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Private Credit Explained: Plug The Gap - Minimizing Value Leakage

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Why Value Leakage Matters

When negotiating credit agreements, lenders will focus on how to maximize the prospect of their loan being repaid in full at maturity. If money and/or assets can leave the borrowing group (the “Group”), then such leakage of value could impact the borrower's ability to meet its payment obligations, increase default risk and, ultimately, be detrimental to lenders' recovery prospects. Therefore it is important for lenders to ensure that effective documentary controls are put in place to bring and retain as much value as possible within the Group, whilst also trying to accommodate operational requirements and flexibility requested by borrowers to grow their business and implement strategy. However, and despite the best of intentions, documents can also include loopholes allowing unforeseen leakage to occur.

Anticipated Cash Leakage: Permissive Baskets

One of the main purposes of the various covenants and restrictions present in credit documentation is to prevent as much value as possible from leaving the Group. Any exceptions to this rule are therefore a focus in negotiations for all parties.

From a documentary perspective, these exceptions will typically be included in the “permitteds” section (in English law LMA style documentation) or, in the general undertakings schedule (in credit documentation with NY law style covenants).

Broadly speaking, permitted baskets can be classified into three principal categories:

- baskets that are necessary for the day to day operations of any company (e.g. payments towards company expenses, taxes, etc.). These baskets will be subject to less commercial negotiation and often agreed on the basis of suitable caps or appropriate language, ensuring payments are reasonable and/or on arm’s length terms;

- baskets intended to provide the required flexibility to grow the business (e.g. making certain permitted investments and disposals); and
- baskets that are more bespoke and designed to provide capacity for shareholders to extract value under specific circumstances (e.g. certain permitted payments).

Unsurprisingly, as documentation flexibility has expanded, the list of negotiated exceptions has become progressively longer over the years. However, because these permissions will typically be negotiated and agreed with lenders from the outset, this affords a certain degree of foreseeability as to quantum and available capacity the Group has going forward.

Why basket types matter

Baskets provide lenders with a level of control as to how much value leaves the Group. However for these controls to be effective, lenders need to ensure that baskets are not only appropriately sized (overly generous flexibility on day one may result in excessive leakage going forward where baskets can be increased, re-allocated and/or re-classified), but also that these are appropriate for the type of business being operated today and projected for the medium term.

Fixed, grower and ratio baskets

One of the most basic leakage controls available to lenders is the use of fixed numerical baskets which, as their name suggests, are capped at a pre-agreed fixed amount at closing. However, to ensure that the borrower benefits from any future growth in the business, most borrowers will insist on a grower element too. A grower basket will be sized by reference to the "greater of" the fixed amount and a percentage of a variable, commonly EBITDA. As a result, if EBITDA increases in the future, the basket will also increase in a proportionate amount but, if the EBITDA level decreases below its level at closing, the fixed amount of the basket will effectively act as a floor.

In contrast, some baskets may include a feature allowing the fixed basket amount to permanently increase with an increase in the business' EBITDA, and to maintain that higher level even if EBITDA subsequently decreases. This is known as a "high watermark" feature. Although most lenders will push back on such flexibility on the basis that it completely erodes the link between the financial performance of the business and the corresponding capacity to make payments, it remains present in some larger deals.

Finally, some permissions rather than being subject to agreed caps will, instead, require the borrower to comply with certain financial covenant metrics prior to being available to the Group (e.g. compliance with a leverage test before making a restricted payment). Borrowers will therefore be able to take advantage of such permissions without being capped to a specific amount, provided that the applicable test is met at the relevant time.

Carry-back and carry-forward baskets

Another flexibility present in loan agreements (in both mid-market and large cap deals) is the ability for borrowers to utilise unused capacity from one period during another period, either by carrying-forward unused amounts to the next year or by carrying-back available amounts from the next year to the current year.

Lender protections in these scenarios include limiting amounts that can be rolled forward or back (e.g. only permitting 50% of the available basket capacity to be rolled forward or back) and requiring that carry-forward amounts are used last so as to avoid unlimited rolling of amounts into subsequent years.

Builder basket

A notable exception to the general prohibition on cash leakage is the inclusion of a "builder basket" or, also known as the "available amount". This basket effectively builds up capacity to make restricted payments, which would have otherwise been prohibited, from a number of components. This "available amount" typically starts with either retained excess cash (which essentially includes proceeds not required to be applied in prepayment of the loan) or consolidated net income and followed by a number of other elements.

In smaller deals, although the concept remains relatively rare, when present, the available amount will typically include fewer components (usually limited to cash available to the business and excluding any other elements such as capital contributions or other debt proceeds) than those present in larger deals. It is not surprising however that the list has gradually expanded, often times with many of these building elements overlapping amongst them. As a result of this, the actual capacity under this basket can sometimes be too complex to measure and quantify.

In terms of use, the builder basket will typically be available for limited categories of payments: shareholder debt and dividends (in mid-market deals), but potentially also other restricted payments, including payment towards junior debt and other unsecured or subordinated debt as well as investments (in large cap deals).

Access to this basket will usually require the Group to de-lever to a certain level or meet another pre-agreed metric (such as a fixed charge coverage ratio). Default or event of default blockers are usually also applicable, although often limited to certain events only (e.g. non-payment and insolvency events of default), if not completely absent in some of the larger transactions.

Although originally intended to provide borrowers with the ability to use cash generated in the business for purposes other than debt service, the deterioration of meaningful protections and leverage restraints in documentation represents an increasing risk of value leakage though this exception.

Unexpected Leakage and Manipulation

Covenant protections have eroded over the years as sponsors negotiate increased documentary flexibility. Recent liability management transactions have highlighted the dangers of permissive payment/investment baskets. Lenders may be aware of weaknesses in the covenant protections and willing to allow them, mistakenly assuming that the sponsor is unlikely to make use of these opportunities, but challenging liquidity requirements have resulted in the sponsor exploiting these loopholes.

Reclassification and re-allocation

Most lenders will focus their attention on the obvious exceptions, but some of these will be more subtle, resulting in unexpected leakage.

Reclassification and re-allocation provisions are one of these exceptions. These allow borrowers to either:

- swap capacity under fixed baskets into ratio baskets (e.g. once the group meets the applicable test metric) effectively leaving the group with renewed capacity under the fixed amount; or
- re-allocate capacity across different types of baskets (e.g. conversion of debt capacity into restricted payment capacity).

These provisions can provide unexpected flexibility to increase leakage capacity to levels that can prove difficult to quantify (in particular when it comes to re-allocating capacity across different baskets). Therefore it is important for lenders to understand these and ensure they are considered together with all other permissions rather than as distinct and separate concepts.

Unrestricted subsidiaries

The concept of an unrestricted subsidiary has its origins in US high-yield bond markets where it was initially developed to determine which subsidiaries of the issuer would not be subject to the covenant restrictions in bond documentation. The concept has since migrated to leveraged loans and, although still relatively rare in the mid-market private credit space, is now also a common feature of large cap European leveraged loan documents.

Unrestricted subsidiaries, not being members of the “restricted group”, do not provide any credit support for the borrower’s obligations and therefore are generally free to undertake what would otherwise be activities restricted by the covenants (e.g. incurring debt, granting security, making investments, restricted payments, etc.). Consequentially, any dealings between the group and unrestricted subsidiaries are controlled (in the same way as they would be with third parties). Conversely, unrestricted subsidiaries’ income and results of operations are not taken into account in any financial covenants calculations.

Although borrowers may have legitimate reasons for using unrestricted subsidiaries (e.g., operating certain parts of the business independently), having the ability to designate entities as “unrestricted subsidiaries” – and therefore lifting any controls on them – can generate problems, in particular when the intention is to transfer value outside the Group.

Loan agreements with an unrestricted subsidiary concept included will typically permit designation of subsidiaries as unrestricted subsidiaries provided certain conditions are met. In particular, the designation will only be permitted if the Group has sufficient investment capacity to make such designation (i.e. that the leakage of cash and assets held by the restricted subsidiary is permitted as a result of it effectively becoming a third-party entity).

Lenders also need to have regard to permissions allowing ongoing payments to, and investments in, unrestricted subsidiaries. Such future transfers of value should be considered carefully, as often capacity will not be limited to a specific unrestricted subsidiary basket. Permissions under various carve-outs and baskets – including the builder basket and other payment baskets – may result in the amount of unexpected value leakage to be significant.

Although most deal documentation today will include controls to prevent such value leakage, these tend to focus on restricting specific transfers to close loopholes that have been exploited in the past – such as restrictions on transfers of material IP to unrestricted subsidiaries as a result of the J.Crew transaction – rather than addressing the broader issue of ensuring that all of the unexpected ways that value can leak from the restricted group are considered.

Summary

The key takeaway is that calculating overall leakage capacity will not always be straight forward. As discussed above, when considering the total capacity available to transfer value out of the Group, permissions should be considered in aggregate and not separately with respect to individual and specific baskets. Documentation with looser terms will require more attention to analyze the flexibility that may sometimes hide material loopholes.

This is the second article in our Private Credit Explained series, with the first article covering delayed draw term loans in the private credit market (available here).

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