Feature

KEY POINTS

- Debt incurrence flexibility is very wide on European term loan transactions with borrowers benefitting from a range of permitted debt baskets.
- Top of the market trends include aggressive dividend to debt toggles, large inside maturity baskets and generous contribution debt allowances.
- The current macro-economic climate is causing senior lenders to take a more conservative approach to debt incurrence and give additional scrutiny to these provisions.

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Don't put all your debt in one basket: debt incurrence flexibility in leveraged finance transactions

The era of cheap debt is over (at least for now). However, debt of course remains a key financing strategy for European companies. Sophisticated sponsors and borrowers are focused on ensuring maximum flexibility for debt incurrence under the terms of their facilities agreement – both to protect against a downside scenario and to ensure sufficient capacity to meet the requirements of their business plans. This article outlines what those flexibilities currently look like in market documents and where they are heading, with a close focus on the institutional term loan market.

The debt covenant (together with the restricted payment and the acquisition/investment covenant) is one of the key covenants which borrowers focus on. Its purpose is to provide borrowers with sufficient flexibility to incur debt for operational and growth purposes while ensuring that such debt is sustainable and can be serviced over the life of the loan. The covenant links back to the "debt" or "borrowings" definition in the facilities agreement and is often subject to a high degree of negotiation. Exclusions usually include, among others, shareholder funding, deferred acquisition consideration and other contingent funding. Typically, there are two ways for a borrower to incur debt – either pursuant to a pre-agreed ratio test or by using an available permitted debt basket. The different types of permitted debt baskets are set out in more detail below and are usually structured as grower baskets, so they are sized at the higher of a fixed cap amount and a percentage of consolidated EBITDA – the idea being that as the borrower group's consolidated EBITDA grows, so does the basket capacity.

CREDIT FACILITIES BASKET

This is fairly obvious, but the credit facilities basket essentially permits the incurrence of committed day one debt under the borrower's main facilities agreement and refinancing thereof and is sized to reflect that. It is not typically subject to a grower feature though this point is often negotiated. It covers the term facility as well as any revolving credit facility, capex, acquisition or guarantee lines. Originally a feature of the high yield market – where it would provide headroom for future issuance of credit facility debt – it is now commonplace in all term loan transactions.

INCREMENTAL FACILITIES BASKET

A borrower's most likely first port of call for *pari passu* senior debt will be its incremental facilities. Incremental debt (sometimes referred to as an accordion) can either be incurred by borrowers under the same facilities agreement as the initial senior facilities or pursuant to an incremental equivalent debt issuance outside of the facilities agreement (a so-called "side car" financing). The framework for issuance of incremental debt is set out in the facilities agreement and would usually involve the service of an incremental facility notice by the borrower on its lender group, accession of any additional lenders to the facilities agreement and a standard suite of conditions precedent documents. An incremental facility is put in place without requirement for an amendment and restatement of the facilities agreement.

The size of any incremental debt issuance will be largely driven by the specific business need and the borrower's ability to comply with an agreed *pro forma* ratio test discussed in more detail below. There are certain other documentary conditions that will also need to be ticked off ahead of issuance.

You will see "most favoured nation" (MFN) provisions attach to incremental facilities. These "anti-embarrassment" provisions protect lenders under the initial facilities to some degree such that any incremental debt issued within six or, less frequently, 12 months of the initial debt issuance, cannot be priced higher than a certain pre-agreed cushion above the initial debt. In many recent deals, borrowers have also been able to negotiate inside maturity baskets for incremental debt which allow the incremental debt to mature before the existing senior debt (sometimes by passing the MFN protection altogether) and not be subject to the same conditions on amortization. In the current economic environment, senior lenders are much more reluctant to see other debt maturing ahead of theirs and these baskets are either being reduced in size or coming out of loan documentation altogether.

RATIO BASKET

The ratio-based basket allows a borrower to incur debt at any time over the life of the debt facilities provided that a specific *pro forma* ratio test is complied with at the time of incurrence. The tests vary depending on the type of debt being incurred. A typical suite of ratio tests include: (i) a senior secured leveraged ratio for senior secured debt; (ii) a total secured leverage ratio for junior secured debt; and (iii) a total leverage ratio; and/or (iv) a 2:1 fixed charge cover ratio for secured and unsecured debt. The ratio basket for total indebtedness typically permits such indebtedness to be incurred by borrowers, guarantors and non-guarantor restricted subsidiaries (subject to a cap for non-guarantor restricted subsidiaries).

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FREEBIE BASKET

The freebie basket is what it says it is – it is additional debt capacity that can often be used irrespective of the company's prevailing leverage ratio. We have seen this sized anywhere between 25-100% of EBITDA but given market conditions, the size of this basket is dropping.

GENERAL BASKET

A borrower can also obtain additional financing capacity through its general basket. This is a general catch-all debt basket which is available in circumstances where the proposed debt incurrence does not neatly fit into any other basket or permission or the other relevant baskets have been used up. Borrowers should monitor the use of this basket carefully to ensure it is not being exceeded.

DIVIDEND TO DEBT TOGGLE

Otherwise known as the "Available RP Capacity Amount" basket, a dividend to debt toggle effectively allows restricted payment capacity (payments being dividends, distributions, equity redemptions and repurchases) to be sacrificed and converted to debt capacity. Usually this can be *pari* secured debt without being subject to a ratio test. This is a top of the market trend (with European provisions much more aggressive than in the US) which is being removed from deals in the current market environment. If included, the usual points of negotiation are around which restricted payment baskets can be converted, and whether the rate of conversion should be 100% or higher.

ACQUIRED DEBT AND ACQUISITION DEBT BASKET

There are two types of acquisition-related indebtedness which are permitted under a facilities agreement: (i) acquired debt; and (ii) acquisition debt; the incurrence of both is permitted, assuming certain ratio tests are met.

Acquired debt allows for any debt in an acquired entity as long as such debt was not incurred in contemplation of the acquisition and provided that such debt is discharged within a specified period of the acquisition (often three months). Acquisition debt is debt incurred expressly to finance an acquisition and is usually subject to the same ratio tests as specified above.

MANAGEMENT ADVANCES

The facilities agreement also usually includes a management advances permission which allows a borrower to incur debt to fund or guarantee advances made to directors or employees in the ordinary course of business.

CONTRIBUTION DEBT BASKET

The contribution debt basket (often known as the equity credit basket) allows a borrower to borrow additional *pari* senior secured debt on the basis of the amount of equity its shareholders have injected into the restricted group either on a £1 of equity to £1 of debt basis, or in more aggressive deals, a £1 to £2 debt basis, which is common in the US. This has been relatively controversial in recent years with sponsors pushing for the basket to be accessed by non-guarantor entities, thereby permitting the incurrence of structurally senior priming debt. Also note this basket should for the avoidance of doubt exclude any closing date equity contributions.

CAPITALISED LEASE OBLIGATIONS AND PURCHASE MONIES

Borrowers will usually negotiate a capped basket for indebtedness incurred to finance the purchase, improvement, repair, renewal etc of property (including the purchase of stock of a person owning such property). This is often secured on the assets financed and is available to non-guarantors. There had been a trend for these to be uncapped if in the ordinary course of business or consistent with past practice, which has since come out in many more recent deals.

LOCAL LINES

The local facilities basket is very useful for international groups with facilities with local banks that need to remain in place. This debt is usually allowed to be incurred by non-guarantor entities thereby creating structurally senior debt.

RECEIVABLES FINANCING

This basket permits factoring, receivables-backed financing and securitisation debt either on a recourse or non-recourse basis. Non-recourse transactions are generally not subject to a cap while recourse financing is capped. Secured debt under this basket is often permitted to be structurally and effectively senior but capped by the value of the relevant asset. The facilities agreement will also typically include permissions for sale and leaseback and letters of credit subject to individual basket limits and potentially aggregate limits across these baskets. Borrowers should be able to justify these requirements based on their business plans and operational activities.

INCURRENCE TESTING

Borrowers generally have a good deal of flexibility and discretion in how they manage compliance with these baskets. Most European institutional term loans provide borrowers with the ability to incur a single issuance of debt across more than one basket if necessary because one basket is already partially full, or they want to preserve capacity in a basket for a future transaction. Borrowers are also able to reallocate or reclassify used capacity under a debt basket to another basket. The exception to this is the credit facilities basket which is the largest basket and hence typically excluded from the reclassification regime. Borrowers further have the ability to effectively select the dates at which debt incurrence is tested. This can usually be either at the date that the relevant financing is committed or signed up pursuant to definitive documentation, or the date the debt is actually incurred. This allows the borrower leeway to choose an opportune date for deemed incurrence which would be most advantageous from a covenant perspective. Hence, if the borrower elects for the ratio to be tested at the date of commitment, any fluctuation in EBITDA or other ratios shall not be taken into account for determining compliance.

CONCLUSIONS

As we navigate turbulent economic waters, we expect a continued focus by sponsors and borrowers on their ability to incur debt both to protect against any future liquidity shortfalls as well as to meet strategic and operational objectives of the business. Whether the flexibilities outlined above continue to exist or are further eroded will be driven by parties' relative negotiation leverage on a case-by-case basis and the tolerance of the institutional term loan market to these terms. ■