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INTRODUCTION

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What a Difference a Year Makes…

Following on from a booming two years in the leveraged finance market (which, despite the global COVID-19 pandemic, saw record levels of primary leveraged loan and high-yield bond issuances), 2022 can be characterised as a period of stark downturn and market volatility. The European leveraged finance markets look set for their slowest year since the eurozone debt crisis, with reports that primary issuances are down over 80% (for high-yield bonds) and over 60% (for leveraged loans) compared to this time last year.

The events in Ukraine combined with soaring inflation and uncertainty around rising interest rates led to a virtual shutdown of the European leveraged loan and high-yield bond markets over the summer – new underwritten transactions not signed before the Ukraine invasion were largely placed on hold, as underwriting banks have been looking at more and more creative ways to get transactions signed earlier in the year off their books. In particular, bankers have been seeking to pre-place large ticket sizes with direct lenders or with banks themselves, pursuant to Term Loan A (TLA) structures, or to re-cut deals entirely, to try and sell them in the US market instead.

The mood and forecast generally remains gloomy, with a sense that the European markets will be unable to return to normality until there is some certainty around interest rate expectations and an improvement in the unstable geopolitical situation in Ukraine.

An outline of some of the common themes and trends seen so far this year is set out below.

Leveraged Loans, High-Yield Bonds and Direct Lending – an Overview

The key themes affecting terms in the European leveraged finance market – and largely, this is the leveraged loan market, as high-yield bond markets so far generally remain closed (although there have been some green shoots in recent weeks) – have been changes to the size and overall structure of transactions combined with a significant increase in pricing. There has also been some tightening of documentary terms in syndication, largely led by private credit lenders who have stepped into the liquidity gap for syndicated loans left by collateralised loan obligations (CLOs).

In terms of the structural changes, new issuances have generally been marketed at a smaller size than originally anticipated, with large portions of the original debt being shifted into TLAs held with institutional bank lenders (and any underwritten commitment papers signed after the Ukraine invasion generally contain a specific ability to effect this via a “structural flex”). This has become an increasing theme, and, in some transactions, it has become a necessity to deal with a stub, given there is generally insufficient liquidity in the syndicated loan market to syndicate the full amount of the underwritten commitments. This has been done either with the co-operation of the sponsor private equity companies backing the transactions or, for transactions signed later in the year, pursuant to specific flex rights that give the underwriting banks the ability to invoke a structural flex to a TLA if necessary as part of the syndication process and strategy. Given the recent increases in the pricing of syndicated loans (described further below), some banks (particularly commer-

cial and relationship banks) seem to be realising that it is again profitable for them to hold debt on the balance sheet (or, in some cases, necessary due to the lack of liquidity in the syndicated market). Interestingly, the terms of these TLAs are on the whole no different to those of the syndicated term loans or high-yield bonds they have replaced (in particular, they don't necessarily have traditional amortisation payments or a financial covenant).

In addition to the TLA theme, European syndication desks are also looking to US investors to offload their commitments, by re-cutting deals for dollar investors or creating dollar tranches to sit alongside the euro tranches. This has stemmed from the fact that the US leveraged finance markets, although also suffering the effects of rising inflation and uncertainty around interest rate hikes, are more sheltered from the Ukraine energy crisis than European companies, and therefore less affected in terms of reduced liquidity (and so have remained "open").

With secondary levels (across both leveraged loans and high-yield bonds) plummeting to depths not seen since the global financial crisis (with the exception of a couple of months at the onset of the pandemic), coupled with thinning liquidity driven (in the case of leveraged loans) by less-than-expected CLO issuance and, of course, rising interest rates, yields have jumped to eye-wateringly expensive levels, even exceeding 10% (on an all-in basis) for some senior secured issuances.

Besides that (certainly in the top tier/large-cap space), it is notable that – at least in the first instance – issuers/borrowers have continued to seek extremely flexible, "top of the market" covenants and other documentary terms. These have however ended up being tempered to some extent in syndication, particularly where the underwriting banks have sought to sell large tickets to direct lenders. In particular, terms have been tightened to include items customarily or traditionally found only in direct lending "unitranche" transactions, such as a financial maintenance covenant for the benefit of the term debt, "hard" call protection and additional information requirements like provision of an annual budget. Tighter controls around debt incurrence and liens (particularly ability to "prime"), and the ability to make restricted payments, have also been an area of focus and have been tightened in these recent transactions (again, bringing them in line with a more customary large unitranche or direct lending transaction). This appears to be the case even in transactions papered prior to the Ukraine invasion – where the banks were not necessarily contemplating any such syndication to direct lenders and did not therefore benefit from a specifically tailored package of flex items – but have been effected with sponsor co-operation.

The Continued Rise of the "Megatranche"

In recent years, there had already been a rise in the provision of financing by private credit funds on a bilateral or club basis, as an alternative to the syndicated term loan and high-yield bond products. Credit funds were already increasingly competing with banks to underwrite deals directly, whether in full or together with another credit fund, and whether for the entire capital structure or part, and have since become willing and able to finance ever-larger deals and to compete with underwriting banks on documentary terms. This theme was further compounded by both the COVID-19 crisis and, more recently, the Ukraine energy crisis, as direct lenders continue to seek to entrench themselves as an alternative option for large transactions and take significant market share from the syndicated and

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high-yield bond markets. This has become even more viable given the increases in pricing that have affected the new issuances in such markets (as described above) and the risk of execution (private credit funds/direct lenders hold the debt to maturity and there is no syndication risk involved for the sponsors/borrowers).

While in previous years the terms of unitranche deals were much more conservative than the alternative financing sources available to private equity firms and companies in Europe – and were generally utilised in small or mid-cap transactions – since 2020 the terms and conditions executed on such transactions have been moving even closer to the terms in the large-cap syndicated or even high-yield bond markets. On the whole, some differences remained even prior to the recent downturn (given the difference in underlying investment philosophy between such credit funds – that take and hold the relevant credit – on the one hand, and underwriting/arranging banks – that syndicate to investors – on the other) but the convergence has become even more notable in 2022 given the fact that the syndicated loan markets have, as described above, themselves been influenced by (and moved towards) the unitranche/direct lending markets.

Other Notable Trends

Environmental, social and corporate governance (ESG)

Throughout the course of last year, ever-increasing volumes of ESG bonds and loans were seen in the European leveraged finance market – particularly "sustainability-linked" high-yield bonds and syndicated loans (with over 40% of new issuances of loans and nearly 20% of high-yield bonds containing some ESG element). This theme has continued in such new issuances as there have been in 2022, with a significant number of them continuing to be "sustainability linked" (and this also extends to new direct lending or unitranche deals too).

As part of this rise in ESG-linked products, borrowers and issuers (and the sponsor private equity companies behind them) have become increasingly creative in the use and setting of, and measuring compliance with, the relevant key performance indicators (KPIs). In response to this, and having regard to the recently published International Capital Market Association/Legal Marketing Association (ICMA/LMA) guidelines relating to sustainability-linked loans and bonds (and to allay concerns around "greenwashing"), the market seems to be moving towards a more standardised approach to documentation. In particular, what has been seen in more recent deals in the market is increased focus on the determination and measurement of KPIs, and in particular on ensuring some form of third-party verification (via an independent adviser) to verify compliance with the relevant KPIs on a yearly basis. This was always expected by investors in the bond market but has not historically always been required in the loan market.

Restructurings

Given everything that has been said above, it is perhaps not surprising that restructuring activity picked up in 2022. While the signs of distress existed prior to 2022, the geopolitical and macroeconomic events of 2022 have served as a catalyst to move things along. With the iTraxx Crossover Index touching 650 at the time of writing, the markets certainly seem to be pricing in a wave of restructurings in the short-to-medium term. Soaring inflation, a hawkish Bank of England, the recessionary outlook and floundering sterling will likely combine to put UK issuers high in that pecking order.

Conclusion

A decade of the bull market, fuelled by cheap debt and high leverage, is well and truly behind us. And with no obvious stimulus to stem the tide, the recovery promises to be long and slow. For years, market participants have speculated on how sponsors, borrowers and/or creditors would react in a distress scenario against the backdrop of cov-lite financings and aggressive documentation. The following 12 months will likely answer that question. But with private credit funds sitting on ample amounts of dry powder and looking for opportunities to invest with the thinning M&A pipeline, "priming" and "uptiering" transactions may be more than just buzzwords in 2023.

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Milbank LLP has been in London for over 40 years, assisting clients with their most complex, high-profile and ground-breaking cross-border transactional and contentious matters. Now the second-largest office in Milbank's global network, the London office has over 160 lawyers providing English and New York law advice on UK, pan-European, Asian, African and other global matters. The strength of its leading UK and US practices provides the firm with a unique ability to handle the most complex and demanding transatlantic mandates for its clients.

Contributing Editors

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