Goodbye 2016...

2016 was certainly a seismic year, what with the Italian earthquakes, terrorist atrocities on European soil, the escalation of the refugee crisis, events in Syria and voter dissatisfaction with the status quo leading to Brexit, Trump's election and Renzi's defeat in the Italian constitutional referendum.

The resulting political uncertainties have impacted on the European leveraged finance market. The tremors have predictably been felt most in relation to large European LBOs. LCD reports (looking at the latest survey produced by the Centre for Management Buy-Out Research) "*a pronounced fall in the second half of the year*" with half the number of mega deals (being businesses with an enterprise value of more than €1bn) being done in the year to December 2016 than done in 2015 and those deals being worth less than a third of the value of the mega deals done in 2015. The mid-market, whilst also impacted, has remained relatively active notwithstanding the aftershocks.

With money to put to work, loan market investors are chasing what opportunities there are and private equity sponsors are benefitting from this competition in documentation terms.

In Spring 2006 I wrote an article (a version of which was published in IFLR) called "*Too Hot to Handle – developments in the leveraged finance debt market*" which explained how maintaining a balance between competing effectively whilst protecting the viability of the banking package was more difficult for lenders than ever and looking at the then hot topics surfacing in negotiation.

Reading that back, what strikes me is that those same documentation issues have become common again as we end 2016 and actually additional borrower flexibility is frequently being built into today's sponsor-backed finance documents. We are seeing: EBITDA equity cures; the erosion of financial covenant protections with cov-loose packages becoming more common (interest cover and cashflow cover often being the first to be dropped); grower baskets; on-going downwards pressure on guarantor coverage and the scope of Agreed Security Principles; borrower flexibility to make new acquisitions and disposals and to incur additional debt, with incremental facilities baked into the documentation which often have no hard cap and can potentially be made available by third party lenders; and erosions in the de-levering required before dividends can be paid. Then there's the scope of EBITDA adjustments and synergies which remains a hotly negotiated topic on many deals.

Of course leverage is lower in 2016 than it was in 2007. Leverage has been creeping up though with (according to LCD) senior leverage around 4.7x (which is on the par with senior leverage recorded in 2007) and 2016 total leverage averaging 4.97x year to date compared to 6.28x in 2007. There are a few examples of current deals with total leverage above x6 though, including BSN Medical and Parkdean but such deals remain exceptional and have to be seen in light of the size of the required equity cheque.

Against this background, many people believe it to be a good thing that the ECB intend to implement guidelines on leverage along similar lines to the US leveraged lending guidelines which have been in place since 2013.

Whilst the ECB guidance will be non-binding, the supervisor expects all significant credit institutions under its supervision to translate the guidance into their internal policies. It is quite complex to work out the scope of the guidelines. Whilst all "significant credit institutions" supervised by the ECB under Article 6 of the SSM regulation should make the Guidance part of their internal policies, "*the implementation of each aspect of this guidance should be consistent with the size and risk profile of institutions' leveraged transactions relative to their assets, earnings and capital*". Given the structure of many banks operating in Europe, working out which banks/ branches are within scope can be tricky. Having said that, even if an arranger is not subject to either the US or the ECB guidelines (being for instance a British, Swiss or Japanese bank), indirectly they will be affected because many potential syndicate members will be subject to those limitations.

The guidance broadly dictates how credit institutions should monitor and control that institution's risk appetite and governance of leverage loans. It is likely that the biggest issue with the guidelines if they are implemented in their current form will be the "cap" on leverage: "*Underwriting of transactions presenting high levels of leverage* [defined as exceeding times x6 total debt: EBITDA] *should remain exceptional... and trigger a referral to the highest level of credit committee or similar decision-making level. For most industries a leverage level in excess of x6 total debt : EBITDA raises concerns*".

What "a leveraged transaction" actually is for these purposes is widely defined in the draft guidelines and encompasses "*all business units and geographical areas*". Whilst each institution is to come up with its own definition, that should be constructed so that the transaction is treated as leveraged if either: (1) the facilities give the borrower a post financing leverage which exceeds x4 total debt : EBITDA; or (2) where the borrower is a portfolio company owned by one or more financial sponsors (irrespective of total leverage on the deal).

Obviously the definitions of total debt and EBITDA for these purposes are key. It's notable that as currently drafted "EBITDA" refers to unadjusted EBITDA (i.e. realised EBITDA over the previous 12 months with no adjustments made for non-recurring expenses, exceptional items and other one offs). This is different to how EBITDA is usually defined and calculated in the finance documents.

Some commentators have said that the implementation of the ECB guidelines will give competitive advantage to those institutions (in particular to unregulated debt funds and other direct lenders many of whom are capable of doing larger sized deals these days) who are not subject to either the US guidance or the ECB guidance. However, most unregulated lenders in our experience are also keen to ensure that leverage does not spiral further upwards given some of the documentation erosions prevalent in the current market.

So goodbye 2016 – you weren't all bad – after all you brought us the Rio Olympics and Pokémon Go, not to mention 14 successive victories for the English rugby team.

Bring on 2017... and in the meantime the Hogan Lovells team wishes you all a very happy Christmas.

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Some of our Recent Deals

Santander and HSBC
Advising the lenders on the refinancing of the D&D restaurant group

Alcentra and RBS
Advising the lenders on the financing of Equistone's acquisition of Apogee Group

Lloyds, Bank of China, HSBC, ING and SMBC
Advising the lenders on the financing for the acquisition of the Mayborn Group by the Shanghai group Jahwa (an investor controlled by the Ping-An Group)

Ares Management
Advising Ares Management on the provision of finance to VetPartners UK Limited for the acquisition of numerous vet practices

European Capital, ABN AMRO Advising European Capital and ABN AMBRO
Advising the lenders on the unitranche financing for the acquisition of Xendo BV by Sovereign Capital

Lloyds, Hayfin and Bank of Ireland
Advising the lenders on the provision of senior term and revolving facilities in connection with the acquisition by Exponent of the online and publishing business of the Racing Post

Barings
Advising Barings on the unitranche facility to support the acquisition of Michell Instruments by Battery Ventures

HSBC, Lloyds and RBS
Advising HSBC, Lloyds and RBS on the financing for Inflexion's acquisition of Reed & Mackay

ID Logistics Group
Advising ID Logistics Group on the financing for the acquisition of Compagnie Financière de logistique SAS (CEPL)

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