

Milbank



10 QUESTIONS

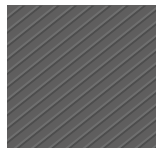
DEVELOPMENTS IN LEVERAGED FINANCING

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10 QUESTIONS: DEVELOPMENTS IN LEVERAGED FINANCING



FW speaks to Neil Caddy, a partner at Milbank, about developments in leveraged financing.



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FW: Reflecting on the last 12-18 months, what do you consider to be the most significant developments in leveraged finance? What overarching trends are prevalent?

Caddy: The last 12 to 18 months has seen the continued development of the cov-lite loan product in Europe and an uptick in the number of alternative capital providers out there offering a wider array of products to a wider array of borrowers. On the cov-lite side, the product does seem readily available for big-ticket financings in particular and absent a wider market correction, seems here to stay. Indeed, many smaller credits have also been able to access the cov-lite market, although the availability in that space will be more dependent on the particular credit in question. The sheer number of alternative capital providers which have entered the market or raised funds to be deployed in Europe over the last 12 to 18 months mean that borrowers have many more avenues to explore when seeking to raising funds.

FW: How would you characterise the demand for leveraged finance? What activity levels and deal volumes are you seeing in the M&A and high yield markets?

Caddy: Overall this year, demand on the borrower side has not been that high. Deal volumes are generally quite far below what we've seen in prior years, both in the loan and high yield markets. M&A driven leveraged finance has threatened to pick up, in particular with some large ticket deals potentially coming to market, but a number of high profile transactions have ended up with an IPO or the target has been sold to strategic buyers leaving the leveraged finance market frustrated. That said, there do seem to be quite a few auction processes either in progress or about to kick off, so the signs are that Q2 will be stronger than Q1. At the moment, my sense is that there is demand from the buy-side for paper but that the

deals aren't there yet to satisfy that demand.

FW: Have there been any recent leveraged finance transactions which reflect the nature of today's lending environment?

Caddy: One interesting transaction announced recently was the 625m unitranche provided by one fund to the Italian chemicals group Polynt. It's more evidence that alternative capital providers seem to have more and more capabilities to write cheques that would historically have been too large for funds. I think the perception is still that deals of this nature will be one-offs and that transactions of this size 99 percent of the time will be financed by traditional syndicated loan and debt capital market deals, but it will be interesting to see if this perception continues if more funds demonstrate that they are willing and able to deploy this amount of firepower. It seems to me that the nature of the funds providing this capital, being as they are 'take and hold' investors, will mean that doing deals of this size – or anything approaching it – will remain rare and highly dependent on the nature of the credit they are financing.

FW: Would you say there has been a significant shift in the attitude of banks and other lenders, in terms of the overall culture of lending, and the appetite to lend? In what ways has the diversity of the market changed the way capital is sourced?

Caddy: The proliferation of alternative capital providers indicates that either the lending attitude has shifted or at least banks will have suffered as a result of the competition. In some cases, alternative capital providers may well have a competitive advantage in terms of being more nimble in gaining approvals for transactions and generally able to do more bespoke deals that don't necessarily conform to the norms that bank lenders would be accustomed to. However, this generally comes at a price; indeed, a

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number of alternative capital providers – although not all – will have return hurdles which mean they are more expensive. Financing approaches have changed, more options will be entertained. As for borrowers, there are more options to choose from and debt advisory firms will often facilitate the process.

FW: How is the current attitude of lenders to risk impacting the way deals are planned and structured? How would you describe trends in loan pricing and covenants?

Caddy: There will always be pressure on terms from debtors and there will always be pressure on the lender side to ensure discipline with respect to deal structuring and credit analysis. However a paucity of deals can actually lead to a worsening of terms for investors since they are chasing deals in order to deploy capital and therefore with fewer deals to choose from have less incentive to push back on terms. That said, I don't think we have seen a marked reduction in pricing but I think we are continuing to see the continued influence of looser terms being imported from the loan market in the US and the high yield market. Alternative capital providers also face pressure to loosen terms but for the most part they are successful in resisting aggressive terms that are prevalent in the syndicated loan and bond markets.

FW: Can you outline any innovative products or structures being employed in transactions?

Caddy: There hasn't really been too much in the way of new or innovative structures recently. First out/second out unitranche structures provided by funds have been around a while now. Cov-lite transactions will usually contemplate what could potentially be quite an interesting capital structure as they will be set up to allow the incurrence of first lien notes and loans, second lien notes and loans and senior subordinated notes and loans – and any

combination thereof, but typically only one or two of those instruments will be there on day one. This makes for an interesting intercreditor agreement as they will be 'future-proofed' so that new debt can just 'plug-in' in the future.

FW: What challenges exist for lenders in complying with today's more rigorous regulatory environment? How do you expect the regulatory regime to develop going forward?

Caddy: Banks will continue to have to grapple with the additional capital controls and requirements associated with Basel III and its implementation through the CRD IV Directive. Plus, the leveraged lending guidelines issued by the Federal Reserve in the US will also continue to affect banks that operate in the US or are regulated there, even with respect to lending activities carried out in the UK. It will be interesting to see if the regulators turn their sights on alternative capital providers at all.

FW: To what extent does the current macroeconomic landscape affect the dynamics of the leveraged finance market?

Caddy: The macroeconomic environment certainly does have a significant impact on the leveraged finance market. The bond market is more sensitive than the syndicated loan market, but both markets are influenced. They are influenced in terms of the number of deals that are being done – M&A volumes will deteriorate if buyers and sellers are holding off until economic uncertainties have passed, and equally investors will be reticent about investing when there are macroeconomic factors at play which will impact liquidity and, therefore, pricing and potentially whether banks are confident enough to underwrite deals. At the moment the Brexit referendum looms large; as we get closer to 23 June, I suspect that a lot of activity will pause until after the result of the vote is announced.

FW: What advice can you offer to entities looking to secure leveraged finance? How can they increase their chances of success within the lending environment?

Caddy: Put simply, those looking to secure leveraged finance are best served by appointing a good adviser.

FW: What expectations do you have for the leveraged financing market over the next 12 months or so? Are there any particular trends or new developments on the horizon?

Caddy: The coming 12 month period is difficult to predict. As mentioned, the Brexit vote is imminent and a lot could depend on that. In any event, given activity levels to date this year, it seems that deal volumes in 2016 will not reach 2015 levels unless Q3 and Q4 are very busy. However, I think the trends referred to above will continue. It will be interesting to see the development of the alternative capital market. I've seen various reports which variously foretell of funds eating banks' lunches or pies. Clearly, the funds active in this area have demonstrated a healthy appetite but it remains to be seen whether the banks will be going hungry. ■