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Private Equity 2020

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Sixth Edition

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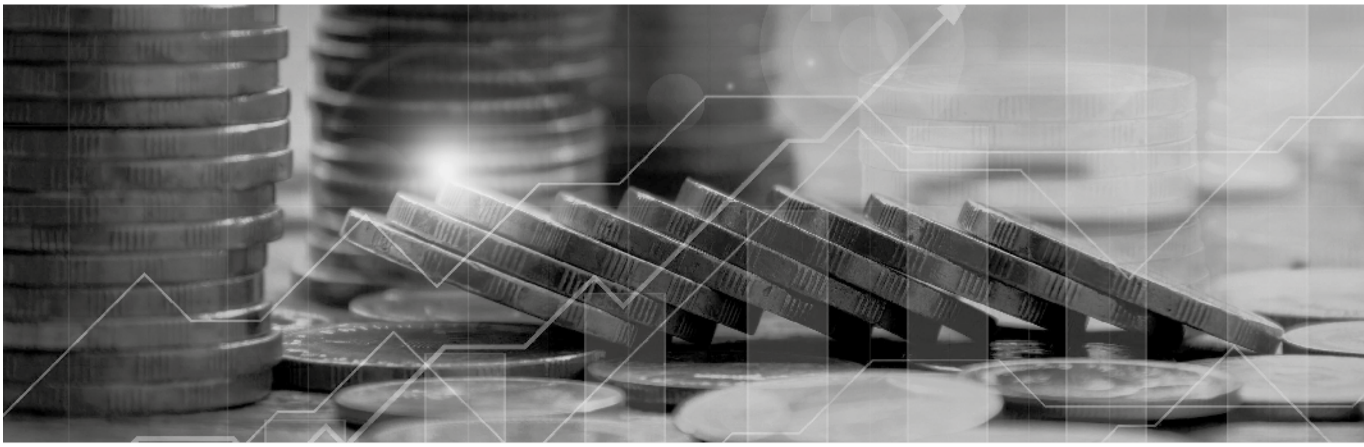

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Defensive Strategies for Sponsors during Periods of Financial Difficulty

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"Having a large amount of leverage is like driving a car with a dagger on the steering wheel pointed at your heart. If you do that, you will be a better driver. There will be fewer accidents but, when they happen, they will be fatal." **Warren Buffett**

Introduction

The events of 2020 have seen massive reductions in both revenue and cashflow for many businesses. As a result, financial sponsors ("**Sponsors**") have watched with growing concern, fearing certain of their struggling and highly-leveraged portfolio companies are heading inexorably into the sort of 'accident' Warren Buffett described.

However, the proliferation of covenant light ("**cov-lite**") debt packages and the absence of ongoing performance metrics in credit documentation, may mean that Sponsors have a stronger hand when dealing with lenders in distress scenarios than current headlines regarding market conditions might suggest. The continued wall of money across the deep high-yield capital markets and syndicated and alternative lending markets favours equity Sponsors who have become increasingly adept at running competitive debt processes.

This chapter will explore some of the options available to Sponsors that are considering the adoption of defensive strategies in the face of lender-led distressed approaches.

Identifying the Distress

Typically, restructuring discussions will begin shortly after a waiver is requested from a portfolio company's lenders in relation to a default under that company's credit documentation. Although there can be material benefit to starting those discussions earlier, depending on circumstances and the relationships involved. Indeed, discussions often begin as soon as a covenant or other default is anticipated owing to macro events or a softening of performance.

According to S&P Market Intelligence, as at 31 January 2019 approximately 82% of all outstanding leveraged credits in Europe were cov-lite. Given the massive growth in the use of cov-lite documents, there has been a general erosion of the 'early warning systems' traditional debt documentation included. By way of illustration, pre-2008 syndicated debt would typically include four performance triggers (which would customarily include covenants on leverage ratio, interest cover, debt service cover and capex). By contrast, a cov-lite facility would include only a springer covenant applicable to the revolving credit facility and which operates more as a clean down than a traditional financial covenant. Alternative lending deals usually have a single leverage covenant, but increasingly with significant headroom and generous add-backs and look-forward *pro forma* adjustments for internal operational restructurings and cost-saving projects (amongst other things) giving Sponsors significant release valves in times of distress.

As a result, lenders are being brought to the table later and Sponsors and their portfolio companies are likely to have significantly more preparation time to appraise and improve their negotiating position before engaging with lenders. Good early analysis and strategic advice pay dividends in executing a successful defensive strategy.

In the absence of substantive performance triggers, cash flow and liquidity are likely to be the key drivers in assessing the imminence of default. In particular, the Sponsor and the board of the portfolio company will need to consider (among other matters): (i) whether interest payments can be made on time; (ii) how accurately cash flow can be mapped against near-term liabilities; and (iii) whether there are any short-term financing options permitted under the credit documentation (e.g., factoring arrangements, sale and leaseback schemes or the execution of an asset sale).

Duties and Conflicts

Where insolvency is a real possibility, both the Sponsor and the board of the portfolio company will also need to be mindful of the shift in directors' duties toward value preservation for creditors. This can place Sponsor-appointed directors in a particularly difficult position when it comes to conflicts of interest. While it is usually permissible for a director to vote on matters in respect of which they have an interest if it is declared, the dynamic opens up an unhelpful avenue of attack for lenders. This risk can be partially mitigated by the Sponsor through the adoption of stringent governance protocols and, when appropriate, arranging for the Sponsor and the portfolio company to retain separate and independent counsel.

In a similar vein, the Sponsor will need to be mindful of the risks of shadow directorship and the possibility that transactions entered into during the applicable look-back period are reviewable, and potentially voidable, in the event of an insolvency.

What Are the Sponsor's Aims?

Assuming that distress has been identified and a liquidity or solvency default is expected to be triggered under the credit documentation, a Sponsor must first ask itself what it ultimately intends to achieve before seeking to implement a defensive strategy. The answer will be dependent on a number of factors, including: (i) the performance of the portfolio company to date; (ii) whether it is realistic to expect future returns from the investment if it is retained; and (iii) the life cycle of a fund that holds the company and, in particular, whether that fund is able to provide additional liquidity and where in the capital structure such funding can be advanced. Whether there have been previous injections of further funding by the Sponsor is particularly relevant in this context, as limited partners in the funds will be concerned as to whether following their money is still the right thing to do, or whether it is time to cut losses. Questions will inevitably arise around the overall sector performance and its future, particularly in this era of paradigm shift, as well as the management team and whether changes need to be made to weather the storm and get back on track.

One other significant consideration will be whether the Sponsor is currently fundraising. If the Sponsor is forced to realise an impairment during a fundraising cycle this will have a detrimental impact on returns and, potentially, the Sponsor's reputation. For Sponsors that are perennially fundraising, this concern may be particularly acute. In these circumstances, the Sponsor may decide to look hard at ways of retaining an asset to avoid disrupting the fundraising process. General reputational and track record considerations will always apply.

This assessment may be done in parallel with the review of the Sponsor's negotiating position under the credit documentation or otherwise (see *Passive and Active Levers*, below) so that the Sponsor arrives at an informed view of risk and reward. It is not uncommon for Sponsors that learn they have more negotiating leverage, or hold-out value, than previously thought to suddenly see a distressed asset in a more favourable light. Similarly, where a Sponsor lacks strategic levers to prevent a lender-led restructuring, it may decide that a swift and fully consensual exit is the best way forward, even for assets which might otherwise remain attractive. If the fund or funds are otherwise performing well and have completed a high number of successful exits, an orderly handover of the keys or an exit to a distressed specialist investor may be a more logical and better outcome than a 'Hail Mary' play to save the business in current ownership.

Passive and Active Levers

At the same time as considering how attractive the retention of the relevant portfolio company is in the abstract, a Sponsor should consider what leverage it has by virtue of the facts and circumstances intrinsic to the situation (passive levers), and the ways in which they can proactively influence the dynamic in their favour (active levers).

Passive levers

Examples of structural or 'passive' advantages the Sponsor might enjoy include whether or not the lender syndicate is highly concentrated (which yields efficiencies in terms of the number of counterparties with whom active engagement is needed, while ceding some negotiating power), how much of the debt stack is under water and whether the lenders have divergent objectives (e.g., distressed investors who have invested at well below par will have different imperatives to traditional bank lenders who have held the debt from the outset). Fully understanding which lenders hold what instruments is crucial in finding a way forward – for example: (i) will certain lenders have a different perspective due to cross holdings in different classes of capital in the structure; and (ii) are all lenders capable of holding equity instruments if that is agreed as part of a broader restructuring solution?

Other (non-exhaustive) examples of structural advantages which may be enjoyed by Sponsors include:

(i) the absence of a single point of enforcement for lenders, with the attendant complexity of enforcement that this entails;
(ii) the requirement that the lenders enforce in 'creditor-unfriendly' jurisdictions; and
(iii) the identity of the security agent.

Active levers

Active levers are the means through which Sponsors and portfolio companies can directly influence the negotiating dynamic. While some of these tactics could be considered aggressive, it will often not be necessary to actually 'use' an active lever; the mere fact that it is available as an option to the Sponsor can significantly bolster its negotiating position.

Examples of 'active' levers include (non-exhaustively):

(i) actively preventing the occurrence of an event of default (through EBITDA add-backs, *pro forma* adjustments or equity cures);
(ii) the policing of transfers into and out of the lending syndicate; and
(iii) transfers of value away from existing lenders where this is permitted due to any gaps in the credit documentation and raising financing against those assets.

Sponsors should be mindful of reputational risk when considering active levers: lenders may be engaged across the Sponsor's portfolio and an overly aggressive approach may make it challenging, or more expensive, to borrow money in future. That said, the Sponsor will also wish to avoid signalling to loan-to-own investors that their portfolio is an 'easy target'.

Having established its view of the distressed portfolio company and the tools at its disposal (both active and passive), a Sponsor should now be well-equipped to turn its attention to engaging with the lender group.

Conclusion

The ubiquity of cov-lite debt packages may present Sponsors with the opportunity to retain assets that they might previously have been expected to consensually exit in distress scenarios. In other words, the general position of Sponsors looks at least as good, if not better, than it did in the financial crisis after the debt binge which preceded that episode. Perhaps foremost among the benefits yielded by the cov-lite regime in this context, is the time afforded to the Sponsor to prepare for its engagement with the lender group. Early preparation with specialist restructuring counsel is crucial in assisting with the development of a coherent strategy which provides the best possible chance of securing a positive outcome.

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Jifree and Mark Knight have just led a large Sidley multi-disciplinary team who successfully completed the Travelex restructuring, achieving a successful rescue for the business and solutions for the investors.

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James Crooks co-leads Sidley's London leveraged finance practice, advising LBO sponsors, their portfolio companies and credit funds on debt financing transactions, including leveraged acquisitions, syndicated lending, asset-backed financings, debt restructurings and general banking arrangements. He is distinguished for playing a crucial role in establishing the thriving practice in Sidley's London office including advising such industry heavyweights in 2019 as Apollo, Blackstone, Compass, HIG, KKR, Northleaf, Soros and TowerBrook.

The Lawyer named James to the 2020 edition of its "Hot 100" list. The annual list recognises the United Kingdom's most daring, innovative and creative lawyers from in-house, private practice and the Bar. James was praised for helping shape the legal profession.

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James Wood is a partner in Sidley's Corporate Department and member of the firm's Private Equity Practice Group. He has significant public and private cross-border M&A experience across many sectors, providing advice to senior client stakeholders on significant, complex and transformative transactions.

Teams led by James have helped clients successfully complete multi-jurisdictional transactions involving up to 70 countries, and he has advised clients on transactions in Africa, Western and Eastern Europe and, in particular, Asia, having lived and worked for four years in Tokyo. He has particular experience advising investors and corporate clients on international transactions and other strategic initiatives in the financial services, life sciences, telecoms and technology sectors. He is recognised by *The Legal 500* for M&A and he has been listed in *Best Lawyers 2021* for Mergers and Acquisitions Law and Private Equity Law. James was a key member of the team that successfully closed the Travelex restructuring.

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She has advised leading private equity Sponsors, other investors and funds (including family offices and sovereign wealth-funds), financial institutions, corporates and management teams. Amongst the investors she has acted for are The Blackstone Group, Cerberus European Capital, Colony Capital, CVC, EQT, First Reserve, GIC, Goldman Sachs, Hamilton Lane, Investcorp, KSL Capital, LetterOne, L1 Energy, L1 Health, Oaktree Capital, Round Hill Capital, Partners Group, Pamplona Capital, Schroders REIT and Third Point.

Eleanor is recognised by leading rankings including *The Legal 500*. In 2016, she was named in the *Financial News* Top 40 Under 40 Rising Stars in Legal Services. She was also named the Most Distinguished Winner of 2015 and awarded Best Private Equity Lawyer in the Women in Private Equity Awards.

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Legal Week named Bryan Robson to its 40 Under 40: Rising Stars in Private Equity list, which recognises the United Kingdom's "finest private equity legal practitioners".

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Prior to joining the firm, Mark served as general counsel and partner of Pillarstone, a KKR turnaround platform which partners with European banks to manage their exposure to NPLs and non-core assets. He was named one of the top-25 "Rising Stars of Private Equity" of 2018 by *Private Equity News*. Mark has recently acted for TowerBrook Capital Partners with Bryan on the distressed acquisition of the Azzurri Group.

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Sidley has an extensive Private Equity practice with lawyers around the world focused on advising our private equity clients, including general buyout funds, specialist funds in sectors like infrastructure, real estate, energy, financial services, insurance and healthcare, sovereign wealth-funds, pension funds, family offices and other limited partners.

Our private equity lawyers possess deep experience across the broad spectrum of private equity transactions, from multibillion-dollar leveraged buyouts (LBOs), platform buy-and-builds, consortium deals and co-investments, large-scale restructurings and distressed investing, to growth equity investments in premium middle markets companies. The firm has built a practice with a committed multi-disciplinary approach as one team with one objective – to help the client meet theirs. Corporate, debt, restructuring, tax and other private equity specialists work seamlessly with a deep bench of specialist employment, wide variety of regulatory, compliance and industry operational legal specialists.

Bloomberg covered the rise of Sidley's Private Equity practice earlier this year, saying that: "*Sidley Austin has shaken up the private equity space, in part using a string of lateral hires from more established PE players to make rapid progress in a market where the top law firms have had practices spanning several decades. [Sidley] saw its revenue from this private equity work hit roughly $300 million this past year, a leap from just $50 million in 2011.*"

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Our team has worked successfully with a number of its Private Equity clients on the early preparations described in this chapter and we have consistently helped them defend and retain key assets where they would have otherwise been vulnerable to loan-to-control investors.

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