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What a Difference a Year Makes:
A Review of Acquisition Financing in 2010

The Dust Settles

In a January 2010 memorandum titled "**Acquisition Financing in 2010 - Trends from 2009**", we considered the state of acquisition finance in 2009 and drew some tentative conclusions about what 2010 might bring. One question left unanswered in that memorandum was whether the trends we observed in 2009 represented a new, post-crisis norm, or a temporary departure from the borrower-friendly standards established during the 2005 to 2007 LBO boom. That question appears to have been answered in 2010. While lending institutions were successful in defending some of the more important post-crisis changes to their financing documentation standards, mandate papers became more borrower-friendly in several key respects. In this memorandum, we look back on LBO financing activity in 2010, assess the extent to which trends we identified last year have held, and consider some new developments.

The Landscape in 2010

The market for acquisition financing rebounded strongly in 2010. LBO loan volume for large and mid-cap borrowers increased ninefold from 2009 (a significant rebound though still only one-quarter of 2007 volume). Leveraged dividend recapitalizations and stock repurchases approached the levels seen in 2006 and 2007 and set an all-time record in the fourth quarter of 2010. High-yield bond issuances had a record-setting year and the institutional loan market rebounded strongly, with volumes 30% greater than 2008 and 2009 combined, though still far short of 2006 and 2007 levels. Market sentiment was bolstered by improved credit conditions evidenced by loan default rates, which fell from 10.8% in November 2009 to 1.9% by the end of 2010. As conditions improved, the appetite for leverage grew: equity contributions in connection with LBOs averaged 40% in 2010 (down from a peak of 50% in 2009), though anecdotal evidence suggests this soon will (or already has) returned to the 30% levels last seen in 2007. Meanwhile, average leverage levels for broadly syndicated LBOs increased to 5.5x, with leading-edge LBOs breaching the 6x barrier.

This improved market sentiment and increased volume had a profound effect on the process for securing financing commitments. In many, though not all, respects, the process for securing bank and bridge financing commitments for acquisitions by private equity sponsors began to exhibit the same intensely competitive, precedent-driven and time-compressed characteristics seen during the last LBO boom. Some of this was to be expected as competition among financial institutions increased. It is unsurprising, for example, that major sponsors are asking their counsel to produce the first draft of mandate papers (sometimes accompanied by a "sponsor grid" setting out key economic terms) so that they can quickly and efficiently compare multiple proposals. Furthermore, fierce competition between sponsors for the underlying asset and, in many cases, a desire by sponsors to "preempt" a general auction, combined with a strong interest in maintaining a sense of urgency among the banks competing for the underwriting business, frequently means that arrangers are forced to complete diligence, obtain internal underwriting approvals and paper commitments under extreme time pressure. This has been exacerbated by recent requests from sponsors for arrangers to underwrite covenant packages from unrelated transactions. Doing so requires arrangers, with the assistance of counsel, to become familiar with those covenant packages, the precedent transaction, the relevant company and industry for which those covenants were negotiated, and to analyze them against other comparable transactions and current market trends, all within the same compressed time frame. On the back end, rating agencies have recently insisted on seeing draft credit agreements before issuing ratings. This can mean that financial institutions and their counsel must turn to definitive documentation immediately upon announcement of an acquisition in order

to ensure that indicative ratings are in place in time to launch the syndication (often within a week or so of announcement). The desire of participants to document complex transactions on such an accelerated schedule will be one of the continuing challenges for 2011.

Everything Old Is New Again

Conditions Tighten and Certain "Frothy Market Features" Return…

In 2010, most LBO acquisition agreements were structured without a financing condition but with a reverse termination fee payable by the buyer in the event that financing proved to be unavailable. Reverse termination fees in 2010 continued on average to be higher than the 2-4% often seen in the period leading up to the credit crisis. Unsurprisingly, sponsors continued to push for minimal conditionality in debt financing papers, so many of the pressures on conditionality that we identified in our 2009 memorandum remained and increased in 2010. Large sponsors' papers typically featured so-called "SunGard" protection, though these provisions continue to be closely scrutinized by arrangers. Minimum ratings conditions and leverage or other performance conditions were largely absent and "market MACs" were nowhere to be seen. Sponsors were also successful in reserving the right to modify the acquisition agreement unless the modification would be materially adverse to the lenders (with certain changes, including price reductions in excess of a threshold amount, being deemed to be materially adverse).

In addition, many "frothy-market features" from the LBO boom returned in 2010. As demonstrated by several recent transactions (including the LBO of Commscope by Carlyle Group), covenant-lite loans are available for the right credit. It was also not uncommon to see transactions that contained only a single net leverage (or net first lien leverage) ratio set at a cushion of 25 to 30% over levels projected in a sponsor financial model and subject to broad, underwritten EBITDA add-backs. Equity cures also became part of the boilerplate in many forms, though they continue to be subject to certain conditions, including caps on the number of cures in any year and over the life of the facility. General purpose incremental facilities have returned and have taken on a life of their own, as discussed further below.

…But Certain Credit-Crunch Technology Survives

Arrangers have successfully defended certain technology that arose directly from credit-crisis litigation. Parties are required to submit to the "exclusive" jurisdiction of New York for any disputes. Acquisition agreements routinely contain so-called "Xerox" protections limiting lender exposure to a seller. Arrangers closely examine financing provisions of acquisition agreements to ensure the target is obligated to provide its financial information in a timely manner, and to provide other assistance needed, in order to achieve a successful syndication of the bank facilities or marketing of any securities. The solvency representation is a condition to closing even in SunGard-protected deals, as is the delivery of a solvency certificate (with a form of the solvency certificate now sometimes pre-negotiated and attached to the mandate papers). The so-called "loss mitigation" provision (permitting the arrangers to flex terms in circumstances where the arrangers do not believe a successful syndication is possible) has survived, and relatively robust (compared to 2006 to 2007) flex provisions continue to be a key protection for arrangers. Finally, provisions that ensure that the base rate can never be less than 100 basis points above one-month LIBOR have survived and are part of most banks' forms.

Bridge Financing; a Continuing Battleground

Bridge financings (and in particular securities demands) continue to inspire spirited negotiation between a borrower and its banks, although it is possible to identify some areas of emerging consensus. Sponsors have been largely successful in eliminating pre-closing securities demands (i.e., the arranger's ability to require that securities be issued into escrow) and in rolling back index-based pricing caps that appeared in certain deals in 2009. Failure to comply with a securities demand now typically triggers an increase in the interest rate payable on the bridge to an agreed cap, the payment of the "conversion" or "rollover" fee, and certain changes to assignability and call protection. Arrangers generally continue to insist on being

able to make a demand for securities at the cap on the closing date (without a post-closing holiday), although there is some evidence that this can be negotiated on a case by case basis (e.g., if a drawn bridge is contemplated in light of the transaction timeline). However, despite these areas of general agreement, the terms and conditions of the securities demand will continue to be an area for debate in 2011.

New Developments in Financing Commitments

Borrowers Focus on Financing Flexibility

In the years following the credit crisis, in the context of approaching maturities, tighter credit conditions and worsening economic and financial performance, many borrowers began to look for ways to adjust their balance sheet by extending maturities, retiring loans through repurchases in the open market or through modified dutch auctions, or refinancing debt through longer-term facilities with less restrictive or no financial maintenance covenants. In many cases, however, they found that their credit agreements either did not contemplate or did not permit such transactions. Therefore, in 2010, sponsors sought to pre-wire financing flexibility for their portfolio companies when preparing mandate papers.

Two techniques employed by borrowers to manage near-term maturities are loan buy-backs and "amend and extends". The typical credit agreement did not expressly contemplate either of these transactions, and assessing their permissibility frequently raised difficult questions of interpretation. Mandate papers now commonly include language contemplating and permitting loan buy-backs (by both the borrower and the sponsor), subject to certain defined parameters designed to ensure procedural fairness and minimize interference with the normal lender-borrower relationship (these largely follow the Warner Chilcott model set in late 2009). Similarly, many forms also permit extensions of maturity with the consent of the extending lenders subject to certain procedural requirements and sometimes "most favored nation", or "MFN", pricing protection. Although arrangers frequently retain the right, through market flex clauses, to eliminate these provisions if they encounter resistance in syndication, there is so far little evidence of a properly structured amend and extend or loan buy-back provision receiving significant resistance from loan market participants.

Another relatively new feature of sponsor mandate papers is the so-called "refinancing facilities" provision, which must be read side by side with the incremental facilities that have become part of the boilerplate in many forms. Both provisions are designed to ensure that the borrower has the flexibility to raise additional debt (up to a cap and/or subject to a maximum leverage test), or refinance all or part of the committed facility. That incremental or refinancing debt can be incurred either as part of the committed facility, as loans under a separate facility or as debt securities, subject to certain conditions (e.g., as to maturity and intercreditor arrangements and, sometimes, subject to "MFN" pricing protection). Many of the features of these provisions are not new. For example, credit facilities often permit the incurrence of junior debt subject to a cap without required lender consent. The real innovation of these provisions is the ability to incur refinancing debt that shares equally and ratably in the collateral and may or may not be part of the committed facility, all without required lender approval. As with loan buy-backs and amend-and-extends, arrangers sometimes retain the right to flex these provisions away, but similarly there is little evidence of general resistance in the loan market.

Underwriting Terms and Documentation Standards

When it comes to describing the terms of the proposed financing in commitment letters, Borrowers typically push for detail and specificity - or at least references to existing documents with which they are familiar – while arrangers, typically prefer more flexibility. In 2010 we saw two emergent approaches to resolve this tension.

The first recycles the approach that was frequently taken during the 2005 to 2007 period, namely a requirement that, except as set forth in the mandate papers, the definitive documentation must be

"consistent with sponsor precedent". This formulation is a double edged sword. On one hand, the generality of the standard can provide arrangers some flexibility when faced with a difficult syndication. On the other, it invites the sponsor to cherry-pick from top-of-the-market deals, and to import concessions that were cheap in one deal but meaningful in the next.

Under the second approach, the arrangers are asked to underwrite a specific precedent transaction. This replaces the approach sometimes seen in 2006 and 2007 where lengthy, detailed covenants and definitions were negotiated and then attached to the commitment letter. Arrangers will typically undertake a detailed analysis of the referenced precedent and the context in which it was negotiated before agreeing to such a standard and, if they do agree, will add a list of the items they are not comfortable underwriting to the "flex" provisions of the fee letter.

Under either formulation, both the arranger and the sponsor are generally required to act reasonably and to take into account certain factors, including the industry, size and financial condition of the borrower, the borrower's and the sponsor's business plans and, sometimes, prevailing market conditions at the time of syndication. As discussed above, sponsors have attempted to have these standards apply not only to bank and bridge terms, but also to the terms of contemplated debt securities, including demand securities. Market practice has not yet coalesced around a single approach or formulation and, in our experience, parties continue to negotiate these difficult provisions deal-by-deal, bank-by-bank and sponsor-by-sponsor.

Other Trends/Developments

Financial system reform and other regulatory changes impacted financing terms in 2010. Concerns about costs arising from the Dodd Frank Wall Street Reform and Consumer Protection Act and Basel III have caused many lenders to add a provision to their forms designed to ensure they have flexibility to pass those costs on to borrowers. On the flip side, it has generally been accepted that FATCA (Sections 1471 to 1474 of the Internal Revenue Code of 1986) costs will normally not be passed along to borrowers and this, together with certain other changes, is causing many financial institutions to substantially rewrite the tax provisions of their forms for the first time in years. Both of these developments, together with a close analysis of defaulting lender provisions, are the subject of a continuing study by the LSTA in connection with its Model Credit Agreement Provisions revision project[1].

Acquisition Structure

Another notable trend in 2010 was the increased use by financial sponsors of the "two step" tender offer as the deal structure of choice. In a two-step tender offer, if a sufficient number (typically 90%) of the company's shares are tendered, the parties can effect an immediate "short-form" merger, avoiding the need to schedule a subsequent shareholder meeting and vote. A two-step tender offer also benefits from streamlined SEC review and shortened Hart-Scott-Rodino waiting periods. Accordingly, if a short-form merger is available following a tender, the entire process can be completed in 20 to 45 days, as compared to 90 to 120 days for the typical "one-step" merger. Acquirers and sellers have long valued the two-step structure for the ability to gain control quickly and minimize the risk of topping bids or adverse developments impacting the acquisition. However, they were out of favor for many years until, among other things, the SEC clarified its "best price" rule for tender offers in 2006. Several prominent financial sponsor deals (e.g., 3G Capital's tender offer for Burger King, Bain Capital's tender offer for The Gymboree Corporation and GTCR's tender offer for Protection One, Inc.) were structured as tender offers in 2010. In some of those transactions, the parties deployed a so-called "top-up" option, which allows the

[1] We represent LSTA in these efforts.

acquirer to purchase newly issued shares of the target as necessary to reach the 90% threshold typically required to complete a short-form merger. We expect that this acquisition structure will continue to be attractive to all parties when completing an immediate second-step merger is feasible.

Conclusion

Those expecting 2009 to represent an inflection point in the acquisition financing market were likely disappointed by developments in 2010. The big story of 2010 is the long awaited increase in LBO activity and the impact that has had on process and terms. However, while some provisions and practices at first blush appear strikingly reminiscent of their 2007 counterparts, a closer look often reveals the presence of certain nuanced protections successfully incorporated by lenders and arrangers. Moreover in 2010 both sponsors and arrangers introduced new terms designed to adapt to the changing regulatory environment or in anticipation of future financing needs. If January activity levels are any guide, 2011 promises to be another pivotal and exciting year in the acquisition finance market for arrangers, sponsors and their respective advisors.

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