Covenantive Easing (Fourth of a Series)

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Our special series on envelope-pushing in the world of loan covenants continues with a look at “limited condition transaction” provisions. These provisions allow the borrower to decide, at its option, when it wants to test the conditions to entering into a transaction (typically an acquisition) that is not subject to a financing condition – sometimes described as a “no-outs” acquisition.

If the borrower enters into a definitive purchase agreement for one of these acquisitions, the limited condition transaction provisions allow it to elect to test whether it can satisfy the financial tests applicable to that acquisition (and the related funding, under the credit facility, if there is one) at the time of signing rather than at deal closing.

With such transactions, the borrower may include the debt incurred and Ebitda acquired in that transaction at the time of signing, even though the deal hasn’t actually closed yet. In addition, if another transaction occurs after signing, but before closing, the borrower still gets to “count” the transaction that is in process as if it has closed — although if the new transaction is a dividend, issuers aren’t typically permitted to include the target’s Ebitda until the in-process acquisition has actually closed.

What other provisions in debt covenants are hotly negotiated? “Lenders are concerned with items like the ability to incur additional incremental debt up to a particular leverage multiple (sometimes called ‘ratio debt’) and incremental equivalent debt (i.e., debt outside the credit facility that notionally replaces incremental debt), particularly in smaller deals,” said Ian Wenniger of Morgan Lewis. “Having to contend with pari passu creditors can create complications in workout or bankruptcy scenarios.”

Another category of hotly negotiated terms are the refinancing provisions. “These allow the sponsor flexibility to replace a portion of the debt under the credit facility, within certain pre-agreed parameters,” Wenniger said. “Common requirements include limitations on additional collateral and requirements to share prepayments.”

“After these, the covenants we see the most negotiations around, besides debt and liens baskets are restricted payments and investments, since they deal with cash outflows.”

What are the key categories of covenant basket that get negotiated? “There are ‘general’ baskets, not tied to any specific ratio or test,” Wenniger told us. “Then ratio-based baskets and ‘grower’ baskets tied to a percent of Ebitda. For restricted payments, we often see the ability to make tax distributions, buybacks from retired or departed officers and directors, and an unlimited basket if leverage is at a certain level – typically a fairly low one, reflecting significant de-leveraging since the closing of the financing.”

What other significant trends have been noted? “The prevalence of grower baskets,” he said. “You will hear this term often because sponsors now expect them even in smaller deals. The concept is that a key negative covenant provision or event of default, such as a carve-out permitting investments, will be expressed as a percent of Ebitda. For example, ‘the greater of $5 million or 5% of Ebitda.’”

“It has become common to have carve-outs and permissions for some transactions, such as investments, dividends/restricted payments, etc., to be based on a pro forma leverage-ratio. The ratios are negotiated based on the closing date level. Sometimes, the ratios will reflect step-downs from the closing date level.”

Wenniger continued. “The ‘available amount’ basket – also called a ‘builder basket’ – grows over time with unapplied excess cash flow, equity contributions that are not applied for other uses and proceeds of investments made with the basket. The basket will typically include a negotiated starter amount, and builds over time. It’s then reduced by actual usage of the basket for investments, acquisition or distributions.”