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Why sponsors are extracting the cash

Cover story

Private equity firms and their lawyers argue that loosening the restricted payments covenant is necessary to ensure their interests match those of the borrower by keeping the sponsored company in financial good health. But it's a controversial development, finds David Turner

There's an old joke that runs as follows: "A large hole has appeared in the road. The police are looking into it." Readers may not be laughing; lawyers certainly aren't.

Lenders have always allowed for some money to be taken out of borrower companies sponsored by private equity under pre-defined conditions; they have even, in many cases, permitted the removal of assets. However, the holes by which the money can escape are getting bigger and more numerous. Sponsors and their lawyers defend this by arguing that their interests match those of the borrower: to keep the sponsored company in financial good health.

Experts often refer to this phenomenon as "leakage": the ability of sponsors to take value out of their investments. The clauses that govern the removal of cash are known as restricted payments clauses.

Some sponsors also seek the ability to move assets from those subsidiaries of the company that are governed by the terms of the loan agreement

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>
> **TEMITOPE ADESANYA**
> **Reorg**

to those that are not. The latter are known as "unrestricted subsidiaries" (see box on J Crew).

"In terms of restricted payments, there's an unending assault on the protections that investors used to have," says Temitope Adesanya, senior legal specialist at Reorg, the financial data provider, in London. "A lot of investors feel that in a lot of instances they can't push back on the flexibility demanded by borrowers."

Reorg numbers show that in 2019, 17 percent of European syndicated deals allowed sponsors to keep taking restricted payments out of a portfolio company even if the business was in default or had triggered an "event of default" – a serious adverse event, such as a covenant breach. In industry parlance, there was no "default stopper".

Going ultra-loose

Figures for US syndicated loans from Covenant Review, an arm of ratings agency Fitch, show a marked rise in incidence of an ultra-loose form of control on restricted payments, whereby money in restricted payments baskets is out of reach only if there has been an event of default involving non-payment on the loan or bankruptcy. The numbers have risen from 14 percent of deals in 2017 to 23 percent in 2019, and to 31 percent in the first eight weeks of 2020. The most stringent terms – where the basket is not available if any default has occurred for any reason – were seen in 31 percent of deals in 2017, but only 22 percent in 2019.

Similar data for direct lending deals rather than syndicated loans are harder to come by. However, experts believe the direct lending markets show a similar trend.

Scott Selinger, finance and private equity partner at law firm Debevoise & Plimpton in New York, detected the first sign of "some shift from the more traditional restricted payment construct" in 2012-13. Before this point, "the vast majority of the capacity to take money out of the company was based on some kind of builder basket linked to financial performance, with more limited general baskets". Under this traditional system, the builder basket started at zero on day one, and then gradually built up as the borrowing company generated money – hence the name "builder basket". For bonds, this was most often a percentage of consolidated net income – often 50 percent of it – and this measurement gradually seeped into the upper reaches of the loan market. However, excess cashflow – generally net income plus depreciation and amortisation, but minus capital expenditure needed to sustain operations – tends to be used for smaller loan deals.

In the old days, this basket was generally governed by a default stopper: if the borrower had defaulted or was set to do so, no money could be taken out of the basket by the sponsor. Moreover, if 50 percent of CNI was added, by the same token in bad years 50 percent of negative CNI was taken away.

General baskets, also known as free baskets, contain a pre-set amount of money that the sponsor is allowed to take out of the portfolio company, without this money having to be earned by the gradual accumulation of net income or other such measures. These can be used by the sponsor to do various things – depending on precisely what has been negotiated for each general basket – such as taking dividends or paying down more expensive junior debt. They are different from investment baskets, which can be used to make investments in unrestricted subsidiaries.

However, Stephen Mostyn-Williams, a Europe-based consultant to investment funds, says the terms of some investment baskets have recently been loosened so that the money can be paid to the sponsor in a roundabout way, thus creating what he describes as "a very large hole".

Sponsors were also often able historically to negotiate permitted payments baskets: baskets that gave them an additional amount of money they could take out of the company, without having to meet any conditions.

Legal wrangles are rare

Greater freedom around restricted payments can be beneficial and, even where it's not, there's scant appetite to take action

"See you in court" is a common threat in *Suits* and other legal dramas on TV. After sober consideration, however, it is rare for lenders to make good on this threat in real life, no matter how aggrieved they are about clauses for restricted payments and unrestricted subsidiaries.

This is partly a question of timing: at a benign point in the credit cycle, sponsors have not had to stretch the bounds of what is possible in their credit agreements very often.

Another consideration is that even when businesses are in trouble, in most cases sponsors are not simply abandoning portfolio companies and their lenders to their fate in order to focus instead on buttressing their own returns. "For the most part, the instances in which the market has seen the restrictive covenants have an impact are not scenarios in which sponsors say, 'Great – I have the ability to pull money out and pay dividends to my investors,'" says Judah Frogel, a partner in Allen & Overy's New York office. Instead, they have used these freedoms mainly to engage in what he calls "self-help manoeuvres", where the sponsor tries to stave off the fall of a portfolio company into distress.

For example, the sponsor might move assets around to refinance and reduce expensive junior debt. In many cases, the senior loanholder might well accept the need for debt restructuring if this improved the chances of keeping the company going. The bone of contention is that it would prefer to have a say in this restructuring, and the power to agree a compromise that protected its interests.

On the other side of the Atlantic there are cultural barriers to legal action. "In Europe, bondholders are incredibly litigation-averse: they don't really sue," says one observer of the European scene.

But even in the US, lenders may ultimately recoil from legal action because of a lack of ammunition. "Investors might say, 'We never intended that a sponsor could move assets and put them in an unrestricted subsidiary, where they could be used to pay down junior debt and allow the junior lender to leapfrog us in the capital structure. It would not make sense,'" says Frogel. "But the argument that it does not make sense is not likely to resonate with a New York court."

Frogel gives the following warning for lenders: "Don't complacently assume that it won't happen simply because it's unfair or illogical."

The dangers of a trap door

J Crew brought into focus the movement of assets from restricted to unrestricted subsidiaries

The trap door has been a staple of adventure stories over the years, allowing heroes and villains to make quick exits and escape each other's clutches. "With one bound he was free," runs the formulaic language.

In 2016 the term entered debt market lingo, when two private equity sponsors used what is still known with awe as "the J Crew trap door" to spirit away the brand name and other intellectual property of the US apparel retailer into a newly minted company beyond its lenders' reach. With one bound TPG and Leonard Green were free.

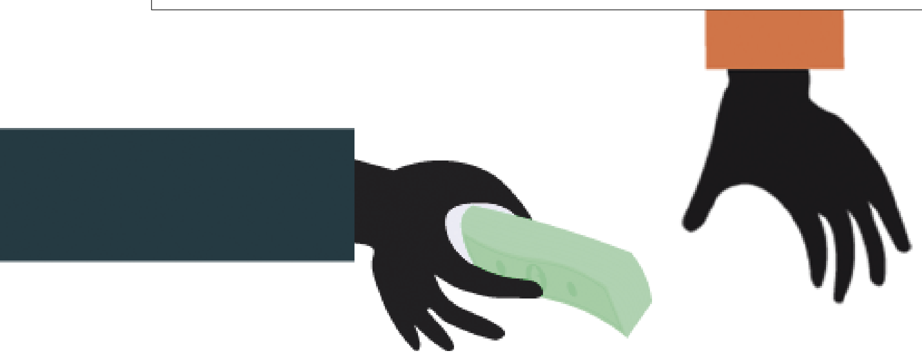
Putting this in legal terms, the intellectual property was transferred from a "restricted subsidiary" to an "unrestricted subsidiary". A restricted subsidiary is a company governed by the loan agreements, including the obligation to hand over collateral if the loan goes bad, and limitations on its ability to borrow more money. An unrestricted subsidiary is a company not governed by the loan agreement. The existing lenders were furious, but J Crew and its sponsor argued that the move was not forbidden by its original loan documents, and the dispute never went to litigation.

The J Crew move emboldened other sponsors. For example, in 2018 beleaguered US retailer PetSmart moved valuable assets out of reach of loanholders and used some of them to pay a dividend to a holding company controlled by its leading private equity sponsor, BC Partners. This prompted a lawsuit, although the two sides eventually settled out of court.

Selinger of Debevoise says his firm has seen market participants try to tighten up credit agreements to shut any trap doors. However, Covenant Review found that 21 percent of US mid-market direct lending deals in 2019 had a J Crew trap door. In Europe, Adesanya of Reorg has not seen any cases where these trap doors have been used. However, that is not the same as saying that there are none sitting unobserved in agreements, ready for use as necessary.

"Investors are being made to commit on the basis of termsheets that only tell you about the commercial aspects – not on the basis of the credit facility agreements," she says. It is the more detailed credit facility agreements, which come later, that will contain the trap doors. "This means that they make commitments with very little information."

Adesanya adds that a lot of the loopholes and trap doors are hidden in "carefully worded language where the implication is not always upfront".



Since 2012-13, however, Selinger has seen the injection of various flexibilities into some deals. Default stoppers have disappeared in some deals in the US as they have in Europe. In many cases, a sponsor can pay itself unlimited dividends provided the leverage ratio is below a certain level.

Value out on day one

Different lawyers have their own favourite examples of flexibility. One says: "To me, ultimately the most aggressive of the whole package is the capability that sponsors have to take a significant amount of value out of the company on the day after a leveraged buyout" – in other words, without any build-up of income or other excess cashflow over time.

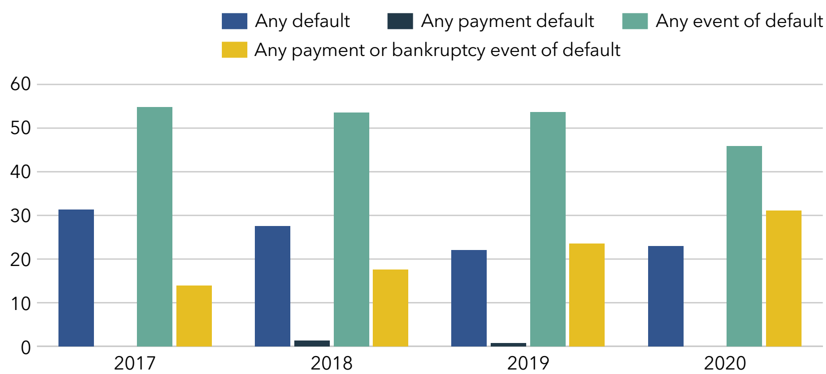
Observers say that although this liberalisation of restricted payment terms began in the US, it is now almost as great in Europe. Mostyn-Williams worries about "the multiplicity of what are generically referred to as free baskets: general baskets which are just numbers, in most cases not even limited by there being an event of default stopper.

"You have a starter basket", which allows a company to take on more debt without a debt incurrence test. "Then you have a general basket; then you have another general basket; then you have a general basket for a particular capacity; and then another basket for a capacity that is related to leverage, so everything has a free element to it before you begin to apply a financial test to the ability to use baskets. And if you add up all the various freebies that sponsors can take at any time, it looks pretty painful."

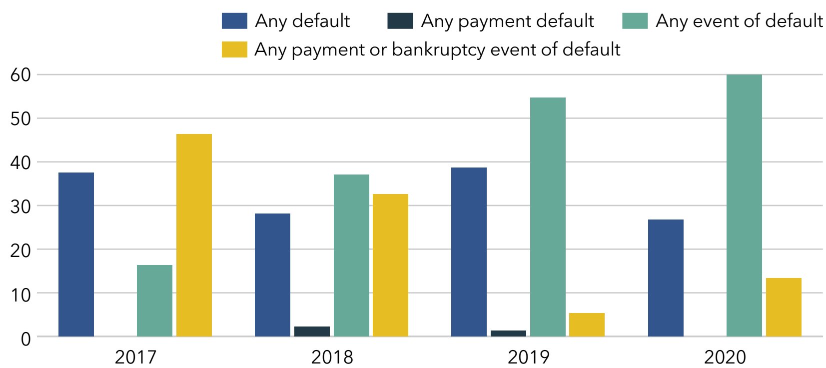
Mostyn-Williams also notes that in many cases the amount in a builder basket is no longer reduced if the borrower company posts a loss in a particular year – instead, it simply does not grow for that year.

Borrowers are ultimately able to indulge in such practices because of their market clout. As Judah Frogel, partner in the New York office of Allen &

Restricted payments in US loan deals (%)



Restricted payments in European loan deals (%)



Source: Covenant Review

Overy, the law firm, puts it: "Private equity sponsors now have a lot more negotiating leverage because of debt investors' desire for better yield in low interest rate environments."

This subtle shift was marked by an intriguing change: instead of lenders presenting their own standard loan document, which was then haggled over, sponsors started presenting their own draft document for wrangling. Sponsors' lawyers acted as a channel for this market power, but they also accentuated the trend.

Mostyn-Williams explains: "Top-tier sponsors' terms have been driven down into the middle market by certain law firms that have used them as a marketing tool to get more work by going to mid-market sponsors and saying, 'You saw the deal they got. We can get that deal for you.'"

The very speed with which deals are now snapped up, in a crowded market where lenders are vying with each other, gives the sponsors and their lawyers power. This, in turn, allows flexibility to creep into the documents.

Sabrina Fox, executive advisor at the London-based European Leveraged Finance Association, which represents lenders, notes this interplay between speed and complexity when it comes to the specific issue of permitted payments. "There are more different types of carve-out, capacity has become a lot higher, and the traditional toggle effect – where the cash carve-outs reduce the builder basket's capacity – has gone completely out of the window," she says. "So now, permitted payments baskets actually represent incremental additional capacity above and beyond the builder basket in many cases."

Moreover, "this is a highly negotiated provision, which is presented smack in the middle of the covenant, in only three lines". The consequence: "You're looking at three lines of text that can make a difference to hundreds of millions of pounds' worth of capacity."

The acceptance of deals too quickly, with too little consideration, and too much opacity, says Adesanya of Reorg, "is continually happening, and that to my mind is a failure of the market".

Profit sharing

Another reason borrowers are able to make terms more flexible is that in many cases lenders are relatively relaxed about this. Annette Kurdian, banking and finance partner at Linklaters in London, notes: "Every CLO investor I have spoken to says, 'We prefer a good credit with bad documents to a bad credit with good documents.'"

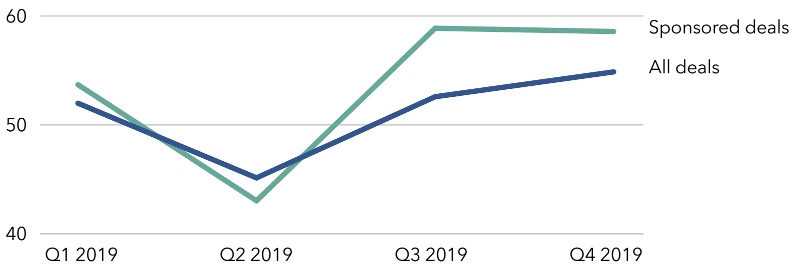
In theory, and in most cases in practice, it is not in the interest of a private equity sponsor to strip its portfolio company bare. Sponsors say they merely want to use restricted baskets to share in the profits made by portfolio companies, and to do so before exiting the investment (or at least their lawyers do – no sponsor agreed to be interviewed for this piece).

Caroline Chapman, banking and finance counsel at Linklaters, talks of a sponsor's desire to obtain a return on its investment while it holds the asset, rather than waiting to make all of its return on exit. This boosts internal rates of return, since money early is worth more on a net present value basis than money late. It is also particularly prized by sponsors at a point when the next market downturn may come soon, thereby making exits harder.

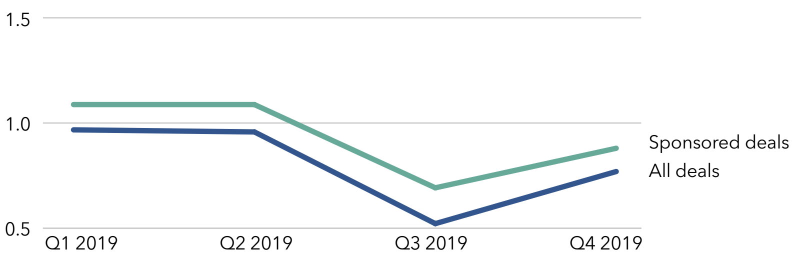
But what if the sponsor has already taken its equity out, or the company is in trouble, rendering the equity more or less worthless? In such cases, cynics suggest it might be in the sponsor's interests to take as much cash out as it can.

However, many market observers – and not just sponsors and their lawyers – emphasise that there are at least some

Deals' day-one restricted payments capacity as proportion of EBITDA (%)



Net total deleveraging required to meet restricted payments ratio test (%)



Source: Covenant Review

limits to the flexibilities that sponsors can demand. Some suggest that many private debt funds are stricter about leakage than banks.

"Direct lenders are much more disciplined about documents, for good reason: they take all the risk themselves, unlike banks and funds in syndicated deals," says Frogel of Allen & Overy. Because of this, "they're keen to make sure that even if value leakage is not completely closed off, it's at least limited to a known universe of baskets that is manageable and understandable, without loopholes and with fixed dollar amounts or percentages of EBITDA or assets".

This central role also gives them more power, thinks Pierre Maugüé, London-based finance partner at Debevoise & Plimpton: "If you're negotiating with the direct lender for a big chunk of the debt, the direct lender will probably have more leverage to disagree with some of the more recent aggressive improvements."

Data from Covenant Review, outlining headline numbers rather than the incidence of loopholes, show that mid-market direct lending deals tend to have smaller baskets than mid-market syndicated deals.

There has been some pushback against the more aggressive terms – but with limited success. Last year, investors successfully tightened restricted payment provisions during syndication in only 17 percent of European deals reviewed by Reorg.

Patchy counterattack

Why has the counterattack against restricted payments terms been so patchy? "Last year saw a bifurcation, which has continued into this year," says Chapman of Linklaters. "Although investors remain focused on leakage from restricted payments, good credits have tested the market and been successful in achieving quite flexible terms. In contrast, more difficult credits have seen pushback on similar points during syndication and have needed to make adjustments to get the deal done."

Market observers cite the contrasting experiences of two outwardly quite similar companies, both in the financial data sector: Kantar and Refinitiv. Kantar, sponsored by Bain Capital, had to accept a tightening of its restricted payments covenant before selling its debt in October. Contrast this with the Refinitiv deal, pushed through by its sponsor Blackstone amid hot demand. It was, as Adesanya of Reorg puts it, "the poster boy for in-your-face" when it came to stretching the notion of flexibility beyond previous norms.

Under the publicly disclosed terms of the Refinitiv bond, which Adesanya believes should largely have been mirrored in the loan, the agreement dispensed with the usual requirement for a debt test before the CNI builder basket could be used. The builder basket also began with a £1 billion ($1.29 billion; €1.16 billion) "free and clear" amount. This is the highest yet seen by Adesanya in the European market, though she thinks amounts of this order are not uncommon in the US.

However, not every investor is prepared to play a game with such rules. "Greater flexibility with restricted payments is turning off potential limited partner investors," says Jeff Davis, partner at Eaton Partners, the placement agent, in Rowayton, Connecticut.

It is deterring some general partners too. Chris Lyons, head of private credit at Voya Investment Management in Atlanta, invests mainly in investment-grade private placement bonds, but also considers non-investment grade direct lending.

At the moment, however, he is steering clear of this market: "We are happy not to go into it because we believe it is going to be a train wreck when the economy turns, as terms have been given up – not just for restricted payments, but a lot else too." ■