CLIFFORD CHANCE

Client briefing
October 2011

Mezzanine's Moment?

Will the current dearth of the availability of debt in the leveraged finance market eventually lead to the rebirth of mezzanine finance and, if so, on what intercreditor terms?

For the most part, the mezzanine community suffered in the credit crunch as a result of value breaking in the senior debt and the senior creditors (often in conjunction with the relevant sponsor) taking the credit away from the mezzanine lenders, whether by means of a pre-packaged insolvency process or otherwise.

Post-credit crunch, as a result of the availability (until mid July) of high yield and sponsors writing cheques for a bigger proportion of the capital structure than had previously been the case, there have been very few opportunities for mezzanine finance. That said, as we know, mezzanine loans have featured in a few post-credit crunch deals (i.e. Pets at Home, WorldPay, Foncia and IMCD), but the market has predominantly dismissed those deals as creating a precedent for one reason or another (although mainly because a large part of the mezzanine finance was underwritten by persons very closely connected with other parties to the transaction (namely sponsors, vendors or their M&A advisers)).

So, will we see the re-emergence of a market for mezzanine finance with real depth – especially if the high yield market is slow to re-open? A relevant factor will be the intercreditor terms. As previously said, the mezzanine community suffered in the credit crunch and, rightly or wrongly, several members of that community believe that their recoveries would have been greatly improved if the intercreditor terms were more favourable to them. Indeed, in the few post-credit crunch transactions to feature mezzanine finance, the mezzanine lenders have pressed for improved terms.

Key areas where the mezzanine community are focussing their attention are as follows:

1. Concessions to equity:
2. Permitted payments to the mezzanine lenders;
3. Restrictions on the ability of senior creditors to amend their documentation;
4. Amount of senior headroom;
5. Equality of information;
6. Enforcement.

Key Issues

Permitted payments

Senior headroom

Enforcement

If you would like to know more about the subjects covered in this publication or our services, please contact:

James Johnson +44 (0)20 7006 2764

Taner Hassan +44 (0)20 7006 2505

Lorraine Vaz +44 (0)20 7006 2731

To email one of the above, please use firstname.lastname@cliffordchance.com

Clifford Chance LLP, 10 Upper Bank Street, London, E14 5JJ, UK
www.cliffordchance.com

As regards what might be termed the "concessions to equity", these really amount to (i) an ability to allow the future conversion ("toggling") of the mezzanine cash pay interest into payment in kind interest, (ii) having senior lenders on side from the outset of the deal to allow a future conversion of mezzanine loans to equity and (iii) the ability of the borrower to buy-back the mezzanine debt. Prima facie from the senior lenders' perspective the toggling of cash interest and the conversion of mezzanine to equity would not seem to be a problem as it clearly relieves the pressure on cashflow. However, in reality they can also have the effect of effectively increasing the tolerance within the financial covenants to the point where they cease to do the job they were designed to do. To counteract this possibility, the senior community may ask for senior leverage and senior interest cover covenants in addition to the total leverage and total interest cover covenants. At that point sponsors will no doubt take a view as to whether the flexibility they would like in relation to the mezzanine financing is worth the additional covenants. As regards the ability of a borrower to buy back its mezzanine debt, given that most intercreditor agreements have provided that the mezzanine debt can be prepaid with a senior majority lender consent, it would seem reasonable that a borrower should also be able to buy back its mezzanine debt with the same consent.

In relation to permitted payments, the concerns have focussed on three issues. First, the right of the mezzanine lenders to obtain consent and waiver fees where the senior lenders are getting the same. In practice, this is almost certainly not a real issue as if the consent of the mezzanine lenders is required they should be able to ensure that a suitable fee is payable. The second concern is that mezzanine lenders want to be able to ensure that they can have their expenses covered in relation to advice they need in a default scenario. In that respect, the market seems to be moving to a situation where payment of such expenses will be permitted subject to a cap and subject to suitable caveats, such as the expenses are not incurred in relation to litigation. Finally, the last issue is when can stop notices be served by the senior creditors to prevent payments to the mezzanine creditors, i.e. on any senior event of default?, any specified senior event of default? or any "material" senior event of default? To a certain extent this debate is somewhat academic as any senior event of default gives the senior creditors the right to accelerate their facilities and the mere existence of that situation would almost certainly stop payments to the mezzanine creditors. However, once such payments are stopped, all creditors know that the mezzanine lenders will be in a position, subject to the agreed standstill terms, to commence an enforcement process.

Turning now to the mezzanine community's desire to ensure that they have more control over amendments to the senior documentation, it has always been a feature of intercreditor agreements that the consent of the mezzanine lenders is required for increases in senior interest, deferrals of amortisations and like matters, in each case, outside certain parameters. The focus of the mezzanine community has centred on the senior financial covenants and any subsequent tightening of those covenants. That concern is readily understandable given such a tightening would make the mezzanine debt potentially more at risk. It would therefore seem reasonable that the mezzanine lenders have a consent right in relation to the tightening of the senior financial covenants.

As regards senior headroom (i.e. the amount of additional senior facilities that can be provided which will also rank ahead of the mezzanine debt), traditionally that has been set at a level of 10% of the committed amount of the senior facilities with capped accordion type uncommitted facilities being taken into account without eating into the headroom. Post the credit crunch the mezzanine community have sought to have the headroom used up by the amount of waived mandatory senior prepayments (other than facility B/C decline rights), deferrals of senior amortisation and the roll-up of senior interest. It seems that the senior community have little issue with the waivers of mandatory prepayments and deferrals of amortisation, but they find the third aspect harder to swallow as it involves interest and not principal. In a similar vein, there has been another request from the mezzanine community and that is in the event that the senior lenders waive a mandatory prepayment, the amount waived is applied in prepayment of the mezzanine facility. That has not found favour with the senior community as, fairly obviously, in waiving a prepayment the senior creditors will have done so for a reason, i.e. in good times to, say, finance an acquisition or, in bad times, to provide liquidity. However, in fairness to the mezzanine community they could quite correctly point out that in such circumstances they had an expectation that the amount of secured debt ranking ahead of them would come down. It will be interesting to see how this particular point plays out in the market.

The request of the mezzanine community for equality of information is generally aimed at the default scenario. In an ideal world they would wish to see all the reports and other information which is provided to the senior lenders. Understandably, the senior community feels strongly that there are certain items of information that should only be seen by them. The market seems to be heading for a situation where reports effectively commissioned by the borrower (as opposed to the senior creditors) in relation to an analysis of its present and future financial position and the valuation of its business can be distributed to all creditors, while reports giving recommendations for strategic options should only be available to the senior creditors.

Finally, in relation to enforcement the mezzanine community has a number of requests. They mostly relate to proof of value of an enforcement sale and their right to participate as bidders in any process. They want to see competitive situations in relation to an enforcement sale and therefore favour auctions (whether formal or informal), and also want to see independent third party involvement through the appointment of advisers coupled with a duty on the security trustee to consult such advisers on recommended procedures to be used for obtaining fair value. Some mezzanine lenders would go further and press for a fair value opinion (a concept borrowed from the high yield market). In all such cases,

© Clifford Chance LLP October 2011

acceptance of these requests will be the price for the release of the claims of the mezzanine creditors. Additionally, mezzanine creditors also want the right to participate in the bidding process – something which potentially could be adverse to the senior creditors as such right could be exercised to delay (or even frustrate) an enforcement sale.

It will be interesting to see how far the resolution of the above issues determines the availability of mezzanine finance. There are some who would have us believe that mezzanine finance has already been used to take out some of the high yield bridge facilities which have become stuck as a result of the current closure of the high yield market. However, such finance is best recognised for what it is, namely hybrid subordinated debt whose terms are dictated by the constraints of the terms of the original bridge facility and the terms of the agreed pricing and structural flex. For traditional mezzanine finance the market still awaits to see if its moment is about to come again.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

If you do not wish to receive further information from Clifford Chance about events or legal developments which we believe may be of interest to you, please either send an email to nomorecontact@cliffordchance.com or by post at Clifford Chance LLP, 10 Upper Bank Street, Canary Wharf, London E14 5JJ.

www.cliffordchance.com

Clifford Chance LLP is a limited liability partnership registered in England and Wales under number OC323571.

Registered office: 10 Upper Bank Street, London, E14 5JJ

We use the word 'partner' to refer to a member of Clifford Chance LLP, or an employee or consultant with equivalent standing and qualifications.

© Clifford Chance LLP October 2011