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Feel the flex

As the high yield market stalls, a flexible and creative approach is increasingly important to access liquidity. Journalist Brian Thompson looks at the challenges facing high yield and leveraged loan markets, and the key issues ahead.

While the first half of 2011 saw a buoyant high yield market supporting robust primary and refinancing activity, the second half has been a different story. As Michael Dakin, Clifford Chance partner and high yield specialist, explains, "the first six months was a very busy time, with transactions ranging from all-bond, super senior and *pari passu* deals to new money and refinancing deals. But in mid-July the bank and bond market fell off a cliff due to concerns over the federal budget in the US, the Greek contagion and other macro-economic instability."

In August, there were €2.8 billion of outflows from European high yield funds and the market saw no issuance at all. The situation improved slightly in September, with net withdrawals slowing to approximately €600 million and some new issues led by higher quality credits such as Fresenius, Peugeot and Heidelberg Cement.

With the high yield market freezing up and the lending market also heavily constrained (just €63 million lent during August), conditions quickly became very challenging. Perhaps none were more challenged than those who found themselves caught in bridges – short-term loans designed to provide a bidder with committed financing prior to completion of an acquisition. Given the strength of the high yield market over the last two to three years, numerous deals were funded directly by high yield note issuances and, where funded, most bridges were quickly repaid with the proceeds of bond issuance. With the high yield market suddenly unavailable, some deals found themselves in so-called hung bridges, where the previously agreed route to the other side of the bridge has been swept away by changing market conditions, leaving the sponsor and their lender hanging.

New routes to liquidity

But, as always tends to be the case in leveraged finance, where there's a will there's a way. Or as Tony Lopez, partner in Clifford Chance's Capital Markets

"The markets are presently experiencing considerable challenges and creativity will be key to unlocking the liquidity needed to do deals in the current environment."

Michael Dakin, Partner, Clifford Chance

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James Boswell, Senior Associate, Clifford Chance

practice, puts it, "Money in search of yield will, like water, find its own level – it will seep into whatever cracks are available". This has led to some highly interesting developments, not least the return of mezzanine financing. Declared dead by some commentators following the credit crisis, and kept firmly in the shadows by the high yield market ever since, mezzanine debt was quickly identified as an alternative source of liquidity to tap into in current conditions. And mezzanine players appear to be rising to the challenge, with reports of new funds being raised to take advantage of opportunities in the market.

A good example was the recent Securitas Direct deal, which used a €394 million ($568 million) mezzanine issuance to replace part of a bridge that was originally going to be financed through the sale of high yield bonds. This can be a complex option though, as Richard Sharples, partner in Clifford Chance's Banking and Finance practice, explains. "The challenge is to create an instrument into which mezzanine funds can invest, but which from the sponsor's perspective is not materially different to the bridge facility which the arrangers are already on the hook to provide. From an intercreditor perspective, any solution also has to work alongside the secured bridge and the secured super senior RCF."

We examine later how the use of alternative structures can create a number of potential difficulties, but first let's take a look at some of the other fixes being used to plug the gap created by waning high yield appetite. Swedish cable company Com Hem AB, which is being acquired by BC Partners Ltd, saw arrangers reduce senior leverage on the deal via a €100 million Payment in Kind (PIK) Facility and then place another €50 million to the PIK Facility with Original Issue Discount (OID) of 94-95. Another method that had fallen out of favour, second lien finance (which lies behind the senior debt but ahead of any subordinated debt), saw a renaissance in the deal for German outdoor apparel and equipment company Jack Wolfskin. Although these are likely to be more of a one-off than a precedent, it will be interesting to see the scope of flex terms when the next round of facilities are committed.

Building bridges

As all these examples make clear, flexibility and creativity are key to unlocking the liquidity needed to do deals in the current environment. Achieving this flexibility, however, requires careful attention to a number of issues. On pricing flex, for example, the deal's success will depend on matching the market's demands in terms of yield, balancing both OID and margin, yet at the same time the sponsor will need protection to ensure that the overall cost of any funding increase will be capped. But it is structural flex that offers the biggest potential headaches. Whether it is building flex into new agreements to anticipate possible future needs, or attempting to find flexibility in existing deals, there are a number of key challenges.

To illustrate some of the potential pitfalls in structural flex, James Boswell, senior associate in Clifford Chance's Banking and Finance practice, offers the example of a deal that was meant to be a senior secured bond with a super senior revolver. "It follows the fairly well established market precedent that the bondholders control security enforcement for the first six months, after which the RCF lenders can take over. Now suppose you decide the senior secured bond is too large and that you need to downsize it by slotting in a subordinated bond or mezzanine facility. These junior debt instruments have different rights, but they are each subject to standstill and payment block provisions of up to six months. The upshot is that, without careful structuring, there's a risk that by the time the RCF gets to control enforcement, the junior debt is not subject to a payment block or standstill."

Another issue to consider is security hardening periods. "In a jurisdiction like England issuing new notes should not pose a problem, but in other jurisdictions fresh security documents may be required when new notes are issued. This

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Esther Cavett, Partner, Clifford Chance

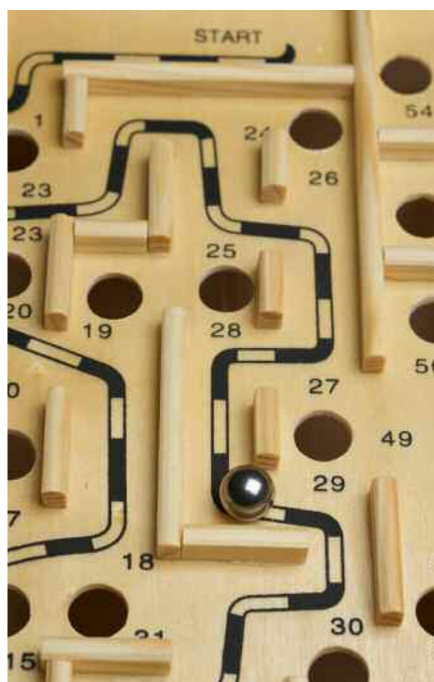
could lead to a challenge if an insolvency occurs, because if the bridge has not been fully paid off they will effectively be sharing in the hardening period risk all over again," James explains. Voting enforcement is another key area. Lenders have generally been able to retain a disproportionate level of control over security enforcement in normal *pari passu* senior secured deals, but bridges are not necessarily being done in this way. Instead, a number give equal treatment to the lenders and bondholders. James notes that "it will be interesting to see whether new *pari passu* senior secured structures follow this more bond-friendly approach when the market returns".

Trustee considerations

With structural flex likely to upset the balance of power between creditors, it's important to recognise the key role that trustees, and their counsel, can play. As Esther Cavett, partner and head of Clifford Chance's Corporate Finance Trusts group explains, "a deep knowledge of what will actually work or not work from a transactional perspective can add significant value".

While many dealmakers are looking to increase structural flexibility, trustees and security agents require certainty, with narrow duties and limited or no discretion. Otherwise they can find themselves exposed to significant liability, particularly where there are different classes of creditors with differing commercial interests. Getting the agreement of the bond trustee will also be vital if the inbuilt flex proves inadequate and an amendment to the transaction is required. Esther also highlights a number of other issues for security agents, including 'snooze you lose' clauses, where security agents might be unable to obtain instructions from their creditor groups within the period. "And how do we deal with a flip from bond to bank control on the enforcement of security where the bondholders have given their instructions, but failed to provide an adequate indemnity to the security agent?", adds Esther.

All these examples highlight the importance of getting the trustee



perspective well before new or flexed transactions get to the final stages.

Back to the future

What are we likely to see ahead? Firstly, more bank bridges with flex to allow the insertion of a replacement instrument that meets capped cost parameters. Also, perhaps, the creation of stand-alone collateral pools that can be tapped into by new creditors without revamping intercreditor arrangements – almost a blending of asset-backed, securitisation and high yield concepts. What seems fairly certain is that the conflation of mezzanine and high yield will continue. As well as mezzanine debt with incurrence-based covenants.

It would also be wrong to write off the high yield market. The US is stabilising with cash flowing back into high yield funds and deals getting done. Indeed major US financial publications have recently been trumpeting how returns are back to levels that far overcompensate for default risk. Perhaps positive sentiment like this could help drive growth in relatively unexplored areas with great potential.

But, as demonstrated by the return of old favourites such as mezzanine debt, perhaps the best way to look ahead may be by examining the past. And looking back to 2008-9, and the looming refinancing wall of 2010 onwards, a creative approach always seems to have triumphed, often finding ways of reusing and repurposing established structures to meet the latest market challenge. As Tony Lopez, paraphrasing Mark Twain, puts it, "history might not repeat itself, but it sure does rhyme."

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