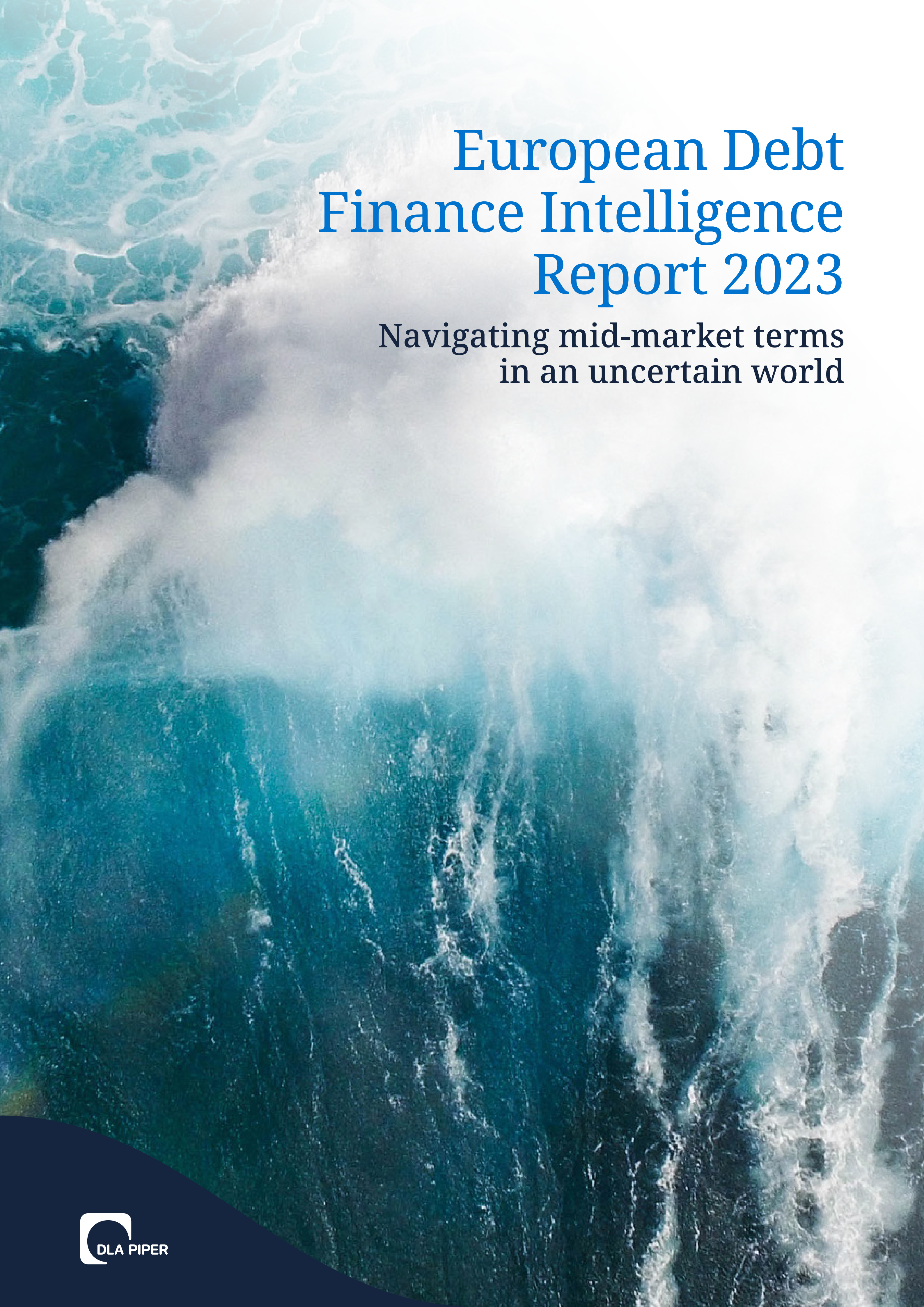
European Debt Finance Intelligence Report 2023

Navigating mid-market terms in an uncertain world



DLA PIPER

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Introduction

2022 was a challenging market, at least compared to a record-breaking 2021. The financial markets were dislocated throughout much of 2022 because of geo-political events. The high yield debt capital markets/ bond markets were mainly shut, and several large-cap leveraged deals were hung in syndication. That lack of liquidity saw a number of the larger direct lending funds fill the gap, in turn leaving a partial vacuum in the mid-cap liquidity space. Additionally, the lack of lender appetite for some assets (or at least at leverage levels seen in 2021) plus the gap between the value expectations of buyers and sellers saw a number of sale mandates flip into recaps/refinancing.

Generally, we saw deals taking longer to commit and/or close, with lenders asking more questions/diligence around potential deployment opportunities. Almost inevitably, terms tightened and as the year marched on many lenders (and sponsors) focussed on their portfolios to deploy follow on funding, or even just to kick the tyres, rather than chase the market for 'one last deal'. In some jurisdictions, lenders made it clear as early as October/ November that they were happy with their year and would likely sit on the side lines until 2023.

At DLA Piper, the benefits of having a large portfolio of deals, and a strong roster of clients (both lenders and sponsors) came through, with the team across Europe remaining busy, but not so busy that we couldn't develop our practice in other areas; for example, we led the market in annual recurring revenue (ARR) deals for private equity-backed tech businesses, whilst our sports financing team also had a very productive year.

Neil Campbell
Partner – UK

Matthew Christmas
International Head of Leveraged Finance – UK

Wolfram Distler
Partner – Germany

Juan Gelabert Chasco
Partner – Spain

Introduction *(continued)*

Now we are into 2023, it still feels too early to call. Many participants expect a subdued H1 but with momentum picking up as we move through the year. There is just too much dry powder – both debt and equity – for people to stay out of the market for too long. In the meantime, some banks seem confident that the market may be moving towards them – in terms of borrowers' appetite to take on a bit less leverage, the lower all-in-price of RFR plus margins compared to pricing required by private credit funds and generally a more conservative outlook on risk. If banks could offer a one-stop shop solution for bigger ticket sizes – and some banks look at HSBC as an example of how this can work – then perhaps they can reclaim market share from the credit funds. Similarly, in the Netherlands, we have seen certain financial institutions teaming up with pensions funds or insurance providers to provide a more conducive financing solution.

The preparation of this report and its theme of 'Navigating mid-market terms in an uncertain world' began in January, as we started to look at our deal data for 2022. The contributing partners were then asked to provide their analysis of the 2022 data and what they thought 2023 might bring.

In the period of submitting the initial draft to the publishers and receiving it back, Signature bank had collapsed, SVB UK was purchased by HSBC and Credit Suisse had been rescued by UBS, whilst weekends were spent advising borrowers and lenders on the 'Impaired Agent' and 'Defaulting Lender' provisions in their credit agreements. An uncertain world indeed.

Whilst the recent turmoil in the financial markets doesn't change the retrospective view of 2022, clearly it may have repercussions for the remainder of 2023. Dealmakers were talking of activity levels picking up in Q2 (and certainly in H2) of 2023 given the pipeline of mandates that they need to bring to market (already facing a bit of a backlog in the UK after the brief dalliance with Trussonomics caused a hiatus in deal-doing). We hope that won't change, albeit we may see deals may get done during 'windows' of activity/relative calm, but the cautious optimism in the report should probably be moderated slightly given the nervousness in the markets at time of writing. A period of stability would be just what people need in order to focus on the opportunities that are out there.

As always, time will tell. But for those setting budgets and forecasts for the period ahead, it's a tricky one to call and depends on if your glass is half full or half empty.

In this report, we've applied a risk management lens to our market terms data to provide trend analysis and insights on some of the key issues that matter to both lenders and borrowers in times of uncertainty.

We hope you find the report useful and please contact one of the report contributors to discuss any of the topics covered.

César Herrero
Partner – Spain

Sophie Lok
Partner – France

Max Mayer
Partner – Netherlands

Richard Normington
Partner – UK

PART 1

Mapping international trends

MAPPING INTERNATIONAL TRENDS

Financial covenants

Number of maintenance covenants

It comes as no real surprise that it is now relatively common for European mid-market deals to have only one maintenance financial covenant. Documentary convergence between the large-cap and mid-market is by no means a new concept, but our data shows us that the mid-market generally continues to resist the cov-lite structures associated with the large-cap market (save perhaps in the upper mid-market). This is a trend we expect to continue.

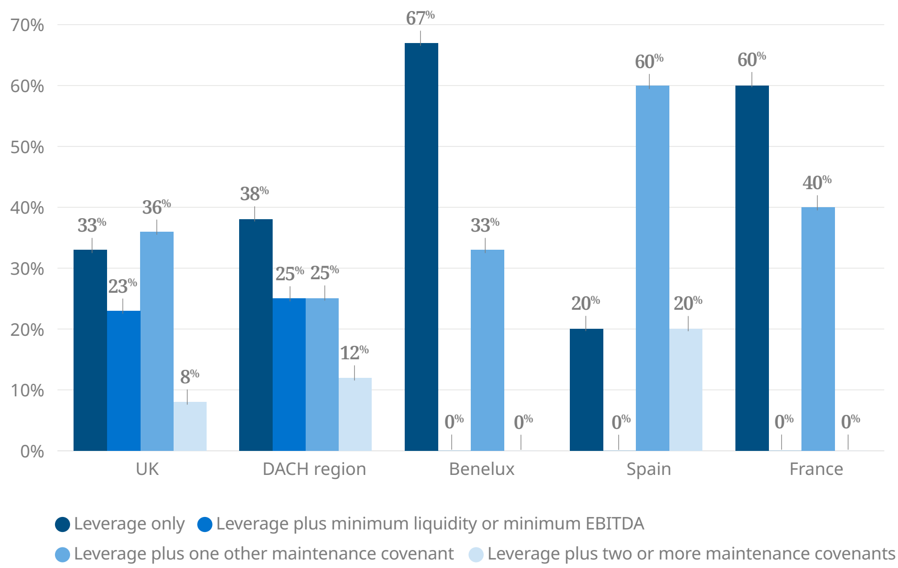
Again, very unsurprisingly, the most common maintenance covenant in European mid-market deals is a leverage test (being the ratio of Total [Net] Debt to [Adjusted] EBITDA).

As a result of the challenging economic environment and the strain this is causing on borrower balance sheets, we expect the upward trend of covenant waivers and resets will continue well into 2023. As covenant compliance pressures rise, we may start to see lenders turning to minimum liquidity tests and cashflow reporting (as they did during the COVID-19 pandemic) as well as minimum non-adjusted EBITDA monitoring or even interest cover tests to maintain visibility over a borrower's ability to service its debt (particularly as reference rates remain higher than they have been in recent years).

It's worth noting that the presence of only one maintenance covenant does not in itself necessarily increase the risk profile of a deal – the risk often lies in the calculations that underpin the covenant testing and the allowances within it. We will turn to these points later in this report.

"As a result of the challenging economic environment and the strain this is causing on borrower balance sheets, we expect the upward trend of covenant waivers and resets will continue well into 2023."

Maintenance covenants



Financial covenants (continued)

Headroom and covenant resets

Over the years, as a general principle, the mid-market has accepted the continued trend of increased headroom against the lender base case. This headroom represents an agreed percentage deviation, to allow for some deterioration in performance, before covenants would be breached.

During the course of 2022, we've seen senior leverage reach 7x, but after headroom is applied, maintenance covenant levels increase to over 11x. As market uncertainties rise in parallel with the costs of borrowing, it's reasonable to expect the amount of headroom and maintenance covenants to come under closer scrutiny.

In addition, more and more 2022 deals, especially those looking to support a buy-and-build strategy, have featured a 'reset' mechanism, allowing the sponsor to reset the covenant headroom following debt financed EBITDA acquisitions, once applicable adjustments, savings and synergies have been applied – a sponsor-driven, and lender accommodated, ever-green headroom approach. As markets are becoming tighter, and lenders are scrutinising deployment opportunities, these features are also becoming more regulated, to mitigate the risk that sponsors use this feature to 'cleanse' non-performance. Generally, lenders are supporting these features, if they are applied rationally and appropriately, and thereby facilitating the longevity of the financing arrangements and the growth strategy of the sponsor's investment.

> "During the course of 2022, we've seen senior leverage reach 7x, but after headroom is applied, maintenance covenant levels increase to over 11x."

Wolfram Distler
Partner – Germany

"In Germany, we have not seen a major change to headroom flexibilities on recent deals. However, those deals with greater headroom have often been accompanied by an additional minimum liquidity covenant."

Max Mayer
Partner – Netherlands

"We are increasingly seeing a 'meeting of minds' in the European mid-cap space, where it is more important to have a solution driven and strategy facilitating debt package than a precedent competition – practical reality over 'nice to haves', albeit with the necessary downturn protection for both the sponsor as well as the lenders. This includes the approach on headroom, resets as well as financial covenant definitions – the engineering needs to work. Quality is key."

MAPPING INTERNATIONAL TRENDS

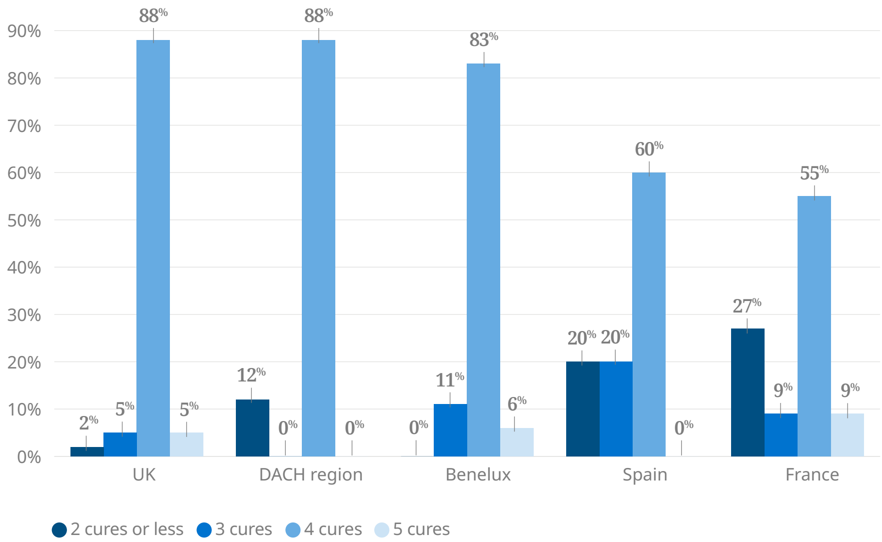
Cure rights

Our deal data shows that equity cures and deemed cures are very much an accepted part of the mid-market landscape and in a challenging market we anticipate that sponsors will be keeping a close eye on their ability to cure a financial covenant breach by contributing additional capital into certain portfolio businesses. Debtwire Par's recent survey of lenders found that over half of the respondents thought that equity cures would be exercised in their portfolios during H1 of 2023.[1]

The European deals reviewed generally permit four cures over the life of the debt and usually include a restriction on cures being applied in respect of consecutive financial quarters. The mid-market has continued to push back on the requirement for a cure amount to be applied in mandatory prepayment of a loan – this requirement has made its way into only 11% of our European deals, which makes sense, because in many equity cure situations a business will need the cash.

> *"11% of European deals include a requirement for a cure amount to be applied in mandatory prepayment of a loan."*

Number of equity cures



As always, we expect lenders (and their lawyers) will remain focused on the interaction between equity cure provisions and those relating to the payment of dividends and the repayment of subordinated debt to ensure that a cure amount is not used to remedy a breach and then immediately paid back out to the sponsor. The 'round-tripping' of cash fails to cure a breach and deprives the borrower of much needed capital – a scenario that lenders will want to avoid as we head into a period where we expect the use of cure rights to be on the rise.

It should also be noted that, in practice, in many situations where a sponsor agrees to contribute additional capital into a business, it will look for something in return for that support; for example a covenant re-set. Exercising a cure right in and of itself remains unattractive economically for a sponsor, unless it is an EBITDA cure. In other words, we often see that the equity cure provisions are not strictly used as such, but rather there is a consensual arrangement, at the point of support, to allow a business some breathing room to trade through a, hopefully temporary, difficult patch.

1 https://www.debtwire.com/intelligence/view/intelcms-2t9mjf

Cure rights (continued)

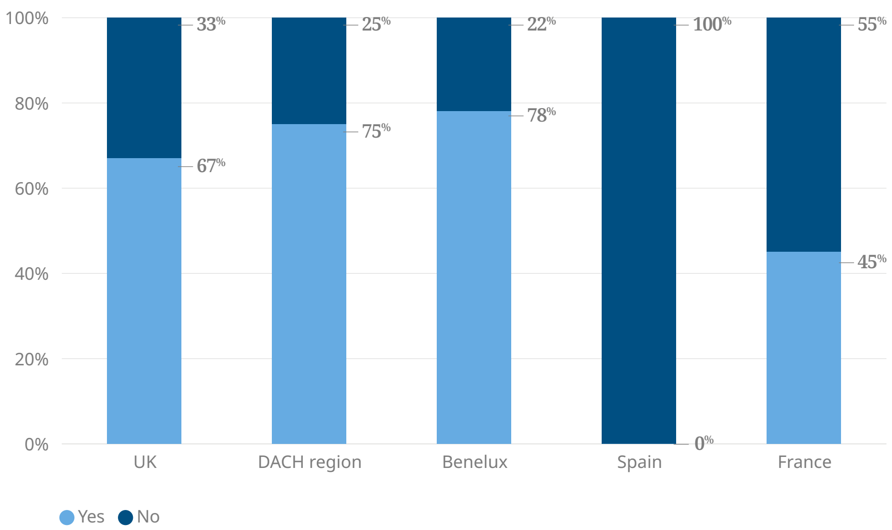
Deemed cures

Deemed cure provisions remain prevalent in Europe, although our data shows us that there is variation between countries.

Deemed cures provide that a financial covenant breach is deemed to be cured if, at the next financial covenant test date, the borrower is in compliance and the lenders have not taken any enforcement action in the meantime. The provision effectively acts as a long stop date for lenders, by which they either need to have waived the covenant breach and agreed a work-out or opted to exercise their rights and remedies under the loan agreement.

Given the unlikelihood of a lender taking enforcement action against a covenant-compliant borrower based solely on a historic failure to comply, the mid-market in the UK has generally accepted this position, although the position is not consistent across Europe as we can see from the chart. Indeed, in some geographies, we'd question whether a court would uphold or allow any enforcement action in respect of an historic covenant failure where at the time of the enforcement action the borrower is covenant-compliant.

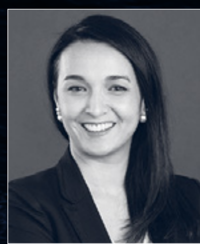
Prevalence of deemed cure rights



As mentioned, many believe we will see a rise in equity cure rights being exercised over the coming months and the same might be true for deemed cure right provisions, if lenders allow enough time to pass whilst a business is in breach – although the latter is potentially unlikely.

Wolfram Distler
Partner – Germany

"German banks have always been more reluctant to accept deemed cure rights than private credit funds. In any case, it is questionable whether a German court would consider an acceleration of a financing to be effective when based solely on a historic default of the borrower."



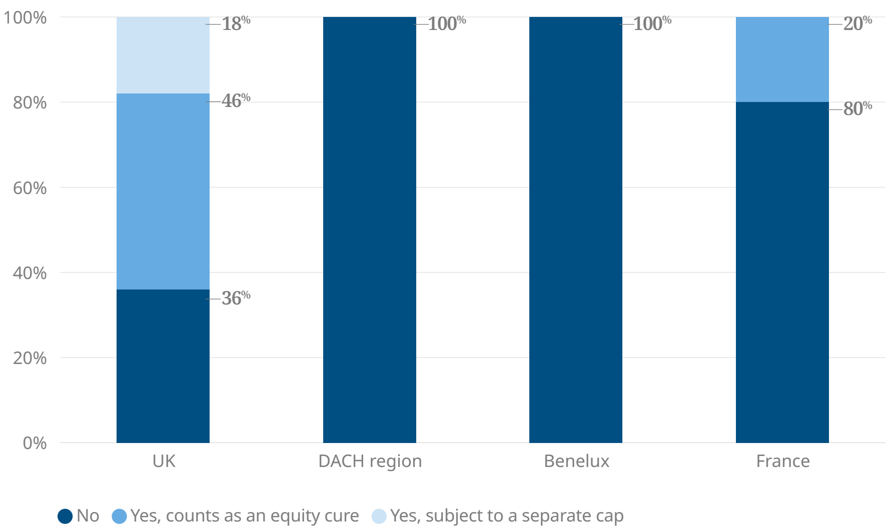
Sophie Lok
Partner – France

"In France, deemed cure rights are widely off-market for bank deals in the mid-market but relatively common on private credit fund deals. We see the prevalence of deemed cure rights increase to over 60% when considered as a percentage of our French private credit fund deals."

Cure rights (continued)

Interestingly, controls to ensure that deemed cures are only used to remedy short periods of irregular under-performance and not to mask continued underperformance or create artificial headroom in the financial covenants are uncommon outside of the UK. However, it is worth noting that this has been a fairly recent development in the UK (within the last three to five years) and we may see this trend evolve across the European market.

Are there controls around the permitted number of deemed cures?



Juan Gelabert Chasco
Partner – Spain

"Unlike other jurisdictions, deemed cures are not so common in the Spanish market. Although, in practical terms this is likely to be the position lenders accept – it is highly unlikely that a breach of covenant, especially if quarterly tested, will prompt lenders to initiate action."

Sophie Lok
Partner – France

"Controls over the number of permitted deemed cures are not very common in France. When there are such controls, the deemed cure will usually count as one equity cure."

Wolfram Distler
Partner – Germany

"We have started to see more pushback from private credit fund lenders on unrestricted deemed cures in recent deals. The credit funds are becoming stricter and are seeking controls similar to those that feature in the UK mid-market."

Cure rights (continued)

EBITDA cures

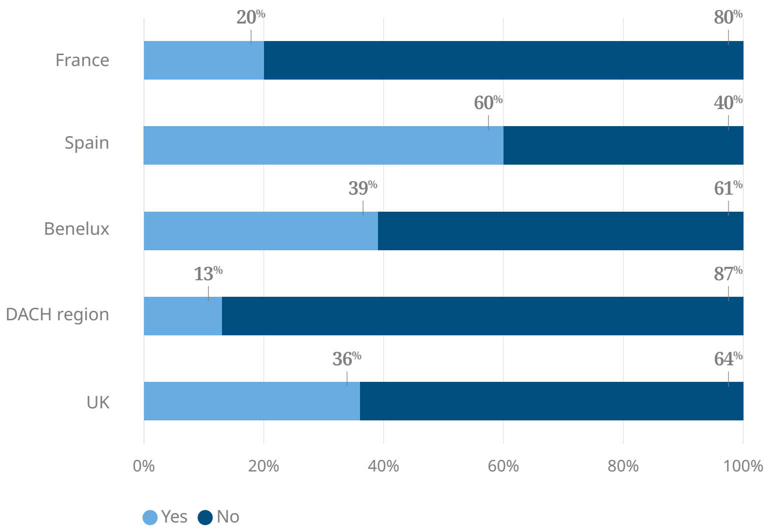
Although on most deals cure amounts are deemed to be applied to the debt side of the leverage ratio, we have seen a gradual uptick in EBITDA cures. That said, EBITDA cures are by no means customary, as demonstrated by our European deal data.

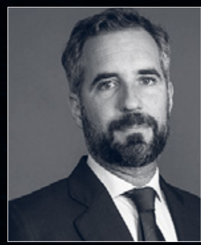
Applying the cure amount to the EBITDA side of the leverage ratio is a much stronger position for borrowers/sponsors given the favourable effect this has on the ratio calculation, significantly reducing the capital required to effect a cure.

Given the significance of this ratio effect, we see a restriction on overcures on EBITDA cures on 100% of our deals.

Lenders should note the potential for a disconnect in super senior/unitranche structures depending on how the financial covenants have been set –
*see **SUPER SENIOR AND UNITRANCHE INTERACTIONS** for more detail.*

Prevalence of EBITDA cures





Juan Gelabert Chasco
Partner – Spain

"Given the strong position of borrowers/sponsors in recent months, EBITDA cures are common in Spanish mid-market deals, although usually limited in number (typically not more than one)."

Neil Campbell
Partner – UK

"We see EBITDA cures on about a third of deals. Those EBITDA cures are mostly on private debt deals (c.70%) but also (therefore) on a not-insignificant number of bank deals (c.30%). EBITDA cures are still quite tightly controlled; in the most part only one is available over the life. 100% of our deals include a restriction on overcure on an EBITDA cure."

MAPPING INTERNATIONAL TRENDS

Transferability

In challenging times, lenders may look to reduce their exposure to certain sectors, countries or currencies, and the transfer provisions in a loan agreement provide a mechanism by which they can transfer their interest in a loan.

Our data shows that sponsors have taken advantage of the competitive capital deployment market of recent years and have continued to push for more restrictive conditions around loan transferability, with consent being required on the vast majority of our European mid-market deals.

We typically see this consent right survive the occurrence of events of default, sometimes other than significant/credit-related events of default such as non-payment, financial covenant breach (which event of default is of course subject to broad equity cure rights discussed earlier in this report) and insolvency-related events of default (at which point consent is no longer required).

Loan-to-own/distressed investors

We have continued to see borrowers maintain their consent right over transfers to loan-to-own/distressed investors, although this right does tend to be disapplied if the business is deteriorating (i.e. while any credit related events of default mentioned above are continuing). Although there is variation across the European mid-market as to the exact trigger that enables a lender to freely transfer the loan, we can see from our data that lenders are mindful that distressed investors are likely to be the only parties interested in stressed/distressed assets.

While the overwhelming majority of lenders in the mid-market consist of take and hold investors which do not look to trade out of their positions (indeed in our experience they look to support their borrowers as much as possible) situations can change. As such, it will be essential for borrowers and lenders alike to be aware of the permitted transfer provisions in their financing documents. For example, if one class of lender has preferential (i.e. less restrictive) transfer provisions, what protection do the other counterparties have, such as a right of first refusal? This might be particularly relevant given the new tools that creditors can use to reshape capital structures – *see* ***UNDER DISCUSSION – WHAT ARE THE KEY CHALLENGES AND OPPORTUNITIES FOR MID-MARKET PRIVATE CREDIT FUNDS OVER THE COMING PERIOD*** *with regard to special situations.*

Free transferability to loan-to-own/distressed investors:

UK	77%	on specified significant/ (credit-related) Event of Default
BENELUX	72%	on acceleration only
FRANCE	50%	on specified significant Event of Default
DACH REGION	25%	on specified significant Event of Default
SPAIN	20%	on Event of Default

Transferability (continued)

Industry competitors

In addition to dealing with loan-to-own/distressed investors, the large majority of transfer provisions also specifically deal with industry competitors – prohibiting a lender from transferring commitments to industry competitors without borrower's consent, even in circumstances of non-performance and acceleration. This is driven by sensitivities from the sponsor community to restrict access to information that could otherwise become available to industry competitors as a result of them holding part of the debt made available to a sponsor's investment.

Approved lender list

It's commonplace for loan agreements in the mid-market to include an approved list of entities to which a lender can transfer its interest without requiring further consent from the borrower. Although the approved lender list cannot override other agreed transfer principles such as in relation to distressed investors or industry competitors. While the detail will vary on a case-by-case basis, below are some of the areas we think lenders and borrowers will be considering, as we expect transferability rights to remain a hot topic for the period ahead:

- ☑ Number of entities that can be unilaterally removed by the borrower
- ☑ Requirement to agree replacement entities and/or maintain a minimum number of entities
- ☑ Removal of entities that have been acquired or merged with an entity that is not on the approved lender list
- ☑ Requirement to notify the borrower of a transfer pursuant to the approved lender list

Richard Normington
Partner – UK

"Approved lender lists have become a standard construct on mid-market transactions. Lenders take comfort from the number of institutions listed – they typically include a large variety of bank and private credit fund lenders. Negotiation of the list itself tends to focus on a sponsor removing specific lenders that have fallen from favour or those known to take an aggressive approach particularly in a downside scenario."

MAPPING INTERNATIONAL TRENDS

Pricing and hedging

Pricing

Across the European mid-market, we have seen margin pricing move upwards over the past year, with upfront fees increased in the bank space, and featuring as a competitive negotiation tool in the private credit funds space.

Country	Margin price increases
UK	50 bps
France	50 bps
Benelux	50-100 bps
DACH region	50-100 bps
Spain	100-250 bps

Hedging

Given current economic conditions and the rate rises to tame inflation, the direction and speed of change in interest rates has been a critical consideration for all borrowers.

Borrowers are rightly concerned about the prospect of rates reaching levels that could make their interest expenses unaffordable or stress financial covenants. Many market participants and our DLA Piper structured finance specialists have noticed a marked uptick in finance linked derivative products. As such, there is a renewed focus on putting suitable protection in place by way of hedging and, accordingly, there will be increased attention on the hedging provisions in debt documents.

Where hedging is now being put in place, lenders should be conscious of ranking and waterfall provisions in any applicable intercreditor agreement. In most super senior/unitranche deals an element of hedging can rank super senior and this will need to be taken into account in terms of recoveries of a unitranche lender, and also if the unitranche lender looks to exercise its option to purchase *(see **SUPER SENIOR AND UNITRANCHE LENDER INTERACTIONS** for more detail).*

We are however seeing banks and private credit funds across the European mid-market take different approaches when it comes to their hedging requirements.

Richard Normington
Partner – UK

"We have seen the general increase in pricing across the market leave the opportunity for some less established credit funds to get a foot-in-the-door by pricing competitively to win transactions they may not have secured 12-24 months ago."

Max Mayer
Partner – Netherlands

"We've seen some new money deals re-introducing mandatory hedge provisions, for example, a requirement to hedge in respect of 50% of interest rate exposure over a minimum of 2 years."

César Herrero Mazarío
Partner – Spain

"In Spain, hedging tends to be a requirement on bank lender driven deals. However, we haven't seen this hard requirement on our alternative credit providers deals. Entering into an intercreditor agreement can be difficult, time consuming and the value of the security package could be diluted if swap instruments are put in place."

PART 2

Under discussion

The key challenges and opportunities for mid-market private credit funds in the coming period

UNDER DISCUSSION

Challenges

Lack of quality assets coming to market

We expect a relatively subdued M&A market in the first half of 2023, with caution in both equity and credit, and participants being very selective in asset choice (where there is even an asset choice available!). Although perhaps (he says hopefully) the economic outlook isn't quite as bad as we feared, and there seems to be some hope, if not necessarily at this stage expectation, that there may be some reasonable activity in H2. There doesn't (yet) seem to be the huge amounts of doom and gloom we've experienced in previous contractions/downturns/cycles. Which is nice. However, there clearly remain material and significant economic challenges (in particular aggregate interest costs and inflation), which have already led to an increase in restructuring activity, although, at this stage, that has largely been a reversion to historic averages from particularly low levels over the past few years. If, and it's admittedly a big if, central banks don't need to raise rates as high as first expected, and the various circumstances contributing to higher costs etc abate a little, confidence will improve and more sellside processes will be launched, but, until then, lack of quality assets coming to market may prove the most significant challenge in 2023. Fingers crossed for bland rather than disastrous.

Neil Campbell
Partner – UK

"We expect a relatively subdued M&A market in the first half of 2023, with caution in both equity and credit, and participants being very selective in asset choice."

Shift of focus

Debt funds may need to shift their focus from deploying capital to managing their existing portfolios in order to maximise value and returns for their investors. This shift will test them, and ultimately, their appetite for supporting sponsors. The deal activity that we've seen across Europe so far this year indicates that many borrowers are bracing themselves for covenant tensions and working closely with their lenders to find solutions. But this won't be appropriate for all borrowers – some borrowers are particularly susceptible to shock and will not manage to navigate challenging times unscathed.

As mentioned previously, while the general increase in margin pricing across the market has created an opportunity for less-established funds to win transactions by pricing competitively, the more established players may be left re-assessing their existing portfolios and, in some instances, having their resources diverted by amendment and waiver requests and, in some cases, restructuring and enforcement processes. Enforcement action, or a deterioration of assets such that a sponsor has handed ownership to the lenders means that a number of private credit funds now find themselves with a portfolio comprising not only debt, but also equity, investments.

Lenders will need to be proactive and adaptable when it comes to mitigating restructuring risk. Early engagement and communication will be key to finding successful solutions.

Gemma Lawrence
Senior Market Intelligence Manager – UK

"Early engagement and communication will be key to finding successful solutions."

Challenges (continued)

Increased diligence and fund-raising

Richard Normington
Partner – UK

Sponsors have recognised the fragility of both the M&A and credit markets and with an increased focus on diligence the risk of transactions failing or being unable to secure the required lenders is a key area of concern. Attention has therefore rightly focused towards successful execution and closing, rather than pushing hard for the most competitive sponsor terms on documents or 'precedent building' for the future. As a result, lenders are finding success in maintaining house positions.

There is some evidence that fund-raising is slowing, with investors perhaps reflecting on the difficulties certain funds have found on deployment in recent years in such a competitive market with such large reserves of dry powder. As private credit fund lenders are naturally increasing their focus on diligence, the lenders to the lenders are likely to do likewise and any tightening of controls over the portfolio included in fund financing transactions may impact the terms of leveraged transactions at an asset level. A re-focus on what has traditionally been considered the gold-standard of direct lending – a senior secured position (whether through a unitranche structure or otherwise) seems likely rather than a desire to deploy through the higher risk (but higher return) second lien and holdco PIK structures.

> *"As private credit fund lenders are naturally increasing their focus on diligence, the lenders to the lenders are likely to do likewise and any tightening of controls over the portfolio included in fund financing transactions may impact the terms of leveraged transactions at an asset level."*

Competitive tensions

Liam Mills
Legal Director – Ireland

As markets have tightened, the opportunity for refinancing on more favourable terms has also dwindled. As a result, with maturity walls looming, some borrowers are needing to amend and extend for 12 to 24 month periods to mitigate short term liquidity concerns. While the approach typically leads to higher margins, covenant resets and amendment fees, the certainty of funding and clarity in terms of repayment horizon, particularly in an uncertain economic environment, means the trend is set to continue during 2023. The challenge for lenders in the period ahead will be in assessing the viability of refreshed business plans to support increased economics, whilst ensuring margin/pricing uplifts appropriately compensate the extra credit risk involved with continuing to fund businesses in certain sectors – with lenders set to favour borrowers in more stable parts of the economy. Although banks should remain competitive with comparatively lower margins, the ability of direct lenders to provide more hybrid pricing solutions (through the use of PIK and equity instruments), coupled with a greater flexibility on terms and hold levels, means that borrowers may sway towards refinancing with direct lenders where that option is available. However, for those borrowers facing near term loan maturity, the main challenge will be in proving to lenders that they continue to have realistic growth prospects, which can support the revised economics of amended deals – with those that fail likely needing to consider more formal restructuring options.

UNDER DISCUSSION

Opportunities

Capital remains available

Max Mayer
Partner – Netherlands

Lenders will be increasingly disciplined and selective – however, where the combination of timing, asset and sponsor matches, we expect the seasoned private credit funds to engage competitively – using their characteristics and tools to their advantage. Capital remains available and needs to be deployed. Diligence and investment committees will be more challenging – but if the shoes fits then the deployment gear will be engaged. And if there is that green light, then sponsors will receive the full benefit of the available capital of the private credit fund space. Funds will seek to diversify their deployment activities, although sponsorless deals do require more time which on thinner platforms remains a challenge. That being said, the sponsor base that is embracing private credit fund solutions is also becoming larger, specifically in the lower mid-market space, opening opportunities for private credit funds with smaller or no deployment limitations.

"Capital remains available and needs to be deployed. Diligence and investment committees will be more challenging – but if the shoes fits then the deployment gear will be engaged."

Retrenchment of traditional bank lenders

Wolfram Distler
Partner – Germany

Despite market uncertainty and macro-economic concerns, 2023 is likely to present new opportunities for private credit funds. A trend that has the potential to gather pace is credit funds pursuing opportunities in geographies where the market conditions have led to an accelerated retrenchment of traditional bank lenders – giving fund managers the opportunity to gain further market share and diversify their portfolios.

The COVID-19 pandemic and today's market volatility has brought about a rise in bank retrenchment. As an example, in the German market we have seen several smaller German banks leave the leveraged finance market and these movements will only drive opportunities towards credit funds over the coming period.

"A trend that has the potential to gather pace is credit funds pursuing opportunities in geographies where the market conditions have led to an accelerated retrenchment of traditional bank lenders."

Opportunities (continued)

Asset-based lending

Joseph Frew
Partner – UK

We expect to see more structures in 2023 where asset-based lending (ABL) is part of the capital stack, i.e. funding sized by reference to, and which can fluctuate with, an underlying 'borrowing base' of assets such as trade receivables, inventory, plant and machinery, real estate or (perhaps) intellectual property rights.

In 2022, we saw funders with their own in-house ABL products actively use those products to de-risk their other funding lines (such as traditional revolving credit facilities (RCFs)) by switching to less committed, more reactive ABL facilities. We expect this trend will continue to be part of the toolkit for funders who have dual ABL and traditional lending capabilities.

We will also continue to see non-recourse receivables funding used where baskets allow, and supplier finance facilities offered to those businesses with customers such as the large supermarkets.

It was once said that ABL could not sit comfortably alongside third-party term debt because the intercreditor principles were too difficult to agree; there was (and is) a fundamental difference between the world view of an ABL provider and that of a term debt provider relying on EBITDA-based metrics. However, we've seen enough deals written between ABL and term debt in the last three or four years to show that agreed positions can be reached on ranking, enforcement and standstills etc. with sufficient compromise from both sides, although the fact remains that compared to a combination of, for example, unitranche and super senior RCF, the typical ABL intercreditor negotiation will still take longer and should be started as early as possible in any process. Both sponsors and term/RCF lenders will need to interrogate the degree of commitment offered by the ABL provider, and understand what levers could be pulled in a downside scenario.

Some of the more interesting opportunities in ABL in 2023 are likely to be seen with the (relatively) new entrants to the market, where credit funds are increasingly prepared to structure facilities using ABL techniques and by reference to a borrowing base, but with more flexibility than some of the traditional ABL providers. This can include inventory-only funding, FILO ('first-in, last-out') tranches, risk participations or 'stretch' funding (of an asset class which already has a primary funding line).

Finally, we also expect to see new players to the syndicated ABL market, which was once the exclusive domain of the clearing banks and the leading US ABL providers. There are already several ABL syndicates in the UK which include independent/non-bank funders, and that list is growing. This additional firepower will see ABL trying to move up the food chain in terms of ticket size.

"Some of the more interesting opportunities in ABL in 2023 are likely to be seen with the (relatively) new entrants to the market, where credit funds are increasingly prepared to structure facilities using ABL techniques and by reference to a borrowing base, but with more flexibility than some of the traditional ABL providers."

Opportunities (continued)

Special situation type funds

As part of the fund-raising process over the last few years, a number of funds have raised special opportunities/special situation funds focused on higher risk/higher return investments. The support of central banks and governments in response to COVID-19 meant that the opportunities to deploy those funds were limited as businesses did not struggle as much as was anticipated. However, with many businesses facing macro headwinds – energy costs, supply chain issues or interest rate rises, as well as certain sectors facing additional specific issues or only just about recovering after the impact of COVID-19, perhaps now will be the time for these funds to deploy and help turnaround underperforming businesses.

Deal Size

In terms of deal size, we still see special situations as primarily a mid-market opportunity. Larger deals, even arguably stressed situations, often have more mainstream debt solutions precisely because the size of the deals means they get public attention (and often more formalised processes) and are not so off-putting to do even against a more challenging macroeconomic backdrop. So for most funds that we're talking to, the opportunity lies anywhere between writing a cheque for GBP15 million – GBP150 million cheque on a bilateral basis (and that might not be all at once). This is not to say there's not some significant work to be done in the larger space particularly, given new tools (particularly, from a restructuring perspective the new Part 26A UK Restructuring Plans with access to cross class cram down) which may actually cut down the timelines to control or at least force some discipline into control strategies (alongside liquidity of course).

Space/Gap

We've seen banks proactively manage and reduce balance sheet risk in all segments of the market by way of secondary loan trading (even in relatively illiquid assets). Some of this is a function of active risk management, reduction in workout teams and supply-demand dynamic favouring sellers on pricing. Alongside this is that the banks we work with on risk and trading say that buy side have little appetite to underwrite large-scale financings for leveraged buyouts and M&A, let alone esoteric special situations mandates. In theory therefore private credit funds (not just special situations funds) with sufficient capital, flexibility and appetite have an opportunity to fill the void, attracted by larger average yield spreads than are typically found in traditional mid-market deals.

David Ampaw
Partner – UK

Opportunities (continued)

Techniques

Speed and flexibility are key in special situations. Alongside a debt skillset, you will often need to work against imperfect data or a real burning platform (and covenant erosion will lead to more special situations being driven by liquidity) and there's often the need to get hands dirty (i.e. operational involvement and change) to unlock value rather than simply rely on leverage. This eliminates a number of funds in itself. Buying a business out of insolvency, corporate carve-outs or investing in distressed debt markets with a view to a loan to control strategy via a restructuring are just some of the techniques that are commonly used in this context.

One of the areas to watch in 2023 mid-market special situations is around the use of the UK Restructuring Plan – the UK Insolvency Service released the Final Evaluation Report on the Operation of the Permanent Measures in the UK Corporate Insolvency and Governance Act on 19 December 2022. Among the findings was that the Restructuring Plans are considered by stakeholders as a success. Some responses noted that plans could be considered as too costly and onerous in certain situations, although we're already seeing that restructuring plans have been successfully implemented for mid-market companies and situations – including a creditor-led plan in Goodbox. We've been involved in a number of restructuring plans and are aware that further plans for businesses of all sizes are expected in 2023, so watch this space.

"In theory therefore private credit funds (not just special situations funds) with sufficient capital, flexibility and appetite have an opportunity to fill the void, attracted by larger average yield spreads than are typically found in traditional mid-market deals."

PART 3

Comparing the approach of lenders

Comparing the approach of lenders

In the European mid-market, banks continue to look for ways to compete with private credit funds. Despite the potential for a meaningful economic downturn, there is still significant competition in the leveraged lending market, and in part, this is due to the ever-growing market share of funds (and the (still) huge amounts of undeployed capital).

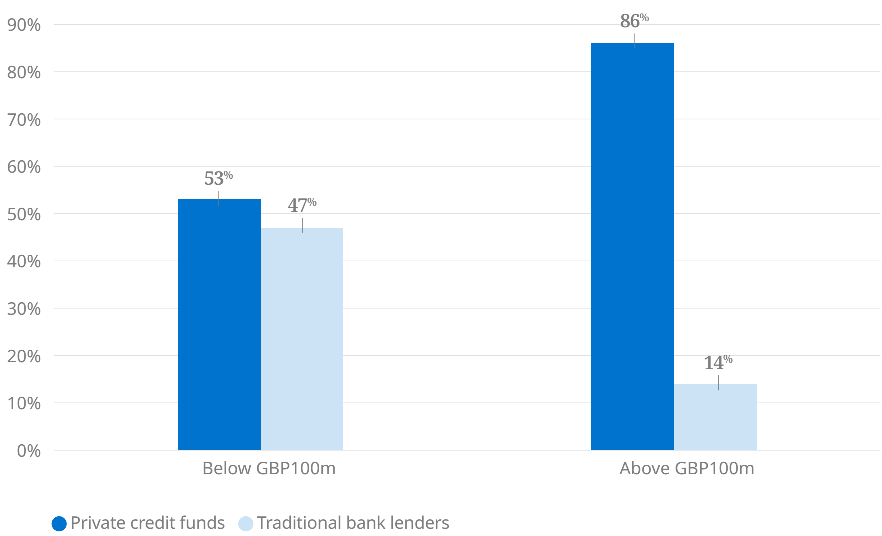
As we look back over 2022, we have continued to see a growing number of banks establish affiliated private credit funds in order to try and compete with their counterparts in the direct lending space, at least in terms of amount of capital available from 'one' institution. As we look to the period ahead, we expect competitive tensions to remain, and we may in fact see these tensions rise if market uncertainties result in a softening in deal flow.

Although our deal data shows us that funds have continued to chip away at the market share of traditional bank lenders, and of course private credit still holds competitive advantages in some circumstances, over the years there has been a gradual convergence between the deal terms offered by all market participants.

Rather than comment on these areas of convergence, here we take a look at some of the terms where we have continued to see funds set themselves apart and sponsors may be looking to take advantage of the (now-familiar) traits of a direct lending relationship.

"We take a look at some of the terms where we have continued to see funds set themselves apart and sponsors may be looking to take advantage of the (now-familiar) traits of a direct lending relationship."

Market share: by debt size



Source: DLA Piper UK Data

COMPARING THE APPROACH OF LENDERS

PIK toggles

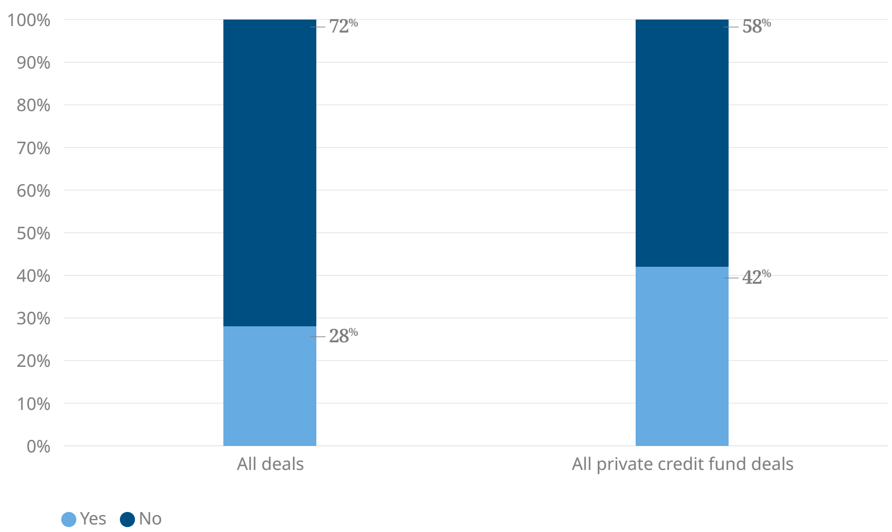
In its simplest of terms, PIK toggle mechanics enable a borrower to elect to convert cash margin into 'payment in kind' interest – this is then capitalised rather than paid in cash. If such an election is made, the aggregate margin will typically be subject to a premium. Where ability to pay interest is strained, the flexibility to conserve some cash may become a particularly sought-after feature.

PIK toggles feature in credit fund deals and not (with a few exceptions) bank deals. Although, when we look at the prevalence of PIK toggles across all of our fund deals, the halfway mark hasn't yet been reached. This is a trend we'll be following closely.

While PIK toggle terms will vary on a case-by-case basis, our data indicates that:

- *Caps – the ability to convert cash margin into PIK margin is often capped at between* ***1.5-2%*** *per annum. In some cases, the cap is expressed as a minimum cash margin requirement, where we see the minimum cash margin set in the region of* ***4-5%*** *per annum.*
- *Premiums – typically range between* ***0.25-0.5%*** *for every 1% of cash margin converted to PIK margin.*

Prevalence of PIK toggles



Source: DLA Piper European Data

COMPARING THE APPROACH OF LENDERS

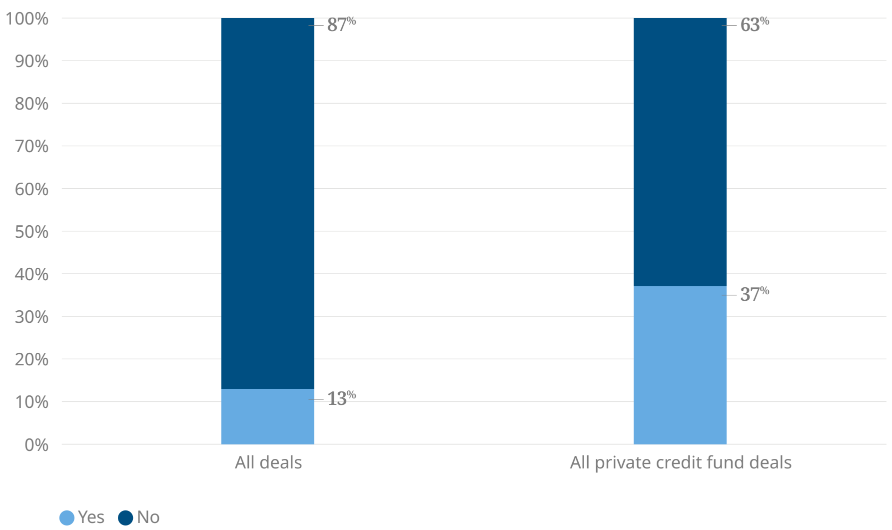
ESG margin ratchets

The direction of travel in relation to ESG is clear and, given the uncertainty in the market, tackling ESG-related issues might well be the key to unlocking long-term viability for some businesses.

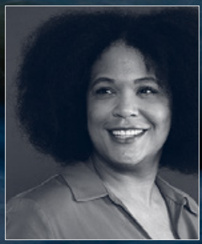
While the LMA Leveraged Finance Facilities Agreement does not yet cater for ESG margin ratchet conditions, margin adjustments linked to the satisfaction of pre-agreed sustainability or ESG objectives have been a hot topic of discussion.

We've seen some interesting variation between jurisdictions in the prevalence of ESG margin ratchets in our mid-market loan documentation. Many banks in the UK market have developed their own form of SLL riders to be incorporated in true SLL compliant deals – for example, our UK team advised Santander on its SLL to Findel Education, thought to be first in the UK educational services sector. Banks seem to be more comfortable with an SLL regime than a simple ESG-linked margin ratchet due to the independent audit requirements that the SLL principles require. Of course, this is not appropriate for all borrowers if they have not sufficiently developed their ESG agenda. In those cases, we've seen private credit funds lead the charge with a less formal ESG ratchet approach – we have also seen prevalence as high as 80% when considered as a percentage of our Benelux private credit fund deals.

Prevalence of ESG margin ratchets



Source: DLA Piper European Data



Gemma Lawrence
Senior Market Intelligence Manager – UK

"Engagement with this agenda is key. The adoption of ESG-linked margin ratchets across the European leveraged mid-market is a step towards embracing sustainability and we have seen some deals allow for both upwards and downwards pricing adjustments (instead of down only). But there is more work to be done and lenders are taking this very seriously – they're acutely aware that the ESG profile of a business runs much deeper than a handful of KPIs."

Matthew Christmas
International Head of Leveraged Finance – UK

"There's no doubt that ESG targets are here to stay given the demands from investors to incorporate ESG metrics in their investments. As the market matures and standardised approaches help to reduce the costs of preparing ESG reports, setting baseline KPIs and the ongoing costs of the annual assurance process it will (we hope) become easier and cheaper to embed these into leveraged loans."

PART 4

Term under the spotlight

Call protection

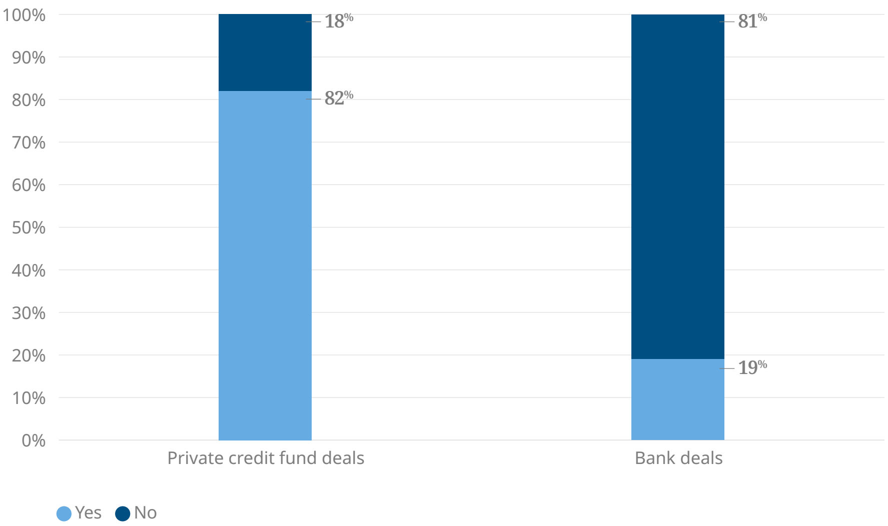
TERM UNDER THE SPOTLIGHT

Call protection

A concept first conceived in the US high yield bond market which has, over the years, made its way into mid-market loan documentation as lenders look to protect their yield if a loan is voluntarily prepaid in advance of its stated maturity. While the concept of call protection is a fairly standard market provision, its relevance, scope and application will vary from deal to deal. In addition, the refinancing risk profile of each deal is inherently different. Lenders will therefore take into account a plethora of factors before landing on the degree of protection (if any) they deem necessary.

One of the factors that has contributed to the increase in use of call protection has been the growing proportion of direct lenders financing the European mid-market. As market share of private credit funds has increased, it's unsurprising that market terms suited to/necessary for their funding structure have emerged and grown with their market presence. Private credit funds have distinguished themselves as a buy-and-hold asset class centred around the fixed/minimum return that they can provide to their investors. Arguably, the redeemable nature of a loan is at cross-purposes with achieving a fixed return for investors; however, call protection (among other tools) offers a private credit fund a way of mitigating against that risk.

Prevalence of call protection: by lender



Source: DLA Piper UK Data

Gemma Lawrence
Senior Market Intelligence Manager – UK

"The right to prepay a loan has its clear advantages to a borrower. If the company's credit-quality dramatically improves during the life of the loan or if market conditions were to move in a borrower-friendly direction, the right to prepay would (you would hope) allow the borrower to refinance the loan at a cheaper price and on better terms. This however leaves the lender high and dry with a wounded return profile."

Call protection (continued)

Hard call protection

True hard call protection is a provision whereby the borrower is strictly prohibited from voluntarily prepaying (calling) a loan/bond before a specified date. This degree of protection is not a typical feature of mid-market leveraged loans in Europe and is instead associated with the high yield bond market, from where the concept originated.

Make-whole (or 'non-call')

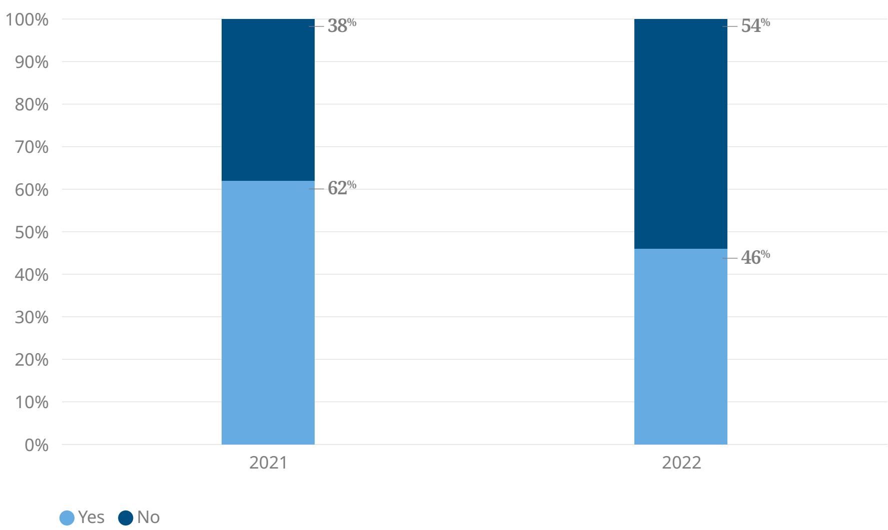
Non-call or make-whole premium offers a high degree of call protection to a lender. On any voluntary prepayment, the lender will be paid (together with the prepayment amount) an amount equal to all required interest payments that would become due on the prepaid amount from the date of the prepayment until the last day of the applicable call period. The make-whole premium is often determined on a present-value basis whereby margin is discounted by a gilt or bund rate (being a marginal spread above government-backed securities with comparable maturities) to reflect that the lenders receive the prepaid amounts today (and ceases to have the credit exposure) rather than at some point in the future.

Soft call protection

In contrast, soft call protection is less restrictive, and the loan agreement will typically set out an applicable call/prepayment fee schedule that will apply for a certain period from the closing date. Soft call protections are often referred to as 101 or 102 – being a 1% or 2% premium on prepaid amounts. The call schedule is aimed at compensating the lender for some loss of interest income and opportunity cost.

"Arguably, the redeemable nature of a loan is at cross-purposes with achieving a fixed return for investors; however, call protection (among other tools) offers a private credit fund a way of mitigating against that risk."

Prevalence of call protection: all deals



Source: DLA Piper UK Data

Call protection (continued)

Key features of call protection provisions

There are several ways call protections can be further relaxed and below are some of the borrower/sponsor-driven exceptions:

Annual prepayment basket – a right to prepay a certain percentage of the loan each year, without penalty/premium, is another feature of the high yield bond market that has made its way into mid-market loan documentation. This gives a borrower the ability to deleverage by a relatively small amount, without incurring prepayment fees. We typically see this percentage as 10% of the aggregate commitments under the applicable facility per financial year (or other 12 month period).

Sunset date – being the date on which the call protection falls away. The typical period for this protection is 12-24 months from the closing date and our UK deal data indicates that 4% of loans containing call protection expire after 6 months, 20% expire after 12 months, 8% expire after 18 months and 68% expire after 24 months.

Waiver on refinancings – in the case of a prepayment made during the call protection period where the prepayment is funded by a full refinance of the debt, we often see a waiver in respect of any prepayment fee due to an existing lender to the extent they continue to participate in the refinanced debt.

ANNUAL CALL

10% of the aggregate of the total commitments under the applicable facilities per financial year

SUNSET DATE

4% of UK loans containing call protection expire after 6 months

20% expire after 12 months

8% expire after 18 months

68% expire after 24 months

Call protection (continued)

Key features of call protection provisions (continued)

Specified exceptions – to ensure the prepayment fee regime is only applicable to voluntary prepayments scenarios or an exit (given that a sponsor's decision to exit is a strategic voluntary action) we often see specified exceptions. These exceptions are designed to capture scenarios that (i) fall outside of the control of the borrower/sponsor, (ii) require a mandatory prepayment to be made (for which the loan agreement typically prescribes a separate commercially agreed prepayment schedule) or (iii) other circumstances attributable to the lender and a prepayment premium would therefore be inappropriate.

These exceptions may include:

- ***Mandatory prepayments*** *(such as acquisition, disposal, insurance and listing proceeds and excess cashflow regimes)*
- ***Illegality***
- ***Right of cancellation and repayment in relation to a single lender*** *(tax gross-up, tax indemnity or increased costs etc.)*
- ***Right of cancellation and repayment in relation to a defaulting lender***
- ***Replacement of lender*** *(yank-the-bank provisions) – a key area for lenders to consider as it could give rise to a non-consenting lender being repaid at par and losing out on their right to a prepayment premium*

Striking the right balance between a borrower's need for flexibility and a lender's need for yield protection continues to operate on a sliding scale and market conditions will play a part in where parties land on these terms.

Although there is uncertainty around the current economic outlook, and this is likely to affect the ability for some businesses to refinance and reprice, we expect yield protections and controls will continue to feature in mid-market loans (at least until we start to see a surge in risk appetite from lenders) and borrowers will continue to use exclusions and carve-outs to erode the value of the protection afforded to lenders.

Neil Campbell
Partner – UK

"Call protection is included on the significant majority of our private debt deals. The most common call protection we see is nc1, 101, albeit there is a reasonable degree of variation across deals, and certainly across geographies (call protection is not permitted in Germany for example). Around half of our deals include a 10% freebie prepayment basket. It is of course standard to exclude call protection on any prepayment that is outside the control of the borrower/ sponsor (i.e. everything but voluntary prepayments and exit)."

PART 5

Super senior and unitranche lender interactions

Super senior and unitranche lender interactions

Mid-market participants will be all too familiar with the rise in recent years of the number of transactions which are financed on a super senior – unitranche basis. When things go well, this can be a capital structure that works well for all parties – the sponsor gets the leverage it needs from the (usually sole) credit fund as opposed to a club of bank lenders and the RCF lender can hoover up all the ancillary income for itself while being protected as the super senior lender.

However, of late it's been said that some banks are not happy with the RCF only role – they don't get the economic returns, yet the amount of work involved to approve the transaction is the same as if they were providing the acquisition financing. Certainly, banks have tightened their super senior terms from the earlier deals that were done, and they remain a key stakeholder in discussions should a borrower's financial performance begin to deteriorate. Where a borrower does have both super senior and unitranche lenders in its capital structure, there will be specific points to focus on to navigate through trickier times.

In this section of our report we take a look at some of the market terms and trends that we expect super senior and unitranche providers will be focused on as we navigate the uncertain, and potentially challenging, months ahead.

Matthew Christmas
International Head of Leveraged Finance – UK

"While the received wisdom in earlier deals/documents was to keep the super senior RCF lenders at arm's length in a stressed situation so that the sponsor and unitranche lender could agree terms between themselves, the practicalities of a more dramatic intervention by the unitranche lender (such as taking the keys to a business) and/or a breach of the super senior covenant means that engagement with the super senior lender is almost inevitable. The best outcomes we've seen – for funders and sponsors – have been on deals when there's been good engagement with all parties in the capital structure and as a result each one of them has stepped up to provide further support for the borrower."

SUPER SENIOR AND UNITRANCHE LENDER INTERACTIONS

Material Events of Default and standstill periods

Material Events of Default form a separate class of events of default which are solely for the benefit of super senior lenders. These allow the super senior lenders to accelerate despite not having the voting status of a majority lender.

Unitranche lenders will typically control enforcement and on the occurrence of a Material Event of Default the super senior lenders will 'standstill' for a period of time whilst the unitranche lenders determine what (if any) enforcement action they wish to take.

Before we move onto looking at our data on standstill periods, here we have set out the de minimis thresholds and grace periods that we have seen built into Material Events of Default definitions. In its simplest of terms, these added flexibilities delay the commencement of the standstill period by the super senior lender. Undoubtedly, these will be under scrutiny if borrowers start to encounter issues.

Our data shows that super senior and unitranche lenders have not yet strayed away from the standstill periods historically accepted on senior/mezzanine deals and such standstill periods generally begin on the date the super senior enforcement notice relating to the relevant Material Event of Default is delivered.

These periods are intended to give the unitranche lender a period to agree a consensual restructuring outcome or, failing that, maximise the value of the security proceeds. As they are 'last out' of the waterfall, they invariably have the most to gain/lose (as the case may be).

Where there can be a debate, is on the ability to extend the standstill period beyond the original time limit if material enforcement action is being taken and/or regulatory approval to a disposal is required. Our results show that:

- *in the majority of cases* ***(65% of UK deals)*** *the extension for material enforcement action is typically* ***45 days****; and*
- *where an extension for regulatory approval is provided for* ***(48% of UK deals)*** *the average extension is* ***135 days****.*

NON-PAYMENT DE MINIMIS*

100K

Average is
GBP100,000

Note that we typically see the non-payment de minimis apply to any other amounts that may otherwise be due from time to time in relation to the super senior facilities, as opposed to the non-payment of any principal or interest.

FAILURE TO DELIVER FINANCIAL STATEMENTS

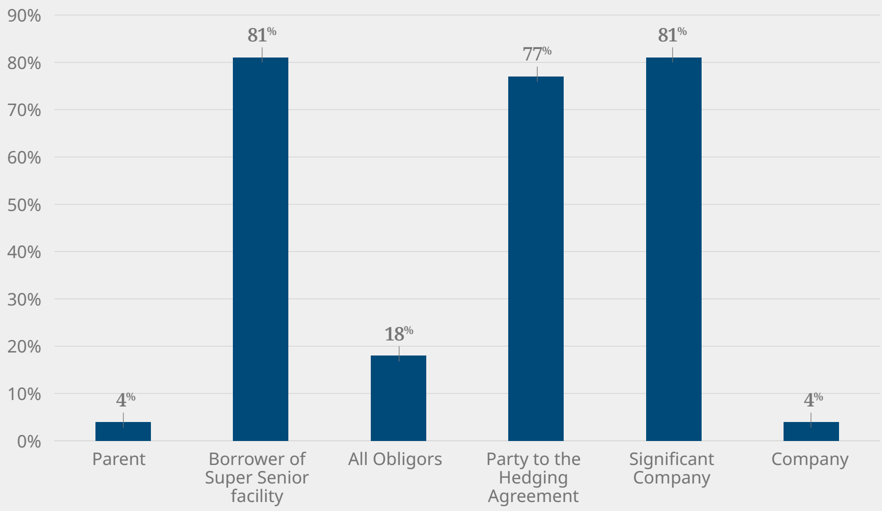
20

Average is
20 Business Days

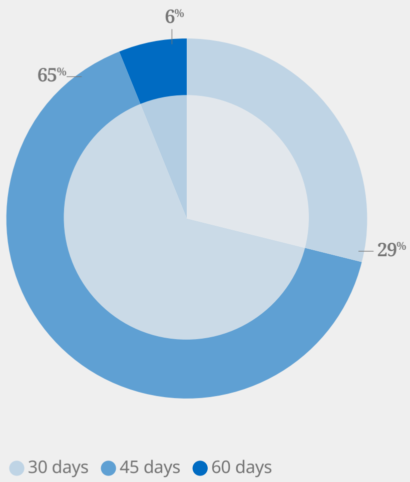
*Based on UK data denominated in GBP, whilst we are observing similar levels for EUR denominated European deals.

Material Events of Default and standstill periods (continued)

Insolvency – set by reference to:



Extensions – Material Enforcement Action



TYPICAL STANDSTILL PERIODS

90

Non-payment breach
90 days

120

Super senior financial covenant breach or failure to deliver the information required to test the covenant
120 days

150

Other Material Events of Default
150 days

SUPER SENIOR AND UNITRANCHE LENDER INTERACTIONS

Super senior financial covenants

The list of Material Events of Default for the benefit of the super senior lender will vary from deal to deal but will generally include as a minimum non-payment of amounts owing under the super senior facilities, insolvency related events and breach of a financial covenant. This super senior financial covenant will typically be a leverage test with slightly more headroom than the general leverage test (generally in the region of 10-15%), a leverage test by reference to drawn super senior facilities only or a minimum EBITDA threshold.

Notwithstanding where the lenders land on the appropriate financial covenants for a deal, the general principle will be to ensure that the super senior lender, given its position in the borrower's capital structure, sits behind the unitranche lender. The super senior covenant essentially acts as a backstop if the business is significantly underperforming.

Lenders will not only need to be mindful of how the unitranche and super senior financial covenants interact with each other, but also the impact of related provisions, in particular:

- ***Will the unitranche provider have the benefit of the super senior covenant?***
  In 58% of our UK deals, the unitranche lender also has the benefit of the super senior covenant.
- ***Will the equity cure rights apply equally to both financial covenants or is there potential for one lender's covenants to be cured but not the other?***
- ***Where the super senior covenant is a minimum EBITDA threshold, will the lender accept an EBITDA cure?***
  In the vast majority of our UK deals, we have seen super senior lenders resist EBITDA cures.

77%

of UK deals contained a super senior financial covenant set by reference to a leverage test with additional headroom

SUPER SENIOR AND UNITRANCHE LENDER INTERACTIONS

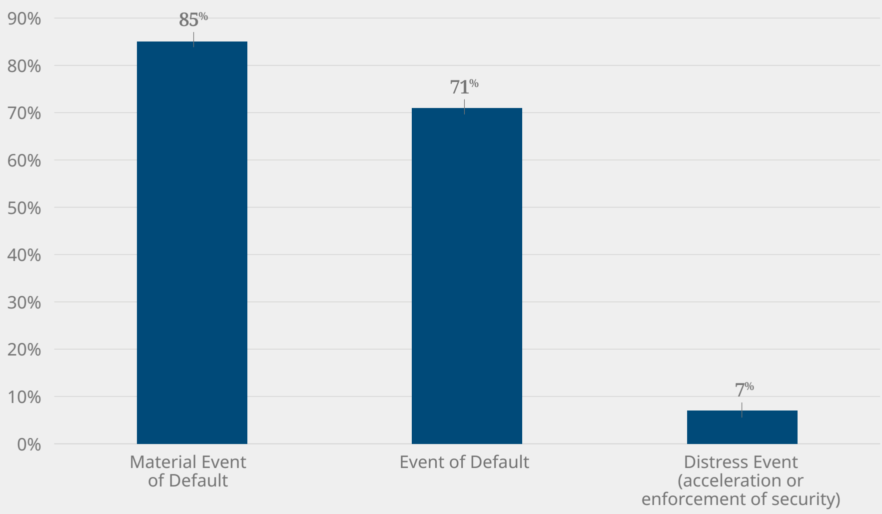
Option to purchase

A unitranche lender's option to purchase the super senior liabilities (and, in some cases, the super senior hedging liabilities) at par following the occurrence of an Event of Default or Material Event of Default (those for the benefit of the super senior lenders) is a protection that market participants will be very familiar with, providing time and control in any negotiations with the borrower about a potential restructuring.

Although this option is rarely exercised in practice, it does provide the unitranche lender with a solution if it is faced with a super senior lender that is threatening to take pre-emptive enforcement action against a borrower or in a situation where a work-out scheme requires necessary voting and it is essential for the unitranche lender to gain more control over such voting by acquiring the super senior position. However, this can be an expensive cheque to write for the unitranche lender, especially if any hedging must also be transferred or closed out (see below). Further, consideration will need to be given to any other soft limits or ancillary facilities that the bank is providing (e.g. BACS). While these may not be part of the secured facilities package, the bank may not be willing to leave these in place when the rest of its facilities have been purchased/transferred to the unitranche lender. A solution may need to be found as to how to deal with these if the borrower requires them to remain in place.

"However, this can be an expensive cheque to write for the unitranche lender, especially if any hedging must also be transferred or closed out."

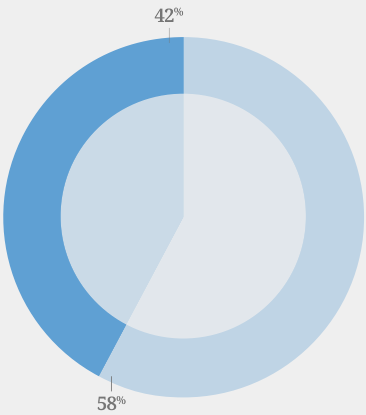
Option to purchase trigger



Option to purchase (continued)

A related consideration for unitranche lenders is the option of closing out any hedging or transferring the hedging liabilities to a third party. By ensuring that the intercreditor agreement adequately provides for this, the unitranche lender can avoid having to request consent, and potentially losing some of its bargaining power over the super senior lenders, at the most crucial of times.

Hedge transfer



Unitranche lender cure right

In a very small number of deals, we have seen unitranche lenders with the ability to step in and provide further debt/equity if the sponsor cannot or will not exercise its own cure right.

Exercising this right can be done in a number of ways. For example, by way of fresh equity into the existing structure or by employing a more aggressive loan-to-own strategy. Credit funds will want to consider the challenges they may face when exercising their rights and how this may affect their reputation in the market. Equally, sponsors will not want a lender to have a unilateral right to increase debt/subscribe for equity (and we would question how practical this is to implement anyway).

Max Mayer
Partner – Netherlands

"Sponsors are finding it increasingly challenging to source RCFs for their private credit funded deals – it is simply not an attractive product for a financial institution to merely provide a small RCF – regardless of the super senior waterfall position. This is becoming a real issue in the smaller deal space where the private credit fund bridging solution is simply not the same as a true RCF provided by a bank. Offering a FOLO solution makes this more attractive for the banks – but often the debt quantity is not there on the smaller deals where the private credit funds want (or need) a minimum capital deployment themselves. It is a real product gap – and we know private credit funds are working on this."

4%

of UK deals contained a unitranche lender cure right

SUPER SENIOR AND UNITRANCHE LENDER INTERACTIONS

Acceleration – voting rights

Control over an acceleration process is fundamental to a unitranche lender, given the amount of skin it has in the game. Control will typically be afforded to lenders which contribute over two-thirds of the secured debt. But with 38% of our UK deals permitting incremental super senior facilities to be established, the majority senior creditor calculation will always need to be carefully considered. As we look ahead to potentially challenging times, where we may see an uptick in borrowers making use of their incremental facilities to meet their increased debt needs, this consideration may grow in significance.

It is important to note that access to incremental facilities will often require compliance with a financial ratio (in most cases this will be a leverage test) and this may be a stumbling block for most stressed/distressed borrowers.

Lenders will also need to be mindful of The Corporate Insolvency and Governance Act 2020, which represents a clear move towards a debtor-friendly insolvency regime. The introduction of a Restructuring Plan, with the option for cross-class cram up/down rights, is a welcome addition to the restructuring toolkit. However, it is now possible for a company to propose a plan binding on all creditors, even if only one class of its 'in-the-money' creditors approves the plan, provided that no other class of creditors is worse off than they would be in the relevant alternative. It is also possible for a more junior class of creditors to cram up and impose a restructuring on more senior classes.

We expect to see intercreditor arrangements put to the test considering this meaningful change to the restructuring landscape.

38%

of UK deals provide for incremental super senior facilities to be established

Treatment of mandatory prepayments prior to enforcement

We typically see unitranche lenders paid out ahead of super senior lenders as part of the mandatory prepayment waterfall under the senior facilities agreement (SFA), reflecting that the super senior RCF is generally only 'first pound out on enforcement' and that mandatory prepayments (e.g. from disposals) would usually be applied against term debt and not prepay or cancel the revolving facility used for working capital.

That said, we have worked on a number of deals where instead the waterfall in the intercreditor agreement is applied (i.e. the super senior is paid out first).

Recent examples include:

- Proceeds from a change of control that are insufficient to discharge all amounts under the SFA must be applied in accordance with the intercreditor agreement (ICA).
- Whilst a super senior enforcement notice is outstanding, all mandatory prepayment amounts are held in a blocked account until (i) such notice ceases to apply (when paid in accordance with SFA) or (ii) the super senior can enforce (when applied down ICA waterfall).
- Following a distressed disposal, recovery proceeds from acquisition claims to be applied via the ICA waterfall.

18%

of UK deals include bespoke provisions relating to the application of mandatory prepayment proceeds

SUPER SENIOR AND UNITRANCHE LENDER INTERACTIONS

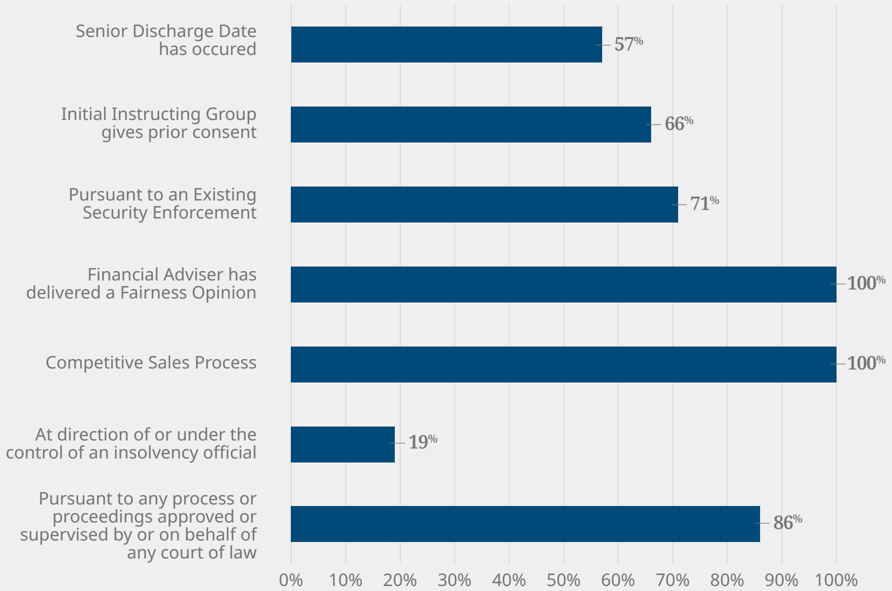
Fair value safe harbours

It's market standard for unitranche lenders to benefit from fair value protections. These protections require that the super senior lenders may only release the unitranche liabilities on the implementation of a distressed disposal if the super senior enforcement is:

- *by way of a competitive sales process run by an internationally recognised investment bank/ accountancy firm;*
- *a process approved or supervised by a court; or*
- *where a financial adviser has delivered a fairness opinion (stating that the enforcement proceeds are 'fair from a financial point of view taking in to account all relevant circumstances, including, without limitation, the method of enforcement or disposal').*

Based on our UK deal data, some fair value protections, such as a process controlled by a liquidator (or similar), have been a less common feature (included in only 19% of our UK deals), however we have seen a gradual increase more recently.

Permitted super senior enforcement: Fair value safe harbours



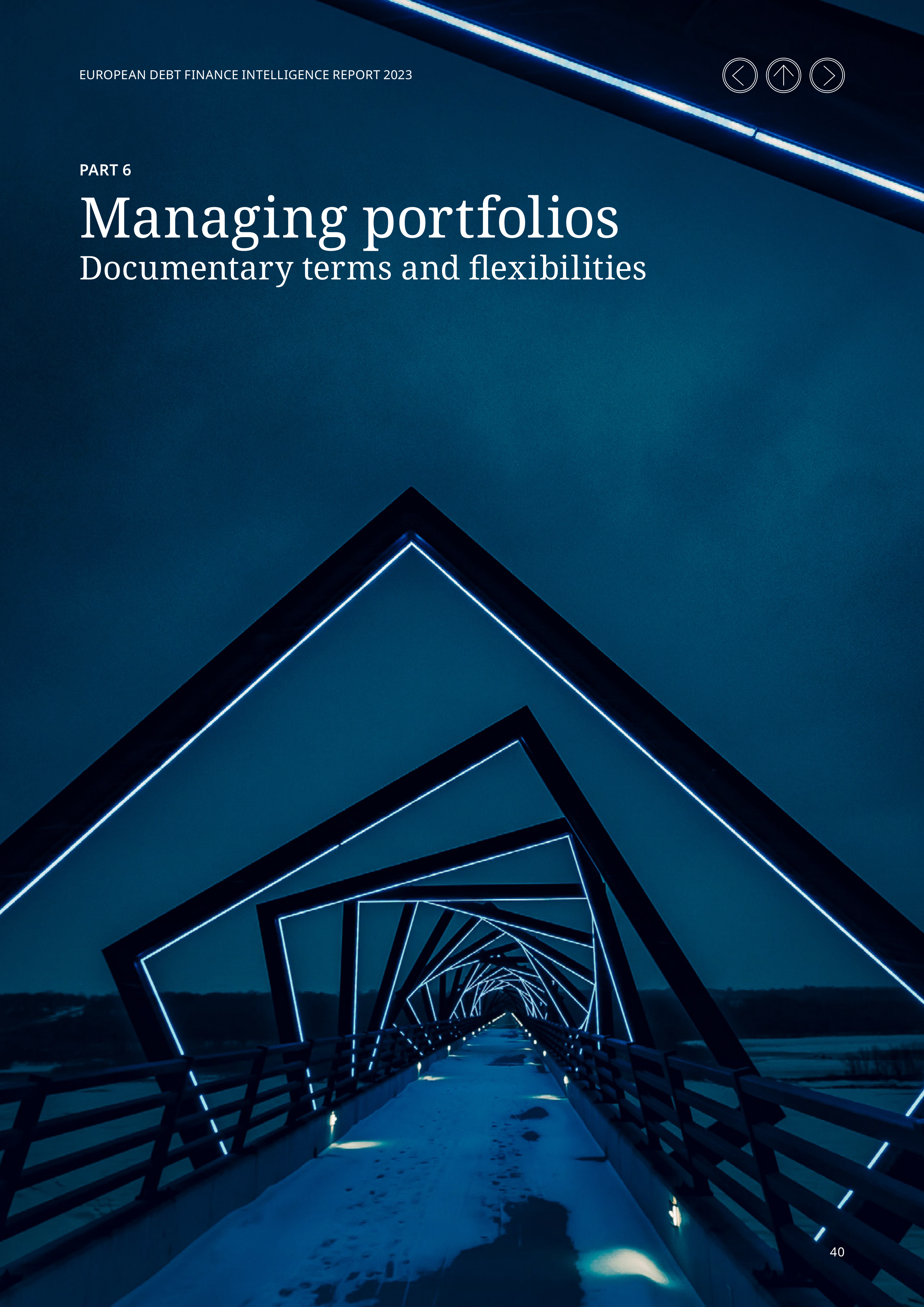
Source: DLA Piper UK Data

Sophie Lok
Partner – France

"The super senior/ unitranche structure is quite cumbersome to put in place in France because the super senior facility and the unitranche facility are not documented in the same documentation due to French banking monopoly. This can then often lead to protracted negotiations between the two groups of lenders. Since there is no established market practice in France on this structure, it is recommended that the parties agree the intercreditor principles in advance in order to avoid any delays to completion."

PART 6

Managing portfolios
Documentary terms and flexibilities



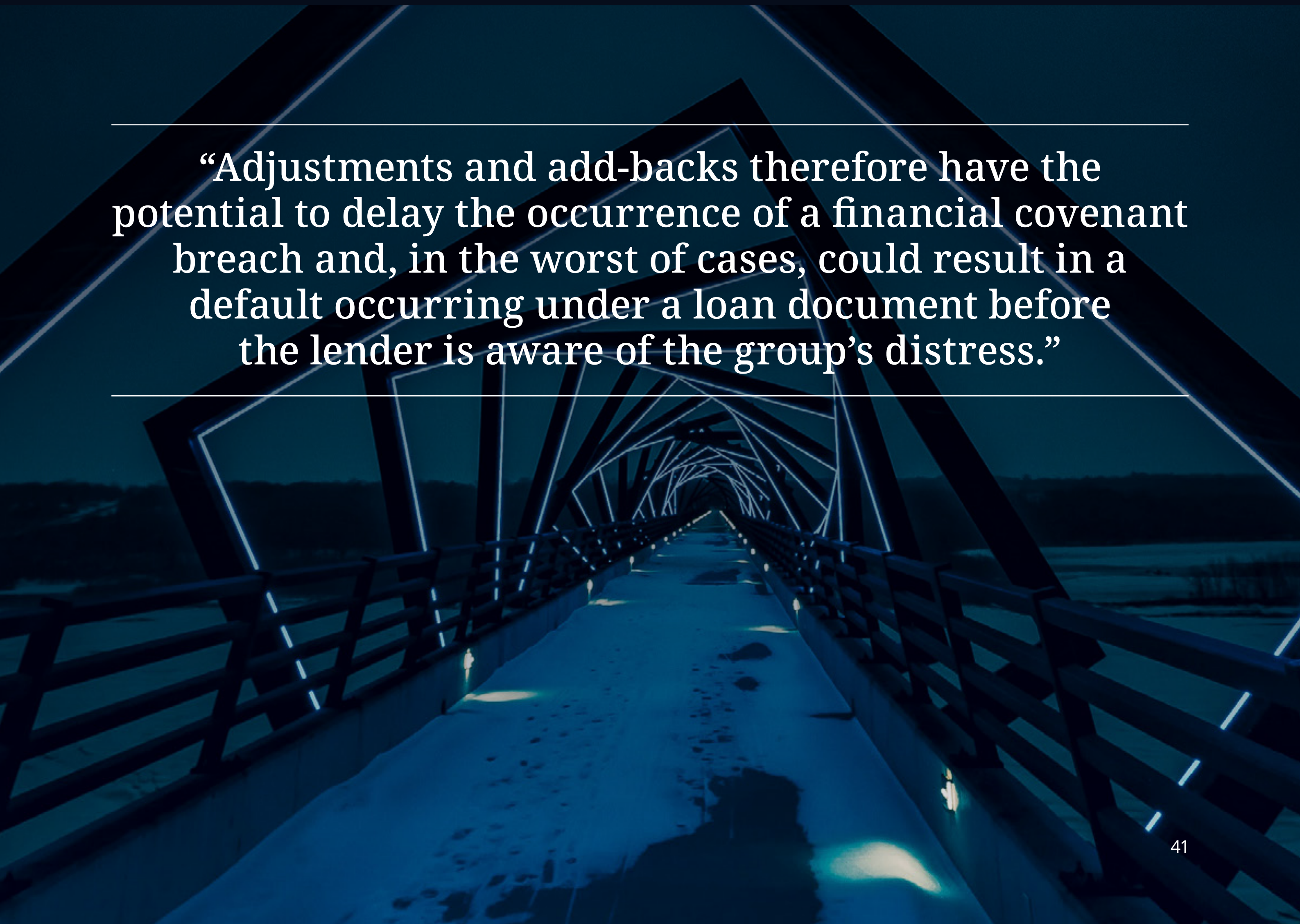
MANAGING PORTFOLIOS

Documentary terms and flexibilities

Notwithstanding the significant macro headwinds, sponsors have successfully managed to hold their ground on terms, but we will be watching this space carefully.

The market has certainly become used to the terms and flexibilities driven by sponsors in recent years and, while we don't expect to see the market regress back to the days of multiple financial covenants and a wholesale tightening of terms, we do expect lenders to exercise caution over the coming period.

Of course, what's done is done and it means that existing deals may not have as much control as lenders might think or would like. Consequently, here we will take a closer look at some of the market terms and trends that may come under closer scrutiny as sponsors and lenders debate whether or not a covenant breach has occurred.



> "Adjustments and add-backs therefore have the potential to delay the occurrence of a financial covenant breach and, in the worst of cases, could result in a default occurring under a loan document before the lender is aware of the group's distress."

MANAGING PORTFOLIOS

EBITDA adjustments and add-backs

An assortment of concepts and provisions are determined on the basis of EBITDA, and our deal data tells us EBITDA adjustments have remained an area of focus for both lenders and sponsors in 2022.

Although the mid-market has for many years accepted that EBITDA adjustments can be permitted, and that the debate is no longer confined to the large-cap arena, we've continued to see the parameters and controls around these adjustments evolve. As sponsors continue to strive for flexibility, and the scope to increase EBITDA, lenders look to limit these opportunities and impose restrictions where a lender's ability to monitor or verify the figures might be impeded.

As shown earlier in this report, we continue to see mid-market loan documentation include at least one maintenance covenant (typically a leverage covenant of Total [Net] Debt to [Adjusted] EBITDA). It therefore comes as no surprise that adjustments and 'add-backs' have the potential to result in a significant overstatement of EBITDA and, as a result, a significant understatement of leverage of a business.

Adjustments and add-backs therefore have the potential to delay the occurrence of a financial covenant breach and, in the worst of cases, could result in a default occurring under a loan document before the lender is aware of the group's distress.

As the market turns and balance sheet pressures loom, borrowers and sponsors will (understandably) be looking to maximise the use of adjustments in order to remain covenant-compliant. We expect lenders will remain alive to the issues created by over-inflated EBITDA reporting, and, especially in times of uncertainty, look to exercise discipline.

As the market turns and balance sheet pressures loom, borrowers and sponsors will (understandably) be looking to maximise the use of adjustments in order to remain covenant-compliant.

Wolfram Distler
Partner – Germany

"We have noticed that lenders are becoming stricter on exceptional items and prefer to have these capped at a certain percentage, typically in the region of 15 per cent."

Richard Normington
Partner – UK

"EBITDA adjustments have rightly been a key focus of lenders for a number of years, particularly as sponsors have successfully broadened the categories of what may be used to make such adjustments. When combined with the headroom offered on financial covenants, EBITDA adjustments of up to 20% mean there may be a significant underperformance as against modelled earnings before financial covenants are tripped. Lenders' concern around such adjustments has spread to other add-backs, including the typically uncapped add-backs for exceptional items. We are seeing some evidence of lenders now successfully capping such exceptionals on a limited number of deals."

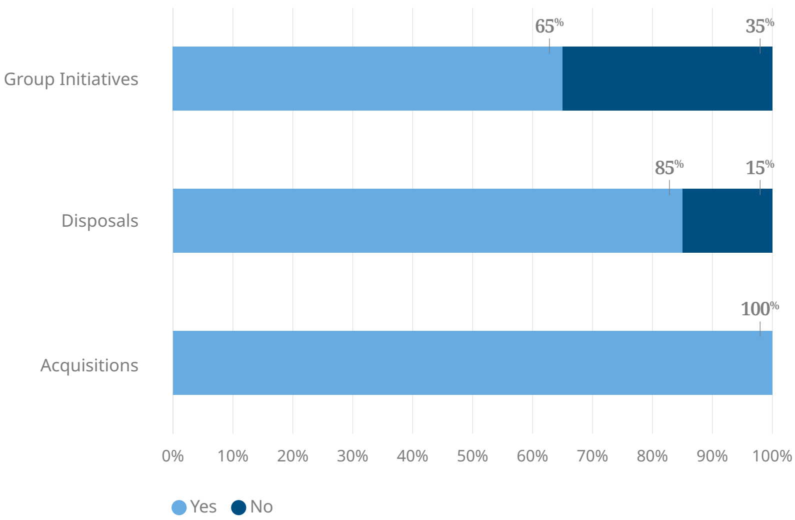
EBITDA adjustments and add-backs (continued)

Applicable transactions

The transactions that can trigger cost synergies and cost savings have broadened over the years. Historically, adjustments were limited to the projected savings and synergies associated with only completed identifiable transactions, such as acquisitions and disposals. In recent years, we have seen the inclusion of group initiatives (such as restructurings, reorganisations and other operational improvements) steadily permeate mid-market loan documentation – making its way into 65% of the UK deals reviewed.

While you would expect greater flexibility to be reserved for deals with a larger debt size, our analysis indicates that EBITDA adjustments for group initiatives have fully penetrated the mid-market.

Applicable transactions



Source: DLA Piper UK Data

"In recent years, we have seen the inclusion of group initiatives (such as restructurings, reorganisations and other operational improvements) steadily permeate mid-market loan documentation – making its way into 65% of the UK deals reviewed."

GROUP INITIATIVES: BY DEBT SIZE

74%

of UK deals
below GBP50 million

86%

of UK deals
above GBP150 million

EBITDA adjustments and add-backs (continued)

Cost synergies vs revenue synergies

In contrast to the large-cap market, we have continued to see mid-market lenders holding firm on the exclusion of projected revenue synergies (vs cost synergies) from permitted adjustments.

While cost-synergies look to remove duplicative costs and expenses following an acquisition, revenue synergies are aimed at increasing revenue.

Given the highly speculative nature of revenue synergies, it is unsurprising why mid-market lenders have exercised caution and have remained focussed on the distinction between realised and unrealised amounts – only permitting the latter where they constitute 'true' cost savings and cost synergies, and do not venture into forward looking and unrealised revenue streams. This is a trend that we expect to continue for the time being.

Verification thresholds

The vast majority of our mid-market deals include a requirement for third-party diligence or verification by auditors/consultants in respect of projected synergies above an agreed percentage of EBITDA (prior to adjusting for the relevant add-back).

In 73% of UK deals this was a prerequisite for adjustments representing 7.5% or more of EBITDA.

On the face of it, independent verification provides a lender with comfort in advance of the total cap on adjustments being reached (more on this below), but some market participants question the value this truly adds. It's often the case that these certifications are limited in scope – confined to a confirmation that the projected cost-saving is 'not unreasonable' and whether the confirmation is given on a reliance basis or not often remains up for debate.

73%

of UK deals, third party verification was a prerequisite for adjustments representing 7.5% or more of EBITDA

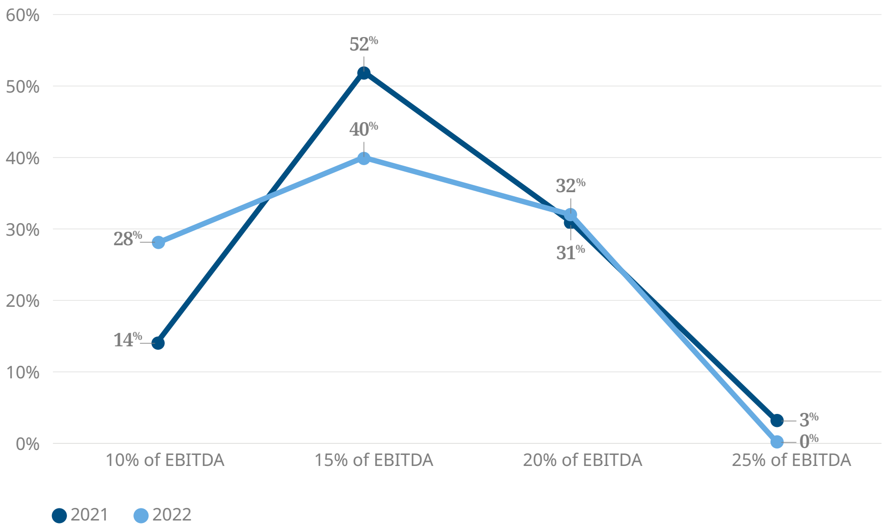
EBITDA adjustments and add-backs (continued)

Total caps on synergies

Lenders have continued to control overly optimistic projections through the use of total caps on EBITDA adjustments.

Over the years, we have gradually seen caps rise in the mid-market and the majority of our deals have included a cap of between 15-20% of EBITDA. Last year we saw a slight tightening on what was previously a steady upward trend – we expect this will continue to be a key area of focus for the period ahead.

Total cap on synergies



Source: DLA Piper UK Data

Time periods

Mid-market lenders have continued to use time periods to control the scope of synergies, and in the vast majority of deals (as many as 90% of our UK deals) we have seen the cut-off for the realisation of synergies set at 12 months. Following the expiry of this time period, the borrower then loses the ability to add the synergies back to EBITDA.

A trend that we have seen driven by sponsors of top-tier credits is the creative use of time periods in conjunction with caps in order to stretch the scope for adjustments. In these formulations:

- *higher caps are paired with shorter time periods for realisation; and*
- *lower caps are paired with longer time periods or even no cut-off period for realisation at all.*

Wolfram Distler
Partner – Germany

"We expect to see greater attention on adjustments and add-backs in Germany, but so far, the market has only changed slowly. We are still seeing sponsor-friendly concepts like ARR financings, which shows that the market is still open for new products and is still able to provide sufficient liquidity."

Sophie Lok
Partner – France

"While UK deals would typically see 12 months as a cut-off for the realisation of synergies, we have seen more flexibility given to sponsors on French deals – 12 months is standard but this may be extended to 15 or 18 months. In contrast, we rarely see caps on synergies above 15% of EBITDA."

MANAGING PORTFOLIOS

Baskets/thresholds

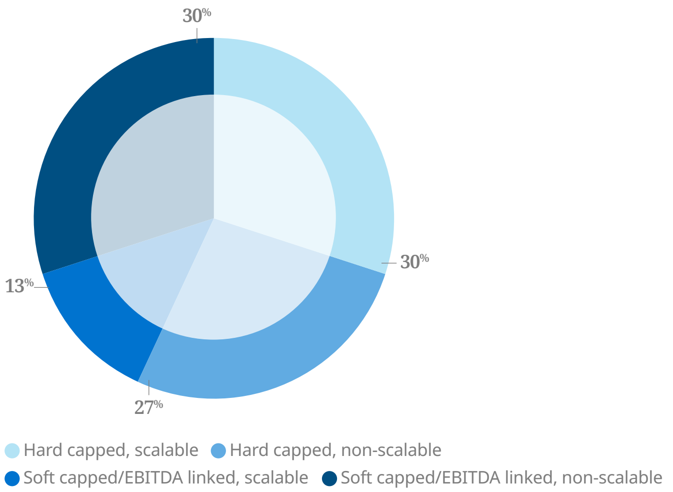
Striking the right balance between operational flexibility and curtailing leakage has continued to be a hot topic in mid-market negotiations, and we expect this to continue into the year ahead.

Baskets and thresholds have the potential to materially change the risk profile of a deal given that these permitted allowances and carve outs run through all manner of details: whether the borrower has the right to incur financial indebtedness, grant security or dispose of assets, to name but a few.

We anticipate lenders will have a careful eye on thresholds and baskets (including whether these are hard capped, soft capped or scalable) and continue to find ways of mitigating their exposure to the risk of leakage. That said, we don't expect to see the deal terms pendulum swing back fully in favour of the lenders given the level of competition that remains in the market for good quality assets.

Here, we take a closer look at some provisions that we expect mid-market participants will focus on during times of balance sheet tightening.

Basket caps and scalability



Source: DLA Piper UK Data

"We anticipate lenders will have a careful eye on thresholds and baskets (including whether these are hard capped, soft capped or scalable) and continue to find ways of mitigating their exposure to the risk of leakage."

Grower baskets

The use of soft-capped, grower baskets (the ability to increase specified baskets by a proportion equal to increases in EBITDA – often expressed as the greater of GBP/EUR/USD X million and Y% adjusted EBITDA) is well entrenched in the mid-market and, unsurprisingly, we note that the prevalence of this concept increases with deal size.

A further flexibility we expect mid-market lenders will be paying close attention to is the acceptance of one-way grower baskets (i.e. baskets that can only ever increase in size). To date, we have seen a cautious approach in respect of grower baskets remaining permanently increased (i.e. through a separate scalable mechanism). Despite the gradual convergence of other terms from the large-cap market, the mid-market might hold firm on this one for the time being.

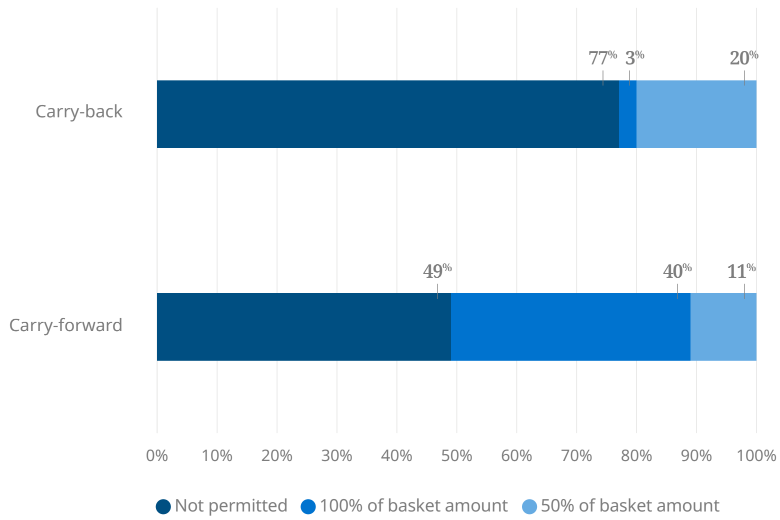
Baskets/thresholds (continued)

Carry-forward and carry-back

We have continued to see the increase in use of carry-forward and carry-back of unused operational basket amounts in our mid-market loan documentation.

Our deal data shows us that carry-back provisions were less common than carry-forward. Where carry-forward is permitted, it tends to allow for carry-forward of 100% of unused amounts. In the 23% of deals that allowed carry-back, the majority of those only allowed carry-back of 50% of the relevant basket amount.

Carry-back and carry-forward on basket amounts



Source: DLA Piper UK Data

Reclassification

The borrower's ability to reallocate basket capacity across different baskets or permissions (or even split capacity across multiple qualifying baskets or permissions) is now commonly included in loan documentation. It should be noted that, whilst 'sponsor precedents' often expressly include the ability to reclassify and split amounts across baskets, the LMA does not feature a regime for this, so it is unregulated, which does not mean that it is not permitted, in fact it arguably implies that it is permitted. For example, if a finance lease can be permitted under a finance lease basket or a general debt basket, there is nothing to say that is has to be incurred under the finance lease basket.

Deals containing soft capped/ EBITDA linked baskets

- *Permitted Financial Indebtedness – range from 5%-31% of EBITDA. Average is 10% of EBITDA.*
- *Permitted Disposals – range from 2.5%-20% of EBITDA. Average is 10% of EBITDA.*

MANAGING PORTFOLIOS

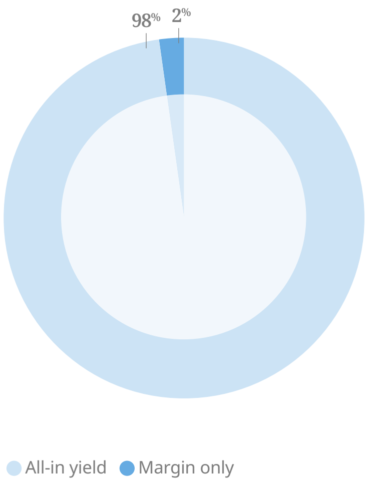
Debt incurrence

It is well established for mid-market loan agreements to permit the incurrence of additional pari passu ranking secured debt by way of incremental facilities and we have seen this flexibility in 71% of our UK deals.

During the current climate, as borrowing conditions remain challenging, we expect that many borrowers will look to exercise their incremental/accordion facilities; perhaps to take advantage of opportunistic acquisitions. Similarly, incremental facilities are a useful way for lenders to deploy capital, to businesses they know well, in a difficult lending market.

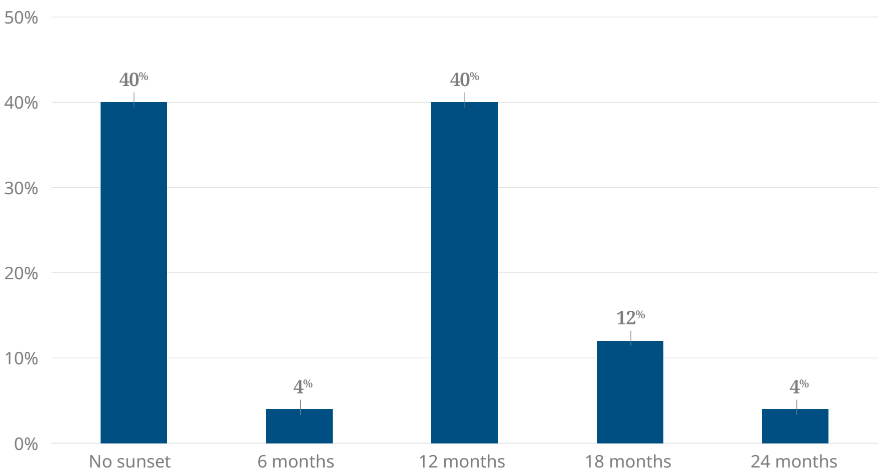
Continued use of incremental facilities may lead to lenders carefully considering their most favoured nation protections. Over the years, the parameters and controls have evolved – here we provide a snapshot of our view of the current market position.

Yield control defined by reference to:



Source: DLA Piper UK Data

Sunset time period per cent cap applies for (from the closing date)



Source: DLA Piper UK Data

Sophie Lok
Partner – France

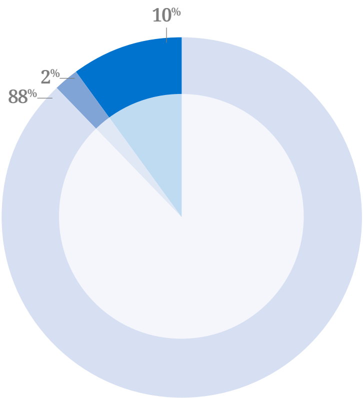
"In France, MFN provisions are broadly in line with the UK mid-market position – generally with a sunset period of 12 months and an all-in yield cap of 1% above the existing facility."

Liam Mills
Legal Director – Ireland

"Although we are starting to see some incremental/accordion facilities being activated, this is not yet widespread. However, given the cost saving compared to papering a new deal, we'd expect more borrowers to use this option in the current climate if available. MFN terms in Ireland generally align with the UK mid-market (following LMA provisions and capturing all-in yield), albeit sunsets can vary deal to deal."

Debt incurrence (continued)

Maximum per cent cap above existing facility



1% 1.50% Other

Source: DLA Piper UK Data

As mentioned earlier in this report *(see* ***SUPER SENIOR AND UNITRANCHE LENDER INTERACTIONS*** *for more detail)*, we anticipate that lenders will remain mindful of how super senior incremental facilities could potentially impact recoveries of non-super senior debt and, in the case of sizable new super senior debt, potentially impact voting rights. The added possibility of cross-class cram down or cram up under the new Restructuring Plan in the UK (and its European equivalents) is another reason why lenders will need to remain watchful of these sponsor driven flexibilities.

> "During the current climate, as borrowing conditions remain challenging, we expect that many borrowers will look to exercise their incremental/accordion facilities; perhaps to take advantage of opportunistic acquisitions."

71%

of UK deals provide for incremental/additional facilities

PART 7

Outlook and potential market trends

Outlook and potential market trends

France

Sophie Lok

Towards the end of 2022, we found credit processes to be much slower and less predictable. Lenders (both banks and credit funds) were much more reluctant to underwrite leveraged buyout financings, except for high quality assets. In 2023, we expect to see continued polarisation of the sectors, potentially a rebalancing of negotiation power between sponsors and lenders and an uptick in unitranche club deals. Despite the many uncertainties, market participants remain optimistic.

Sophie Lok
Partner – France

Germany

Wolfram Distler

The German leveraged loan market was strong in the first half of 2022 but did slowdown in the second half of the year. We've seen documentation become a bit tighter, and in particular we've noticed that private credit funds are less flexible than they were this time last year. The German economy is doing better than predicted last summer, however there are still many uncertainties and higher interest rates have not helped. That said, many funds are still keen to lend. Some private equity investors are busy with their portfolio companies (some of which have faced some difficulties) and therefore reluctant to do new deals. We certainly expect to see more restructurings in the year ahead.

Wolfram Distler
Partner – Germany

Ireland

Liam Mills

In line with other markets across Europe, M&A activity in Ireland slowed towards the end of 2022, following a bumper run of deals in 2021 and into early 2022. While some sectors remained resilient, increased costs affected many businesses, which had a knock-on effect on valuations that ultimately impacted deal flow. However, as the fundamentals of the Irish economy remain strong, we expect continued interest from international sponsors in Irish assets (particularly in the energy, healthcare, technology and financial services sectors) in 2023, which should provide ample opportunities for lenders (both banks and credit funds). Although credit processes for LBO financings may continue to be protracted due to volatile economic conditions (with the propensity for conservative leverage limits and a heightened focus on hedging interest rate exposures set to continue), the desire to underwrite quality assets will remain, with flexibility in terms, structuring and speed of delivery likely to be determining factors for borrowers. ESG is also increasingly coming to the fore across all sectors – with borrowers who have a genuine commitment to ESG availing of the opportunity to reduce their borrowing costs, and lenders (particularly bank lenders) publicly stating climate ambitions and commitments, while focusing on improving green asset ratios ahead of reporting on the 2023 financial year in accordance with the EU Taxonomy regulation in January 2024. As such, one of the key challenges for the year ahead will be locating quality assets where credible key performance indicators and sustainability performance targets can be documented at origination or within 12 months of closing, to ensure loans can continue to be referred to as sustainability-linked.

Liam Mills
Legal Director – Ireland

Outlook and potential market trends (continued)

Netherlands

Max Mayer

The Dutch leveraged market was strong and steady throughout 2022, with a slight slowdown in the latter half of the year when compared to the feeding frenzy from previous years. Credit processes became much slower and less predictable – lenders required more time and became more selective. Lenders that had previously been less competitive are now seeking the opportunity of not being outbid by larger capital providers. Larger capital providers are exercising more scrutiny, certainly towards the beginning of the 2023 season. First signals indicate a recalibration of the market, with less choice on offer, terms are tightening in favour of the lenders. We expect a flight to quality where the solution driven and user-friendly approach will prevail – a flight to process quality. We understand that market participants remain optimistic in that there are and will be opportunities, that capital on the equity and debt side are available, however value and return expectation may need to re-adjust.

Max Mayer
Partner – Netherlands

Spain

César Herrero

The Spanish market continued to be busy during 2022 and we expect a good level of activity to be maintained in 2023, mostly in the mid-market and venture capital space. There's still liquidity in the market, and we anticipate that bank lenders and private credit funds will team up for certain deals. Nonetheless, the ability of borrowers to comply with the terms of their existing facilities will be tested in 2023 due to the current market conditions (in particular those businesses still feeling the effects of the COVID-19 pandemic), and this will very likely result in a number of refinancings.

César Herrero
Partner – Spain

UK

Neil Campbell

As for the year ahead, we expect there to plenty of competition for the best assets in the best sectors, as there is still plenty of undeployed capital, but lenders will likely (continue to be) more discerning on other deals. There are plenty of processes ready to go across Europe, but confidence will need to improve a little before we see a really significant increase in activity. As always, certain provisions will come under increased focus from time to time as the market develops and deal processes play out (for example right now an aggregate cap on Exceptional Items and pro forma adjustments seems to be a topic of the day). On that note, we have also seen, tentatively, some lenders being a little bit braver in the comments they are prepared to raise on term sheets, on certain processes, in light of less competition on those deals and perhaps a general nervousness about changing markets.

Neil Campbell
Partner – UK

Conclusion

So to summarise, and as we said in the introduction, we're still in the 'wait and see' phase of the cycle. Many commentators and market participants believe that the markets will pick up during the second half of the year. We share that optimistic view (although we should note that our restructuring team is getting busier...).

Matthew Christmas
International Head of Leveraged Finance – UK

Inevitably, it will not be the same across all sectors or jurisdictions. Diligence will be key – lenders will want to run the rule over assets carefully to ensure (as far as possible) that they're backing a winner. For the well capitalised, there will be good deals to be done. With our global footprint and sector approach, wherever you find an opportunity to deploy, the DLA Piper leveraged finance team is on hand to assist.

"With our global footprint and sector approach, wherever you find an opportunity to deploy, the DLA Piper leveraged finance team is on hand to assist."

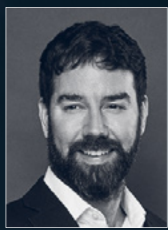
Our team

The insights in this report are drawn from the experience of our European Debt Finance group which includes over 25 partners and 80 lawyers across 32 offices. The data referenced is taken from over 100 of our 2021/2022 sponsor-backed European leveraged finance transactions.

David Ampaw
Partner, UK

Stephen Bottley
Partner, UK

Ugo Calo
Partner, Italy



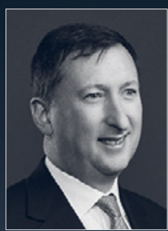
Neil Campbell
Partner, UK

Matthew Christmas
International Head of Leveraged Finance, UK

Kate Curneen
Partner, Ireland

Sarah Day
Partner, UK

Wolfram Distler
Partner, Germany



Mark Dwyer
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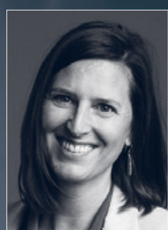
Partner, Spain

Børge Grøttjord
Partner, Norway

Xavier Guzman
Partner, Luxembourg

César Herrero
Partner, Spain



Caroline Hoste
Partner, Belgium

Our team *(continued)*

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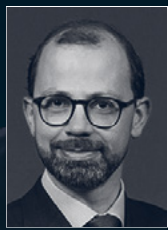
Mariusz Hyla
Partner, Poland

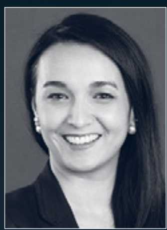
Joachim Kundert Jensen
Partner, Denmark



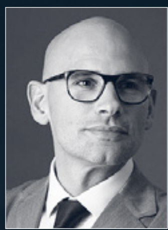
Erwan Lacheteau
Partner, France

Gemma Lawrence
Senior Market Intelligence Manager, UK

Allan Leal
Partner, UK



Sophie Lok
Partner, France



Max Mayer
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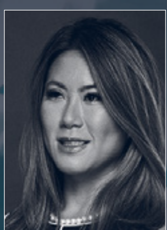

Mei Mei Wong
Partner, UK