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US debt for European deals

Accessing the high yield and US bank finance markets is increasingly attractive for European private equity deals, write Latham & Watkins' Dominic Newcomb and David Walker.

While the last 12 months have continued to see improvements in liquidity in the European leveraged finance bank lending markets, including the (limited) re-emergence of various CLO funds which were a significant driver of the private equity boom through to 2007, the availability of senior and mezzanine finance packages with the right combination of required quantum, competitive pricing and flexible terms remains subject to certain constraints. As a result we have seen private equity sponsors increasingly seek out alternative arrangements to finance their deals. This has led them to look to both the high yield market and the US bank finance market for debt.

WHAT'S HAPPENING IN THE MARKET?

At press time, the European high yield market was enjoying another record year of issuance and had out-paced the loan market in terms of quantum. Indeed, whereas historically high yield was just part (and the junior piece) of a sponsor's overall capital structure, we have increasingly seen transactions funded entirely with bonds (either a single tranche or multiple tranches with resulting priority arrangements) with, if required, a (smaller) super senior revolving credit facility. In such structures, the bonds will be governed by New York law with the revolving credit facility governed by English law, but the latter will also have a negative covenant package (and potentially other provisions) mirroring the equivalent bond clauses and being interpreted in accordance with New York law. In addition, in an auction, the sponsor will require bridge facilities (typically English law but again with bond-style covenants under New York law) at the time of signing up to the purchase, pending the opportunity to issue the bonds either into escrow pre-closing or otherwise shortly post-closing to refinance the bridge loans.

Similarly, a number of deals have been financed in the US term loan B market which has been able to meet the requirements of sponsors described above, in particular with respect to lower pricing and increased flexibility, and potentially with covenant-lite structures including those without financial covenants save for a leverage ratio which applies only to the benefit of lenders with respect to any revolving credit facility and then only applies when more than an agreed amount of such facility is drawn. In such situations, the loan financing is documented under New York law and largely in accordance with US market practice, but with some or all of the debt intended to be allocated to European investors.

WHAT IMPACT IS THIS HAVING ON TRANSACTIONS?

While the trends described above have given sponsors greater access to liquidity, they have also made financing structures more complex. This requires all parties involved, whether sponsor, lender, investor, legal advisor or otherwise, to be able to offer expertise across multiple products, geographies and legal systems.

The complexity involved in successfully accessing these markets should not be underestimated: indeed the differing laws, market practices, and insolvency regimes all combine to create potential conflicts and inconsistencies that need to be very carefully navigated. For example, sellers expect private equity buyers to have "certain funds" to finance an acquisition in Europe at the time of signing a sale and purchase agreement; in the US, this level of certainty is still a foreign concept, with debt commitments – and therefore sale and purchase agreements – more conditional than in Europe.

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In addition, significant thought needs to go into making the structural adjustments required to enable (in particular intercreditor) provisions originally intended to operate under the US Chapter 11 insolvency regime to work effectively under the myriad of different insolvency regimes throughout Europe, and indeed in some cases the market has not yet determined how many of the differences should be addressed. There are also material co-operation provisions, which will be quite foreign to many European sellers, that need to be included in a sale and purchase agreement to ensure that the target provides the assistance required to the private equity buyer to enable it to access the high yield markets as quickly as possible and (ideally) to avoid funding under the bridge facilities at closing of the sale. On top of all this, the private equity sponsor needs to ensure, particularly in an auction context, that the seller does not have any concerns about the interaction of US and English law and US and European market practice which could impact on its ability to commit to and fund the transaction.

While the European private equity market developed from the US market some time ago, deal terms have become materially different. It will be interesting to see if over time the growing use of US law and market financing techniques will result in a broader convergence of deal terms between the US and European private equity markets. In the meantime, lawyers able to provide the expertise described above are being kept very busy.

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