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Navigating challenging markets, part one: term loan B syndications

By Jason Kyrwood, Meyer Dworkin July 01, 2022

Davis Polk co-head of finance Jason Kyrwood and partner Meyer Dworkin review the tools available to borrowers and underwriters to optimise outcomes in TLB syndications

Recent market conditions have once again highlighted the risks associated with underwriting and marketing term loan B (TLB) and/or high-yield bonds financings. Over the years, loss mitigation technology has developed to address these risks. However, sustained periods of market volatility have been rare, so this technology is not always well understood. In this first chapter of our two-part memorandum on navigating challenging markets, we review the tools available to borrowers and underwriters to optimise outcomes in TLB syndications, notwithstanding market conditions.

The syndicated TLB market operates on an "arrange-to-distribute" model. In the acquisition finance context, a relatively small group of lenders will initially commit to provide an agreed financing package subject to negotiated terms and conditions. These initial lenders, or their affiliates, will then seek to arrange, or syndicate, the financing, selling the loan exposure to institutional and other lenders and investors prior to (or concurrent with) funding, so that the initial lenders themselves are fully de-risked. If the syndication of the loans is unsuccessful, the initial lenders will still be obligated to provide the financing, as successful syndication of the financing is not a condition precedent to the initial lenders' obligation to fund. However, holding TLB exposure that could not be syndicated within the agreed economic parameters is generally a costly and undesirable outcome for arrangers and their lending affiliates. Among other things, the arrangers or their applicable affiliate may need to recognise a loss on the loans held by them, and this exposure may reduce their ability to take advantage of other attractive opportunities to deploy capital. Recent market volatility and delayed or failed TLB syndications highlight the importance of developing and understanding loss mitigation techniques that both minimise the risk of loss and minimise that loss when it does arise.

Market flex provisions

Market flex provisions are ubiquitous in committed acquisition financings, and are at the heart of the loss mitigation techniques mentioned above. These provisions permit the majority lead arrangers to unilaterally modify certain indicative terms set forth in the agreed financing term sheet (or the underwritten document precedent) in consultation with, but without requiring the consent of, the borrower. These adjustments typically can be made if, in the reasonable judgement of the majority lead arrangers, such changes are either "necessary" or, sometimes, "advisable" to achieve a successful syndication. Successfully syndicating a TLB often requires numerous, real-time multilateral conversations between the arranger's sales desk and potential investors, so it is often difficult to determine precisely the combination of pricing and other terms that will result in a fully allocated financing. That is why arrangers typically will seek greater discretion in determining which combination of flex adjustments can be implemented in any particular transaction. While borrowers may fairly object to giving arrangers too much latitude, in practice arrangers will consult closely with the borrower prior to exercising any market flex, with the intent of reaching general agreement on the package of proposed changes to ensure a successful process for both the arranger and borrower.

Categories of flex

The terms that are permitted to be modified pursuant to the market flex provisions, though often extensive in the TLB context, are carefully negotiated and strictly limited. Key among these are economic flex provisions, which would include pricing, call premium, most favoured nation protection, maturity and other adjustments to the key economic characteristics of the TLB. Pricing flex provisions are particularly important, and allow the arrangers to increase the interest rate margins on the TLB by a negotiated amount (often with ratings-based or, for longer-dated commitments, time-based step-ups). They also permit a portion of that increase to take the form of additional original issue discount (OID) or upfront fees on the financing.

A second, potentially powerful form of flex is so-called "structure" flex. In a difficult market, visibility as to the most attractive mix of the debt financing with the greatest source of investor demand is

more limited. For example, in certain financing transactions, syndication may be greatly assisted by reallocating a portion of a contemplated TLB into pari passu high-yield secured bonds (or vice versa). Arrangers may, therefore, seek the right to move a portion of the underwritten financing package into a different – non-underwritten – instrument (e.g., a bond or holdco note) or between underwritten tranches (e.g., from first lien TLB to second lien loan or into a different currency). Borrowers need to carefully weigh the attractiveness of, for example, adding a call-protected, fixed-rate high-yield bond into their capital structure, in lieu of a readily prepayable, floating-rate TLB. Borrowers will also want protection as to the aggregate cost of debt across the capital structure, and may seek to impose a weighted average pricing cap across the entire package and/or specific caps for each debt tranche.

The last general category can be broadly described as "terms" flex. This focuses on modifications to other terms either set forth in the term sheet or in the underwritten precedent that might result in market pushback or prove to be too aggressive to clear, given market conditions. It is worth emphasising that outside of the specifically enumerated flex terms, the arrangers' ability to deviate from the documentation precedent identified in the term sheet is typically strictly limited. Borrowers negotiate for rigid adherence to the documentation precedent – a typical formulation is that the credit agreement must be "identical to" or "not less favourable to the borrower than" the identified precedent (and the target's credit facility, where applicable). This is, at least in part, to preserve certainty of funds – to minimise any risk that the document cannot be agreed by the closing date. Arrangers therefore cannot rely on flexibility to negotiate terms in definitive documentation, but rather must specifically identify areas of potential market pushback and ensure they are covered in flex or explicitly reserved in the term sheet.

Closing and post-closing flex

Most acquisition financing commitments permit market flex to be exercised at closing if a successful syndication has not been accomplished by such date. This feature allows arrangers to make and hold the financing on their balance sheets on the "fully flexed" (i.e., most lender-favourable) terms, maximising the likelihood that the initial lenders will be able to sell the financing post-closing at attractive prices. It also, at close, reduces the extent of the loss that the arranger may be forced to recognise.

Notwithstanding this "auto-flex" right, borrowers and arrangers can and often do agree to defer and reserve flex rights for some post-closing period. Many fee letters expressly contemplate flex surviving the closing date. But even if this is the case, and certainly where it is not, the parties should consider making technical adjustments to the market flex provisions themselves, either through a supplement to the existing fee letter or by entering into a separate post-closing flex letter. For example, any increase in interest rate margins that was formerly permitted to be in the form of OID would need to be paid post-funding as a direct fee to the lenders, and arrangers should consider clarifying that such OID can only be funded with a drawing under the revolving facility (and not the issuance of additional term loans, as is typically the case for pre-closing exercises of pricing flex). On the other hand, if the fully flexed OID is taken at closing, borrowers may seek to clarify that if the TLB is then successfully syndicated within some agreed post-closing period with lower OID than was paid by the borrower at closing, the initial lenders must reimburse the borrower for such excess.

The credit agreement should also permit the amendments necessary to implement any post-closing market flex with as little input from others as possible, consistent with the fee letter flex provisions. The parties should consider how to ensure that the arrangers maintain control of implementing flex even where, for example, the borrower refuses to execute the amendment reflecting that flex, or where there are other lenders party to the credit agreement that do not have a right to vote on the exercise of flex. And there is also the credit agreement "integration clause" to consider, which should expressly reference and include the continuing (and amended) post-closing market flex rights in the fee letter.

Fronting letters

In a financing that involves multiple initial lenders, the fronting arranger (customarily the lead left arranger for each applicable tranche), typically agrees to fund the entire amount of the loans to the borrower on the closing date on behalf of the other initial lenders. The fronting arranger then individually assigns the loan to the institutional investors that received allocations in syndication. In the event that an assignment to any investor does not settle within an agreed period following the closing date, the other initial lenders agree to purchase their pro rata share of the loans fronted by the fronting arranger. This arrangement is documented in a fronting letter signed by the fronting arranger and the other initial lenders. In a deal that is fully allocated at closing, the price at which the other initial lenders are required to purchase the loans from the fronting arranger is known at closing and set forth in the fronting letter.

In a hung deal or a deal that is only partially syndicated at closing, the fronting letter takes on new significance. The first decision will be whether or not the lead left arranger should front at all. As to any portion of the financing that has been allocated to investors, for operational convenience it would make sense for the lead left arranger to front according to the typical arrangements. As for the unallocated portion, however, the lead left arranger may be unwilling to front on the basis that, without an allocated syndicate, each arranger should hold its own exposure. If the lead left arranger does agree to front in this circumstance, it is a different type of fronting from the ordinary case, as the OID that the market will ultimately receive, and therefore the price at which the other initial lenders should purchase the exposure – and indeed whether or not the loan will ever be fully allocated – are not known at funding. The arrangers will in such circumstances need to discuss and agree on the price at which the other initial arrangers will purchase the loans and how any losses in syndication will be shared. The fronting initial lender will also need to have the right to put to the other arrangers their pro rata share of the unallocated loans at the purchase price paid by the lead arranger (or its affiliate) in the initial funding. These complications argue in favour of each lender funding its committed portion of the financing where a deal is not syndicated at closing, unless there is near-term visibility as to post-closing allocations and price.

Sell-down letters

Sell-down letters provide that, for an agreed period post-closing, no initial lender will sell-down – defined broadly to refer to any sale, assignment, participation, syndication or other transfer of loans – any loans without complying with the protocol set forth in the sell-down letter. The protocol provides that all sell-downs be generally made pro rata across the initial lenders, subject to each

initial lender having an opportunity to decline to participate in each pro rata sell-down. While any initial lender may reject the opportunity to participate in any specific sell-down, subsequent sell-downs will continue to be made on a pro rata basis based upon closing date holdings, such that the initial lenders are not incentivised to hold out on an earlier sell-down in favour of a greater than pro rata participation in a subsequent, potentially better, offer. The sell-down letter is intended in a partial syndication to work in conjunction with the fronting letter and ensure an orderly post-closing syndication: the sell-down letter applies to the unallocated portion of the loans, while the fronting letter addresses the allocated portion (though, as noted above, there is some overlap). One challenging issue that arises is the allocation of the underwriting fees that the arrangers are required to use to successfully syndicate the transaction at a price above the fully flexed yield payable by the borrower. As these fees are paid in full to the initial lenders at closing, a suitable mechanism for ensuring each arranger passes through its pro rata share of the fees needs to be either incorporated into the sell-down letter or separately agreed.

Master consents

Assignments of terms loans are subject (other than in limited circumstances) to the consent, not to be unreasonably withheld, of the borrower. In a fully syndicated transaction, a master consent is executed by the borrower prior to closing, pre-consenting to assignments by the fronting lender to all investors that have received an allocation. In a transaction that is not fully allocated at closing, those investors might not be known, such that the borrower may, under the terms of the credit agreement, retain consent rights over post-closing assignments of the then-funded loans. One way to address this and provide arrangers with comfort around a post-closing allocation is to allow the arrangers a specified post-closing period to assign the loans (other than to disqualified lenders) without any borrower consent. If a borrower objects to this approach, an alternative is to get a borrower's pre-approval of likely investors by including those lenders in an executed master consent. Ultimately, a borrower may be uncomfortable pre-approving a broad list of hypothetical assignees, and as a practical matter this will be a topic for discussion between the arrangers and the borrower depending on the status and expected timing of the syndication.

Post-closing trading and loss sharing

It is not uncommon in TLB syndications for the lead arranger to engage in market making activity. In a fully allocated transaction, this may take the form of the arrangers shorting the loans by allocating more than the aggregate principal amount of the loan. The arrangers will then purchase loans in the open market to cover that short position, thereby facilitating early trading in the loans. In a deal that is not fully allocated, the lead arranger may instead seek to support secondary trading prices by going long on the loans for some period of time (either in the initial allocation or via immediate post-allocation purchases). In such a circumstance, the lead arranger may find itself taking losses if it subsequently sells the loans it has acquired at a price less than the purchase price. In this case, the lead arranger may seek to enter into a loss-sharing arrangement with the other initial lenders to ensure that any such trading losses – which are intended to benefit the unallocated loans of all initial lenders – are shared equally among the arrangers.

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Navigating challenging markets, part two: bridge loans and high-yield bonds

By Jason Kyrwood, Meyer Dworkin July 06, 2022

Davis Polk co-head of finance Jason Kyrwood and partner Meyer Dworkin review the tools available to issuers and bookrunners to optimise outcomes in marketing bridge facilities and high-yield bonds

Recent market conditions have once again highlighted the risks associated with underwriting and then marketing term loan B (TLB) and high-yield bond financings. Over the years, loss mitigation technology has developed to address these risks – but sustained periods of market volatility have been rare, so this technology is not always well understood. In this second chapter of our two-part

memorandum on navigating challenging markets, we review the tools available to issuers and bookrunners to optimise outcomes in marketing bridge facilities and high-yield bonds, notwithstanding market conditions.

As discussed in part one, initial lenders are obligated to fund TLB financings to which they are committed regardless of syndication, and that exposes those initial lenders to potential losses if a successful syndication cannot be achieved. A similar dynamic is at play where the contemplated permanent financing package includes high-yield bonds. Due to legal and regulatory restrictions, investors are typically not able to commit in advance to purchase high-yield bonds issued by an issuer. However, the issuer will need committed financing at the time the acquisition agreement is signed in order to assure itself – and the seller – that sufficient funds will be available when needed to consummate the acquisition. A high-yield bridge loan "bridges" this gap by providing the issuer with a commitment from the initial lenders to fund an (initially) short-term loan in the event that the contemplated high-yield bonds are not successfully offered prior to, or concurrent with, acquisition closing. The initial lenders are de-risked of their bridge loan exposure principally through the successful offering of the high-yield bonds which, upon settlement, reduce the bridge commitments.

The initial lenders or their respective affiliates may also seek to de-risk by entering into agreements with investors to purchase participation interests in the bridge loans if they are ever funded. As with the TLB, funding the committed bridge loans (or taking notes issued in lieu thereof that they cannot resell) is generally a costly and undesirable outcome that initial lenders (or their affiliates) will seek to avoid.

Market flex

In the bridge loan context, market flex rights, if any, are usually very limited. That is because the focus from the bridge lender's perspective is not the syndication of the bridge exposure, but rather the reduction of that exposure as a result of the successful offering of the high-yield bond takeout. Where there are bridge-specific market flex rights, they are typically limited to certain adjustments to call protection and structure flex, which allows the reallocation of a portion of the bridge commitments to other parts of the proposed capital structure, such as a second lien or additional TLB. Initial lenders may also be entitled to conform the bridge loan terms to any TLB terms subject to market flex, though commitment letters are often silent on this point.

Securities demand

As noted above, arrangers and issuers rarely expect high-yield bridge loans to be funded and, instead, they serve solely to provide issuers with comfort that committed financing will be available if the intended high-yield bond offering cannot be consummated in connection with acquisition closing. Given this limited function, the issuer and its investment banks focus primarily on the marketing and offering of the high-yield bonds, rather than syndicating the committed bridge loan.

Accordingly, the focus of the initial lenders is less on the ability to flex the bridge loan terms, and more on the ability to force the issuer to issue debt securities – or demand securities – to finance the

acquisition (and reduce the bridge loan commitment) pursuant to a securities demand. The threat of invoking their securities demand rights may be used by the arrangers to incentivise the issuer to consummate a high-yield bond offering in advance of (or concurrent with) acquisition closing, rather than funding the bridge loan and delaying the bond offering until markets improve.

In circumstances where there is no ability to issue the bonds, securities demand also serves as a loss mitigation device by allowing the initial lenders (or their broker-dealer affiliate) to hold bonds, rather than bridge loans, which they may view as less expensive to carry and more readily able to be sold when conditions improve. It is important to note that the initial lenders may only be able to distribute the demand securities post-closing with the cooperation of the issuer – e.g., as to the provision of updated financial information – so including an ongoing requirement for the issuer to provide such cooperation is important.

Certain conditions to a securities demand

Securities demands can typically be exercised no more than two to three times, from five business days prior to the closing date until the 12-month anniversary of the closing date. From the initial lenders' perspective, it is critical that the securities demand may be exercised on the closing date in l ieu of funding the bridge loans**.** Prior to the 2008 financial crisis, it was common to have a post-closing holiday, during which the bridge would be funded and no demand could be exercised. One of the enduring changes in market practice following the financial crisis – in which many investment banks found themselves long large, illiquid bridge facilities – was the broad elimination of the post-closing holiday. Indeed, it is not uncommon in long-dated commitments for the initial lenders to be able to demand the issuance of securities into escrow, subject to certain agreed parameters.

Commitment letters often include a requirement that the issuer be given an opportunity to market the bonds and/or that a customary high-yield roadshow has been conducted, as a condition to making a securities demand. While not objectionable on its face, arrangers should consider whether this requirement effectively provides the issuer with a veto right (by simply refusing to participate in the roadshow). One mitigant is to provide that no roadshow is required if it would be "commercially futile". It is also helpful to clarify that the high-yield bond marketing period – typically a condition precedent to the funding of the bridge loans – satisfies the roadshow requirement; i.e., there is no need to conduct a separate roadshow for the demand securities once the bond marketing period has run.

It is also common for securities demand rights to provide that the issuer need not satisfy certain demands if they would result in adverse tax consequences (typically, borrowers are concerned about cancellation of debt income that may arise from replacing a funded bridge loan with securities issued at a discount to par). Arrangers typically scrutinise this provision carefully to ensure that it applies solely to post-closing demands, so that they preserve their right to demand at closing. The issuer will often still retain the right not to comply with a closing date demand if it would have an adverse tax consequence, but that failure will result in a demand failure, with the associated consequences (described in more detail below). A similar issue arises from a common requirement – often but not always tied to the "no adverse tax consequences" requirement – that a demand may only be made for some period of time if the bonds are being purchased by bona fide third-party purchasers. This can

undermine one of the central objectives of the demand, i.e., flexibility for the investment banks to hold the demand securities for later distribution in circumstances where there is not sufficient third-party demand. Those provisions therefore are typically drafted to apply to post-closing demands only.

Demand securities

There are limits to the terms of the securities that the initial lenders may demand, including with respect to call protection, maturity, seniority and, critically, the maximum weighted average yield and minimum issue price of the demand securities (the total cap). Increasingly, the terms of the demand securities will be tied to the terms of an identified indenture precedent, and/or be required to be "no worse" than the terms of the concurrent TLB. This latter requirement in particular can be problematic and should be considered when negotiating commitment papers. TLB terms have in some respects become more aggressive than typical high-yield bond terms, and there are some terms (such as leverage ratios) that do not translate cleanly from the first lien TLB to the unsecured high-yield bonds.

However, it is the total cap that plays the critical role in determining which party bears the risk of loss in the contemplated high-yield bond offering. Where, for example, a high-yield bond offering is available at acquisition closing at a yield greater than the total cap (usually in the form of an issue price that is lower than the minimum issue price permitted under the securities demand), the issuer has the option of simply refusing to issue the high-yield bonds (at the higher-yield) and, instead, forcing the initial lenders to fund the bridge or, if a demand is made, issue demand securities that bear interest at, or have a yield equal to, the total cap. In practice, the initial lenders may prefer to lock in their loss by compensating the issuer to issue the high-yield bonds at the clearing price (in an amount equal to the difference between the clearing price and total cap) rather than funding the bridge loan or making a securities demand.

Intra-syndicate issues

The securities demand can usually be exercised by a majority of the investment banks determined, in many cases, on the date the commitment letters are signed. Disagreements within the investment bank group over whether to proceed with the bond offering at the clearing price (and realise the associated loss) or to accept the demand securities at the total cap (and other demand terms) and hold them until market conditions improve may lead to interesting inter-bank discussions. In particular, an investment bank that elects to hold the demand securities at the total cap may be required to disclose that fact in the bond offering materials, which may result in market overhang, as investors fear that the demand securities may flood the market at some point in the future.

Alternatively, where a majority of the initial lenders are looking to crystallise their loss, they may elect to reduce the size of the bond issuance, such that it only covers the commitments of the majority initial lenders participating in the offering, leaving the non-participating, minority initial lenders holding an unattractive bridge loan, with no clear near-term path to converting the bridge to securities.

Demand failure events

It is important to note that the failure of the issuer to comply with a securities demand is not an event of default under the bridge credit agreement nor is it a condition precedent to funding of the bridge loan. Nor can the issuer actually be forced to issue the securities. Rather, if a valid securities demand is issued and the issuer does not comply with the demand, the interest rate of the bridge loan increases to a fixed rate equal to the total cap, the conversion or rollover fee on the bridge (usually equal to the pre-agreed underwriting fee on the high-yield bond takeout) is immediately payable, the bridge loans benefit from the same call protection as the high-yield bonds and the issuer's (limited) consent rights to assignments of the bridge loans fall away.

Bridge participations

Initial lenders may seek to reduce their bridge loan exposure through a syndication process. This is customarily accomplished through a participation arrangement, under which institutional investors interested in obtaining allocations in the expected high-yield offering agree to purchase participations in the bridge loan commitment from the initial lenders. The terms of the participation provide that in the – unexpected – circumstance in which the initial lenders are required to fund the bridge loans, participants will within a short period (three to five business days) thereafter purchase their participating amount of such bridge loans from the lenders, so long as the terms of the bridge loans broadly conform to the underwritten terms and subject to very limited conditions. As compensation, the lenders agree to pass through to the participants a portion of the bridge commitment and funding fees paid by the issuer on their participation amount.

Participation agreements do not generally address circumstances in which the high-yield bond offering occurs but at a price resulting in a loss to the lenders (as described above). In such situations, the participants are not typically contractually required by the agreement to assume their pro rata share of these losses, notwithstanding the – unwritten – commercial understanding that the bridge participation will entitle the investor to a corresponding allocation in the high-yield bond issuance. In a fully participated bridge loan commitment, this concern is largely theoretical; if the participants do not participate in the bond offering (or otherwise agree to absorb their share of the loss), the arrangers may refuse to consummate the bond offering, thereby forcing the issuer to draw the bridge loan which will crystallise the loss for the participants.

In contrast, where the bridge commitment is only partially participated to investors, the initial lenders may strongly prefer to cause the borrower to issue the bonds – which they can resell at a loss – to funding the bridge loan, but are unable to pass a pro rata share of that loss to the participants. Although there are regulatory and liability considerations in this fact pattern, appropriate drafting may be able to address this risk in the participation agreements (e.g., allowing the arrangers to reduce the size of the bond offering so that it only reduces the non-participated portion of the bridge loan commitment). In any event, it is critical for arrangers engaging in a bridge loan participation process to fully understand the scope of the participation agreement and available protections or loss-sharing rights, if any.

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