Baker McKenzie.

In The Know

Leveraged Finance Annual Report | 2020

TRANSACTIONAL POWERHOUSE

Leading and closing three deals a day

CONTENTS

Introduction

Welcome to Baker McKenzie's first EMEA Leveraged Finance "In the Know" Annual Report. In this report, we take a look at 2019 results for the EMEA leveraged finance market, make 10 predictions for 2020 and include our monthly "In the Know" newsletters from the past year, covering a variety of topics including the Net Short Noteholder Predicament, trends in Green Bonds, Direct Lending and Cannabis Debt Financing, developments in the LIBOR debate and a market snapshot of Turkey.

2019 - The Year In Review

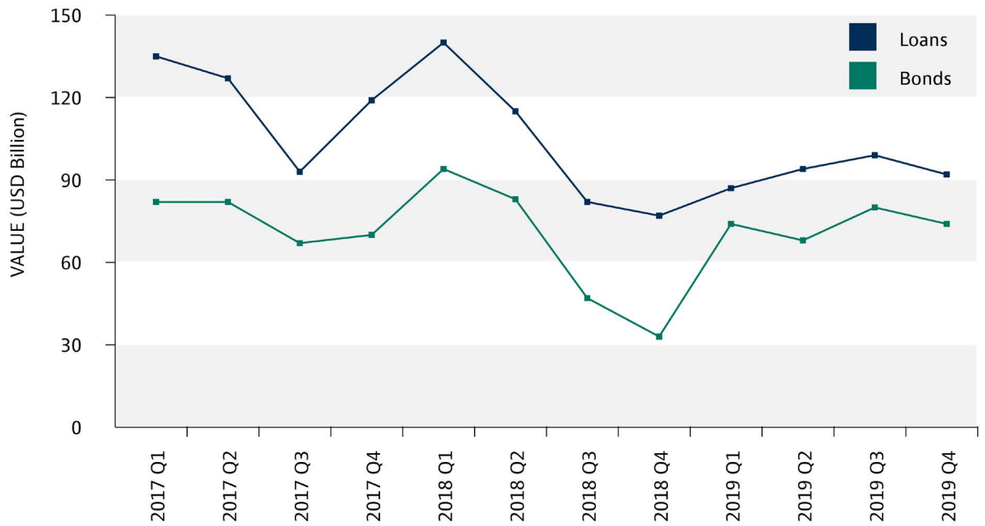
The EMEA leveraged finance market in 2019 showed a continuation of trends from prior years in terms of product mix. The Term Loan B remains a product of choice, although high yield bonds saw a resurgence, particularly in the BB corporate issuer space, with a number of high profile refinancings. The convergence of markets and products continued, and continued covenant easing was met with a proliferation of 'review' services providing more biting analysis of market developments and some coordination between investor groups. Direct lending also persisted in its upwards trajectory, as deal size increased and new participants entered the market.

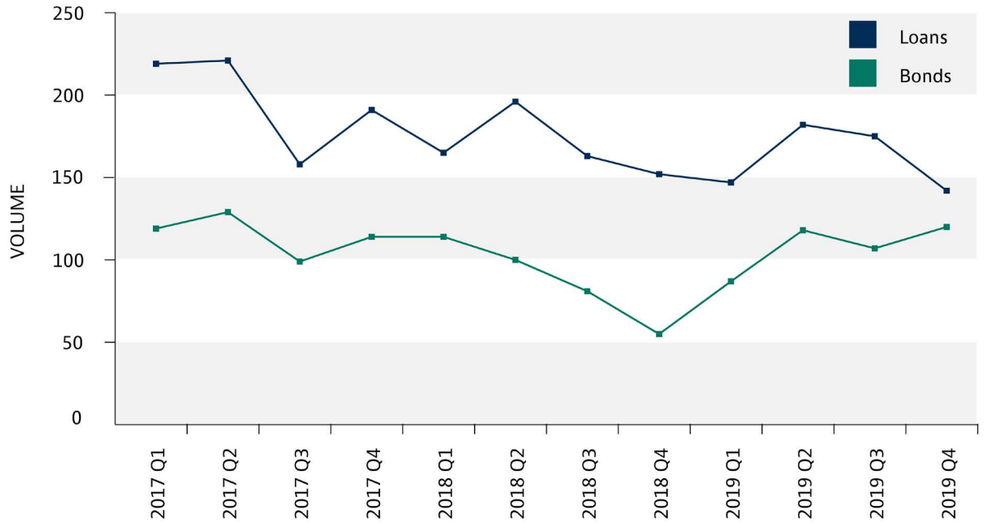
Market participants kept close watch of shifting macro-economic factors, including geo-political events, Central Bank policy and commodity pricing. While in prior years this may have led to volatility, in 2019 the market was kept in check but open. Green bonds and sustainable energy financings received significant press attention as the markets continued to develop, particularly in emerging countries.

2019 by Product

In 2019, both the EMEA loan and bond market saw an uptick from a slow second half in 2018, and activity picked up during the year, but below the peak volumes and aggregate deal value seen in late 2017 and early 2018. A mix of refinancings and M&A activity kept the market busy, and a weaker than expected IPO market directed fund raising to the debt markets.

The chart below shows deal volume and value of high yield debt and loans by quarter since 2017:



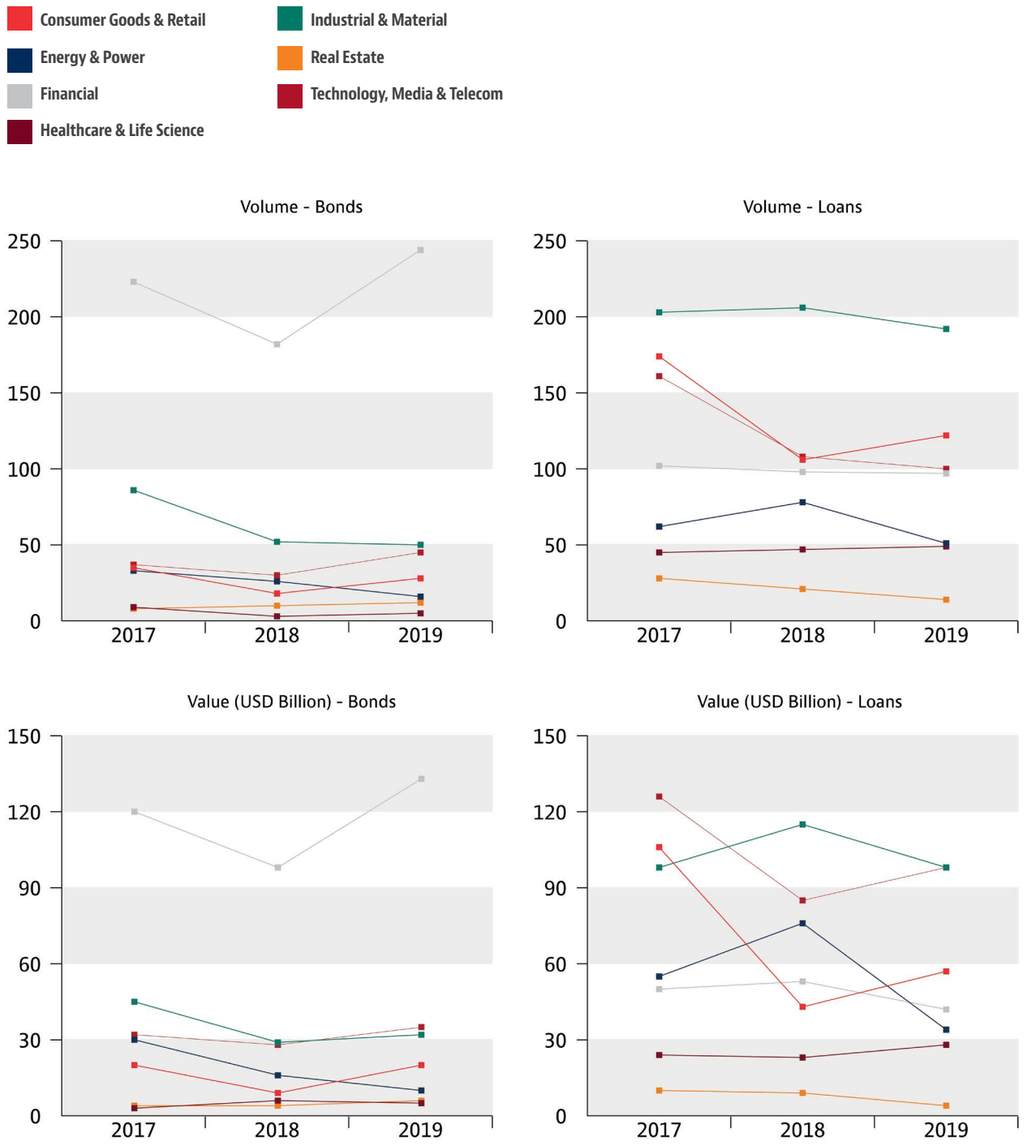


Source: Refinitiv

2019 by Industry

Transactions by industry remained relatively constant in 2019, with the outlier being the increase in bond financing in the financial sector. Other sectors remained relatively consistent year-to-year, with activity showing all markets remained open, despite uncertainty in certain sectors, including consumer goods and retail. Proportionately higher deal value in the loan market continued to reflect the preference of sponsors for loan-funding in LBO activity.

The chart below shows deal volumes and values of high yield debt and loans across EMEA broken down by industry:

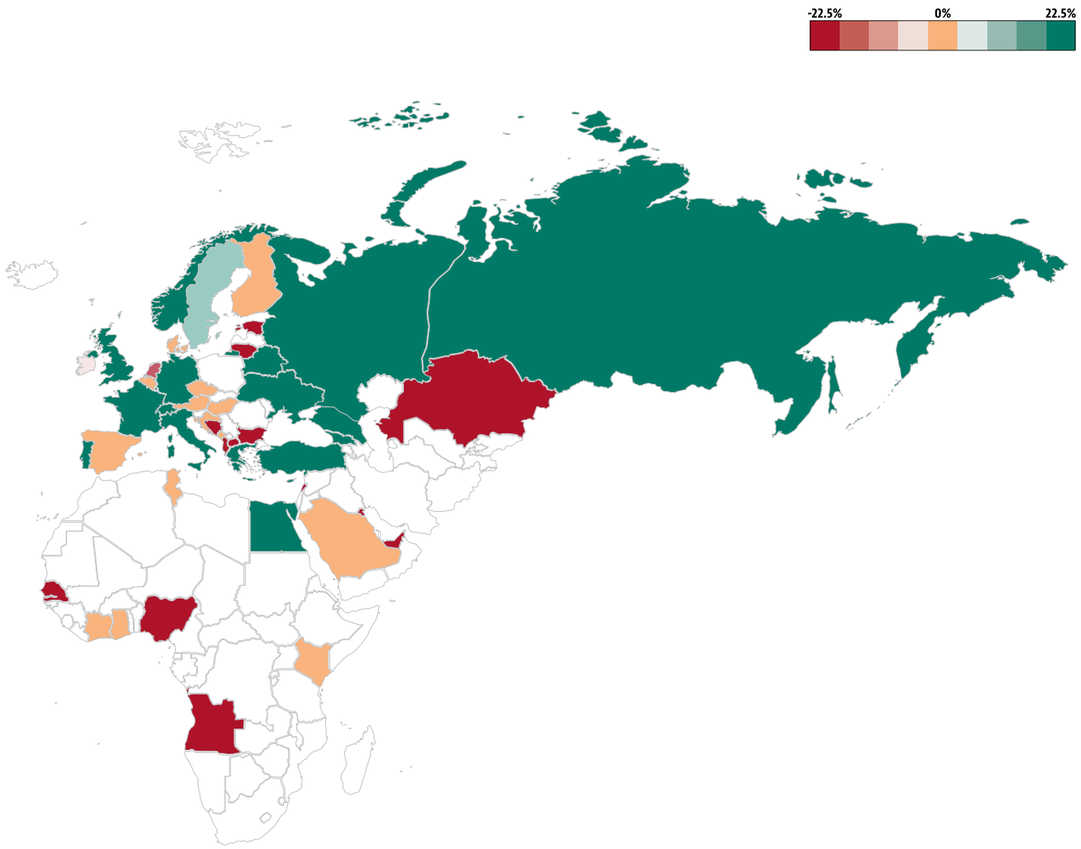


Source: Refinitiv

2019 by Geography

Changes in product mix in 2019 versus 2018 show some interesting developments that may not reflect trends so much as confirm the fact that products are available interchangeably across EMEA. From both a volume and an aggregate deal value perspective, high yield bonds in 2019 saw the largest upticks in the United Kingdom, Turkey, the Nordics, Italy and Germany, while loans increased most in Germany, Spain, Sweden and certain CIS countries.

The chart below shows movements in bond volumes by jurisdictions comparing 2019 to 2018:

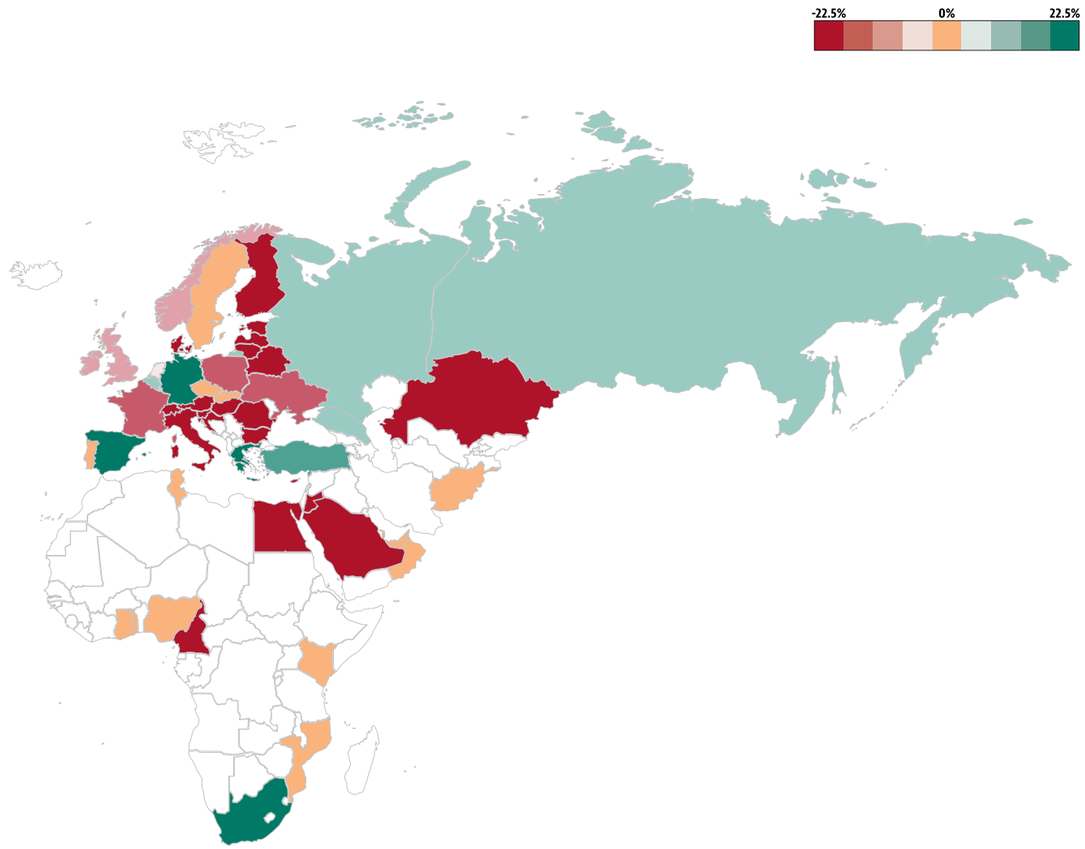


Source: Refinitiv

In France and Italy the bond market grew at the expense of a proportional contraction in the loan market. Despite Brexit uncertainty, in the United Kingdom the amount of bond transactions and aggregate value also increased while loan volume decreased, although notably the aggregate value of loan transactions still increased despite the lower deal flow due to a few big ticket jumbo transactions in 2019. Norway, Finland and Switzerland saw significant decreases in the volume and aggregate value of loan transactions over the year, but loans still represent more than three quarters of the sources of financing for sub-investment grade borrowers in those jurisdictions as opposed to bonds that have historically not been as prevalent.

It will be interesting to watch 2020 to see if any of these developments are product trends.

The chart below shows movements in loans volumes by jurisdictions comparing 2019 to 2018:



Source: Refinitiv

2020: Ten Predictions for the EMEA Leveraged Finance Market

1) Geo-political uncertainty likely to impact the markets as the year progresses

In recent years, the world financial markets have become more resilient when faced with discrete economic or geo-political events, including international or domestic political unrest or catastrophes, negative financial outlooks or other uncertain economic indicators.

2020 will be a year to watch for the possibility of a perfect storm that may test that resilience. Pick one or several of:

- Elections in the US that are shaping up to be potentially divisive;
- The rise of nationalism in certain jurisdictions and the effect on international perspectives;
- Disruption in the Hong Kong market;
- Increased turbulence in the Middle East;
- Countless parliamentary elections throughout Europe, Asia and Africa;
- UN's prediction of a global recession; and
- Brexit uncertainty.

2020 Prediction:

We expect 2020 to start strong for leveraged finance across products, industries and jurisdictions, given a solid pipeline and generally favourable global economic outlooks. As the year progresses, we predict that the drivers listed above, and others that develop over the year, will impact the markets, more likely in the negative, but results may vary across platforms.

2) Effect of covenant relaxation of later stage R&I to rear its head

Restructuring and Insolvency (R&I) activity takes many forms, including early planning and action by a proactive company when its business deteriorates or suffers from economic challenges (e.g., falling commodity prices or regulatory changes) through to a bankruptcy or liquidation scenario.

The advent of "incurrence-based" financial structures, and in other cases diluted financial or maintenance covenant protections, has provided sponsors, borrowers and issuers with additional flexibility to incur debt, make investments and in many cases, pay dividends.

The other key result of "incurrence-only" protections is that a company that continues to make interest and principal payments is less likely to default based on a business decline or negative economic event, which would historically have led to stress on a maintenance covenant much earlier in the process.

As an example: Hypothetically EBITDA dropped to zero, which would be a clear warning sign to lenders that a business may be in trouble. Compare a company with an incurrence-based debt test and a maintenance test:

- In an incurrence-based scenario, if the company continues to pay interest and principal but does not take an action which would require it to test a financial ratio, then the drop in EBITDA itself would not trigger a default.
- In a maintenance-test scenario, the quarterly or annual debt to EBITDA (or similar) metric would be tripped, and lenders would have an opportunity to work with the company to retain value much earlier in a possible downturn scenario.

2020 Prediction:

We expect a robust R&I market in 2020 as companies in certain industries struggle to maintain their debt profiles. The international finance markets have become more sophisticated in their approach to R&I situations, even compared to just a few years ago, and now a number of court-tested options are available (e.g., exchange offers and UK schemes of arrangement) with much more predictable processes and outcomes. In 2020, we expect to see more companies reach a "crisis point" at a later point in time in a distressed situation, which could lead to reduced recoveries for lenders.

3) The high yield vs. TLB battle 2020 edition

Following the the financial crisis of 2007/2008, high yield debt became a preferred source of funding in the international markets due to a number of factors, including more restrictive regulatory and capital requirements placed on bank lenders and tightened risk profiles from these lenders.

As discussed above, one key feature of high yield bonds compared to traditional bank loans is the "incurrence-based" covenants, which proved quite appealing to CFOs who had lived through the downturn when they were required to undertake repeated timely and expensive negotiations with lenders to avoid maintenance covenant breaches.

The lending market has since countered with the Term Loan B (TLB), which generally comprises a term loan with "high yield" type covenants. Because fixed rate high yield bonds include no-call periods and quasi-public reporting requirements, sponsors in particular lean towards a Term Loan B solution, either in an acquisition finance scenario or a refinancing. As a result, since 2015, the high yield bond market has seen a retraction while the Term Loan B market continues to grow. The high yield bond market has also seen a chipping away of the make-whole protection (not found in TLBs) as a sign of these products potentially converging.

2020 Prediction:

We expect to see this trend continue in 2020, under the following general guidelines:

- TLBs: Preferred by sponsors and certain corporates in acquisition financing structures and certain refinancings.
- High Yield Bonds: Preferred by BB credits or better who can benefit from covenants trending towards investment grade; preferred in emerging markets; preferred by corporates establishing "public" disclosure in anticipation of a future IPO; included in a very large LBO.
- Other Bank Debt: To hold consistent, particularly in markets where local financing is inexpensive.

4) Sustainable finance takes off full blast as source of funding

While "Green Bonds" and sustainability-linked term loans have yet to show a material pricing benefit for issuers and borrowers, corporates who avail themselves of a "green" or sustainable offering get a positive market perception kick, both externally and often within the organisation. 2019 has seen a large uptick in these offerings, particularly in Western Europe, where the initiatives have wider political backing than in other regions, and procedures for verifying compliance are becoming more universally agreed and accepted.

2020 Prediction:

"Green" and "sustainable" verification standards will become more broadly agreed and accepted, leading to take-up in regions where compliance concerns have kept the market from full development. Companies will continue to seek out green financing initiatives, and social, political and economic incentives, as well as investor interest in these types of products, will strongly drive the continued growth of sustainable financing in 2020. The recently announced EU Green Deal will inject real momentum into this growth. There will be some balkanisation of green debt products with green bonds, sustainability-linked bonds and transition bonds each having their buy-side advocates.

5) Emerged/emerging markets - Activity to pick up for maturing markets; bridge loans with take-out options to become more prevalent

As emerged/emerging markets continue to develop in 2019, we expect to see more complex financial structures adopted. Historically, topics like uncertainty of priorities, corporate benefit and financial assistance considerations, enforceability of judgments, and trustee structures, among many others, have left investors reluctant to fund in new and untested regions.

One example is the use of the bridge loan in acquisition financing structures, to be used to provide certain funds (or otherwise meet a jurisdiction's requirements for proof of funding) in connection with a financing bid, which then gets taken out by a permanent financing in either bank loan or bond form. One good recent example is the bridge financing by South African corporate Implats Platinum Holdings to finance its acquisition of Canadian corporate North American Palladium.

2020 Prediction:

We expect to see lenders/underwriters willing to implement more complex financial structures in emerged/emerging markets in 2020. One example is bridge loans for acquisition finance, particularly in situations for EBITDA generating acquirors (and acquirees) and sponsor-led transactions.

6) Direct lending - More to come, commoditisation risk vs. new customised products

Direct lending products fall into a number of categories (US and Euro private placements, unitranche, equity-linked loans, exchangeable and convertible securities, etc.) and were made available in 2019 by a variety of lenders (e.g., credit funds, special situations desks and institutional investors). While certain types of these financings (e.g., investment grade US private placements) are negotiated from pre-agreed forms, many direct lending transactions involve discrete one-off situations, whether in structuring, adequate credit support, unique covenant protections, transferability or mix of products (debt, preferred, warrants, etc.), resulting in uniquely customised terms for each transaction.

2020 Prediction:

As any financial product becomes more prevalent, it tends over time to migrate towards being perceived as a commodity product rather than a premium, customised product. We believe that, on one hand, certain types of private placement financings will migrate towards the commodity space in 2020 and beyond as the precedent base grows and well-established protocols are developed. On the other hand, these products will also evolve in new directions in 2020 and beyond, given the nature and sophistication of lenders and the growth of availability of funds for these purposes. In addition, creative solutions provided by lenders will continue in 2020 to take the market in new directions that will require customisation.

7) Litigation plays a role

A tangential take-away from the now well vetted Windstream case and other litigation is that, behind the scenes of the primary and secondary markets, distressed debt investors and others are actively monitoring companies, corporate actions and covenants to look for possible breaches or other points of potential leverage to engage in a dialogue with a corporate or sponsor (in an attempt to extract value). For example, high yield covenants ported from a New York law indenture to an English law Term Loan B credit facility could have unexpected consequences, even with respect to 'boiler plate' concepts such as 'ordinary course of business', which may be interpreted differently under the two legal standards. So there are many angles to consider.

2020 Prediction:

This practice is not new, but some of the following factors should contribute to an increase in litigation, or threatened litigation, in 2020:

- Paid covenant review services taking more aggressive positions or analyses of general and specific covenant terms as they continue to compete for a market share;
- The availability of improved online access and more sophisticated search tools that streamline these types of searches; and
- In certain circumstances, corporates and their advisors pursuing broad covenant interpretations, for example, with respect to the reclassification of baskets to provide for more credit or dividend capacity.

8) Refinancing wall to be considered

Looking back from 2020 at the financial crisis of 2008, one big concern from market participants at the time was the reduced availability of funding alternatives to service the 'refinancing wall', i.e., corporate debt with near term maturities that might be difficult to refinance in a more restrictive market if there is a lack of market liquidity. The market played through fears, in part fuelled by the rise of high yield debt as a preferred source of international funding.

2020 Prediction:

Many market watchers are predicting a slow 2020 for the leveraged finance markets, in part due to a predicted weakened M&A market and the disrupters described above. However, corporates who remember the squeeze from the prior decade are likely to look closely at their refinancing profiles and fuel the refinancing market by taking advantage of low interest rates and loose covenants while they last, particularly in the BB range.

9) Influence of investor advisors continues to rise

As the international debt and equity markets become more complex, with a variety of potential products being pitched to corporates, the EMEA markets have seen a rise in the use of an investment advisor. Corporates, who previously might have relied on their investment banks or lawyers to steer them through the available options, now more often look to specialist third party advisors to help them navigate these complexities.

2020 Prediction:

Given that these advisors have become commonplace, and the suite of available products has become more complex, and in some industries more specialised, it is more likely that a CEO or CFO of a debut issuer (or a corporate positioning itself for growth or a potential restructuring) will look to an advisor to help guide them through the matrix of possibilities.

10) Jurisdiction-specific discrete market offerings challenge traditional finance

The last few years have been marked by significant convergence across products and markets, as both the US and international markets have cross-pollinated in many respects, resulting in bank loans and bonds, sharing common features. This is not true in all respects (e.g., European portability and "heads of trees" commitment processes) but is a trend that is generally expected to continue.

2020 Prediction:

The homogeneity of products also provides an opportunity for more discreet product offerings, and has helped drive the direct lending market described above. Another trend we expect to see continue in 2020 is the growth of regional finance (which is then invested primarily locally, but the investor bases are expanding), in the form of both bank and bond debt. Two examples:

- Schuldschein: Popular in Germany and Austria but potentially branching out. A Schuldschein is a local law hybrid loan-bond product that can be issued with limited disclosure and in smaller denominations than a more traditional finance product; and
- Nordic bonds: Bonds issued under local law with limited disclosure and a unique set of covenants (sometimes including maintenance covenants). Often used for financings of Nordic-based oil & gas companies and real estate.

The Net Short Noteholder Predicament

July 2019 | Rob Mathews, Matthew Smith, Nick O'Grady and Ben Bierwirth of Baker McKenzie London

In the wake of bondholder activism in the Windstream case, certain issuers and borrowers have taken documentary steps to protect against action by so-called "Net Short Investors".

In this newsletter we propose to take a look at the high yield bond market response, including the inclusion of certain new provisions in indentures and some of the potential consequences thereof.

Windstream

In 2015, Windstream entered into a sale-leaseback transaction which, more than two years later, an investor holding certain notes issued by Windstream alleged created a covenant breach.

The bondholder was an activist investor that, after making a determination that the sale-leaseback transaction violated the indenture, purchased in excess of 25% of the outstanding principal amount of the notes along with credit default swap protection in respect of the credit in an amount greater than their holding of notes thereby creating a net short position. After the bondholder accelerated the notes (as holder of greater than 25% of the outstanding principal amount of such notes), litigation ensued and the court found that the sale-leaseback transaction did indeed violate the covenants. Ultimately, Windstream filed for bankruptcy after the court determined that the principal amount of the notes, plus interest and additional amounts, became due and payable as a result of the covenant breach.

The Windstream case gave rise to a debate over whether an issuer group should be afforded protection from investors who might be financially incentivised to act in a manner adverse to the interests of the issuer group (and potentially other investors). The risk arises not so much around actions leading to a default (as these remain within the control of the issuer group), but rather around the exacerbation of such defaults caused by activist noteholders who benefit from the deterioration of the credit due to short derivative instruments.

Documentary responses to net short investors

In response to the Windstream case, we have observed certain provisions added to financial instruments, including high yield bonds, intended to curtail the activities of net short investors. Two limitations currently being tested in the market are the contractual shortening of the applicable statute of limitations on the timing to call a past default and the disenfranchisement of net short noteholders. While, as of the date of this article, these provisions have been included in certain high yield transactions in the US market, we are also seeing these included in the latest deals in the European loan market and, therefore, expect to see them promulgated internationally as well.

Shortening of statute of limitations

The shortening of the statute of limitations is the most prevalent limitation on net short noteholder activities as well as the most straightforward one we have observed in the market to date. This change provides for a two year time limit on the period during which a notice of default may be given after an action is taken. Without specifying the statute of limitations, a suit could usually be brought until the maturity date. In simple terms, this limits the threat of an open-ended notice of default and gives the issuer group peace of mind after the statute of limitations has elapsed.

Over the past few months we have observed the shortening of the statute of limitations in high yield bond offering transactions in the US, including five deals in June 2019. One example of this language is to include a proviso in the Event of Default covenant in the following form:

> *"However, a Default... will not constitute an Event of Default until the Trustee or the Holders of 25% in principal amount of the outstanding Notes notify the Issuer of the Default and... the Issuer does not cure such default within the time specified... after receipt of such notice; provided that a notice of Default may not be given with respect to any action taken, and reported publicly or to holders, more than two years prior to such notice of Default."*

Though this limitation may have been specifically added as a consequence of net short investors raised by the specific facts and circumstances in the Windstream case, it effectively imposes a statute of limitation on all bondholders, regardless of intent and doesn't directly address the issue but simply limits the risk. This seems to be the sledgehammer solution to the issue as it imposes restriction across the board which may overreach by limiting remedies for undiscovered historic defaults where such remedies would be appropriate, but it does not in our view resolve the issue at hand.

Disenfranchisement of net short noteholders

Another restriction on net short investors has been disenfranchisement from the ability to participate in an enforcement action under the indenture. This limitation is more technical as it requires defining the scope of net short investors captured.

The disenfranchisement of net short investors is also generally included in the Event of Default covenant in the following form:

> *"Any notice of Default, notice of acceleration or instruction to the Trustee to provide a notice of Default, notice of acceleration or take any other action (a "Noteholder Direction") provided by any one or more Holders must be accompanied by a written representation from each such Holder to the Issuer and the Trustee that such Holder is not Net Short, which representation, in the case of a Noteholder Direction relating to a notice of Default shall be deemed repeated at all times until the resulting Event of Default is cured or otherwise ceases to exist or the Notes are accelerated."*

This restriction revolves around the definition of net short which is assessed based on the underlying value of short derivative instruments compared to the value of notes held and any long derivative instruments. This provision has not yet been tested in practice, but potential issues may arise in the valuation of derivative instruments and the variance of such valuation over time (which may be exacerbated by repeating representations as to net short status).

A collateral concern here is that certain noteholders who hedge investments in the ordinary course (as opposed to debt-activist funds who are weighted more on the short side) may be caught and their rights limited because of these provisions (in the loan market this risk is somewhat mitigated by excluding regulated banks and day one revolving facility lenders from disenfranchisement, although arguably this unfairly benefits banks over bona fide fund investors). Due to the fact that net short investors are generally only excluded from the numerator, as opposed to the standard affiliate disenfranchisement mechanic which excludes affiliates from both the numerator and the denominator, one could theoretically arrive in a situation in which there are not sufficient non-disenfranchised holders to deliver a notice of default. Though only theoretical, in a situation in which the credit had significantly deteriorated to the point where the notes lost most of their value, any investor holding a short instrument may well be net short at that point. The flip side of this is that if the denominator were also adjusted (a position we see in the loan market where net short lenders are deemed to have voted in the same proportion as lenders who are not net short), some minority noteholders may be disproportionately represented in these potential default situations which may in turn lead to other problems.

In addition, the effectiveness of these provisions relies on self-policing by the noteholders requesting acceleration and accountability of affiliates in order to avoid structuring around these restrictions. When affiliates are accounted for, this may incidentally impose overly burdensome monitoring requirements (especially on larger institutional investors) but if they are not taken into consideration, structuring loopholes may be exploited to circumvent these restrictions.

Should investors be concerned about such issues, an unintended consequence of these new provisions may be that investors reduce or even discontinue entirely their purchase of credit default protection instruments relating to high yield credits in which they hold or intend to hold a position leading to a commensurate pricing premium to reflect the uncovered risk and/or reduced liquidity.

A recent development we have observed in the market has been mandatory transfer provisions with regard to net short investors. This goes one step further than simply disenfranchising these investors as, on its face, it requires net short investors to transfer their notes at market price.

Where to next?

Short-selling and conflicting financial incentives are not new phenomena in the international financial markets and have been a long topic of debate, and in some circumstances, preventative regulatory action. The Windstream case presents a set of facts and circumstances that market participants believe can be addressed by specific covenant changes, which is a new development in the issuer-investor dynamic. Whether these changes are effective in practice, or become commonplace in the market, we expect will be an evolving process and, although we have focused on bond covenants here, we have also observed such responses in the loan market.

As market standard provisions are being fleshed out, key points to monitor are (i) accountability of affiliates, (ii) transferability and liquidity repercussions (whether mandatory or collateral to onerous monitoring requirements), (iii) determination of net short positions and (iv) international regulatory responses with regard to potential market abuse, manipulation or investors taking uncovered risk positions in high yield bonds. What is certain is that net short activist investors are out there and issuers and borrowers are reacting to limit actions that they can take.

Market Update: Turkey

August 2019 | By Erdal Ekinci and Muhsin Keskin of Esin Attorney Partnership Istanbul and Ian Jack of Baker McKenzie London

Trying to recover from the currency shock in 2018, the Turkish financial markets are open for business in 2019 stimulated by governmental intervention in the form of changes in the withholding tax rate and the introduction of the Framework Agreement regarding financial restructurings in Turkey. Our newsletter highlights these recent regulatory developments of interest as well as the proliferation of the "Covenanted Eurobond" in Turkey.

Withholding tax change - early bond repurchases

Pursuant to a recent presidential decree, the withholding tax rate on interest income derived from bonds issued by Turkish resident companies outside of Turkey has been decreased to 0% for bonds 'with a maturity of more than 3 years' (before 21 March 2019, it was 5 years).

This change is particularly relevant for an issuer that wants to repurchase and/or redeem its bonds prior to maturity through a tender offer, open market purchases or by other means.

Under Turkish tax rules, the date of repurchase or redemption of the bonds is considered the maturity date for purposes of determining whether withholding tax is due on the bonds.

The following amendments were made to the withholding tax rates applied on the interest that Turkish resident companies pay on notes distributed abroad:

- For notes with maturities of less than one year: decreased from 10% to 7%
- For notes with maturities of one to three years: decreased from 7% to 3%
- For notes with maturities of at least three years: 0%. Before the amendment, 0% was applicable only for the notes with maturities of at least five years.

For example, if an issuer were to issue five year bonds on 30 June 2020, a redemption of those bonds prior to 30 June 2023 would trigger the withholding tax, but a redemption on or after 30 June 2023 would not. While this penalty during the earlier period is still more restrictive than in many jurisdictions, the change does provide improved refinancing optionality to issuers as their bonds approach maturity.

Note that the presidential decree (which introduces the new withholding tax rates mentioned above) does not expressly provide that the new withholding tax rate is applicable to bonds issued before its effective date (21 March 2019). Therefore, it is not clear that the buyback and cancellation of a bond issued before the effective date can benefit from the reduced withholding tax rates. We expect this issue could be clarified following submission of a request for a ruling to the Revenue Administration.

The "Covenanted Eurobond"

Debt securities offered by Turkish issuers typically follow the international Eurobond structure ("Investment-grade"-type covenants, English law). Borrowers also turn to the local bank market, which historically has been available to corporates at attractive rates and with limited covenant restrictions.

With pressure on the Turkish sovereign rating and the value of the Turkish Lira, international debt securities issuances (e.g., denominated in US dollars) out of Turkey face more scrutiny by the international investing community. While US/European style high yield issuances (full "high yield" covenants, New York law) are infrequent in Turkey, one trend in the market, to establish a balance of market flexibility for issuers and appropriate protections for investors, is the "Covenanted Eurobond" (also referred to as a "hybrid" debt security).

The "Covenanted Eurobond" is based on the traditional Eurobond model, with one or more additional incurrence-based covenants included in the terms and conditions, which are designed to address specific investor concerns.

One example of this trend is the recent offering by Turk Telecom of USD 500 million 6.875% notes due 2025. In that case, a unique post change-of-control debt incurrence leverage test was included in the terms and conditions to provide full flexibility to the current owners to optimise the capital structure but give future protections if and when ownership is transferred.

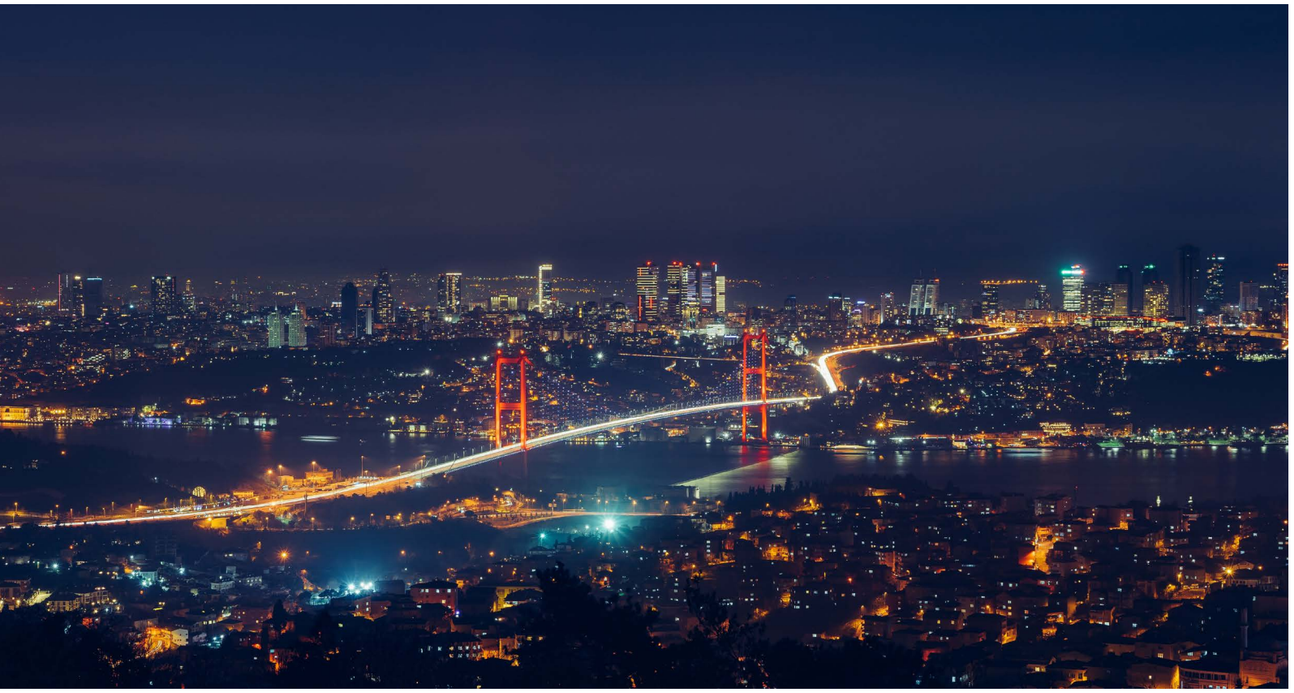
We expect to see more of these stylised issuances in the future, in both Turkey and other jurisdictions with similar economic and political challenges.

Restructuring stressed Turkish debt

The financial situation in Turkey has increased the level of stressed debt to unprecedented levels. Market participants are seeking solutions to ease the growing debt burden.

In August 2018, the concept of "financial restructuring" was introduced in Turkey following the country's currency crisis and became a major agenda item for Turkish financial institutions and regulators. The aptly named "Framework Agreement" that entered into force as a result of the joint efforts of the Banking Regulatory and Supervisory Authority and the Banks Association of Turkey was of particular importance as it set out a new framework for financial restructurings in Turkey.

Some of the key features of the Framework Agreement are:



- Arrangements are only binding on parties who have entered into the Framework Agreement
- Out-of-court contractual procedures for companies approaching distress as well as those in it
- Non-resident banks can join on a case-by-case basis
- Creditors cannot apply to commence the process, only borrowers can initiate
- Applies only to financial debt, not shareholder debt
- Cannot do debt-for-equity swap without shareholder approval

We are aware that the Turkish Banking Association is working on a special type of Framework Agreement that will be applicable to financial restructurings with SMEs. This will further expand the restructuring initiative; currently, only borrowers with more than TRY 100 million of financial debt can make use of the Framework Agreement.

To date restructurings commenced pursuant to the Framework Agreement have been progressing very slowly and, in most cases, have reached an impasse. This is in part due to the complexity of the untested agreement, uncertainty of implementation under the agreement and the reluctance to date of many international non-resident banks to sign up.

There are several changes that could be made to the legal and tax regimes that might lead to greater adoption of the process such as: (i) allowing for the write-down or other restructuring of debt and equity swaps, (ii) broadening the scope of creditors included in order to promote international engagement and a more collective effect, (iii) facilitating the provision of additional funds to the defaulting debtor by reducing barriers to entry for international banks and debt funds in the Turkish market, (iv) facilitating NPL transactions in order to allow distressed companies or banks holding such distressed assets to offload them, and (v) improving enforcement mechanisms to ensure that the path to enforcement is as smooth and efficient as possible, and that proper recourse can be had against debtors and/or their assets.

Other options that remain available to Turkish borrowers and their creditors include consensual restructurings, Chapter 11 filings or the use of the UK Scheme of Arrangement or the legacy Concordat (Turkish Scheme of Arrangement) process. As the focus on financial restructurings in Turkey is a relatively new development, it will be interesting to watch which of these options, each with pros and cons, becomes preferred, and whether the Turkish authorities will continue to make improvements and clarifications to the Framework Agreement to ensure its wider adoption and use.

Where to next?

The Turkish economy has not fully recovered from the 2018 currency shock, but targeted governmental relief such as the changes to the withholding tax regime and the new restructuring framework are evidence of progress. As the benefits of facilitated early bond repurchases and financial restructurings kick in, distressed companies will more readily be able to recover, thereby alleviating pressure on the Turkish financial market. Although external macroeconomic factors will also play a significant role going forward, steps such as these and recent "Covenanted Eurobond" deals in Turkey indicate some reprieve in the storm.

Green Bonds: Growth & Challenges in the 144A Market

September 2019 | Adam Farlow, Rob Mathews and Ben Bierwirth, with Michael Doran and James Tanner of Baker McKenzie London

What is a Green Bond?

While there is no one global standard as to what makes a bond a "Green Bond", the most established and commonly used set of criteria is that set out in the International Capital Market Association (ICMA) Green Bond Principles (GBPs), which describe the product as follows:

> *"Green Bonds are any type of bond instrument where the proceeds will be exclusively applied to finance or re-finance, in part or in full, new and/or existing eligible Green Projects and which are aligned with the four core components of the GBPs."*

A "Green Project", as defined in ICMA's GBPs, is a project with an environmental objective such as climate change mitigation or adaptation, environmental conservation or pollution prevention and control. The four core principles are: (i) use of proceeds, (ii) process of project evaluation and selection, (iii) management of proceeds and (iv) reporting. All four of these components are required for the characterisation as a "Green Bond", but the key element is the underlying Green Project.

The label of Green Bond carries certain benefits, such as encouraging certain ESG-focused investors to buy the bonds and the public relations benefits and opportunities of being seen to be aligned with sustainability (although to date there is scant evidence of any pricing benefit (or "green bond premium" or "greenium") for issuers). Such benefits are, however, accompanied by certain responsibilities and potential costs for Green Bond issuers, including: (i) a high level of transparency and third party review at issuance and over the life of the bond (which, while not subject to specific penalties, are required if the issuer is to follow best practices for Green Bonds and non-compliance may result in reputational costs); and (ii) challenges arising from different market participants having different criteria for evaluating and addressing sustainability, as well as different rules and regulations between jurisdictions that pose additional standards and create potential liability for issuers (for example, Green Bonds are typically included in the Climate Bonds Initiative (CBI) database, but the CBI employs additional criteria and, in limited cases, has rejected bonds from database inclusion that have otherwise met the GBPs and been approved by third party reviewers).

Growth of the Market

As investors and corporations embrace ESG considerations, Green Bonds have gained momentum as a source of funding and are now one of the capital markets' fastest growing segments. Many "green" renewable energy companies, sovereigns, supranationals and "brown" corporate issuers are seeking to transition some or all of their business to "green" operations as their stakeholders are holding them more accountable for their environmental footprint. Sustainability considerations have contributed to the increase of Green Bond issuances in a number of sectors, including, in particular, transportation (auto, airline and shipping) and natural resources (oil & gas, chemicals, mining & metals and renewable energy).

Global Green Bond issuance in 2019 is projected to hit USD 200 billion (up from approximately USD 170 billion in 2018). Green features have also expanded across the asset class of traditional corporate bonds to project bonds, asset-backed bonds and covered bonds, with 2018 witnessing the first green commercial paper programme.

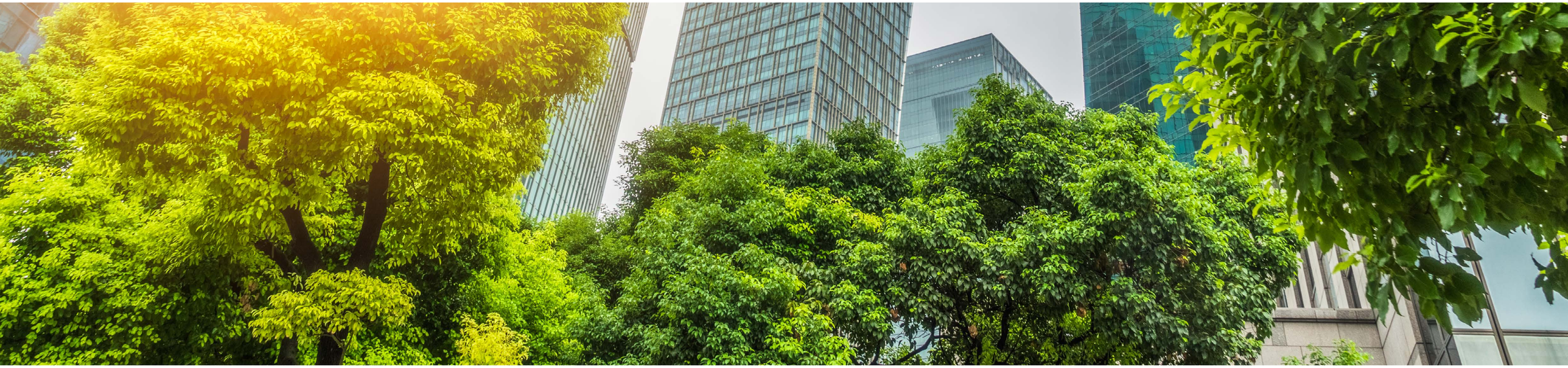
With the Paris Agreement and United Nations Sustainable Development Goals as the compelling double catalyst, and the United Nations stating that the world needs USD 90 trillion in climate investment by 2030 to achieve these, Green Bonds appear to have a very bright future.

However, the US market has lagged significantly behind the rest of the world in the number and volume of Green Bond transactions, despite the world's largest issuer of Green Bonds in most years being Fannie Mae in the US and a significant amount of US municipality bonds being green. According to S&P Global, since 2013, North American non-financial companies have issued only approximately USD 19 billion of labelled green debt, far below the EU and other developed economies as a percentage of total debt issued.

This lag reflects two factors. On the sell-side, issuers and their underwriters remain wary of US liability. On the buy-side, US investors have, by and large, yet to prioritise ESG considerations in the way other investors have.

The 144A Liability Concerns

Offerings of securities into the United States are subject to certain US federal securities and state anti-fraud laws that may create a higher level of liability than an issuance that is conducted solely outside of the US. In particular, Rule 10b-5 of the Securities Exchange Act of 1934 provides that



an issuer (and potentially other parties to the transaction, including the underwriters and named experts) may be subject to civil liability if the disclosure documents used in connection with the transaction are found "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."

Second Opinion Reviews - Diligence and Liability

Green Bonds are initially labelled as such by their issuers who also monitor compliance with ICMA's GBPs themselves and 'self- certify' in the disclosure documents. While self-labelling could lead to abuse, the Green Bond market has devised an oversight mechanism by which an independent third party provides an assessment of the framework and analyses/confirms the eligibility of the bonds under the GBPs. Such review is generally called a "Second Opinion Review" or a "Second Party Opinion" and may be included in the disclosure document connected with the sale of the Green Bonds.

These Second Opinion Reviews have become a cornerstone of Green Bonds offerings outside of the United States, but, due to the heightened disclosure and related liability standards in the US, may have become an obstacle to offerings into the US. The fact that Second Opinion Reviews are included in the offer document means that they are subject to Rule 10b-5 scrutiny and therefore raise liability concerns for the third party providers who are consequentially less willing or unable to provide the proper assurances as to the accuracy of their conclusions. Issuer and underwriter counsel may have reservations about delivering their market-standard "10b-5 disclosure letters" in the context of a Second Opinion Review. They may also be hesitant as a result of related factors, for instance, the fact that sustainability and environmental standards are subject to certain subjective or changing criteria.

Given the critical nature of Second Opinion Reviews, it is worth reconsidering the basis on which they are sought. The point of a Second Opinion Review is not to shift liability to the third party reviewer; it is to assist in the diligence effort undertaken by offer participants. Independent third party due diligence bolsters the due diligence undertaken with respect to the planned and disclosed use of proceeds. As such, the Second Opinion Review is analogous to a number of well-established third party procedures that have long been associated with bond offerings in other contexts. Examples include third party Sharia compliance opinions in Islamic finance or "qualified persons/competent person" reports in mining and oil & gas offerings. While these procedures vary from transaction to transaction, they provide a framework for contractual verification and certification designed to support a due diligence defence in a Green Bond offering. We expect that over time we will see some regulation of Second Opinion providers. While it is too early to say whether the shape of that regulation will be similar to the regulation of credit rating agencies or more like the determinations of "qualified persons/competent persons" under the various agreed standards adopted under regulations impacting extractive industries, in either instance it will benefit the market to clarify the playing field.

Otherwise, market participants should continue to use the approaches that have long been used in Rule 144A bond offerings to ensure disclosure of all material information: robust risk factors, a focus on verifiable fact rather than subjective characterization, and appropriate language in the context of forward looking statements.

Buy-side Incentivization

Despite Green Bonds representing only a small fraction of all bond issuances in recent years, as issuers and investors become more engaged with fast developing ESG considerations we expect that this proportion will grow in coming years. As the Green Bond market evolves and grows, so, we believe, will the mechanics available to provide investors with some comfort that their investments will remain "green" while imposing appropriate penalties on issuers. To date, no consistent framework has been established that gives investors the protections that the investment will stay 'green'. Michael and James make a number of useful suggestions on improving the product in their IFLR article.

Since this is our Leveraged Finance Newsletter, we think it worth considering technology commonly found in high yield and other debt securities transactions to address some of these concerns. Relevant terms include:

- ***Contractual representations and warranties, and indemnification:*** Include provisions in the Purchase Agreement that would give rise to a contractual claim for failure to continue to meet the GBPs.
- ***Interest rate ratchet:*** Automatic increases in the interest rate during any period in which the issue does not meet the criteria (similar to Eurobond provisions for a rate increase upon a ratings decline and a strategy used in "sustainability-linked" loans for several years). Enel's recent sustainability-linked bond shows just one of many possible variations.
- ***Investor put:*** Allowing the investors to decide whether or not to stay in the issue (similar to a change of control offer or asset sale offer).
- ***Issuer call:*** Allowing the issuer to call the Green Bonds if the reason for non-compliance is outside of their control (similar to a tax redemption).
- ***Default:*** Default trigger requiring repayment of the bonds at par (or even including a "make-whole")

While we believe a default trigger on its own would be too harsh a penalty for Green Bond non-compliance to receive widespread acceptance by issuers, some combination of the above may be appropriate to maintain the balance between issuer flexibility and investor protections.

An interest rate ratchet would likely be the most appropriate remedy, potentially together with the issuer call, in particular if noncompliance were due to events outside of the issuer's control. Similarly, in certain circumstances, a default coupled with an issuer call might be appropriate, but cross-default considerations would need to be evaluated.

All of the above would require robust and consistent post-deal reporting, which is generally felt to be lacking in the market.

These improvements would benefit the market as a whole, but perhaps particularly help improve the lagging US market by providing opportunities for additional upside for investors focused solely on yield.

LIBOR Transition: What now for Corporate Borrowers?

October 2019 | By Nick Cusack, Matt Mazenier, Matt Cox and Haden Henderson of Baker McKenzie London, and John Lawlor of Baker McKenzie Chicago

You are a corporate treasurer of a company with debt maturing now or over the next few years, and the company may need to increase its leverage during that period to finance new projects. You are considering the company's options in the debt markets and recall hearing this incessant drone about LIBOR. What is really going on, and how should it affect your thinking?

Unfortunately, trying to make sense of LIBOR can be like trying to take a drink from a fire hose. LIBOR is deeply embedded in the financial world, and many regulatory and industry groups are working on a global transition from LIBOR to alternative interest rates in many currencies, markets and financial products. Further complexity lies in considering aspects of the issue beyond what debt contracts say, including regulatory, tax and accounting aspects. There is a great deal of work product for borrowers to sort through and, despite coordination efforts by the various groups, much of it is not currently in alignment.

To briefly summarise, LIBOR really is expected to go away at the end of 2021, and financial regulators globally have urged all companies to recognise this and factor it into their planning. The chief reason for this is that the short-term interbank funding markets, which historically served as the underpinning for the bank rate quotations from which LIBOR was calculated, have shrunk dramatically. Many LIBOR quotes have been based on estimates, or "expert judgment," due to the lack of actual trades on which to base quotes. Regulators believe that the small size of these markets made LIBOR more susceptible to the manipulations that came to light during the financial crisis. Further, there is an estimated USD 350 trillion of outstanding financial contracts that refer to LIBOR, and regulators have expressed concern with having such a large volume of contracts refer to prices derived from a thinly-traded, much smaller market.

Regulators believe that the inherent weakness of LIBOR may lead market participants to conclude that it is unreliable at some point in the future (recall that LIBOR's perceived unreliability caused significant problems when the financial crisis was at its most severe). Regulators are further concerned that banks may decide to stop submitting quotes due to either the lack of underlying transactions or to avoid liability. Any cessation or perceived unreliability of LIBOR could cause massive disruption.

In 2017, the UK Financial Conduct Authority (FCA) announced that it would not use its power to persuade or compel banks to submit LIBOR quotes after the end of 2021, but also announced that it had secured commitments from the LIBOR panel banks to continue submitting quotes through then. That announcement marked the beginning of a large, global project to come up with interest rate replacements for LIBOR which are better than LIBOR to bolster contractual language and to develop solutions for the many second-order issues arising from these first-order changes. The deadline remains the same and, though considerable progress has been made, the project is not complete and time is growing shorter. Further, despite all of the regulatory activity to date, many market participants are frustrated at the amount of uncertainty and lack of clarity that remains.

So what does all this mean for you?

On the positive side, regulatory bodies have identified "risk-free" rates (RFRs) as interest rate alternatives in all the LIBOR currencies (US dollars, sterling, euro, yen and Swiss francs). While the basis of calculation of these rates differs, these rates are all similar in that they are overnight rates, and do not reflect term risk or counterparty credit risk, thus making them very different from LIBOR, which is a term rate and factors in both of these risks.

These RFRs were developed to meet new regulatory standards for interest rate benchmarks put into effect since the financial crisis, are based on large volumes of actual transactions, and are designed to reduce the opportunity for the conflict of interest and manipulative conduct that plagued LIBOR. These regulatory standards were developed by the International Organization of Securities Commissions (IOSCO), have been endorsed by the global Financial Stability Board (FSB) and are reflected in the EU Benchmarks Regulation (BMR). To be clear, LIBOR (although now reformed) has been judged to not meet these standards.

These RFRs are at different stages of development for the various LIBOR currencies. The RFR for US dollars, SOFR, began to be quoted in 2018. The RFR for sterling, SONIA, has existed since 1997, and, perhaps as a result, there has been considerably more debt volume denominated in SONIA and aggregate notional amount of cleared SONIA swaps than corresponding amounts in US dollars. Trading in the RFRs for euro, yen and CHF, €STR, TONAR and SARON, lags further behind. To complicate matters, in Japan and the euro zone, the regulators have opted for a "multiple rate" approach for interest rate benchmarks. This sees their reformed and improved local IBORs, TIBOR and EURIBOR set to co-exist with the identified RFRs for their currencies. €STR was launched on 2 October 2019 and replaces EONIA (with

EONIA now to be quoted at €STR plus a fixed 0.085% spread from that date until being discontinued completely on 3 January 2022).

The track records for those RFRs that have been available indicate that they may behave differently than LIBOR, particularly during periods of stress.

Many swaps traders have said that they are pleased with these RFRs, and place less of a priority on the development of other interest rates.

Corporate borrowers, on the other hand, have expressed a desire for forward term rates that would replicate LIBOR's current maturity structure. While there has been an appreciable volume of debt instruments issued that are denominated in RFRs, notably floating rate notes (FRNs), these instruments calculate interest in arrears, on a compounded or simple average basis (often using a "lag" or "lockout" mechanism). Many corporates like the certainty provided by LIBOR for setting rates and planning cash flows in advance.

Forward term rates based on the RFRs would address this. However, these forward term rates will also need to comply with the new benchmark regulations, and be based in a sufficient volume of actual transactions to justify forward term benchmarks. The amount of liquidity in the RFRs, and in transactions supporting robust forward yield curves based off RFRs, is therefore critically important to developing these forward term benchmarks.

It is unclear (and perhaps tending to doubtful in some cases) whether these forward term benchmarks will be developed before the end of 2021, although such rates for some currencies may be closer than others. The Swiss regulators announced at the end of 2018 that it was not currently feasible to develop such a rate for CHF. The global regulators have urged market participants to press on with LIBOR transition without waiting for these rates to arrive.

As noted above, there has been notable evidence of a switchover in the FRN markets to RFRs, particularly in SONIA sterling RFR. The growing popularity of these RFRs with FRN issuers and investors has been buoyed by the publication of literature on how to use the RFRs in new FRNs.

However, companies continue to issue debt that refers to LIBOR and matures after 2021. In fact, we are not aware of any syndicated credit facilities in EMEA, the US or in Asia Pacific that refer to RFRs.

For LIBOR-denominated debt (both new issuances and legacy debt), contracts have focused on the insertion of fallback provisions to apply if LIBOR goes away. Two basic approaches have been put forth: (i) an "amendment approach" that provides a mechanism for borrowers and lenders to negotiate and implement a replacement rate by means of an amendment to a debt contract in the future, and (ii) a "hardwired approach" that implements a replacement rate without the need for a future amendment to the debt contract based on triggers, terms and conditions agreed to upfront.

Under the amendment approach, if a trigger event occurs and for some reason an amendment is not agreed to, in most cases LIBOR ceases to be available as a pricing option, and the loan would be priced at the cost of funds rate (or, in the US, at the base rate).

In the US, the Alternative Reference Rates Committee (ARRC) has recommended fallback provisions for US dollar-denominated loans (both syndicated and bilateral), FRNs and securitisations. The ARRC's loan fallbacks offer a choice between the amendment approach and the hardwired approach for loans, but only the hardwired approach for FRNs and securitisations; the amendment option for loans reflects the fact that loans are relatively easier to amend than the other debt products. The ARRC's hardwired approaches all use waterfall provisions to identify a replacement interest rate; we note that the top priority in each waterfall is a forward term SOFR that has been recommended by the ARRC, which rate does not yet exist.

The ARRC hardwired approaches also use waterfall provisions to identify an appropriate credit spread adjustment between LIBOR and the replacement interest rate to account for the lack of counterparty credit spread in the replacement rate; we note the top priority in each waterfall is a spread adjustment that has been recommended by the ARRC — this spread adjustment does not yet exist.

The LMA in EMEA and the APLMA in Asia Pacific have each recommended a variation of the amendment approach in their forms of facility documentation for loans. The Association of Financial Markets in Europe (AFME) has proposed hardwired fallback wording for inclusion in European securitisation documentation.

To date, most LIBOR bank facility agreements we have seen have used some variation of an amendment approach, frequently requiring borrower consent and the consent of majority (not all) lenders. We have seen some evidence of adoption of the ARRC hardwired approach for fallbacks in LIBOR FRNs and securitisations.

It is likely too early to tell whether any of the proposed hardwired fallbacks will be broadly accepted.

While this article focuses mainly on debt products, we note that the International Swaps Dealers Association (ISDA) has done yeoman's work in considering many of these issues as they affect swaps, including developing their own fallback provisions and working on methodologies for credit spread and term adjustments.

The ISDA work has greatly informed the work of working groups for other products and markets. However, while ISDA and the working groups have tried to coordinate their efforts, they serve different masters, and the masters they serve have differing interests. Although a "one size fits all" solution for LIBOR would certainly be appealing, it is far more likely that market participants will need to carefully evaluate the effect of various bespoke fallback provisions and other developments in transactions involving several asset classes, such as CLOs and other ABS transactions, hedged loans or standalone rate swaps, to ensure that they understand any basis risk arising from the fallback and other provisions not being aligned.

So where does all this leave the corporate treasurer seeking to obtain and price debt financing now?

For bank deals, this likely continues to mean pricing now at LIBOR, with an amendment approach fallback. Depending on the currency involved, it may be possible for a company to issue RFR-denominated FRNs now, with interest payable in arrears, consistent with newly developed market conventions. For LIBOR debt with a fallback that remains outstanding, an event will very probably occur with respect to LIBOR (at the end of 2021 or possibly before, if LIBOR is judged unrepresentative of underlying financial reality by the FCA, LIBOR's principal regulator) that triggers the fallback mechanism, and at that time it is hoped there will be more clarity as to what the market has come up with as a replacement rate.

However, if a fallback trigger were to occur today, the rate supplied by the ARRC hardwired approach would be either (depending on the selection made when the fallback was put in place) compounded SOFR or a simple average of SOFR, calculated in each case in arrears, with a spread adjustment. The rate that would be arrived at under the amendment approach if a trigger occurred today is less certain and, of course, subject to the agreement of the parties in each case (assuming the borrower has a consent right). However, there is good reason to think that a compounded or average rate derived from an RFR, calculated in arrears, would loom as a likely option, since there is not yet an IOSCO-compliant forward term rate for any LIBOR currency. The borrower could seek to refinance if it disagreed with the rate the lenders were proposing, but might not find a better deal (and keep in mind that the markets might then be crowded with borrowers seeking a similar deal). Even if the borrower had a consent right, that might be cold comfort if LIBOR were to cease being available and the loan were to default to pricing at cost of funds or base rate until an amendment was agreed.

The development of a forward term benchmark based off an RFR prior to the occurrence of a fallback trigger would make that benchmark an option that many borrowers would prefer (assuming the economics were equivalent). In the ARRC hardwired fallback, if the ARRC were to recommend a compliant forward term benchmark for US dollars, that rate would take priority in the waterfall over compounded/simple average SOFR in arrears.

It may be possible for a company to hedge LIBOR transition risk through a derivatives strategy. We note that many financial institutions see significant arbitrage opportunities in this area.

It is possible that, between now and the end of 2021, loans will begin to be denominated in RFRs, and that market conventions will be developed for those loans (which likely will be derived from the conventions for RFR FRNs). We note that the LMA recently published exposure drafts of facilities agreements for SONIA and SOFR compounded in arrears.

It is also possible that forward term benchmarks derived from RFRs will be developed prior to the end of 2021 and will enable bank facilities, FRNs, securitisations and other products to be priced by reference to such benchmarks. Treasurers may not want to lay odds on this occurring, although it is a reasonable expectation that sufficient liquidity will build in sterling and US dollars, which at some point will enable forward term benchmarks in those currencies that comply with the benchmark regulations. The development of forward term benchmarks in the other LIBOR currencies may take still more time.

Fallback provisions for loans may migrate from the amendment approach to the hardwired approach, particularly if more progress is made in developing actual rates and spread adjustments that would fill in the steps in the waterfall provisions. On a macro level, moving to a hardwired approach would probably be a good thing for the debt markets, since it would mitigate the risks of having to amend a large number of credit facilities at the same time and possibly coming up with inconsistent results.

The RFRs may not reflect bank funding costs, further distinguishing them from LIBOR (which is a cost-plus pricing model). This could lead to banks seeking compensation for these costs through increased spread.

Despite all this, there may be some chance (which may not be more than a forlorn hope) that LIBOR will survive, in some form, after 2021. In order to be viable thereafter, it would need to be revised substantially to comply with the benchmark regulations. Regulators have warned firms not to count on LIBOR's survival and have pointed out that, if it does survive, it may not be compliant (and, if not compliant, banks subject to the BMR would not be able to use it), may not be supported by bank submissions, may not be reliable and may be so changed from its current form as to not be the same thing.

Work continues on a large number of separate workstreams in LIBOR transition. There will be further developments. We expect that progress will continue to be incremental (as well as uneven among currencies, markets and debt products), and that there likely will be no single defining moment when the scales will fall from the market's eyes and all will be clear.

One of the guiding principles that the regulators and working groups hoped to adhere to in the transition process has been the avoidance of value transfer from one side of a trade to the other. Regrettably, that goal may prove elusive.

As always, treasurers should keep their refinancing options open and an eye out for market developments.

We note that the above discusses only a part (though an important one) of the enormous headache that LIBOR transition poses for corporate treasurers, and that, because LIBOR is so deeply embedded in financial contracts, treasurers will very likely need to do much more to understand and manage the total transition risk of their firms. But the discussion of the other parts will need to take place elsewhere.

Considerations for Private Debt Funds on Public to Private Transactions

November 2019 | By Matthew Smith, Nick O'Grady, Robert Adam and Joe Denyer of Baker McKenzie London

While European M&A activity has so far tracked lower this year compared to last (a 29.4% reduction in value against year- to-date 2018 figures) public to private transactions (P2Ps) have been the exception. Recent market data has shown 25 P2Ps being completed so far in Europe this year, valued at a combined EUR 33 billion, which amounts to the highest ratio of public deals by value and volume in Europe since the financial crisis.

Private Equity (PE) houses have been at the forefront of this trend as they have looked to deploy resources in public markets rather than more typical secondary and tertiary private acquisitions. There is an economic logic behind this: with European public companies now increasingly trading at lower valuations relative to the private multiples, P2Ps are now being seen as offering value — even taking into account the additional cost and complexity of a public bid versus an auction.

While debt financing packages backing P2Ps have traditionally been the preserve of investment banks and the syndicated debt market, private debt funds are now becoming a viable alternative to a bank underwrite in PE backed bids; across private and public deals, direct lenders were the debt provider of choice for close to half of all European PE backed buy-outs last year. This is no coincidence; the increasingly mature private debt market offers sponsors access to higher leverage than is available in the syndicated loan market, and, potentially, a single lender process. Although this can come at a cost vs. the syndicated bank market (both from a pricing and a documentary perspective) it seems this is a price sponsors are willing to pay in order to increase their chances of securing a winning offer. And it's not just the loan market that is being squeezed. A select group of larger European debt funds have underwritten in excess of EUR 1 billion over the last year, bringing private debt funds into direct competition with the high yield bond market.

As PE houses continue to look to the public markets for investment opportunities, we expect private debt funds to be increasingly involved in these transactions.

In this article, we look at key issues for consideration when financing P2Ps with private debt. This includes a particular focus on issues in the UK market and compliance with the UK Takeover Code ("Code") (which applies to offers for not only UK registered companies listed in the UK but also some UK registered companies who are deemed to have their place of central management and control in the UK, e.g., unquoted public companies and private companies who have previously had quoted securities).

Managing the "Rule of 6"

A takeover of a quoted company is of course hugely price sensitive, and there are strict rules as to when an announcement is required, even where there has been no leak. In particular, an announcement is required where negotiations or discussions relating to a possible offer are about to be extended beyond a very restricted number of people. This is generally interpreted by the UK Takeover Panel ("Panel") as six parties and is known in the market as "the Rule of 6". Parties falling within this will include potential providers of equity and debt finance, shareholders in the bidder or target, pension fund trustees, potential management team candidates and other third parties, but not those who need to know within the bidder and target nor their immediate advisers. Early consultation with the Panel is needed and there can be scope for the six to become a "rolling 6" over time, e.g., if one debt provider is approached and is not interested, in time (allowing the Panel to feel comfortable that there has not been a leak) the Panel may allow them to fall out of the six and be replaced by an alternative potential debt provider.

Historically, PE sponsors using underwritten bank debt to fund their transactions need not use up more than one or two spots of their six on their debt provider(s). However, with the number of private debt providers increasing exponentially over the past decade, the field compared to the syndicated market is much wider (into the hundreds) and more diverse. As a result, sponsors have been taking great care when choosing which funds to use up one of their six on. Key focuses include fund size, track record and being able to provide certainty around terms early in the process (to avoid the issue of terms/quantum being subsequently pared back/reduced during late stage credit committee decisions) and funding mechanics (see below).

It is also worth noting that private debt deals generally require the appointment of independent third party facility agents and security agents, and this should also be factored in when sponsors are considering who to bring in the tent and when.

Cash confirmation and certain funds

As many PE sponsors will be aware, the Code requires that for any bid (whether made by takeover offer or scheme of arrangement) that is made wholly or partly for cash, a "cash confirmation" is required to be provided by the bidder's financial advisor confirming that resources are available to the offeror sufficient to satisfy full acceptance of the offer. This principle operates so that, if the offer is subsequently declared unconditional or the scheme declared effective, the shareholders can be near certain that they will receive their consideration. In giving this confirmation, the financial advisor is required to act responsibly and take reasonable steps to assure itself that the cash is available. And it takes its role seriously — failure to discharge its obligations here may result in the Panel requiring the financial advisor to make up any shortfall if the bidder does not have enough cash to pay for the shares. This cash confirmation exercise will focus on the source of the funds being used to finance the acquisition (i.e., the equity proceeds and, if the bid is to be partially debt financed, the debt package) and will ensure that conditionality is minimised and potential risks (e.g., currency / volatility) are mitigated.

Structure

On the equity side, the corporate structure of most PE sponsors dictates that they will rely on capital calls from their limited partners (LPs) to satisfy the equity element of the cash offer. The financial advisor will therefore examine in detail the sponsor's investment and constitutional documentation as well as its investor base. This diligence is further supported by the provision of a "representation letter" in which the sponsor confirms to the financial advisor (broadly) that it will do everything required to ensure that the buyer receives the equity proceeds by the time it needs to in order pay the target's shareholders under the Code.

For the debt financing, the financial advisor and its legal counsel will need to be satisfied that the acquisition funding is provided on a "certain funds" basis for the period for which it is required under the Code ("Certain Funds Period").

Historically, with bank funded transactions, the focus of this exercise has been primarily on the documentation itself; all conditions to the financing must be either satisfied or waived (subject to certain limited exceptions, for example, conditions within the control of the bidder or conditions relating to the target group) and there must be a very limited set of circumstances in which the lender(s) cannot be obliged to fund.

In contrast, as private debt funds are generally structured in the same way as PE sponsors, and rely on capital calls from their LPs in order to fund their participations in loans, it is often necessary for a financial advisor to conduct a PE-style cash confirmation exercise on the fund(s) themselves. This can often come as an unwelcome surprise for the notoriously private lenders in question. Any diligence process here is likely to involve requests for constitutional and other corporate capacity documents (including limited partnership agreements, issuing documents and commitment / subscription agreements, etc.) as well as details of their LPs and the signing of "representation letters".

GPs will need to check whether there are any contractual restrictions on the disclosure of LP information in these circumstances and should look to obtain appropriate confidentiality undertakings from financial advisors before disclosing. That is, to the extent that disclosure to the financial advisor itself is necessary at all — often disclosure can be limited to their lawyers only (who themselves are subject to professional obligations of confidentiality).

As discussed in more detail below, many private debt funds also lend through a number of different vehicles, meaning this diligence can be time consuming (and costly). It is therefore important for funds to be aware of what may be required of them here, ideally with appropriately redacted "cash confirmation packs" ready to go when requested.

Funding timetable - Certain Funds Period

During the Certain Funds Period, a lender's ability to cancel acquisition facility commitments or rely on a drawstop to funding will, for all intents and purposes, be suspended. In a P2P, the Certain Funds Period is typically at least six months (taking into account the maximum amount of time that is allowed under the Code for an offer or scheme to be completed plus some leeway) but may be longer.

From a pricing perspective, banks will generally charge a commitment fee (called a "ticking fee") during the Certain Funds Period to compensate it for having to reserve capital for this period of time, with the level of this ticking fee being determined by market precedent. In contrast, private debt funds can often be flexible in determining the level of/requirement for ticking fees. That being said, there can be additional complications for private debt funds who are looking at longer than usual Certain Funds Periods. In particular, a number of private debt funds lend via a large number of different vehicles and determining the allocation of commitments between vehicles can often be challenging even without having to factor in a Certain Funds Period of over six months. A delay in finalising which vehicles are in/out, and their respective allocations, can also have a significant impact on the cash confirmation/diligence exercise outlined above, as swapping vehicles in/out will result in further diligence needing to be started and/or completed.

Funding timetable - utilisation

The Code requires that a bidder must pay the first amounts of cash consideration due to shareholders not more than 14 calendar days from the date that an offer is declared unconditional or scheme declared effective.

As mentioned above, private debt funds typically rely on capital calls from their LPs to obtain funds and it is not unusual for a fund's capital call period to be in excess of 10 business days, so it is essential that consideration is given as early as possible as to whether there may be any issues hitting this deadline.

This is not necessarily straightforward; in particular, thought should be given to when the final financing condition precedent will be satisfied and utilisation request delivered. For example, the final CP is often receipt of the equity proceeds, which itself may take some time to draw down from investors, with sponsors often reluctant to call funds prior to knowing the scheme or offer is effective.

Debt funds will often offer to bridge any timing gap through the use of their own leverage/capital call facilities with a third party debt provider. However, such facilities are usually not provided on a certain funds basis and therefore reliance on this facility to bridge a timing gap could undermine the cash confirmation.

We are increasingly seeing these matters being flushed out by debt advisors/lawyers at term sheet stage in an effort to avoid any last minute complications. As such, private debt funds considering P2Ps should discuss these issues with their advisors as soon as possible to ensure their standing in a competitive situation is not diminished as a result of execution risk when the time comes.

Disclosure of financing documents

The Code requires that copies of all documents relating to the financing of an offer are published on a website no later than noon on the business day following the publication of the bidder's announcement of a firm intention to make an offer and that they must remain available on the website until the end of the offer. This also includes any refinancing or supplementary financing agreement or an amendment to any of the existing finance documents.

This gives the market instant visibility into the terms on which the offer was underwritten and could undermine efforts to sell down participations in the facilities on less favourable terms. This problem is exacerbated in P2Ps where syndication typically happens later than for private company acquisitions (usually only once the bid has been declared unconditional or the scheme declared effective and the Certain Funds Period has ended).

While lenders in the syndicated market may be familiar with this obligation, debt funds that have historically operated in the private sphere on a 'lend-and-hold' basis may find it more challenging to get comfortable with their terms being shared widely. Debt funds that become more active in the public market will need to be able to accept that the commercial terms of their financing, which they may previously have seen as confidential and proprietary, will be publicly available.

While the general rule is that any documents must be disclosed unredacted, underwriting funds can take some limited comfort from the Panel's previous decisions to allow (after consultation with them) certain commercially sensitive information including headroom extensions, equity structures (e.g., leverage within funds or information on LPs) and market flex terms to be omitted from the disclosed documents and kept in separate side letters that are not disclosed (at least for a limited period, for example, market flex terms must be disclosed following publication of the offer document if syndication has not taken place by then).

Post-announcement revolving facility syndication

In contrast to bank-funded deals, private debt funds are generally unable to provide (or at least efficiently provide) undrawn revolving credit facilities or ancillary banking facilities. As such, fund transactions will more often than not require the appointment of a bank to step in and provide these (usually on a super senior basis).

Generally speaking, there is often not enough time pre-announcement to bring both the private debt fund and the bank together and agree documentation, so we typically see the fund underwrite any required revolving facility commitments with the intention being to sell them down to a bank post-announcement. These transfers can give rise to additional legal work between the announcement and the effective date, particularly in relation to the documentation of agreed senior/super senior intercreditor terms (which generally vary from institution to institution/fund to fund). Any delays in syndication could result in a working capital shortfall/expensive working capital debt for the borrower or the target and so should become a priority once the announcement has been issued.

Cannabis Debt Financings: Current Market Snapshot and Considerations for Lenders, Investors and Underwriters

December 2019 | Rob Mathews and Samantha Greer of Baker McKenzie London, and Francois Desmarais of Baker McKenzie Toronto

Industry Overview

The global cannabis industry has experienced exponential growth over the last several years. The steady trend towards legalisation across North America and Europe has significantly expanded market opportunity not only in the cannabis retail sector, but also in the leveraged finance space. While cannabis businesses are looking to access loan markets and debt capital markets more frequently to finance operational build-outs and M&A activity, the heavily regulated and novel nature of the sector presents uniquely complex compliance challenges to lenders, underwriters, investors, and other financial institutions looking to participate in this burgeoning industry.

Regulatory Backdrop

Canada

Medicinal use of cannabis has been legal in Canada since 2001, but it was the legalisation of cannabis for recreational purposes in October 2018 that radically changed the nature of the Canadian cannabis market. As the second country in the world (after Uruguay) and the first G7 and G20 nation to formally legalise the cultivation, possession, distribution and consumption of cannabis for both medicinal and recreational purposes, the cannabis market in Canada earned a head start over other markets that have followed or may be considering following suit. The Canadian regulatory landscape has also fostered the growth and expansion of ancillary cannabis companies (businesses that don't "touch the plant"), including consultancies, software platforms, data analytics providers and independent research firms. Although cannabis remains heavily regulated by various levels of the Canadian government, and notwithstanding the fact that Canadian cannabis equity markets experienced declines over the course of 2019, the industry as a whole remains widely expected to experience significant growth over the long term.

United States

The regulatory backdrop in the United States is more complex, as marijuana is differentially regulated at both a federal and state level. At present, eleven states and the District of Columbia have legalised marijuana for recreational use and thirty-three states have legalised marijuana for medicinal use. However, the possession, use and sale of marijuana remains illegal under US federal law, as marijuana remains a Schedule I drug under the Controlled Substances Act of 1970 (the "Controlled Substances Act"). Under US law, federal law trumps state law and the fact that an act may be legal under state law is not a defence to a federal prosecution. As a result, lenders and other capital providers continue to shy away from potential investment opportunities in states where marijuana debt financing activity is legal under state law.

However, there has been recent movement in federal marijuana regulation in the US. For example, in November 2019, the House Judiciary Committee approved the Marijuana Opportunity Reinvestment and Expungement Act (the "More Act") that would, if passed into law, remove marijuana from Schedule I of the Controlled Substances Act and thereby end prohibition of marijuana at the federal level. However, the More Act still requires approval in the House of Representatives and the Senate before it can become law.

Separately, in September 2019, the House of Representatives passed the Secure and Fair Enforcement Banking Act which, if approved by the Senate, would provide federally-regulated banks with a legal safe harbour to provide banking services,

United Kingdom

The use of cannabis for medicinal purposes was legalised in the United Kingdom in November 2018. However, in contrast to the regulatory environment in Canada and certain US states, recreational cannabis remains illegal in the United Kingdom. As a result, lenders and investors operating from the UK risk committing breaches of the UK Proceeds of Crime Act 2002 (POCA), the UK's principal anti-money laundering legislation, by financing cannabis producers and cannabis-related companies to the extent their business activities are associated with recreational cannabis use. Notably, and subject to certain exceptions, POCA can have extraterritorial effect in that conduct that is legal under the laws of the country in which it occurs may still constitute "criminal conduct" for purposes of POCA, with the proceeds of any such criminal conduct thereby comprising "criminal property" under POCA if it would have been unlawful had it occurred in the UK. This means that UK lenders and investors will need to carefully consider their position under POCA before facilitating the financing of cannabis companies abroad, even if their business activities are legal in their home jurisdiction.

Europe

The regulatory approach to cannabis varies dramatically between European countries and the market is in relatively early stages, but Europe looks to be a high-potential region. A substantial number of European nations now have a legal medicinal cannabis market including Germany, Italy, Spain and Portugal, among others. While a select group of European countries have decriminalised recreational cannabis, to date, none have formally legalised it. However, this appears to be changing, as Luxembourg has declared its intention to legalise recreational cannabis by 2021 (medicinal cannabis has been legal in Luxembourg since 2018 and personal possession of recreational cannabis has been decriminalised since 2001). This development will undoubtedly impact the views of other European governments, and we may continue to see a gradual relaxation on cannabis prohibitions across the continent.

Financing Activity in the Cannabis Sector

The bulk of capital-raising activity across the cannabis sector has taken place in the form of equity issuances and convertible securities offerings. Nonconvertible debt financings have, by comparison, so far been substantially less frequent. However, the Canadian market has started to see a shift towards more traditional forms of debt financing as an alternative non-dilutive means of raising capital.

Previously reluctant to step into the sector, several major Canadian banks have begun accepting mandates to provide financing to cannabis firms predominantly in the form of secured term loans and revolving credit facilities. For example, Aurora Cannabis, one of the largest cannabis firms in the world, has entered into a CAD 360 million secured credit facility with three of Canada's biggest banks, which is one of the largest nonconvertible credit facilities currently in place in the cannabis industry. Nonconvertible debt securities issuances by cannabis companies have also been limited, but we are now beginning to see cannabis issuers test the waters on this front in the international debt capital markets. One notable example is a recent issuance of non-convertible secured debenture and warrant units by a US-based cannabis issuer listed on a major Canadianstock exchange. Though the terms of the debt securities offered were not governed by New York law, they included a full set of high yield style incurrence covenants. Units were offered for sale to Canadian subscribers under a prospectus, to US "qualified institutional buyers" as defined in Rule 144A under the United States Securities Act of 1933 as amended, and to certain additional international subscribers. While not a typical Regulation S/Rule 144A New York law-governed high yield bond issuance, this offering suggests the market for high yield cannabis bonds could be opening up. A continuation of the 2019 slump in Canadian cannabis equity markets and ongoing concerns about the refinancing of convertible debentures may motivate further non-convertible debt securities issuances.

US banks, on the other hand, remain reluctant to service cannabis clients in light of the fact that marijuana is still a federally-prohibited narcotic controlled substance. Financing of cannabis and cannabis-related businesses in the UK and elsewhere in Europe also remains several steps behind what has been observed to date in Canada, as these markets remain less established than their North American counterparts. In our experience, regulated banks operating from the UK have adopted a wait-and-see approach with respect to lending to or otherwise facilitating debt-raising activities by Canadian cannabis firms that are operating in compliance with applicable local law, in large part due to the risks associated with possible exposure to recreational cannabis and the corresponding risk of inadvertently breaching POCA. Financing of medicinal cannabis businesses that may now operate legally in the UK or in certain other European countries remains in a state of relatively early development.

Notably, smaller boutique investment firms, credit unions and other alternative capital providers have found success as cannabis financiers, particularly in markets where cannabis has been legalised but incumbent institutional banks remain reluctant to participate. This is most likely due to the relatively lower level of regulatory scrutiny to which smaller, local lending entities are exposed, as well as what may be a larger appetite for reputational risk, as further discussed below.

Key Considerations for Market Participants

Potential lenders, investors or underwriters that may be looking to participate in debt financings with cannabis and cannabis-related borrowers and issuers will want to consider more than merely the black letter of the law. A multitude of factors will be relevant to a lender, investor or underwriter's decision to enter the cannabis debt financing space, including (but not limited to) the following:

Cross-border elements: In light of the discrepancies in approach to cannabis regulation between countries worldwide, and in particular the extraterritorial application of POCA and other anti-money laundering legislation, financial institutions will want to turn their minds to whether the cross-border elements of a proposed financing are likely to trip up the cannabis laws to which they are subject. Lenders, investors and underwriters should in particular query whether the borrower has subsidiaries, assets or operations in other jurisdictions that have not legalised its cannabis-related business activities, and whether the activity in question would be considered illegal in the jurisdiction in which the lender or underwriter operates.

Dealings with ancillary cannabis businesses: As cannabis markets continue to develop, we expect there will be increasing opportunity to provide debt financing to ancillary cannabis companies that provide secondary services to cannabis producers or sit further up the supply chain. We also expect it will become increasingly difficult to determine whether involvement in any financings for such companies is likely to constitute a breach of applicable criminal and/or anti-money laundering law. For example, consider a scenario in which an investment bank domiciled in the UK is considering underwriting an international securities offering by a hydroponics technology developer based in Canada that primarily services cannabis producers. The development of hydroponics technology is not, in and of itself, criminal conduct, but where it is designed primarily to facilitate cannabis cultivation the question of whether any fees generated from such an underwriting mandate would constitute "criminal property" for purposes of POCA becomes a less straightforward one. In the US, knowingly financing an ancillary business that is designed to support a marijuana business could be considered aiding and abetting narcotics trafficking. These issues will need to be considered carefully on a case-by-case basis in conjunction with experienced legal advisors.

Overall risk appetite: Finally, lenders, underwriters and other capital providers will need to consider their own internal risk appetite, including the following:

Legal risk: Is the financing in question likely to fall afoul of anti-money laundering laws or criminal laws in any applicable jurisdiction, and relatedly, is there ambiguity in the interpretation of the law? The financier will require advice from experienced transactional and regulatory legal advisors, including lawyers with expertise in criminal law, across what is likely to be a number of implicated jurisdictions. Whether the financier is more inclined to accept a conservative or liberal read of the relevant legislation will probably be informed by any concomitant credit and reputational risk considerations, as well as relevant legal precedent and enforcement practices.

Regulatory risk: Regulatory regimes affecting the cannabis industry have been developed recently and remain in flux. Financiers may wish to obtain jurisdiction-specific advice regarding regulations and government relations, including the likelihood of significant changes following elections or government policy shifts. Regulatory risk profiles may vary significantly between sub-segments of the cannabis industry and lenders should treat both pure-play and diversified companies accordingly.

Credit risk: A financier going to a credit committee will want to consider the credit risk associated with the debt financing at issue, including, in particular, the strength of any collateral package. Taking security over the assets of a cannabis producer presents a number of challenges that are unique to the sector—for example, the collateral package may include specialised production equipment that may have limited resale value, and a lender's ability to enforce its rights in the collateral in a default scenario may be significantly restricted by regulation and courts' reluctance to enforce illegal agreements. Obtaining security over a cannabis producer's rights in any real property, if possible, would usually be advantageous from a credit risk perspective.

Reputational risk: Even if the financing in question is legal, the legalisation of cannabis in some jurisdictions is a relatively new development and cannabis remains an illegal substance in a number of key global economies. Consequently, many potential financiers are put off by the reputational risk that accompanies business dealings with cannabis companies. This tends to be a particularly important consideration within large multinational investment banks with stringent compliance functions that rely heavily on their international brand and/or are publicly traded. Private funds or smaller credit unions that operate solely in jurisdictions where cannabis regulation is more relaxed may not be subject to the same level of public scrutiny.

Looking ahead

Cannabis debt financings remain difficult to navigate from a regulatory perspective, and the Canadian cannabis equity markets experienced some high-profile downturn over the course of 2019. Moreover, while we may continue to see marijuana reform at the state level in the US, we think significant federal reform is unlikely in light of the current political climate.

Nevertheless, we think the future in select markets looks promising. Cannabis businesses are particularly capital intensive and we expect that demand for debt financings and other sources of liquidity will continue to increase as these companies expand their operations and become more acquisitive. To date, this has created a niche opening for alternative capital providers that have benefitted from a first-mover advantage in markets where more traditional, incumbent sources of financing have thus far been unable or unwilling to take part. With cannabis legalisation moving up the political agendas in certain European countries, we expect that cannabis-friendly legislative reform in these jurisdictions will serve to broaden the scope of players in the leveraged finance market that are able to participate in European cannabis debt financings going forward. For further industry insights, please visit our global cannabis compliance blog at ***globalcannabiscompliance.bakermckenzie.com***

Contributing Authors

We have an integrated corporate finance and leveraged finance practice made up of leading practitioners representing clients across the whole spectrum of equity capital markets, debt capital markets, public M&A and leverage finance/high yield. Our extensive team is made up of almost 500 fee earners in 34 offices and 25 countries across EMEA.

Robert Adam
Partner | London
robert.adam@bakermckenzie.com

David Becker
Partner | London
david.becker@bakermckenzie.com

Ben Bierwirth
Senior Associate | London
ben.bierwirth@bakermckenzie.com

Matt Cox
Partner | London
matthew.cox@bakermckenzie.com

Nick Cusack
Senior Associate | London
nick.cusack@bakermckenzie.com

Joe Denyer
Associate | London
joseph.denyer@bakermckenzie.com

Francois Desmarais
Associate | Toronto
Francois.Desmarais@bakermckenzie.com

Michael Doran
Partner | London
michael.doran@bakermckenzie.com

Erdal Ekinci
Partner | Istanbul
erdal.ekinci@esin.av.tr

Adam Farlow
Partner | London
adam.farlow@bakermckenzie.com

Samantha Greer
Associate | London
samantha.greer@bakermckenzie.com

Haden Henderson
Partner | London
haden.henderson@bakermckenzie.com

Ian Jack
Partner | London
ian.jack@bakermckenzie.com

Muhsin Keskin
Partner | Istanbul
mushin.keskin@esin.av.tr

John Lawlor
Senior PSL | Chicago
john.lawlor@bakermckenzie.com

Rob Mathews
Partner | London
robert.mathews@bakermckenzie.com

Matt Mazenier
Associate | London
matthew.mazenier@bakermckenzie.com

Nick O'Grady
Partner | London
nick.ogrady@bakermckenzie.com

Matthew Smith
Partner | London
matthew.smith@bakermckenzie.com

James Tanner
Senior Associate | London
james.tanner@bakermckenzie.com

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