Proskauer

Private Credit Deep Dives – Call Protection (Europe)

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“Call protection” (which you may also hear referred to variously as a “prepayment fee”, “prepayment premium”, “call premium”, “prepayment penalty”, “non-call”, “hard call”, “soft call” or “make-whole”) is a core economic term on leveraged financings. The underlying premise behind the concept is that, having advanced a loan, a lender should have contractual assurance that it will earn the agreed level of yield on that loan for a certain period of time after closing (and that it will not be permitted for the borrower to prepay the loan the following day, for example, thus depriving the lender of substantially all the interest income it expected to earn when executing the transaction). Lenders will most acutely feel the risk of being prepaid early on a transaction when they fear a near-term decline in interest rates. Currently the bank-driven credit markets remain unsettled, and there is an acknowledgement from market participants that the levels of pricing for new private credit deals are very attractive in comparison to the last couple of years of this credit cycle. Accordingly, lenders will be eager to lock in these returns for a reasonable period, rather than risk being quickly refinanced with cheaper debt if more optimal credit conditions suddenly return. This is particularly the case for private credit providers that are increasingly financing deals that would previously have gone to the broadly syndicated market. While that market currently remains largely closed to new primary underwriting, in the event it fully reopens in the near future the pricing levels that are achievable will likely be inside of the minimum rates of return for most private credit providers.

This deep dive with Daniel Hendon (Partner) and Phil Anscombe (Associate), lawyers in Proskauer’s Private Credit Group in London, will explain how call protection is commonly achieved in today’s market and how sponsors have sought to limit its scope, as well as describing the current hot topics and potential pitfalls for various deal sizes.

There have broadly been three methods of achieving call protection for lenders historically:

- Firstly, by agreeing that the loan cannot be prepaid (or, in the language of bonds, cannot be "called") within a certain period. This is what was originally meant by "non-call" and it is in reality no longer seen in the European or US loan markets.
- Secondly, by agreeing that, if the loan is prepaid within a certain period (confusingly, this is sometimes referred to as a "non-call period", despite the fact the loan can actually be "called" or prepaid during that period) then the borrower must nonetheless pay all the interest that would otherwise have accrued on the amount being prepaid up until the end of that period. This is a "make-whole" (as the lender is "made whole" for the interest it anticipated otherwise receiving for that period) and remains a common feature of the European market and in lower middle-market sponsored and sponsorless US transactions. This will typically include not only the margin but also the appropriate prevailing reference rate at the time of prepayment (and giving effect to any reference rate floor).
- Thirdly, by agreeing that, if the loan is prepaid within a certain period, a simple premium amount must be paid (calculated as a percentage of the principal amount being prepaid). This remains a very prevalent feature of the market.

It is common for the second and third approaches above to be combined on any particular transaction – for example, it might be agreed that for the first year after closing the borrower must be "made whole" with the full projected interest accrual for that period and that, during the second year after closing, a premium will apply instead. There is a well-established system of shorthand for describing a call protection regime, which it is helpful for market participants to understand in order to be able to navigate grids and term sheets. A reference to NC[X] (e.g., NC1, NC2, NC3) means that any prepayment will be subject to a "make-whole" for X number of years after closing. If you see a protection expressed as 102 or 103, for example, that means that a premium of 2% or 3% applies on the principal amount being prepaid in the relevant year. These data points being expressed sequentially suggests that these regimes follow one another sequentially in time for that particular deal, so for example if you see "NC1/102", that means that there is a make-whole in year one and a 2% premium in year two. If you see 102/101, that means no make-whole applies and there is simply a 2% premium in year one and a 1% premium in year two. Where, on a particular transaction, a make-whole period is followed by a period in which a premium is payable, it is important to draft this so that the make-whole is calculated as the <u>higher of</u> (i) the projected interest accrual for the rest of the make-whole period and (ii) the premium that would otherwise have been due if the payment was made in the following year. Otherwise, mathematically you would end up in the clearly illogical position that a prepayment made on the last day of a make-whole period attracts almost no call protection, whilst a prepayment made the following day attracts a material premium. It should be noted that it was formerly the case that the make-whole would be the <u>sum of</u> those items (i.e., projected interest accrual plus the premium that would have been due in the following year) but that has become relatively uncommon in the European market.

In recent years, sponsors have increasingly used their market power to limit the amount of any call protection that might be payable, the time period during which it applies and also circumstances in which it might become due. While this is generally subject to significant commercial negotiation between principals, the areas of contention are commonly as follows:

1. **High-level terms** – Until recent months, there had been consistent downward pressure on the levels of call protection afforded to lenders for a number of years in the private credit market. While a make-whole was formerly standard in at least

the first year after closing, Proskauer's 2022 European private credit deal data showed make-wholes only now apply on a little over 60% of European private credit deals in year one, with c.65% of deals having either a 2% or 1% premium in year two (rather than a make-whole) and over 80% of deals having no call protection from year three onwards. This still remains on average more conservative than in the US, where the most common formulation from our 2022 data was a simple 102/101. It is worth noting that there is some variation within product type, with sponsorless transactions and subordinated instruments (whether second lien, holdco PIK or otherwise) typically commanding a more robust call protection regime. Signs are that lenders are insisting on better call protection in the current market but further time will need to pass before it can be determined whether this will be a sustained trend.

2. **Type of prepayment** – While it was once the case that any prepayment of the term facilities would attract call protection, that is now very rarely the agreed regime. In the European large cap syndicated market and in sponsor-favorable upper middle market US transactions, the protection is typically limited to what is known as "soft call" (and in that market lenders commonly receive 101 protection for six months only from closing and on a "soft call" basis). What is meant by "soft call" is that lenders are only protected in the instance of a "repricing event". What this broadly means (although there are sometimes additional nuances) is that the protection only applies upon a voluntary prepayment of the facility, funded by new indebtedness, where the primary purpose of that refinancing was to reduce the applicable cost of debt to the group. There would likely be an exception for any such debt incurred in connection with a change of control/IPO or a transformative acquisition, so that this would really be limited to a scenario where the borrower is opportunistically taking advantage of declining interest rates. This "soft call" regime has generally been strongly resisted by the European private credit community. Instead, the most common formulation within private credit will be that any voluntary prepayment (for whatever purpose) will attract call protection, as well any prepayment (whether voluntary or mandatory) made in connection with a major liquidity event for the sponsor (i.e., any change of control, sale of substantially all assets or any IPO), though in the US, these liquidity events may trigger only a "discounted" premium, i.e., 50% of the call protection that would otherwise be payable. It is also typical for US transactions to include call protection with respect to any mandatory prepayments made with debt incurrence proceeds (noting this is not a typical prepayment event in Europe). It has become significantly less common both in Europe and the US to see call protection for other classes of mandatory prepayment (e.g., excess cashflow sweeps, proceeds of asset sales, etc.) on the basis that these are credit-enhancing payments that were contractually required by the lender, rather than directly

benefiting the sponsor, but certain of these are still seen on a small minority of deals. Some lenders also require call protection to apply upon acceleration (such that their claim upon enforcement crystallises the call protection amount as being due and payable) or when being “yanked” from a deal (meaning either being prepaid or replaced by another lender, due to refusing to consent to certain amendments, being replaced due to an illegality issue or otherwise); these remain relatively uncommon in Europe, but US transactions may still require a premium upon a “yank”.

3. **Net present value** – Where a “make-whole” applies, sponsors often look to reduce the amount of call protection that becomes due, by applying a net present value calculation to the projected interest accrual. The rationale for this is that, if the facility had otherwise remained outstanding, the lender would have received its usual interest payments periodically up until the end of the relevant period. Instead, it will be receiving the equivalent amount of call protection in cash up-front on the date of prepayment, meaning that cash could in theory be reinvested in risk-free assets with an almost guaranteed level of economic return for the rest of the make-whole period. As a result, sponsors will suggest that the projected interest accrual amount be discounted (at an annual rate approximate to a risk-free rate) from the end of the make-whole period back to the date of prepayment, so as to ensure the lender is not better off than it would have been had the deal continued. While this is not always accepted by lenders, it is a relatively common feature of the private credit market. In terms of the rate that is used for discounting, this is typically tied to the relevant currency (so for example it may be US treasuries of the equivalent tenor for USD, UK gilts for GBP and German bunds for EUR). When rates were very low, it became common to use a rate with 0.50% headroom to those government rates but in the current market some lenders prefer to remove the headroom concept.

4. **Annual de minimis** – Sponsors have increasingly pushed to be allowed a certain quantum of principal prepayments to be made per annum without attracting call protection. This basket, where accepted (and its acceptance remains mixed in the market), is typically sized by reference to the amount of the term facilities. For example, it might be agreed that 10% of the aggregate principal amount of the term facilities may be prepaid per annum without attracting call protection – where this is agreed, lenders should take care to ensure that it is 10% of drawn amounts only (so borrowers cannot benefit from 10% of the amount of any delayed draw facility if it has not actually been utilised or has been cancelled/reduced). Certain lenders view this basket as designed to permit ordinary course deleveraging (i.e., using excess cash) and that such deleveraging should not be penalised – however, they may take the view that on a material sponsor liquidity event (e.g., a full prepayment on an exit) this de minimis should

not apply and full call protection should be due. The annual de minimis threshold is less common in US transactions, but the underlying mandatory prepayment triggers, particularly as it relates to excess cashflow sweeps and asset sales, will commonly include threshold amounts below which no prepayment (and hence, no premium in the rare circumstances where it otherwise applies), is required. There is typically not an annual de minimis threshold with respect to voluntary prepayments in US transactions.

5. **Permitted refinancings** – Sponsors frequently propose that where a prepayment is made in connection with a refinancing (whether that is a refinancing led by the same sponsor or a refinancing in connection with a change of control/exit) and the same lender participates in the new financing, then call protection will not apply. The rationale for this is that the lender will likely be earning “new money” fees for the new financing and should therefore not also receive a premium on the prepayment of the existing debt. While lenders are generally amenable to this, they look to ensure they are in no worse a position as a result. They either achieve this by saying the exception applies on a lender-by-lender basis, or by saying that the exception only applies to the extent their aggregate institutional commitments under the new facilities (across all of their lending vehicles) are in no less an amount than their aggregate commitments under the existing facilities – if there is an overall reduction in the aggregate hold, call protection would typically still apply to that net deficit. Care should also be taken by private credit institutions to ensure any such arrangement does not cause issues from a fund management standpoint – if the new financing is provided out of a new vintage of fund, with a different set of underlying limited partners, then it may raise questions as to whether it is appropriate (or “arms-length”) for the limited partners of the previous lending fund to forego their call protection so that limited partners under the new fund can earn fees for a new financing. If this creates difficulties for certain private credit lenders, they may look to limit the exception so that it applies only to refinancings out of the same fund.

6. **Deemed cash** – It has become common in the European private credit market for borrowers to have some (limited) ability to capitalise a portion of their interest payments, rather than pay the interest in full and in cash, by way of exercising a “PIK toggle”. The PIK toggle is also a feature in the US but more commonly limited to certain lower middle-market and non-sponsored transactions. For example, if a facility has a margin of 7.00%, it might be possible for 2% of that margin to be capitalised (perhaps for a limited number of interest periods and subject to certain caveats) provided that capitalised margin is paid with a PIK premium of 0.5% (i.e., the cash pay margin would be 5.00% and the capitalised margin would be 2.50%). This feature is a particularly hot topic in the current market, with spiralling

interest rates on floating rate debt meaning the pressure on company cashflows to meet their interest costs are often very significant (and a PIK toggle can help alleviate some of that pressure). The PIK premium (i.e., the extra interest that is charged when interest is to be capitalised) is justified on the basis that the lender is effectively taking on additional credit risk by agreeing to defer actually receiving that cash payment until maturity. Some sponsors therefore argue that when calculating a make-whole, you should calculate it on the basis that all interest would be 100% paid in cash (on the basis that the make-whole is received today, so there is no such additional risk that warrants additional premium). However, certain lenders will take the view that projected interest accruals should assume the same level of PIK toggle usage that is currently in effect at that time. Where there is an actual permanent PIK component to a facility (as opposed to a temporary PIK toggle usage) this debate becomes even more contentious, as the assumed PIK capitalisations may form a core part of the lender's projected return on its investment.

7. **PIK** – Certain aggressive sponsors have proposed that prepayments of principal that constitutes previously capitalised PIK interest (as opposed to principal that was originally advanced as a loan) be exempt from call protection. In general, this is resisted by private credit providers in both the US and Europe.

8. **Delayed draw timing** – Some lenders traditionally took the view that the relevant call protection period for a facility should run from the date on which that facility is first drawn. As such, an acquisition financing facility, refinancing facility or other day one facility would have a call protection period running from the original closing date. However, for delayed draw facilities (bolt-on acquisition facilities, capex facilities or similar), such lenders would take the view that the period for such facilities should run from the date on which they were first drawn (or even that each individual loan should have a call protection period running from the date on which it is drawn). Sponsors have consistently pushed back on this, insisting that call protection periods for all committed facilities should run from the original closing date – while there are exceptions, this has become the most common market position. However, in both Europe and the US, lenders can still be successful at "resetting" the call protection clock when subsequent new money is funded by way of incremental facilities, but that is a negotiated point in each deal.

In summary, current market conditions have led lenders to take a slightly more conservative view of the appropriate call protection regimes applicable to the term facilities they underwrite. Notwithstanding that fact, there remain numerous means by which sponsors look to limit such premia – not just limited to headline terms but also complex exceptions, carve-outs and discounts. We expect this pressure from sponsors to continue, particularly as the private credit product continues to evolve and compete directly with the syndicated lending markets (and we may see an increasing bifurcation between large deals and true mid-market deals). For any related questions on this topic, please reach out to your contact within Proskauer's Private Credit Group.

About Proskauer

Proskauer's Private Credit Group consists of over 90 dedicated professionals, located in London, New York, Boston, Chicago and Los Angeles, and the team consistently executes some of the largest number of private credit financings in the market (closing 250 direct lending deals globally in 2022, representing nearly $85 billion of new capital).

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