending markets in North America and, to a lesser extent, Asia Pacific proved to be more susceptible to these economic and political pressures than their European counterparts. Overall leveraged lending in North America in 2014 declined by around 17 per cent. from 2013, totalling USD $940.06 billion. The U.S. high yield market declined by around 7.63 per cent. from 2013 levels, sitting at USD $307.65 billion by the end of last year. The leveraged lending market in Asia Pacific (excluding Central Asia) fell to a lesser extent to USD $14.2 billion, representing just 1.2 per cent. of the global total, while high yield volumes in Asia Pacific were over USD $18.52 billion last year. In Europe, the leveraged loan market showed a steady increase from USD $191.462 billion in 2013 to USD $200.76 billion in 2014, representing a 4.86 per cent. upswing. According to Moody's, European high yield issuance rose by around 29.69 per cent. from USD $151.9 billion in 2013 to over USD $197 billion in 2014. Loans remained the main source of funding for leveraged finance in the U.S., whereas loan and high yield volumes were almost equal in Europe and high yield was the major source of funding in Asia.

Despite the tepid growth rate and market turmoil of 2014, it was not all doom and gloom. Deal flow remained strong for most of the year as borrowers continued to access the markets while interest rates remained low. Excess cash on companies' balance sheets drove a strong upswing in M&A deals and a consequent rise in acquisition financings. Notwithstanding U.S. banking regulators' efforts to rein in excessive leveraged lending, competition in the credit markets managed to drive average pricing of U.S. leveraged buyouts to near-peak levels, with unregulated credit providers partly filling the liquidity chasm. While overall global leveraged lending decreased by 17 per cent. last year, global loan issuance increased by nine per cent., reaching a notable USD $4.70 trillion, evidencing that, on the whole, loan markets managed to ride through choppy conditions and end in positive territory.

2 Rise of M&A Activity and New Money Deals

The mélange of deals shifted from the refinancings and repricings of 2013 to a renewed focus on new money deals in 2014, particularly to finance M&A activity. Leveraged recaps declined slightly across the U.S. and Europe while ABL deals remained strong in the U.S. Unitranche lending gained momentum in mid-market financings. First and second lien credit facilities also drove volume in the middle market.

Leveraged credit new-issue activity in the U.S. proved robust, reaching the second highest volume on record. Mergers, acquisitions and leveraged buyout activity in the U.S. was at its highest since 2008, at USD $267.34 billion, representing more than a 20 per cent. increase from USD $221.01 billion in 2013. European M&A-related leveraged financings reached USD $60.76 billion in 2014, representing over 30 per cent. of European leveraged loan issuance. Asia Pacific M&A-related financing volumes were at USD $8.9 billion, representing over 62 per cent. of the Asia Pacific total leveraged loan issuance. The increase in M&A deals was partly driven by cash-rich corporates seeking growth through acquisitions whilst interest rates remained low, particularly in the healthcare and pharmaceutical sectors. Private equity deals were less common than in previous years.

Large-cap lending increased significantly while mid-market financing saw less of a growth spurt. There were some jumbo deals in the U.S. and Europe in 2014. In the U.S., U.S.-Singapore chip developer Avago Technologies raised finance of USD $5.1 billion to acquire LSI Corporation and Burger King raised USD $7.25 billion to acquire Tim Hortons. The USD $6.95 billion Petsmart financing was the largest U.S. private equity LBO deal in 2014. Notable European deals included the acquisition financings of the mergers of DE Master Blenders/Mondelez (EURO 7.6 billion), Numericable/SFR (EURO equivalent of 4.5 billion), Dufry/Nuance (Swiss Francs 2.4 billion), GTECH/International Games Technology (USD $10.3 billion) and Combibloc (EURO 3 billion).

In Europe, refinancings totalled USD $130 billion in 2014, as opposed to USD $129.374 billion in 2013, representing over 64 per cent. of European leveraged loan volume in 2014. In the U.S., refinancings totalled USD $546.91 billion in 2014 as opposed to USD $756.77 in 2013, representing over 58.18 per cent. of U.S. leveraged loan volume in 2014. By Q214, companies had already successfully lowered their financing costs and pushed out maturities so as to take advantage of cheap debt financing, thereby lowering the demand for refinancings and repricings. In spite of this, the European market still saw some significant refinancing deals last year (i.e., the refinancings of Grifol (USD $4.8 billion) and Formula One (USD $4.1 billion) and the amend and extend transactions for Alliance Boots (£5.0 billion), Airwave Solutions (£1.75 billion) and eircom (EURO 2.0 billion)). It is likely that the ECB quantitative programme will increase liquidity and promote refinancings and repricings in Southern Europe where borrowers have typically had more expensive financings than their Northern European neighbours who have already largely taken advantage of refinancing opportunities.

This year may pose some challenges to the rapid growth of the M&A boom. The U.S. government recently passed a bill aimed at restricting U.S. corporates from structuring acquisitions that allow them to re-domicile to lower-tax jurisdictions (so called “tax inversions”). Pfizer’s failed take-over of AstraZeneca and Medtronic’s bid for Covidien are representative of the type of deals that the U.S. government is trying to curb. This bill has resulted in certain large cross-border inversion deals being restructured or even cancelled.

Shareholder activism is increasing in both the U.S. and Europe. Several U.S. activists have launched funds in London, including Elliott Management, Tom Sandell and Bill Ackman, albeit that European laws make shareholder activist activity more difficult than in the U.S. Shareholder activism has been a catalyst for transformative corporate events, including spin-offs and related financings.

3 The Reshaping of Liquidity and CLO Issuance

U.S. CLO issuance hit an all-time record of USD $124 billion in 2014, a significant increase from the 2013 levels of USD $85 billion, obliterating the 2006 prior record of USD $97 billion. European CLO issuance increased to EURO 13 billion from EURO 7.8 billion in 2013 but was still less than a third of the peak issuance in 2006. However, Barclays has forecast that European CLO issuance may rise to more than EURO 20 billion in 2015. The CLO market continues to provide attractive spreads to AAA investors, but regulatory overhang from the risk retention rules that will become effective starting December 24, 2016 has adversely affected the year-end issuance of CLOs in 2014 and will likely continue to impact the 2015 pipeline as the market grapples with the potential impact on CLOs. Risk retention is costly, and the requirement will therefore likely slow the influx of new CLO managers and potentially drive smaller managers to combine or exit the market unless they gain access to viable funding solutions that fit within the requirements of the risk retention rules. Investors look to the refinancing option within a CLO as a key part of the economics of investing in these securitisation vehicles, and the uncertainties around how the impact on the risk retention rules on refinancings and questions around managers’ ability to afford the future risk retention already impacts current U.S. CLO issuances. The European Banking Authority recently provided recommendations for how to interpret and apply the European risk retention rules, and among these recommendations was to limit which entities should be permitted to retain the required risk. The recommendation signals a move from an “originator” model where loans could effectively be retained by a special purpose entity set up with the goal of providing a risk retention funding platform towards a “sponsor” model, where the risk will have to be retained by an entity with active involvement in the relevant securitisation. The risk retention rules are already effective in Europe, and until uncertainties around permissible risk retention structures for CLOs subside, the demand from AAA investors will likely be limited.

Relatively deep market liquidity, largely supported by CLOs, has continued to back-stop a market that has seen an overall deterioration in covenant quality and an increase in cov-lite loans, including in Europe. On the other hand, liquidity provided from mutual funds has decreased. A recent focus by regulators (and certain market participants) on deteriorating credit quality coupled with a slight reduction in overall liquidity will likely result in covenant quality improving.

4 European Borrowers Accessing the U.S. Loan Financing Markets

The number of European borrowers accessing the U.S. debt markets has grown. U.S. markets offer deeper liquidity and more favourable lending terms. In the past, European companies would only access the U.S. markets if they had a significant U.S. business. This approach has gradually changed. European companies are increasingly taking a dual track approach where they plan at the outset to syndicate in both the European and U.S. markets (but with the option to drop the U.S. dollar tranche if sufficient debt can be syndicated on satisfactory terms in Europe). The rising U.S. dollar may result in the cost differential between raising money in Europe and in the U.S. (potentially with some level of FX hedging) declining.

One result of the growing U.S. TLB market is that financing terms for loans syndicated in Europe have started to converge with U.S. financing terms. Investors buying into European TLBs are often familiar with the terms of high yield bonds as well as U.S. TLBs. TLBs to European borrowers, whether syndicated in the U.S. or Europe, do not always reflect all the customary borrower-friendly terms seen in the U.S., but further convergence is expected. USD TLBs are usually only borrowed by European borrowers for larger cap deals. They are more often than not cov-lite.

Certain areas where there may be some differences between a covenant package for a TLB for a U.S. borrower and a TLB or other cov-lite loan for a European borrower are referred to in section 7 below, but the area is developing and there are no hard and fast rules.

U.S. deals exclude certain specifically defined and negotiated assets from the definition of Collateral (i.e., equity interests that constitute voting stock of a foreign subsidiary that is a “controlled

foreign corporation" in excess of 65 per cent. of the voting stock of such Subsidiary and certain other UCC asset classes). There is no equivalent to these asset classes in the laws of European jurisdiction and the legal treatment of collateral varies widely between European jurisdictions. As a result, in Europe, it is more common to negotiate a set of security principles which sets out the types of security to be taken. In the U.S., sponsors often resist requirements for control agreements on the basis that these are often time-consuming to put in place. In Europe, the perfection steps for European collateral differ from those required in the U.S. and therefore, different arrangements are usually agreed.

5 Asian Borrowers Accessing the U.S. Loan Financing Markets

TLBs have not taken off to the same extent with Asian borrowers. The deal size, requirement for ratings and higher price tags often precludes a U.S. TLB financing. Recovery ratings may also be low as the legal framework is underdeveloped and there is little track record. Most financings in Asia are bank-led deals which feature less aggressive leverage, higher amortisation and maintenance-based covenants. Accordingly, the whole of the TLB may need to be syndicated in the U.S. This means that the business may need to have significant U.S. links or be owned by U.S. sponsors able to market the debt in the U.S. However, Asian funds have raised significant capital recently and the position may change.

Recent deals have included the USD $520 million TLB for KKR's buyout of Goodpack, the USD $1.805 billion TLB for Japan's Arysta LifeScience, the USD $1.5 billion financing raised for Carlyle's acquisition of Focus Media (which raised USD $500 million within six months for a dividend recap) and the USD $850 million financing of the sponsor-led acquisition of Chinese online gaming company, Giant Interactive. Chinese banks provided two-thirds of the Focus Media financing which incorporated a China holdco financing structure. Such structures present risks in terms of enforcement and upstreaming of cash offshore but are becoming increasingly accepted.

6 Oil/Gas Effect

A fall in global oil demand coupled with oversupply resulted in a steep drop in the price of oil from above USD $100 per barrel (Brent crude) in June 2014 to below USD $60 per barrel at year end, the lowest price since 2009. Consumer-purchasing power increased as gas prices fell and U.S. automakers and airline companies saw a dramatic rise in profits. Net energy importers (including China, which imports 60 per cent. of the 9.6 million barrels of oil it uses each day) also benefited from the lower energy prices.

Although some have benefited from falling oil prices, the exposure of the credit markets to the oil and gas sector is a cause for concern. Approximately 15 per cent. of the high yield debt issued in the U.S. last year was issued by companies in the energy sector. A sizeable share of lending activity in the mid-market has been to oil and gas companies. Over the past few years, energy companies, including companies in the shale business, have borrowed cheap debt, particularly in the U.S. leveraged loan markets, to finance exploration, new production and related services. This has resulted in a number of over-leveraged North American oil and gas producers, as well as small shale companies, which are expected to face financial difficulty if oil prices continue to decline. The drop in profit and turnover of companies in the energy sector also led to the postponement of several financings planned for the end of last year.

It is unclear for how long oil prices will remain low and the impact of geopolitical forces on the situation is largely unknown. Following the 1980s oil price decline, the market reacted by cutting supply and the oil market took years to recover. OPEC has recently announced that it currently does not intend to cut supply to shore up pricing. Watch this space in 2015 for insolvencies, work-outs and distressed dispositions.

7 Cov-lite Loans

Following the trend of 2013, a significant proportion of sponsor TLB loans issued in the U.S. markets were cov-lite, although enhanced regulatory scrutiny of covenant protection tempered this trend. U.S. cov-lite loan volume hit USD $336 billion in 2014, representing an 11 per cent. decrease year-on-year from 2013.

Cov-lite deals were big news in the European market in 2014. Thomson Reuters reported that there were 26 cov-lite deals in Europe in 2014 compared with 3 cov-lite deals in 2013. The largest cov-lite loan in Europe was the USD $2.85 billion loan to finance French telecom's operator Numericable's acquisition of SFR. Other large cov-lite loans in Europe included CEVA Sante Animale (USD $818 million), Siemens Audiology (EURO 785 million), Mauser (EURO 1.6 billion), Continental Foods (EURO 425 million) and Sebia (EURO 500 million). The cov-lite loan product is more common for loans over EURO 500 million. Cov-lite is still not popular in Asia, however.

A cov-lite loan typically does not benefit from financial maintenance covenants, although a revolving facility in the structure may benefit from a springing financial covenant (where a leverage ratio is only tested quarterly if the loan is drawn 25-35 per cent.). Generally, the borrower is permitted to use an equity cure to avoid a breach of such springing covenant. In addition, the financial covenants may now be set with a 25-35 per cent. cushion to the sponsor's model instead of 20-30 per cent. as seen in prior periods. If the covenant is tested on a net debt basis, then there may be a limit on the cash that may be netted.

Standard & Poor's has warned about the risks of the cov-lite product and it has come under scrutiny by U.S. regulators. In the leveraged loan market, only two Moody's-rated loan defaults were recorded in Q314, both outside of the U.S. The U.S. leveraged loan default rate ended Q3 at 0.9 per cent, down from 1.7 per cent in Q2 and 2.9 per cent in 2013. Standard & Poor's has pinpointed 2017 to 2019 as a potential stress point for the global leveraged financial market as hundreds of billions of loans are due to mature in this period.

Rating agency research indicates that recovery rates for cov-lite loans to U.S. borrowers are not significantly less than for loans with financial maintenance covenants. In Europe, there is no track record for cov-lite loans and there is some concern that cov-lite loans to European borrowers may be more risky than loans to U.S. borrowers as European bankruptcy processes do not typically protect enterprise value. A lack of financial maintenance covenants means that there is no early warning system to trigger a restructuring at a time when more options may be open to preserve value outside a formal insolvency process.

It will be interesting to see whether financial maintenance covenants will make a comeback in restructured oil/gas leveraged loans and in light of or as a result of the crackdown by regulators. On the other hand, due to the heightened scrutiny by regulators, the future months may see intense competition between banks over non-criticised, lower levered deals (giving relevant borrowers more leverage in negotiating loan terms).

The structural integrity of covenant packages has further deteriorated in 2014, particularly in relation to the further widening of ratios for incurrence of debt and restricted payments (dividends and distributions and repayment of junior debt). Moody's measures high yield bond covenant quality on a five-point scale, with 1.0 denoting the strongest investor protections and 5.0 the weakest. Moody's Covenant Quality Index, a three-month rolling average measured across all major U.S. corporate sectors, hit a record low of 4.23 in November 2014 and since has shown no appreciable improvement. Covenant quality may improve as the U.S. Federal Reserve winds down its asset purchase programme and eventually raises interest rates.

U.S. large cap and mid cap leveraged loan terms usually permit the borrower to change its capital structure by incurring incremental debt, refinancing (with some exceptions from the soft call premium), carrying out asset sales and retaining the cash and carrying out acquisitions. Incurrence-based flexibility to incur debt outside the credit facilities (e.g., including equivalent incremental debt that shares in the collateral) and the ability to pay uncapped dividends subject to satisfying a ratio test has been a feature of certain 2014 U.S. top-tier leveraged financings.

European deals are beginning to adopt loan covenants similar to those in the U.S. markets, particularly where the loans are cov-lite or include a tranche to be sold into the U.S. While covenant packages vary significantly from deal to deal, there is a trend towards increased convergence in both the U.S. TLB loan market and high yield bond market.

U.S. cov-lite leveraged loans and European leveraged loans traditionally permitted borrowers to borrow incremental debt that fell within a fixed dollar limit. More recently, U.S. borrowers may be permitted to incur debt up to the greater of a "freebie basket" and an uncapped amount subject to compliance with a *pro forma* leverage test (the ratio debt test). There is some restriction on the flexibility in that the incurrence of senior secured debt may only be permitted if a secured debt to EBITDA ratio is satisfied.

Borrowers may be permitted to re-classify debt previously incurred between the basket and the ratio test to free up capped baskets even though the borrower did not have the EBITDA to support borrowing within the ratio test when the debt was incurred. The freebie basket is usually a fixed dollar cap or the greater of the cap and a percentage of total assets or EBITDA, and may be increased if the credit facilities are prepaid or there is a debt buyback. The freebie basket may permit the borrower to incur debt and exceed its opening leverage whatever its financial situation. Borrowers may be required to use the freebie basket before the ratio debt test to try to restrict the leverage increase and the freebie basket is also sometimes subject to flex rights to remove or modify.

The debt incurrence covenant is in some respects similar to the debt incurrence test applicable to high yield bonds which incorporates a fixed charge coverage ratio debt test set at 2.0x and permits utilisation of a small basket on top of this ratio. The incurrence of debt in subsidiaries designated as "unrestricted subsidiaries" (and therefore not subject to ring fencing covenants) is not restricted. European borrowers of larger cov-lite loans syndicated in Europe or the U.S. have been given similar flexibility to incur debt although the freebie basket is not always seen and there is often no concept of unrestricted subsidiaries.

Borrowers may now be able to incur debt under "sidecar facilities" that permit the borrower to issue *pari passu* notes secured by the same collateral as for the credit facilities or to borrow subordinated unsecured debt or possibly secured debt outside of the credit agreement. This flexibility is creeping into the European market. The incurrence of further *pari passu* secured debt raises credit issues in U.S. loans where the lenders of the original loan may no longer be able to control senior secured debt in a restructuring. In Europe, there may be additional risks as a result of the less favourable bankruptcy laws and the issues posed by legal limitations on up and cross-stream credit support by companies in some European jurisdictions where the new debt is structurally senior.

In the U.S. and Europe, most-favoured nation (MFN) provisions usually apply, which means that if incremental debt is borrowed above the yield for the original leveraged loan by an agreed amount, then the original loan's margin may be increased to an amount that is the agreed amount lower than the yield on the new debt. A sunset provision may apply providing that the MFN will only apply until a specified date (usually 6-12 months) after the closing date, although underwriters may have a flex right to remove this sunset provision. Larger cap European deals typically incorporate an MFN but the treatment of the sunset may vary.

U.S. cov-lite leveraged loans often have an "Available Amount" or "builder basket" based on either a percentage of consolidated net income or retained excess cashflow plus certain new equity contributions and returns on capital and possibly declined proceeds from ECF mandatory prepayments or a percentage of total assets. The builder basket can be used to pay dividends, make investments and repay subordinated debt. The underwriters may have a flex right to reduce the relevant percentage. This basket works in a similar way to the restricted payments test in high yield bond covenants. Typically, high yield bonds also require the borrower to be able to satisfy the debt incurrence ratio test in order to make a payment and for there to be no event of default. Compliance with a ratio test and absence of a default are usually conditions to use of the builder basket for the payment of dividends but may not apply to use of the builder basket for the making of investments or prepayment of subordinated secured debt. The use of builder baskets in European deals is still somewhat variable.

In both U.S. and European deals, add backs to EBITDA are usually permitted for non-recurring charges, run-rates cost savings and synergies, particularly as the sponsor model will often incorporate such adjustments. Sponsors may also seek to add back start-up losses for new facilities. In Europe, borrowers may be permitted to add back cost savings and synergies to EBITDA which can be realised within 12 months and which are often capped at a proportion of EBITDA (up to 10 per cent.) and the amount may be subject to certification or verification. In most European deals, equity cures must be treated as applied against debt for the purposes of the leverage or cashflow cover tests but EBITDA cures commonly seen in the U.S. are making their way into cov-lite loans.

U.S. cov-lite deals have typically included soft call protection requiring a 1 per cent. premium to be paid on a voluntary prepayment using cheaper debt or by the same lenders at a cheaper price. Second lien debt may be subject to hard call protection applying also to mandatory prepayment. The soft call protection may not always apply if the borrower is required to refinance its existing debt to complete a significant acquisition or other transformative event occurs. Soft call protection on European TLBs is now becoming standard but the exceptions to the requirement may vary.

Whereas U.S. cov-lite loans may permit asset disposals provided that 75 per cent. of the proceeds are received in cash or cash equivalents and the proceeds are reinvested or used to prepay debt (including *pari passu* debt), European cov-lite loans have tended to use the more traditional formulation that requires all disposal proceeds to be used to prepay loans subject to certain agreed exceptions, including for reinvestment.

U.S. cov-lite loans will typically not cap the acquisitions that a borrower can make, other than with respect to companies that

do not become guarantors or have assets that are unsecured, and subject, occasionally, to certain leveraged parameters. In European deals, acquisition caps remain common but may be limited to a fixed amount or a ratio test (sometimes by reference to total assets). A guarantor coverage test is fairly standard in European deals which requires guarantors to have together 75-85 per cent. of total assets and total EBITDA. The laws of some European jurisdictions make the grant of guarantees and collateral by targets challenging, so the guarantor coverage test adds protection against significant dilution of collateral protection on an acquisition and is often backed by restrictions on value transfers from guarantors to non-guarantors. However, borrowers often request the ability to make acquisitions and not comply with the guarantor coverage test if the grant of guarantees or collateral would be in breach of applicable local law requirements and therefore they do not need to structure the acquisition in a way that would maintain the guarantor coverage.

U.S. cov-lite deals may incorporate events of default that incorporate certain concerns from the equivalent provisions in high yield bonds including aspects of bond-style insolvency events of default. In Europe, the convergence has been more limited even in cov-lite loans. It is an event of default under most European leveraged loans if the borrower defaults on other debt over a threshold, whether or not the debt is accelerated. Sponsors are now requesting that this be limited to situations where there is payment default or acceleration under the other debt in cov-lite loans, but this remains a negotiated point. In addition, insolvency events of default tend to be tailored for the jurisdictions involved, often requiring much shorter grace periods as creditors may be required by local laws to act quicker or potentially lose their rights.

8 Investment Grade Loans

The investment grade loan market remained strong in 2014. Pricing remained fairly stable across the sector allowing for an orderly flow of renewals and extensions. In addition, the sector had a significant boost due to M&A activity in the pharmaceutical industry.

Provisions related to anti-corruption laws and sanctions became more consistent in 2014. Most investment grade credit facilities entered into (or renewed) in 2014 include representations as to compliance with anti-corruption laws and sanctions (typically including a representation that the borrower maintains internal policies and procedures to promote such compliance), a representation that the borrower is not itself the subject of sanctions and a negative covenant prohibiting the use of proceeds of the credit facility in violation of anti-corruption laws and sanctions.

Turmoil in the Europe money markets edged the screen rate for the euro to dip into the negative, prompting many lenders to insist on including a zero per cent. floor, particularly in multicurrency facilities.

A typical component of the change of control event of default in the U.S. loan market is a turnover of a majority of the board of directors over a specified period of time. Delaware courts have addressed that provision, suggesting that such a provision is an impediment to the shareholder franchise and should be resisted by public companies incorporated in Delaware. As a result, some borrowers negotiate very hard to have that component of the change of control definition removed. Lenders have generally resisted the request, and have in some cases resorted to providing a letter to the borrower verifying the strenuous negotiations.

9 Sanctions

The end of the financial crisis saw a resurgence in sanctions and a crackdown on corrupt activities. The Foreign Corrupt Practices Act (FCPA), enacted to ensure worldwide accounting transparency and curb bribery of foreign officials, gained momentum, seeing a renewed enforcement and imposition of sanctions on policy defectors. Banks and corporates alike have become more attuned to maintaining accurate books and records and establishing systems of accountability. The U.S. Treasury Department's Office of Foreign Assets Control (OFAC) was designed to enforce U.S. economic and trade sanctions. Mid-last year, in a joint effort with the European Union, OFAC issued new sanctions targeting Russian banks and energy companies due to the ongoing Crimea conflict. Shortly thereafter, the U.S. government lifted many of its economic and travel restrictions on Cuba, some of which date back to the Cold War. In a renewed effort to create a unified global watchdog, in January 2015, OFAC released its sanctions list in a new, advanced format, as part of an effort to create a "universal sanctions list" that enhances sanctions compliance and can be used by governments worldwide.

Lenders now often insist on the inclusion in leveraged loan documentation of representations and covenants relating to compliance with sanction laws and anti-money laundering and anti-bribery legislation, including OFAC and FCPA. Where compliance is a requirement to the drawdown of a loan to fund an acquisition, the underlying acquisition agreement often includes corresponding provisions so as to protect the borrower, should compliance not be met and financing not be advanced.

Sanctions and political instability has led to a drop in leveraged lending to the CEE, according to Thomson Reuters. Similarly, leveraged loans to Russian borrowers dropped significantly in 2014, due in part to the Russian sanctions which make lending by U.S. and UK banks to Russian borrowers more challenging.

10 Dividend Recapitalisations

Dividend recapitalisations remained in vogue in 2014. Despite the tapering of the Fed's asset purchase programme and the large bond outflows (which have reduced liquidity in the market), dividend recapitalisation deals continued to find the room for leverage. Return of capital through dividends, in *lieu* of full exits, has remained attractive to asset owners where exits are not optimal and the cost of debt remains relatively modest on a WACC basis. For those sponsors that have pushed the envelope on leverage and fixed charge coverage ratios, dividend recap deals have, occasionally, led to ratings downgrades, increased negative scrutiny by investors and a scepticism when the credit returns to market for refinancing. This was particularly the case for credits where the equity investors had already received a complete cash return of equity.

In Europe, the popularity of dividend recaps through the issuance of PIK instruments diminished last year, not least because of the recent Phones 4U collapse. Phones 4U issued PIK securities to finance a dividend to its sponsors, which ended up making a reported 30 per cent. return on their equity and subsequently wrote down the equity by over 80 per cent. Phones 4U went into administration just over a year after the PIK issuance, leaving senior secured creditors with an estimated recovery in the region of 11 to 29 per cent., and the PIK noteholders with no prospects of a recovery. The collapse of the business occurred primarily as a result of the company losing its remaining three key network contracts within the 12-month period. It is a matter for debate as to whether the company would have been able to offer terms enabling it to renew any of its key contracts had it not used its surplus cash to pay a dividend and re-levered.

11 Return of Upward Flex

During April 2014, deals were flexed in favour of investors nearly twice as often as they were in favour of issuers. This is a major

reversal from most of the past 18 months, whereby seemingly endless cash inflows and increasing investor appetite for yield put leveraged loan issuers firmly in the driver's seat. In mid-2014, 17 per cent. of leveraged loans brought to the U.S. market were flexed upward (in the investors' favour) while 9 per cent. were flexed downward (favouring issuers). The remainder went through syndication unchanged. This is the highest percentage of investor-friendly flexes since June 2013.

European leveraged deals last year also saw a greater usage of flex in favour of investors, particularly in the choppy markets towards the end of 2014. Publicity suggests that: the pricing for the EURO 483 million facilities for the acquisition of Corialis was flexed and documentation changes introduced; pricing was flexed on Amdipharm as well as Mercury's STG's 985 million financing; and both structure and covenant flex were introduced in Styrolution's EURO 1.25 billion-equivalent financing.

12 Unitranche Facilities

Unitranche facilities, which have been coined the 'it' product of the credit crisis, gained momentum in 2014, both in the European and U.S. mid-market. Unitranche facilities, which combine the senior and junior tranches into one unified layer of debt under a single credit facility, remained popular among ACPs not subject to the same regulatory constraints as regulated banks. The unitranche loan is divided into first out and last out tranches with lenders entering into an agreement among lenders (AAL). Engineered and repeat relationships between certain senior and junior providers of capital have been a continued noteworthy trend in 2014.

13 Syndicate Control

Given the diversity of possible investors, 2014 saw borrowers seeking greater control over the identity of their syndicate lenders through restricting transfers without borrower consent to clearly defined white-listed entities (in Europe) and prohibiting transfers to black-listed entities (in the U.S.), as well as seeking enhanced consent rights. A white list is a common approach in Europe where the universe of acceptable lenders may be smaller.

Borrowers may have a limited right in certain circumstances to update the list of disqualified lenders after closing. It is not unusual for investment-grade borrowers to be able to add competitors post-closing. Blacklisting reduces the number of potential buyers, which in turn makes loans more difficult to trade, and can exclude those investors who are better able to fight for creditor rights on a restructuring. Data gathered by Xtract Research shows that 77 per cent. of all U.S. loan deals in Q314 included provisions giving borrowers the ability to block individual lenders, up from 51 per cent. at the end of 2013. Most lists are kept privately by the administrative agents and those banks that arrange the deals. Some investors only find out that they have been barred when they try to complete a trade and are turned away by broker-dealers. Others never know.

14 ABL Deals

In 2014, ABL deal flow improved dramatically, with a renewed focus on the middle market. ABL facilities allow borrowers to obtain higher leverage at a lower cost compared to cash-flow-based term debt, while also providing certainty of execution and a flexible covenant package. Just shy of USD $90 billion, ABL issuance in 2014 marked the second highest annual total on record since the financial crisis (following the USD $101 billion logged in 2011). Over 32 per cent. of total 2014 ABL lending represented new loan assets.

In contrast, syndicated ABL tranches, as part of cross-border leveraged financing deals, were rare in Europe and Asia last year, due primarily to the rather complex structuring considerations related thereto (e.g., these deals often involve a sale of receivables to an SPV to ensure satisfactory recoveries on a bankruptcy under the less creditor-friendly bankruptcy laws in certain European and Asian jurisdictions). These structures remain generally more expensive and time-consuming to implement than their counterpart U.S. ABL structures. Conversely, U.S. ABL structures, which often involve lending to opcos with monitored, strictly defined borrowing bases and cash dominion mechanisms, demonstrated on average a 97 per cent. recovery rate upon bankruptcy in 2014, according to a 2014 Fitch Ratings report.

15 Regulatory and Political Overhang

Globally, the strong flow in the leveraged finance pipeline and the strong uptick of new money deals in 2014 occurred in an uncertain regulatory environment. Entities regulated under the U.S. banking system suffered the most, with their structuring of credit constricted by regulatory guidance. Pressure was also felt by PE sponsors and leveraged corporates. Non-bank lenders gained traction as providers of liquidity for higher levered credits.

October 2014 saw the release of the long-awaited risk retention rules – controversial rules that prohibit banks from engaging in proprietary trading and from holding certain investments, a measure aimed at curbing the kind of risky behaviour that helped fuel the financial crisis. This rule has faced countless criticisms. In January 2015, in spite of a veto threat by President Obama, a bill was passed in the U.S. House of Representatives attempting to delay the implementation of the Volcker Rule until 2019 (the provision is scheduled to take effect in 2017), in a move that seemed as politically driven as it was economically steered. At the time of publication of this article, this bill had not yet passed through the hands of the Senate or the U.S. President. Banks do not only have the Volcker Rule to contend with, but also the Basel III requirements. This calls for banks around the world to meet several tough new capital requirements, designed to increase bank liquidity and decrease bank leverage. In December of last year, the Fed went a step further, proposing that the 8 biggest U.S. banks (whose failure could threaten financial markets) comply with even more stringent capital requirements, including holding an extra capital cushion.

Basel III requires banks to more than triple their holding of tier one capital to at least 7 per cent. of risk weighted assets to meet new liquidity standards and capital ratios. The Vickers and Likanen reports issued in the UK propose ring fencing of certain lending activities which is likely to further constrain lending in Europe.

The Leveraged Lending Guidance (issued in March 2013 by the Fed, FDIC and the OCC) has posed some of the biggest challenges for transactional bankers and CLO managers. The agencies issued FAQs to clarify some aspects of the Guidance in November 2014. U.S. regulators are carefully scrutinising 'criticised' loans, being loans where a borrower cannot amortise or repay all senior debt from free cash flow, or half of its total debt, in the first 5 to 7 years. U.S. regulators noted that the number of criticised loans had grown. Three quarters of criticised loans were leveraged loans last year although leveraged lending only represented a fifth of all lending in the U.S. In the FAQs, regulators also clarified that if a bank wanted to extend fresh credit to a borrower whose borrowing had previously been a criticised loan, then the financing would need to meet the

same standards as a new loan using additional measures over and above cutting of interest rate margins or extending of maturities.

U.S. regulators also noted that in the 15 months from June 2013, 15 per cent. of loan transactions had a total debt to EBITDA ratio of 8.1x. Leverage ratios for the financing of large corporate LBOs averaged 6.6x last year, according to Thomson Reuters data. Last year saw a heightened scrutiny on highly leveraged loans having a leverage ratio of above 6x. In response to a widespread outcry by banks and PE sponsors alike, U.S. regulators have been quick to point out that this clampdown does not amount to a 'bright line' test. It is yet to be seen whether this statement is mere rhetoric.

In Q4, some regulated lenders, in response to this renewed scrutiny, scaled back on underwriting loans with a leverage ratio exceeding 6x or with limited amortisation, while other less risk-averse banks continued to underwrite highly levered loans (the EURO 3 billion loan package for the acquisition of Combibloc was underwritten at the end of 2014 at a leverage ratio of 6.5x). The FAQs clarified that the Guidance applies both to relevantly regulated U.S. organisations (irrespective of where the loan is booked) as well as applicable foreign institutions having a U.S. charter and originating and distributing loans in the U.S. Many large European leveraged financings are impacted by the approach of the U.S. regulators, as such financings often rely on underwriting by regulated U.S. banks or involve a distribution of debt into the U.S.

Whilst domestic U.S. growth has a bullish outlook, we expect U.S. regulators to continue to enforce the Guidance with vigour. In addition, the Bank of England has recently stated that it too will commence a review of the risks of the leveraged loan market in the UK. The Bank of England does not possess the same regulatory clout as the U.S. regulators but they would be able to take various measures to decrease leveraged finance risk, such as introducing a requirement for banks to hold more capital or linking compliance with stress tests. It is possible that other European national regulators may in the near future consider monitoring leveraged loans more closely, given the interconnectedness of global financial markets.

It will be interesting to see how regulation will shape loan terms and deal structures. It is likely that there will be a reduction in leveraged loans with a leverage of over 6x. We may see intensified lender resistance to a borrower being able to increase leverage under the debt incurrence covenant, particularly where opening leverage is close to 6x. Similarly, the ability of a borrower to make payments to shareholders and participate in dividend recaps may be more restricted in 2015. Given the focus in the Guidance on amortisation, borrowers may also find it difficult to negotiate carve-outs from ECF prepayments (for example, prepayments of junior debt, non-*pro rata* loan buybacks or the use of ECF for certain investments and expenditures). While still a prominent feature of U.S. leveraged financings, the excess cash flow sweep is often absent altogether in larger European leveraged loans, so it will be interesting to see if it makes a comeback in this enhanced regulatory environment.

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