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Negotiating Europe’s LBO debt mountain

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Executive summary

The Problem

Approaching $550bn of European LBO loans is due to mature between 2012 and 2016, according to data produced by Dealogic exclusively for Linklaters. The annual volume requiring refinancing ranges from $69bn in 2012 to $103bn in 2016, hitting peaks of nearly $140bn in each of 2014 and 2015. Within these headline numbers are hidden hotspots, where the amounts required in certain jurisdictions and/or sectors are particularly acute at different points.

Refinancing activity had picked up in 2011, following a shaky emergence in 2010 from the period immediately following the collapse of Lehman Brothers in 2008. The fourth quarter of 2011, however, saw this activity choked off. Successful European LBO loan refinancings then slumped back to 2009 levels as concerns about the Eurozone debt crisis and weakening economic conditions took hold and investor confidence seeped away.

Today, refinancing this $550bn wall of debt is subject to greater pressures than ever before.

The wall itself is moving. There is evidence that European LBO loan refinancings done in 2009-11 typically had tenors of between 3 and 5 years, effectively deferring those refinancings to 2012-16. These must be addressed in addition to those originally falling due in 2012-16.

The outcome of the Eurozone crisis remains unclear and the attendant lack of confidence, politically and economically, continues. Whilst this affects European LBO loans generally, countries perceived to be the least strong are affected the most. This sits uneasily with the refinancing needs of LBO loans in those countries.

Banks are likely to be less able to participate in such refinancings, instead required to comply with regulatory requirements to delever their balance sheets and raise more capital. CLO funds, another key investor group from the boom years, are also less likely to be able to participate in the same way as previously, as their constitutions limit the extent to which they may invest or reinvest.

Those entities who are still involved may find themselves approaching such refinancings with a different mindset and objectives, given both the seismic market changes they are witnessing and increased governmental intervention in the restructuring process – directly or indirectly, through government shareholdings in banks or the introduction of regulatory or legislative changes.

Finally, the broader backdrop to this scene is a difficult economic environment. IMF growth forecasts for the Eurozone and individual European countries were reduced in January 2012, reflecting weakening performance. The default rate for the S&P European Leveraged Loan Index jumped in the second half of 2011, and at the 2011 year-end was more than double the 2010 year-end level.

Such defaults also move the wall of debt, bringing forward the date on which a company’s debt structure needs to be addressed. There are signs that, following such defaults, restructurings involving some form of debt write-down or conversion into equity are increasing, as stakeholders acknowledge that covenant breaches may be symptomatic of more fundamental problems with the company’s debt and capital structure. Companies with high debt burdens in vulnerable countries and/or sectors may be more likely to go down this route.

Faced with these challenges, what are the options for addressing this refinancing requirement?
The Solutions

First, banks and CLOs do still have a role to play.

Banks are under pressure to lend, and they must weigh this against the regulatory requirements to which they are subject. This may influence their willingness to lend to certain borrowers, for example possibly leading them to prioritise those incorporated in their home jurisdiction. CLOs will be able to invest until the end of their investment periods – typically between now and 2014, and later for some newer vehicles structured just before the credit crunch – thereby enabling them to make new investments in LBO loans to at least some extent. They may also be able to restructure their existing investments so as to permit their continued investment in those loans.

Secondly, other sources of finance may be available to the right borrower on the right terms. One source is the high yield bond market. In addition to the US high yield bond market which may provide US dollar funding to European issuers, the European high yield bond market looks set to play an increasing role. So-called alternative capital providers may provide another source. This group extends to insurance companies, pension funds, hedge funds and credit funds. Sovereign wealth funds have the potential to invest, and there is a key role to be played by private equity.

Each of these sources will be subject to unique issues and potential constraints on the extent of its investment. While none in isolation provides the whole answer, each can contribute to the solution.

Finally, for those LBO loans which are not able to be refinanced, there may be a more pronounced move towards some lenders exiting by selling their debt into the secondary market at a realistic price, while the remaining lenders enter into negotiations for a more fundamental restructuring of the debt and overall capital structure than might previously have been acceptable. Portfolio sales may therefore increase. Restructurings would likely require deeper adjustments to a company’s debt burden and capital structure, so aiming to provide a lasting debt solution.

As a last resort, insolvency is available. Unless being used as a tool for implementing an agreed restructuring, this is still likely to be viewed as value destructive. But as lenders’ priorities shift, this option may see increased use in certain sectors and/or countries.

There are complexities and nuances to every aspect of both the wall of debt and the potential solutions to refinancing it. The key to negotiating the challenges ahead successfully lies in appreciating these, and seeing how the available options can be best used in individual situations. This report aims to highlight key considerations for today’s market participant.
1. Measuring the wall of debt

> 1.1 Loan market in post-crunch rollercoaster

The European LBO loan market in 2008 was booming, continuing the bull run which started in 2004. Loan volume in the first three quarters of the year totalled $65bn. In September 2008, however, the brakes were sharply applied when Lehman Brothers collapsed and credit markets were dislocated. Hitting a low of $2bn in the first quarter of 2009, the market showed some signs of revival in 2010, though not to the same level as pre-Lehman, according to data from Dealogic (graph 1).

Over this period, annual loan volumes tumbled – from $69bn in 2008 to $11bn in 2009. It became very clear that the high volume of European LBO loans put in place in the bull years would require refinancing in a very different economic environment. In addition to the sheer scale of the debt and the transformed landscape, there was also a timing issue to compound the difficulties. The maturity of these loans typically ranged from 7 to 10 years, meaning refinancing requirements from those years were set to peak between 2012 and 2016.

In 2011 the market appeared to have turned the corner, with volumes returning to early 2008 levels. The second and third quarters of 2011 even outstripped the 2008 peak, hitting $37bn in both quarters. But this was shortlived. By the final quarter of 2011 LBO loan volumes had collapsed to just $4bn, this time triggered by the Eurozone debt crisis.
Compared with data showing European LBO refinancings completed during the same period, a similar pattern emerges. In 2009 this fell to just under $1bn, before surging in 2011 to a peak of over $22bn in the third quarter. By the final quarter of 2011, however, this had collapsed to a low of just $0.68bn (graph 2).

Until that point, the upturn in the European leveraged loan market was starting to chip away at the refinancing wall. As graph 3 shows, 2010 saw a modest increase over 2009 in the volume of leveraged loans used for refinancings (from $34bn in 2009 to $39bn in 2010). In 2011 this soared to $93bn, representing 51% of the total use of proceeds for that year. Graph 4 displays different patterns in refinancing US and European LBO loans in the first three quarters of 2011 – steadily falling in the US, but steadily increasing in Europe – but identical US and European experiences in the final quarter of 2011 when refinancings on both sides of the Atlantic fell to almost zero.
Analysed by country, a more detailed picture emerges. The most common refinancing peak is in 2014 when the greatest volume will need to be met in the UK, France and Germany. 2015 is the peak year for a number of other jurisdictions including Italy, Spain, The Netherlands and Sweden (graph 6).

The burden does not fall equally on all countries. The largest requirement is in the UK, which makes up more than a quarter of Europe’s burden. Around $172bn must be rolled over between now and 2016, reflecting the UK’s dominance of this market. This is more than double the $86bn that falls due in France and the $83bn due for refinancing in Germany. Together, the UK, Germany and France are the European countries most exposed to LBO loan refinancing requirements. While France and Germany dominate the Eurozone’s collective refinancing bill of $373bn over the coming five years, the more troubled countries of Italy ($31bn) and Spain ($25bn) also have substantial refinancing falling due, especially relative to the size of their economies.

> 1.2
The $550bn LBO refinancing wall

The concern therefore remains that, despite the increase in refinancings in 2010 and 2011, the European LBO loan market faces a huge refinancing burden over the coming five years. According to Dealogic, approaching $550bn of European LBO loans is due to mature between 2012 and 2016. As noted above, 2012 sees some $69bn fall due, rising to a peak of $140bn in 2014 and $135bn in 2015, before falling back to $103bn in 2016 (graph 5).
Regional hot spots

The sector picture
Overlaying onto that regional picture a breakdown by years and sectors, a complex web of refinancing obligations is visible, as shown in graph 7. The largest sectoral burden falls on the telecommunications sector where $67bn of LBO loans must be refinanced over the five years to 2016. The next four largest sectors are retail ($47bn), healthcare ($40bn), chemicals ($37bn) and construction/building ($36bn). In 2013, there are peaks for chemicals ($12bn), transportation ($11bn) and healthcare ($11bn). Telecoms ($24bn) sees a peak in 2014, and 2015 marks the peak for retail ($17bn), professional services ($11bn) and construction/building ($9bn).

Olivier Jauffret
Partner – Banking
Paris

“France presents some unique challenges for refinancings in 2012. The presidential and parliamentary elections almost certainly mean further changes in the tax regime affecting leveraged debt.”
Different sectors will prove challenging for certain countries, as shown in graphs 8-12 and analysed in the “Spotlight on UK, France and Germany” and “Spotlight on Italy and Spain”.

**Spotlight on UK, France and Germany**

In the UK, 2012 marks the peak for refinancing LBO loans in utilities and energy. 2013 sees a sharp rise in the requirement for refinancing LBO loans in a number of sectors, including transportation, chemicals, healthcare and insurance. From 2012 to 2016, the largest overall LBO loan requirement belongs to the retail sector. As a sector dependent on consumer discretionary spending and exposed to economic weakness, this may be particularly challenging, as witnessed by the difficulties already experienced by UK retailers La Senza and Peacocks.

In France, 2014 sees several sectors with refinancing peaks, including publishing, healthcare and utilities and energy. Construction, professional services, computer & electronics and food & beverage see their largest requirements in 2015.

In Germany, the dominant refinancing need in 2012 is in the real estate sector, where almost $3bn is required. 2015 sees a number of sector refinancing peaks, including construction/building, healthcare, professional services, utilities and energy and computers & electronics. Telecoms and chemicals peak in 2016.
Spotlight on Italy and Spain

In Spain, computer & electronics has almost $7bn of LBO debt to be refinanced between 2012 and 2016. Likely to be of more concern, given discretionary spend factors, is the retail sector which has $5bn of LBO debt to be refinanced across the same period.

In Italy, textiles and metal & steel have just under $4bn each of LBO debt to be refinanced between 2012 and 2016.

Spanish insolvency laws were recently amended to introduce court approval of pre-insolvency agreements into the Spanish legal system, seeking to achieve a similar result to the UK scheme of arrangement and provide a Spanish statutory cram-down process. However, the effectiveness of this technique has been subject to a series of requirements and restrictions which make this new mechanism difficult to use in practice.

Pedro De Rojas
Partner – Banking
Madrid

“Spanish insolvency laws were recently amended to introduce court approval of pre-insolvency agreements into the Spanish legal system, seeking to achieve a similar result to the UK scheme of arrangement and provide a Spanish statutory cram-down process. However, the effectiveness of this technique has been subject to a series of requirements and restrictions which make this new mechanism difficult to use in practice.”
2. Refinancing faces harsh headwinds

The scale alone of the wall of debt would make the refinancing programme for European LBO loans challenging. However, the presence of additional obstacles, which in the past were absent, amplify this challenge. Factors such as the negative economic outlook and the impact of wide-ranging regulatory change have complex implications for refinancing the wall of debt.

2.1 The European economic outlook

The European economy is expected to post very low growth in 2012 and several countries are already, or are predicted soon to be, in recession. In January 2012, the International Monetary Fund (IMF) announced sharp cuts to its growth forecasts. It expects the Eurozone to suffer a “mild” recession this year, cutting its GDP forecast to -0.5% from the +1.1% it forecast in September 2011. Cutting growth for all major Eurozone economies, the IMF took a particularly severe view in relation to Italy and Spain, slashing growth forecasts to -2.2% and -1.7% respectively. The UK is predicted to grow just 0.6%, compared with an earlier forecast of 1.6%.

This downwards revision of forecasts between September 2011 and January 2012 reflects the limited investor confidence over that period and helps to explain the sharp plunge in LBO loan activity in the final quarter of last year. The austerity programmes in key European economies are also likely to contribute to negative sentiment, at least in the short term, and thereby also impact refinancing activity.

In addition to certain jurisdictions being more affected than others, some sectors may find themselves particularly exposed to declining economic conditions. Consequently, refinancing LBO loans in those sectors may be more difficult. For example, sectors exposed to cuts in government spending, such as healthcare, will be affected, as will those dependent on discretionary consumer spending, such as retail and automotive, and, in turn, businesses dependent on such industries, for example some companies operating in the textiles and chemicals sector.

This outlook is not confined to 2012. IMF forecasts show GDP growth for the Eurozone is likely to average just 0.8% a year over the 10 years to 2016. Combined with the continuing uncertainty over the outcome of the Eurozone debt crisis, this is likely to affect investor confidence and companies’ ability to refinance their loans.

This could also translate into a higher default rate among leveraged loan-backed companies. The default rate for the Standard & Poor’s (S&P) European Leveraged Loan Index (ELLI) stood at 4.1% in December 2011 – more than double the 2010 year-end level of 2%. S&P have suggested this may rise further, potentially looking at a base-case European speculative-grade default forecast of 6.1% for 2012.
> 2.2
The transformed regulatory landscape for banks

To date, bank loans have been the most popular form of financing for LBO transactions in Europe. However, the ability of European banks to offer LBO loan finance is now being challenged. As graph 13 shows, banks’ balance sheets are under pressure as both their assets and liabilities are squeezed.

On the liabilities side, there are various downward pressures on a bank’s core funding. Available sources of wholesale funding are shrinking – for example, securitisation markets are not fully open and the prospects for securitising whole businesses look bleak. Senior bond funding by banks is impacted by Eurozone-related uncertainty and adverse regulatory change, including the prospect of being subjected to “bail-in” (or a haircut) in the event of a bank resolution. Retail deposits by customers are difficult to increase in a low interest environment and, in jurisdictions perceived to be facing particular difficulties, may shrink significantly.

European banks have become increasingly reliant on central bank funding to plug the “funding gap” arising from their inability to fund themselves through wholesale and retail sources. The European Central Bank (ECB) has recently made extensive use of long-term refinancing operations (LTROs) to seek to avert a potential credit crunch affecting Eurozone banks. In the UK, the Bank of England will provide additional liquidity to the bank sector, for instance through operations under the Sterling Monetary Framework.
At the same time, regulatory capital changes introduced by Basel 3 require banks to increase the quality and quantity of their capital, whilst also restricting their leverage through a new leverage ratio. With the Basel Committee estimating that the 87 largest banks globally will need to raise €577bn in new equity to comply with this, and external bodies putting this figure considerably higher, banks may struggle to keep significant holdings of LBO loans.

On the assets side, there are also downward pressures. EU banks which have taken state aid from European governments since 2008 will be required to shrink their balance sheets, including making asset disposals, in order to comply with undertakings imposed by the European Commission. This affects some 50 EU banks, with compliance required by 2015. There may be a question mark over the price which purchasers are willing to pay for any such assets. Any loss suffered by the bank will hit profit and may eat into capital. If banks are unable to raise the additional capital required by Basel 3, they will need to reduce the size of their balance sheets.

For example, banks may wish to allow certain assets to run off, thereby deleveraging their balance sheets. The extent to which this is possible will depend on borrowers being able to repay/refinance loans, which in turn will be affected by the banking sector as a whole deleveraging. Banks and borrowers may find themselves in competition for funding from the debt or equity capital markets. Finally, new liquidity rules will force banks to hold more liquid assets, and this will restrict further their ability to lend.

Overlaying all of this are regulatory and other changes which affect practically every aspect of a bank’s life. From direct regulation on the size and shape of banks, for example in the Volcker rule in the US (which prohibits banks from proprietary trading and from sponsoring funds) and the recommendations of the UK Independent Commission on Banking (which requires UK banks to ring-fence their domestic retail businesses), to increased scrutiny of conduct of business, remuneration, payment systems, bank levies, competition, corporate governance and regulatory structures, the picture is a complicated one. The overall effect is a collision of conflicting requirements, as the refinancing needs of the wall of debt meet banks’ more constrained abilities to address these needs.

Edward Chan
Partner – Banking/Regulatory
London

“Practically every aspect of a bank’s existence is coming under increased scrutiny – conduct of business, corporate governance, remuneration, regulatory structure, competition, bank levies. Those influences will apply over and above the capital and liquidity requirements of Basel 3.”

The net result is to make banks less likely to provide finance for LBO loans as those transactions become more expensive for them and they are compelled to focus on compliance with regulatory requirements. This may drive an increase in portfolio sales to better capitalised funds or banks.
Basel 3 and LBO loan refinancings: key points

To whom does Basel 3 apply?
Banks, extended to medium/large sized investment firms in some jurisdictions (e.g. EU and UK). Does not apply to other types of financial entity, e.g. private equity houses, venture capital firms, hedge funds and CLOs.

What are the key financial implications for banks?
Quality and quantity of their capital to increase, likely to impact negatively on earnings and return on equity.

What does this mean in practice for banks?
Banks likely to have less money to lend, pricing likely to increase. Potential to structure transactions to take account of Basel 3.

What does this mean in practice for entities not subject to bank regulation?
An opportunity to participate in the lending market to a greater extent.

What are the key Basel 3 rules to affect refinancing LBO loans?

> Increase quality and quantity of bank’s capital: a bank’s capital ratio must be 8% at all times. At least 6% must consist of Tier 1 capital, of which at least 4.5% must be in the form of common equity (ordinary shares and retained earnings). The remaining 1.5% may be made up of “additional going concern capital”. A further 2% may consist of Tier 2 capital. This may have more debt-like characteristics than Tier 1 capital, but must nonetheless be deeply subordinated and meet strict criteria as to its loss absorption.

> Restrict bank’s leverage: new non-risk based leverage ratio of 3%, i.e. restricting total exposures of a bank to 33 times capital. This does not (i) take collateral into account, (ii) permit netting of loans and deposits, (iii) risk-weight on-balance sheet assets. This does (i) include off-balance sheet items at their full exposure value, (ii) include derivative exposures (net, subject to certain criteria). This may constrain a bank’s ability to grow (or maintain) the size of its balance sheet.

> Increase bank’s liquidity reserves and reliance on long-term funding: new liquidity coverage ratio, requiring banks to hold a minimum level of highly liquid assets to enable them to fund outflows over a 30 day period of acute liquidity stress. New net stable funding ratio, requiring banks to have sufficient long-term funding to support their long-term assets, preventing over-reliance on short-term liquidity markets.

> 2.3
The shrinking role of CLOs

When securitisation was in full swing during the pre-2008 boom, traditional CLO vehicles were a key part of the funding mechanism for LBOs. As structured funds in which entities such as pension funds and insurance companies may invest, CLOs invest in a wide range of assets to match returns from those assets to the CLO’s liabilities to investors. LBO loans, offering attractive returns, proved an appealing asset class to CLOs. Many CLOs were set up with an investment period of 5 to 12 years. A significant number of those established between 2000 and 2006 are therefore now reaching the end of their investment periods. Once ended, CLOs are no longer permitted, under the terms of their constitutions, to invest in new deals where fresh cash is required.

This means that traditional older constituted CLO vehicles are likely to play a diminishing role in funding new LBO loans. According to S&P, the vast majority of European CLOs are likely to fall away from the LBO finance market at the very time the wall of debt peaks. In a study of collateral portfolios of 205 European CLOs, S&P noted that an estimated €69bn of CLOs by par value end their reinvestment periods between 2011 and 2015 at the same time as approximately €61bn of leveraged loans held within those vehicles are due to be refinanced.

With a retiring CLO sector and headwinds from the economic downturn, market volatility and financial regulation, the issue for the LBO loan business is how the $550bn wall of debt will be refinanced.
The starting point is to consider the nature and strength of the borrower’s underlying business, mapping this to the options therefore available and lenders’ investment strategies.

> 3.1  
Companies performing well first in the queue for bank debt

Companies which are performing well have the most options available to them. At one end of the spectrum, a company which is performing well, but has concerns about disruptions in the market and the future availability of funding, may seek to position itself at the front of the refinancing queue by entering into a forward start facility. As discussed below, this allows a borrower to enter into a new, committed facility ahead of the maturity of its existing facility, thereby eliminating the borrower’s refinancing risk.

Such companies may also see market illiquidity as an opportunity, where this has a knock-on effect on the proper functioning of the secondary debt market. Some companies found, particularly following the post Lehman credit crunch, that the relatively depressed prices at which their debt was trading did not properly reflect the fundamental strength of their business. They therefore took advantage of market conditions, and the fact that their debt was trading at what they perceived as an unjustified discount, to buy back their debt at that discount, strengthening their balance sheet and reducing their overall debt level.

An alternative option, where the underlying business is seen as having potential for growth and is generating sufficient income to meet both its operating expenses and financing costs, is the so-called amend and extend technique. This involves lenders agreeing to extend the maturity of their loans, and to amend certain conditions and covenants, in exchange for a higher interest rate and/or additional fees. The inclusion in the facility agreement of structural adjustment provisions will significantly facilitate implementation of an amend and extend solution.

Forward start facilities

Under a forward start facility the borrower and a group of banks enter into a new facility. The banks in the new facility may be, but are not always, banks in the borrower’s existing facility. Rather than the borrower then immediately cancelling its existing facility, the existing facility is allowed to run to its maturity. The new facility is committed from the date of signing, but does not become available for drawing until the existing facility matures. The new agreement is entered into well in advance of the time when the existing facility would normally be refinanced – usually between 12 and 24 months ahead of this. This offers the borrower certainty over its future funding, eliminating refinancing risk, and locks in the financial terms. It also allows the borrower to retain the full commitment of all its existing lenders through to the original maturity, whilst catering for the situation where there is not unanimity among the borrower’s existing bank group – for example where some existing lenders are not willing to extend.
While lenders may historically have been willing to amend and extend loans until the economy was expected to recover, there appears to be an increasing reluctance to use this technique with companies which are performing less well. This reluctance may be particularly acute where the company is expected to struggle to meet its existing interest payments.

Such companies may already have been through one round of “amend and extend”, for example if their loans fell due between 2009 and 2011 and banks were at that time willing to continue to provide them with finance. Any such extended loans coming up again for refinancing in 2012-16, in a more challenging environment, may be subject to greater scrutiny by bank lenders. If the company’s underlying performance has not improved, banks may be less willing to go through a second round of “amend and extend” at a time when their own resources have become more limited. This will need to be balanced against banks’ likely wish not to crystallise a loss that they would have to account for on their balance sheets. The risk with “amend and extend” is therefore that, for certain companies, it simply delays a restructuring that may inevitably be required at some point.

One of the key potential challenges in using the amend and extend technique is obtaining the requisite level of consent from the lenders. This will typically be a matter for which all lender consent is required. Whilst this may be difficult to achieve on a standard non-leveraged loan, the position becomes more complex for LBO loans, where there are likely to be both a greater number of lenders and more layers of debt, such as senior and mezzanine loans, and potentially other intermediate layers. The syndicate may also include investors whose interests may not be aligned, for example par lenders versus non-par or distressed investors.

Various technical options are available to address this, in particular use of structural adjustment provisions and forward start facilities, and the implementation and cram-down tools used in debt restructurings described in Section 3.3.

Markets are essentially flexible and adaptive. New techniques – and different combinations of established techniques – will continue to evolve as issues require lateral thinking and a fresh approach.

Nick Syson
Partner – Co-head of Leveraged Finance
London

Structural adjustment provisions
Some facility agreements may include structural adjustment provisions, permitting certain amendments to a particular facility with the consent of (i) all lenders under that facility and (ii) a majority of all lenders. This effectively allows a borrower to extend a particular facility without having to gain full approval from lenders who are not part of that facility.
Looking for other sources of capital

With traditional bank loan funding likely to be more scarce as a result of the various pressures on banks, the availability of other sources of capital will need to be assessed. These may include high yield bonds and funding provided by a range of investors who may be classed as “alternative capital providers” – including insurance companies, pension funds, hedge funds and credit funds. CLO fund managers are likely still to have a role to play, albeit a changed role, and private equity is key.

> 3.2.1
The changing role of the high yield bond market

The pattern of European high yield bond issuance from 2009 to 2011 largely mirrors the pattern of leveraged loans for the same period, discussed above. Dealogic data shows issuers raised $166.4bn on European markets over the three years to 2011, with volume peaking at almost $30bn in the first quarter and over $25bn in the second quarter of 2011. However, volumes dropped sharply to just $5bn a quarter in the final half of 2011, echoing the partial closure of the leveraged loan market (graph 14).

According to Debtwire, refinancing was the single biggest use of proceeds from high yield issuance for the three years to 2011. Companies used two thirds (66%) of issuance by value, or €24.4bn, to repay debt, of which €18bn or 74% went to repay loans and the remainder was used to repay existing bonds (graph 15).

While some potential European issuers are currently facing both uncertain access to and high pricing in the high yield market, 2012 has already seen numerous high yield upsizegs and top-of-the-market features, like dividend, PIK and FRN deals, in Europe.
While the high yield bond market is susceptible to opening and closing, it is important to remember that even during times of dislocation the market may remain open for certain issuers. Criteria to be considered include (i) the issuer’s credit rating, (ii) the industry sector in which the issuer operates, (iii) whether it is a repeat issuer and (iv) the issuer’s connection with the US.

Double B rated issuers tend to be preferred, as do non-cyclical sectors with stable earnings. The presence of substantial US operations or operations in a sector well understood and followed by US investors is also likely to facilitate access to the still more stable and liquid US market. Fresenius, the healthcare company, epitomises many of these features and was among the first successful high yield issuers after the market closures in both 2008-9 and late 2011. There are, however, subtleties to this analysis, meaning that even issuers which do not possess all these hallmarks may be able to launch successful refinancings through a high yield issue. For example, split-rated Welltec took advantage of US investors’ familiarity with the oilfield services sector and low swap costs to refinance debt with a debut Dollar-denominated bond.

Sector data shows that the three largest sectors for high yield refinancings in 2011 (by number of deals) were telecoms (10), oil & gas (7) and healthcare (7). Sectors dependent on discretionary consumer spending, such as real estate (0), lodging & dining (1), consumer products (1) and retail (2), saw significantly lower volumes (graph 16).

Nevertheless, access to the US market for certain European issuers does not change the reality that in the less mature European market it is more difficult to find a price for tough credit stories. The share of new issuance in the various ratings categories, as tracked by LCD since 2006, broadly shows Europe being more active in the double B bracket (61.5% of the Bank of America Merrill Lynch High Yield Bond Index for Europe), roughly equal to the US in the single B bracket (30.3% of the BAML index), but far less active in the split B/CCC or CCC bracket.

Yet the European high yield market is likely to remain underpinned by strong fundamentals. Extended monetary policy stimulus, low interest rate expectations, high investor cash balances and the search for yield will facilitate the high yield market offering an alternative source to meet refinancing needs. The arrival of the European high yield market has been prophesied many times. Now, however, the presence of these fundamentals, together with evidence of an increasing number of first-time issuers (36% of all issuance in 2011, significantly up from 23% in 2010 – see graph 17), supports the more established role this market may play.
3.2.2 CLO fund managers still have a role to play

As discussed above, the investment time limits of CLO vehicles established from 2000 to 2006 may make refinancings more difficult to source, which in turn may impact on pricing. However, CLO fund managers do still have the potential to be part of the solution. In the case of a refinancing, recapitalisation, restructuring or amend and exchange deal, many CLO vehicles can still support and participate in the process if they are exchanging one type of instrument for another within the same group or capital structure, and are not required as a matter of course to inject new/fresh money. It will be interesting to see how CLO fund managers tackle companies returning to the market for secondary or tertiary restructurings or refinancings.

Traditionally, CLOs have taken a medium to long-term credit view on companies and their exposure to debt in such companies, instead of seeking to make short-term trading profits based on anticipated incremental movements in the secondary price of debt in such companies.

In addition, many fund managers who were traditionally CLO-only fund managers are now branching out and fundraising not only with respect to new/replacement CLO vehicles, but also other more flexible fund structures. This will enable them to invest in a broader range of financing products on behalf of individuals, pension funds and sovereign funds, many of which would not in the ordinary course directly invest in corporates.

This broader range of focus could include opportunistic financings and special situations, distressed opportunities, high yield and public instruments and direct primary lending. It could result in such fund managers having the ability to provide liquidity as part of a solution to dealing with the wall of debt, and to inject cash in refinancings, restructurings or recapitalisations by using tools outside of or in combination with traditional CLO vehicles.

3.2.3 Potential for alternative capital providers to grow their role

One sub-set within the group loosely classed as “alternative capital providers” is already showing an interest in refinancing LBO loans. A trend is emerging for credit funds to purchase existing CLO vehicles, in order to use the CLO’s database of clients and credits to attract investment into the credit fund. For example, in 2011 GSO, the global credit platform of Blackstone, bought Harbourmaster Capital, a European CLO with €8bn in assets. This effectively migrates the CLO to the credit fund model, with the same end investors involved and consequently those monies available – via a different structure – to meet refinancing needs.

The amount of funding which such institutions are able to deploy is significant. For example, distressed and high yield investment fund Oaktree Capital has over $70bn under management, and other funds manage similarly significant sums. Traditionally US-based investors are now looking into Europe for distressed refinancing opportunities. Funds such as Centerbridge Partners have set up permanent presences in London over the course of the past year. In the last quarter of 2011 a number of investment managers including Avenue Capital, TPG and Oaktree successfully raised sizeable new funds to focus on European distressed opportunities. These amounts are available for investment on a rolling basis, and are likely to be part of a substantial and enduring solution to refinancing the wall of debt, given the right credit and the right financing structure.
Alternative credit providers currently face much less regulation than banks – for instance, Basel 3 will not apply to them. It is unclear whether and how this will change, and it is possible that regulators will seek greater rights to supervise such firms. Given the potential impact of any such regulation on the provision of finance from this source, care will be needed in this area.

Investors in credit funds are likely to be looking for high returns, which will influence the companies they find attractive. These may differ significantly from the companies in which banks, approaching this with a different set of priorities, wish to invest. Cyclical sectors, offering the potential for high returns, may prove attractive to credit funds, but less appealing to traditional investors looking for more settled sectors with stable earnings. For example, the 2010 restructuring of Almatis, a global leader in alumina products, a cyclical sector particularly exposed to economic headwinds, saw a significant credit fund investment to fund its exit from Chapter 11 reorganisation proceedings. An instrument was structured specifically to allow credit funds such as GSO, GoldenTree Asset Management and Sankaty Advisors to participate. With Almatis now performing well, those funds will be able to reap the rewards of their investment. Other sectors, which do not exhibit these features, may see less investment from this source. For example, despite the volume of refinancing required in the publishing sector, the decline in directories’ businesses may mean there is less credit fund appetite for investment in that sector.

Like CLOs, insurance companies and pension funds look to invest in long-term assets which match their liabilities to investors. However, they both face similar new capital and liquidity requirements to those faced by banks. For insurers, Solvency 2, a solvency capital requirement, aims to ensure an insurer has enough capital to continue to operate for 12 months with a 99.5% degree of certainty in the face of insurance, market, credit and operational events. The rules under Solvency 2 are, however, generally not co-ordinated with the rules imposed on banks under Basel 3. This means that the same asset may have different ratings under Basel 3 and Solvency 2, potentially creating opportunities for regulatory arbitrage.

Pension funds are another potential source of finance. They may now be better funded, as companies have increasingly been required to address any deficits in their pension funds, and so on paper a good potential source of funding for loan refinancings. A question mark does, however, hover over the extent to which this will be possible in practice. The number of pension funds who may make such investments is limited. Additionally, there may be regulatory issues resulting from the importation of Solvency 2 to cover pension schemes.

Private equity – back to the future

Private equity firms have a key role to play in relation to the wall of debt. Estimated by Preqin to be sitting on $937bn of unspent capital, they have significant financial resources at their disposal. More than a fifth of that so-called “dry powder” is in funds that usually would have to invest the money within about two years. About 41% is held by leveraged-buoyant funds. LBO funds raised in 2008 have about $91.5bn in unspent commitments, it said.

The wall of refinancing offers opportunities to private equity houses which revert to the business model that fuelled their growth in the recessions of the 1980s and 1990s. Private equity is traditionally based on identifying a loss-making business unit, selecting and incentivising a management team to engineer a turnaround with the aim of returning a capital gain to the partners at the private equity firm.

While the source of opportunity for private equity in previous recessions was a stock of corporates and industrial companies wanting to offload loss-making, non-core units, the equivalent in today’s environment is likely to be financial institutions seeking to reduce their balance sheet and dispose of non-core assets. An example is the acquisition in January 2012 by Bridgepoint Capital, a private equity firm, and the current management team of Quilter, a wealth management company, from Morgan Stanley. So, one of the consequences of the pressures on banks discussed above could be the creation of opportunities for the private equity houses.
Banks are faced with contradictory pressures. They are being exhorted to clear out bad loans, improve their capital positions (preferably without raising equity) and extend new credit all at the same time.

> 3.3 Debt restructuring likely to be more common

In an increasing number of cases, companies have found that their income is insufficient to meet both their operating expenses and the cost of servicing their debt. The typical initial reaction to this problem is to try to cut back on operating expenses, postponing discretionary spending on items such as capital expenditure and seeking to reduce overheads, as loss-making parts of the business are either sold or closed down. This approach is, however, often insufficient when a company’s real problem is that its business does not generate sufficient income, even when operating at maximum efficiency, to support the level of debt on its balance sheet.

Two or three years ago lenders were more willing to agree short-term solutions, such as covenant waivers and relaxations of interest and amortisation payments, in the hope that market conditions would improve, allowing a borrower to trade out of its problems. Now, however, there is an increasing acceptance that such solutions may not be enough, particularly where it is clear that additional funding is required to protect or expand the company’s existing business. Unsustainable debt levels are becoming increasingly hard to ignore.

When a company reaches the point where it is clear that it has more debt than it can realistically service, the key question becomes how best to reduce that debt to a level which is sustainable in the context of the company’s business plan, while not negatively impacting that business.

Given that lenders will rarely be willing to write off debt unless they obtain, at the same time, a share in any equity upside generated by restructuring the company’s debt profile, restructuring solutions often involve some element of debt to equity conversion. Where existing shareholders are unwilling to allow dilution of their equity stake, it may be necessary for lenders to enforce their security over shares in order to obtain their intended shareholding.

A good example of a successful debt to equity conversion is Dometic, a Swedish consumer appliance maker, which was taken over from private equity firm BC Partners in 2009 by a consortium of senior lenders, board directors and employees, following a debt-for-equity swap. In January 2012 private equity firm EQT Partners submitted a SEK12bn (£1.37bn) offer for Dometic in what was seen as one of the first successful sales of an asset seized by its bank lenders in the immediate post-crunch restructuring cycle.

The dynamics of any debt restructuring solution become more complex where additional funding is required, particularly if existing lenders are unwilling or unable to provide new money. An identified funding requirement can open up opportunities for sponsors or other new capital providers who are willing to invest in a revised capital structure, with existing lenders generally accepting that, by providing the funding necessary to implement the company’s business plan, the new funder should be entitled to a significant share of any resulting equity upside.

Once a revised capital and debt structure has been agreed, the focus shifts to its implementation. There have, in this respect, been two significant developments over the last few years, aimed at facilitating the implementation of restructuring solutions, particularly those involving typical leveraged buy-out debt structures.

The first is the increasing inclusion in intercreditor agreements of release provisions which permit a security agent to release junior claims, together with any related guarantees or security, in certain agreed circumstances. This tool is clearly extremely useful where the debt restructuring solution requires junior debt to be written off or otherwise removed from the company’s balance sheet.

Unsurprisingly, provisions of this nature have been the focus of considerable attention (and litigation) in recent restructurings, as they potentially leave junior creditors with no claims and no recoveries.

Intercreditor agreements do not, however, necessarily provide a “one-stop shop” for the implementation of a restructuring plan. It may be necessary to adopt a two-stage implementation approach where it is not possible to use an intercreditor agreement to force an individual senior creditor to accept a restructuring plan, even where it has overwhelming senior creditor support.

Intercreditor provisions may therefore be used in conjunction with a separate statutory cram-down process, such as a UK scheme of arrangement, which would impose the plan on any “hold-out” senior creditors, overriding contractual veto rights.
There will be more conclusive restructurings going forward that are less sticking plaster and more solutions focused.

The evolution of such statutory cram-down processes, particularly when dealing with debt owed to financial creditors, is the second recent development aimed at facilitating the implementation of restructuring solutions. Across much of Europe, it is clear that legislators have been focusing on how best to assist the implementation of such solutions (which typically involve restructuring debt at a holding company level), while avoiding the need to put the operating business into any form of insolvency procedure.

For a company which is unable to use any of the options discussed above, outright insolvency is available as a last resort. Although still likely to be viewed as value destructive, as lenders’ priorities shift, this option may see increased use.

**Legislative reform – spotlight on France, Germany and Spain**

**In France**, reforms which became effective in 2011 sought to assist the implementation of ‘pre-negotiated’ restructuring plans agreed between a debtor and its financial creditors by introducing a fast-track ‘accelerated financial safeguard’ procedure. This new procedure can be used once a plan is produced which has the support of two-thirds of the debtor’s financial creditors (and, if relevant, two-thirds of the debtor’s bondholders). The key objectives of this legislative change are to reduce the duration of any insolvency proceedings and to limit their disruptive effect on the debtor’s on-going business, by removing the need to involve suppliers, customers and employees.

**In Germany**, revisions to the Insolvenzplan procedure will take effect in March 2012, aimed at facilitating both debt to equity conversions (by limiting the ability of existing shareholders to block the process) and the cramming down of junior creditor claims. As in France, two key objectives of this legislative change are to improve the implementation process and to limit its disruptive effect on the debtor’s business.

**In Spain**, the Fourth Additional Provision, which took effect in October 2011, introduced a new procedure for court approval of pre-insolvency agreements, allowing a restructuring plan which has the support of at least 75% of the amount owed to financial creditors to bind the minority who have not agreed it. There are, however, very significant restrictions on the use of this procedure, particularly in relation to secured claims, which will, in many cases involving a leveraged buy-out debt structure, effectively prevent its use.

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i European leveraged loans face funding hiatus as CLO vehicles’ support wanes. 22 August 2011. Standard & Poor’s.

4. Key contacts

London
Jim Rice
Head of Finance and Projects
Tel: (44) 20 7456 4525
Mob: (44) 7710 408 604
jim.rice@linklaters.com

London
Gideon Moore
Global Head of Banking
Tel: (44) 20 7456 4458
Mob: (44) 7770 995 701
gideon.moore@linklaters.com

London
Jeremy Parr
Head of Corporate
Tel: (44) 20 7456 3558
Mob: (44) 7714 232 162
jeremy.parr@linklaters.com

London
Tony Bugg
Global Head of Restructuring & Insolvency
Tel: (44) 20 7456 4470
Mob: (44) 7767 264 175
tony.bugg@linklaters.com

Paris
Olivier Jauffret
Head of Banking
Tel: (33) 1 56 43 57 66
Mob: (33) 61692 3601
olivier.jauffret@linklaters.com

Frankfurt
Marc Trinkaus
Head of Banking
Tel: (49) 697 1003 353
Mob: (49) 1736 666 162
marc.trinkaus@linklaters.com

Milan
Andrea Arosio
Head of Banking
Tel: (39) 02 8839 352 18
Mob: (39) 33577 30606
andrea.arosio@linklaters.com

Stockholm
Per Nyberg
Head of Banking
Tel: (46) 8 665 66 20
Mob: (46) 7032 66620
per.nyberg@linklaters.com

New York
Jeff Norton
Head of Banking
Tel: (1) 212 903 9115
Mob: (1) 917744 0730
jeff.norton@linklaters.com

Amsterdam
Onno Bakker
Head of Banking
Tel: (31) 20 7996 280
Mob: (31) 622 686 283
onno.bakker@linklaters.com

Hong Kong
Trevor Clark
Head of Banking
Tel: (852) 2901 5226
Mob: (852) 9035 5611
trevor.clark@linklaters.com
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