July 2012

Looking elsewhere for liquidity – financing options and strategies for European corporate borrowers

Mounting sovereign debt concerns, macro economic woes and the growing impact of capital regulations are constraining the availability of debt capital in Europe. Many corporate borrowers, eager to access greater sources of liquidity, are looking to the US to fill the refinancing gap. A group of Clifford Chance's leading partners explain the main issues facing those looking to raise financing among US investors, and discuss the latest techniques to access and manage liquidity in the international financial markets. Journalist Brian Thompson reports.

"The so-called 'refinancing wall' remains the backdrop for the market, with hundreds of billions of liquidity required to scale it," says Tony Lopez, a partner in Clifford Chance's global high yield practice. The role of high yield issuance in overcoming this obstacle has become increasingly important ever since the global financial crisis, when leveraged corporates had to look beyond constrained bank lenders and find new ways to access capital. As a result, high yield issuance in Europe increased from 10% of all leveraged issuance in 2007 to nearly 50% in 2010. Reflecting its increasing importance, high yield also stepped up in status from junior subordinated to senior secured debt, often sitting alongside term debt and working capital.

European markets update

"The rise of high yield continued throughout the first half of 2011 in Europe, but it was a different story in the second half as the sovereign debt crisis and economic outlook in Europe led to falling confidence and weaker bank liquidity," explains Clifford Chance partner and London-based high yield specialist Fabio Diminich. As a result of these problems, high yield issuance tailed off sharply in the second half of 2011, leaving some market participants concerned about the financing options ahead. However, there has been some good news in 2012. The European Central Bank's (ECB) long-term refinancing operations (LTRO) helped to relieve pressures on bank funding at the beginning of the year. And rising prices on the high yield secondary market have increased investor appetite for primary issuance.

Despite this positive change, the likelihood is that 2012 will continue to provide a constrained environment for those seeking liquidity. Emma Folds, a partner in Clifford Chance's leveraged finance group in London, puts this down to a number of key factors. "Many European banks are deleveraging as they rebuild their balance sheets and may potentially move resources away from capital-intensive areas such as corporate lending as they prepare for Basel III." In addition, many of the collateralised loan obligations (CLOs) which participated in financings at the height of the market are scheduled to reach the end of their reinvestment periods in 2012-14. Emma believes that this combination of factors is affecting not just liquidity for new financings but also

> "The strong appetite of US investors matches up with capital needs of European corporates, making this a marriage that seems desirable to arrange."
> Tony Lopez, Clifford Chance, London

lenders' appetite for refinancing, and even extending existing deals that are nearing maturity. Her impression from bank clients is that while a financing of up to €500 million can be raised in the European syndicated loan market, anything beyond that sum will require bond issuance or syndication to the US institutional investor base.

US Markets update

As in Europe, the second half of 2011 was considerably weaker than the first half, with economic and regulatory pressures bearing down on markets. However, unlike in Europe, the strength of the large corporate loan market was a highlight of 2011. Overall, US syndicated loan market issuance hit a record high in 2011, increasing by 75% to be worth $1.8 trillion. Volume was also up by 47%, representing more than 3,000 deals. Leveraged loan issuance represented nearly a third of the total by value, making it the strongest market since 2007. Refinancings of existing loan facilities represented one of the biggest factors in 2011, particularly in the final quarter when it accounted for almost half of all leveraged loan activity. Although, just as in Europe, there was a marked decrease in volumes in the second half of 2011, the market still looks relatively deep and resilient. "2012 is off to a good start in the US with sponsors back in the marketplace and dividend recapitalisations on the increase. Although refinancings have cooled a little since 2011 peaks, we expect them to be strong all year," adds Tom Schulte, a New York-based Clifford Chance leveraged finance partner.

Perfect partners?

Given the differing conditions in the two regions, it seems that the strong appetite of US investors matches up with capital needs of European corporates, says Tony Lopez, "making this a marriage that seems desirable to arrange".

In Tony's view, US investors are looking for potential European partners that can demonstrate a set of specific characteristics. "Having US operations certainly helps, as the recent acquisition of Belgian Chemicals company Taminco illustrated," explains Fabio Diminich. Taminco has approximately 40% of its operations in the US, making investors more open to European bond issuance. Certain sectors can be at an advantage too. For example, the oil and gas sector is well understood by US investors, as is the fact that even European energy companies tend to deal in US dollars, which also gives them another advantage when dealing with US investors. "But it's not a deal breaker if the issuer does not operate in the US, or in US dollars, especially if the company looking for capital is a repeat issuer," explains Fabio. Even those companies that appear to fit none of these categories, such as Polish company Polkomtel, have succeeded in raising US funds. US investors understand and like the industry Polkomtel is in – telecoms.

Cultural differences – obstacles to a fruitful relationship?

As Emma explains, the starting point for a US syndicated loan would be a facility agreement governed by New York law and subject to the jurisdiction of the New York courts. The drafting style and terminology is likely to be very different from an English law facility agreement, as is the layout and accessibility. As a result, the European leveraged loan investor base will need to adapt to new ways, although there is increasing familiarity with the US approach – through, for example, the New York law-governed incurrence style covenants used in super senior revolvers.

Litigation is another source of concern for European investors. On the plus side, the ability to waive trial by jury and to submit to the jurisdiction of the Manhattan courts can help to reduce the risks. However, there is no avoiding the fact that the US is much more litigious, in general, than Europe. This is, at least, partially driven by the fact that the unsuccessful party does not bear the costs of the litigation and there are many experienced law firms prepared to take action against leading banks.

Another point to consider in selecting the governing law of the facility agreement is that English law allows the lenders to

> "Many European banks are deleveraging as they rebuild their balance sheets and may potentially move resources away from capital-intensive areas such as corporate lending as they prepare for Basel III."
> Emma Folds, Clifford Chance, London

"2012 is off to a good start in the US with sponsors back in the marketplace and dividend recapitalisations on the increase. Although refinancings have cooled a little since 2011 peaks, we expect them to be strong all year."
Tom Schulte, Clifford Chance, New York

effect an English law scheme of arrangement for an overseas company. That option could be valuable for investors as it has been of crucial importance to some recent European senior creditor-led restructurings.

Who's paying?

About three quarters of the US investor base is comprised of non-bank institutional investors, which have very specific requirements. They are only interested in term debt and their experience as buyers of corporate bonds means they have relatively few demands in terms of covenants. They will not, and often cannot, buy unfunded loan commitments. These are left to the banks, which despite only representing 25% of the market, play a huge part in the origination, arrangement and the syndication of nearly all deals.

Given the predominance of institutional investors in syndicates, Emma Folds believes companies seeking financing need to bear in mind some crucial issues. "Careful consideration needs to be given to local law and regulation in a European transaction, for example the French banking monopoly laws and the Swiss 10/20 rule, which may limit the number of funds in the syndicate," Emma says. Withholding tax treatment also needs careful analysis. Many institutional funds are based offshore in jurisdictions that are considered to be tax havens and could be subject to withholding.

Different approaches

As Karen Hodson, a partner in Clifford Chance's London banking practice, points out, there is a tendency for US investors to see Europe as a single homogenous mass. "In fact, it's a complex system of different jurisdictions. Even within the UK, for example, there is English and Scottish law," she says.

Looking at the issue of security, the US regime is generally seen as 'lender friendly', particularly in areas such as rights over property, future liabilities and assets. In contrast, Europe is characterised as more debtor friendly, with the ability to take security not only more constrained, but varying markedly across jurisdictions.

There is a similar contrast between insolvency regimes. While US bankruptcy restructurings (Chapter 11) and bankruptcy liquidations (Chapter 7) lead to relatively predictable, court-led processes, this is not always the case in Europe. While, for example, US commercial counterparties are unable to walk away from their contractual agreements without court approval when a debtor is in a Chapter 11 process, in Europe suppliers and customers have the ability to walk away and leave the company in a potentially more perilous position.

What this means is issues that are satisfactorily covered by federal laws in the US need to be addressed contractually in the EU.

Getting to the church on time

In the US things tend to move faster than in Europe. Initial documentation tends not to be as extensive. "Commitment letters and SPAs are usually signed contemporaneously, syndication frequently pre-dates signing and closing, and term sheets are typically short-form marketing tools," explains Tom Schulte. Detailed terms are often left to be agreed in accordance with market precedent and taking into account market conditions. There is, therefore, a greater ability to exercise market flex than in Europe and a real possibility that the commercial terms may change.

The loan syndication period in the US is also shorter than in Europe. US non-bank lenders tend to focus on rating and price, they have less due diligence to absorb and, if the information memorandum only contains public information, there are no financial projections to analyse. In contrast, European investors would usually require a minimum of two weeks.

The concept of 'certain funds' is also worth highlighting. "In the US the process that roughly gets the borrower and lender

"There is a tendency for US investors to see Europe as a single homogenous mass. In fact, it's a complex system of different jurisdictions."
Karen Hodson, Clifford Chance, London

to the same place is based on the so-called 'Sunguard' provision. This does no more than align the conditionality of the lending agreement with the acquisition agreement so there is no daylight between them," explains Tom. Certain funds provisions under a European facility agreement are nevertheless tighter than a US-style 'Sunguard' provision, and are not always familiar to US counterparties. In an acquisition context, European-based vendors are likely to require European style certain funds provisions.

Speaking the same language – key terms

Three key commercial terms that US investors cannot live without: call protection (soft and hard calls); LIBOR floors (typically 1% to 1.5%); and limited amortisation.

Next are three US conventions that may cause problems for European issuers: covenant lite (although there are some signs that Europe is getting a little more comfortable with this); equity cures (which typically increase EBITDA $ for $); and the absence of a MAC Event of Default (not typically included in a US deal).

Finally, three documentary approaches seen in Europe but not typical in the US: Cashflow cover covenants (disliked in the US, but on the wane in Europe); bank guarantees and ancillary facilities within the revolving credit facility (not typically included in US-style revolvers, which commonly have 'swingline facilities' where the agent provides short notice, short-term loans); and multicurrency provisions (many US deals are domestic dollar deals).

"Most high yield European bond issues are done in a manner where they can be marketed to US investors and, as a result, the securities offering process, the disclosure regime, the rating agency process and the marketing programme match up well."
Fabio Diminich, Clifford Chance, London

Bonds

This article has focused primarily on loan issuance because, for the most part, bond issuance is a lot less problematic. This is, in part, because most high yield European bond issues are done in a manner where they can be marketed to US investors and "as a result the securities offering process, the disclosure regime, the rating agency process and the marketing programme match up well," explains Fabio Diminich. There are few differences in the covenant packages and, in terms of documentation, they all tend to be governed by New York law, with any exceptions tending to be domestically focused issues governed by the home European country's legislation, but with a covenant package nearly identical to NY law bonds.

Will it last?

Tony Lopez points out that the success of transatlantic arrangements needs the parties to receive a good education on the differing requirements of all those involved, and for their lawyers to work closely together to avoid any mismatches. In terms of longevity, Tony and his colleagues believe that the trend for EU issuers looking West is being driven by present conditions rather than long-term structural changes. No-one should, therefore, count on it to last, or underestimate the ability of European debt markets, particularly high yield, to overcome any short-term difficulties and rise to the funding challenge.

Other financing options

Amend and extend – hollow tranches: this relatively new technique is designed to give borrowers the flexibility to extend the maturity of existing debt with majority lender consent. It is particularly valuable where the borrower would otherwise need to get 100% lender consent to do so and where there is no facility change or structural adjustment provision to enable a new tranche with a longer dated maturity to be inserted into the structure. It can also help where there is a structural adjustment clause, but one which requires a consent over and above majority lender consent.

In essence, the borrower seeks majority lender approval to set up a new *pari passu* ranking tranche. The parameters of the new tranche will be exactly the same as the existing facility but will have a later maturity date. In the waiver request, lenders will be invited to roll into the new tranche instead of participating in the existing facility. Lenders who choose to remain in the existing facility will be repaid on the original maturity date. Emma Folds explains, "We have already put this technique into practice on a number of amend and extends, and with the technology and expertise in place we expect more use to be made of it."

Orphan issuer: using a similar technique, it is also possible to bring bond capital into a company via its credit facility. "Using the orphan SPV issuer structure we simulate a *pari passu* bank bond structure; but instead of having notes issued at the bank borrower, they are issued by the orphan SPV, which then takes the proceeds and provides a new tranche of loan under the existing credit facility," explains Fabio Diminich. The notes share the same security and guarantee package as the lenders, but have high yield incurrence-based covenants rather than bank-style covenants. This structure is typically achieved using an existing structural change provision, but as many credit facilities agreements do not have these it may be necessary to go to the lenders to get them inserted or to use the hollow tranche route.

A shadow over shadow banking?

In a market that is currently driven by non-bank liquidity, regulators having got the banks where they want them are increasingly turning their attention to the shadow banking sector. The fact that we have seen a decline in the participation of CLOs and CDOs, and a rise in that of more 'regulator friendly' institutions such as insurance and pension companies, will probably mitigate some of the risk associated with this, but it is a worldwide phenomenon with an, as yet, unknown outcome.

Outlook

Markets in both the US and Europe are likely to be resilient in 2012 and new solutions will appear to deal with any challenges they face. From repeat to debut issuers, from loan to bonds, and from the US to Europe, current markets present real opportunities to be creative in raising and managing liquidity.

Read our other publications…

If you would like to receive copies of our other publications related to this topic, please email: **tarrah.toth@cliffordchance.com**

More Flexible Approach Announced for Non-U.S. Issuers Seeking to Rely on the Section 3(c)(7) Exception Under the 1940 Act (March 2012)

Filling "hollow tranches": an alternative to the "amend and extend"? (January 2012)

Proposed Enhanced Prudential Requirements for US-Based Systemically Important Financial Institutions (January 2012)

Credit protection in investment grade syndicated credit facilities – recent trends (September 2011)

Feel the flex (October 2011)

Shadow Banking and the Funds Sector (June 2011)

Clifford Chance contacts

To discuss any of the issues in this publication, please contact one of our market experts below:

Fabio Diminich
Partner, London
T: +44 20 7006 1500
E: fabio.diminich@cliffordchance.com

Emma Folds
Partner, London
T: +44 20 7006 2231
E: emma.folds@cliffordchance.com

Karen Hodson
Partner, London
T: +44 20 7006 2439
E: karen.hodson@cliffordchance.com

Tony Lopez
Partner, London
T: +44 20 7006 1565
E: tony.lopez@cliffordchance.com

Tom Schulte
Partner, New York
T: +1 212 878 8403
E: thomas.schulte@cliffordchance.com