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What's Market: 2020 Year-End Trends in Large Cap and Middle Market Loan Terms

by Practical Law Finance

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An Expert's View: Large Cap Loan Market Trends

Scott M. Herrig of Davis Polk & Wardwell LLP discusses the impact of COVID-19 on the large cap loan market and the large cap loan market's later rebound.

How did your practice change after the immediate onset of the COVID-19 pandemic?

As a senior associate at Davis Polk, my partner mentors regularly told me that, sooner or later, everyone in our finance group becomes a restructuring lawyer. The guidance they were providing, of course, was that a well-rounded finance lawyer needs to be prepared to advise not only on new-money financings, but also on distressed situations both in and out of court. As we entered a new reality in March 2020, it seemed like the scales had tipped towards working on distressed matters for the foreseeable future. The various acquisition-related financings I was working on at the time came to a screeching halt, and I ended up spending the majority of my time through the first half of the year advising ad hoc groups of creditors on the finance aspects of restructuring matters.

These matters happened to follow a fairly traditional path: following a default by a borrower under its loan agreement, we negotiated a forbearance agreement with the borrower, which provided the borrower with time to prepare for a Chapter 11 filing, including a DIP financing package to ensure that the borrower had sufficient funds to finance its operations and the bankruptcy case. During the pendency of the Chapter 11 case, the focus from a financing standpoint shifted to the post-exit capital structure, including the negotiation of "take-back" paper as part of the exit consideration.

Despite my experience during the first half of 2020, in my view one of the truly surprising aspects of 2020 was the various ways in which many borrowers in industries impacted by the pandemic were able to find additional capital without the need to file for bankruptcy protection. Our firm and group kept incredibly busy not only with mandates related to the US government's response to the pandemic, but also on an extraordinary number of traditional high-yield debt offerings that provided companies with much needed liquidity. We also worked on many novel financings to this effect, especially within the airline industry. For example, my colleagues and I worked on complex financings for airlines secured by their loyalty programs (and in certain cases, their brand intellectual property). At the same time, we at Davis Polk kept abreast of the well-publicized ways in which distressed borrowers sought additional runway either by using transactions in which lenders improved the priority of their claims in consideration for providing priming new-money debt (which we refer to as up-tiering transactions) or by using transactions in which lenders provided structurally senior financing secured by assets outside the existing collateral package often, though not always, by transferring intellectual property to unrestricted subsidiaries (which we refer to as drop-down financings).

With the continuing challenges of the pandemic, did you anticipate that the LBO market would rebound so quickly? What were some of the most important issues to borrowers and lenders in the origination and syndication of deals as the market recovered?

We saw the beginnings of the acquisition financing resurgence in August 2020, which came at precisely the same time we were experiencing a crescendo of liquidity financings and in-court restructurings. Since then, our work has gradually skewed back towards our traditional acquisition financings and, more recently, a significant number of repricings and refinancing transactions.

In the new-money acquisition financing market, arrangers and direct lenders are focused more than ever on protections against:

- Up-tiering transactions, which typically focus on the voting threshold to modify pro rata sharing or payment waterfall provisions or to subordinate the liens or obligations of the existing lender group.
- Drop-down financings, which typically center on governing the terms of any transfer of material intellectual property to non-loan parties, including unrestricted subsidiaries.
- The release of a guarantee solely as a result of a guarantor becoming a non-wholly owned subsidiary.

At the same time, these discussions with borrowers are against the backdrop of an active debt financing market with robust demand, so lenders and their counsel remain thoughtful in choosing the points that are most meaningful to a particular credit. Aside from the negotiation of these terms, all else equal, it is difficult to discern significant and consistent differences between the terms of a January 2021 committed financing in the large cap market and a pre-pandemic, January 2020 financing.

We also saw many challenging deadlines for acquisition financings, especially at the end of 2020. In particular, many parties sought to sign deals before the US presidential election in November with a closing before year-end. To satisfy this incredibly tight timeline, many arrangers were asked to directly fund the committed debt at closing, with syndication to the market occurring only on a post-closing basis.

The primary issue that arose in these transactions was the terms (including pricing) of the funded loans. While borrowers sought to close into financings on the indicative (or even better) terms of the commitment letters, banks, which were holding the risk that a successful syndication may not occur, often pushed to include certain "market flex" provisions at closing to ensure that the borrower's flexibility was appropriately constrained during the pre-syndication period.

Relatedly, in this type of financings involving high-yield bonds, arrangers were often forced to fund the committed bridge loan facility, as there was insufficient time to fully market and syndicate the bonds given the December "blackout" period. As bridge financings are rarely funded in the ordinary course, arrangers and borrowers were forced to grapple with the intended meaning of certain imprecise language (for example, "in a customary manner") in bridge commitment letters.

Given the strength of the leveraged loan and high-yield debt markets in January 2021, arrangers that had pre-funded these financings, whether loans or bridge, before a customary marketing period or road show were typically able to syndicate them after funding without the need to exercise market flex or securities demand rights.