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# Financial distress: opportunities in leveraged finance debt

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## Key Themes

The following key themes were discussed during a lively debate among the panellists at Baker McKenzie's seminar on **Financial distress: opportunities for corporate and real estate debt** held at The Connaught Hotel on 17 May.

### ▶ The LevFin/High Yield Market Is Volatile and Unpredictable

- The panellists agreed that extended planning horizons are a pronounced trend in the UK/European leveraged finance market, especially in the high yield bond market. There are some green shoots in the primary markets, but volatility pervades.
- Sponsors are closely examining the capital structures of their portfolio companies, looking at potential debt-for-equity swaps and exit opportunities but also considering refinancing opportunities. As with the debt sector generally, rising interest rates and falling valuations are presenting significant challenges.
- Timeframes for refinancing transactions have stretched out, with increasing numbers of requests (from lenders) for documentation and security reviews and enforcement memoranda, and (from sponsors/borrowers) waiver requests.
- At the moment, lenders are for the most part agreeing to reprice and roll existing debt for a short period; and there are signs of sponsors looking to remove banks who are unable or unwilling to agree to extensions. This action is creating opportunities for credit funds able to fill those gaps.
- The panellists are seeing more bespoke refinancing transactions rather than a wave of distressed debt activity. Windows permitting refinancing activity are, though, short; borrowers/sponsors therefore need to close refinancing transactions quickly, and the panellists are seeing credit funds, in particular, offering bespoke solutions and the ability to act quickly, decisively and fairly.
- The panellists noted that in many cases, lenders, borrowers/sponsors and advisers have worked together in a proactive way, for example by deploying interest rate hedges to lock in interest rates for extended or new loan terms. However, inflation has had a big impact on businesses facing margin pressures (e.g., consumer durables and discretionary-focused businesses). who aren't able to pass through prices and are having to deal with very thin margins. As was discussed further in more detail by the Real Estate Debt panel, rents, yields and interest rates for real estate assets across the UK and continental Europe are compressing.

### ▶ Thus Far, Distressed M&A Activity Has Been Low

- Distressed/potential distressed M&A levels have remained low, with some exceptions across the mid-market and in retail, life sciences/pharmaceuticals and certain real estate sectors.
- M&A transactions typically involve some debt financing. As noted above, credit analysis and processes are taking a lot longer, and lenders (whether bank lenders, high yield bondholders or credit funds) are therefore looking at a broad range of potential solutions.
- Increasingly active regulatory environment means it is essential to consider early any timing implications in affected industries and/or for affected parties.
- Insurance on distressed sales is available but can be slow to arrange, and expensive. Shareholder / management engagement is key.

### ▶ Assessing Potential Opportunities

- Many borrowers/issuers who have raised debt previously in the European leveraged finance and high yield debt markets are highly leveraged on cheap fixed rate debt, and facing impending maturities over the next couple of years. In most cases, however, the transaction structures are "covenant-lite", so even with falling valuations and rising interest rates, there may be no immediate catalyst for a restructuring or an opportunity to inject additional debt or equity capital.
- Notwithstanding this background, the panellists have seen a lot of demand from venture capital-backed businesses which are unable to inject additional debt or equity, and from industrials and consumer-facing businesses who need bridge financing until they are able to access longer-term debt. These factors are creating opportunities for credit funds, either as new lenders or as acquirers of assets which sponsors or borrowers have identified as necessary to sell in order to reduce debt.
- As with most options, however, the appetite of the credit funds to provide debt, or consider debt-for-equity swaps, will depend on valuations, options available under the existing debt documentation and, for portfolio companies, the actions and appetite of the sponsors.
- The documentation for leveraged finance and high yield bond transactions is complex, even if "covenant-lite". A detailed review of the documentation is necessary in order to determine whether, for example:
  - there is flexibility to raise new debt:
  - there is collateral available to providers of new debt, on a priority basis;
  - if so, what is the value of that collateral, and how liquid is it?
  - what representations, warranties and covenants would be available to providers of new debt?
- Other relevant considerations identified by the panellists included:
  - is the borrower/borrower group generating operating cashflows (minus capex) necessary to cover all its debt, including new debt?
  - would it be preferable to amend and extend existing debt rather than raise new debt?
  - would a liability management exercise, or a distressed debt-for-equity exchange, be a better solution?
  - has the borrower/sponsor identified the holders of all the debt and, therefore, the likely dynamics of any new debt or restructuring transactions?
  - what timeline does the borrower/sponsor need to work towards.

### ▶ No More Cov-Lite? Changing Deal Terms

- The panellists noted that, for refinancings and new transactions, they are seeing a tightening of commercial terms, including in "baskets" and debt incurrence permissions/covenants, a scaling back of flexibility in financial covenants, and an increase in flex available on syndication of levfin debt.
- Up-tiering/priming and asset drop-down structures remain difficult in the English law/European levfin market. In the high yield and levfin markets, the panellists noted an increase in so-called "J Crew blockers", in an attempt by lenders/bondholders to increase their protection from losing access to collateral such as intellectual property rights and other key strategic assets, and in the imposition of restrictions on investments by the borrower group into non-guarantor group entities.
- Lenders are looking to agree with sponsors/borrowers, at the outset of any new financing or a refinancing, plans for mergers and assets sales over time.

### ▶ Non-Consensual Restructurings: the Option of Last Resort

- If a consensual restructuring cannot be agreed, panellists are continuing to see the use of schemes of arrangement in order to effect a restructuring of debt.
- There has been an increased use of English law restructuring plans before the English courts. The panellists are starting to see greater appetite among borrowers/sponsors and creditors to use court-supervised restructuring plans in other jurisdictions (using recently-implemented legislation), notably in Germany, France and the Netherlands. In addition, there is an increasing use of court-supervised insolvency processes in emerging markets such as the UAE, Saudi Arabia and India.
- The use of such court-supervised restructuring options will continue to be driven by valuations, available cashflows of the debtor entities, and the appetite of their shareholders.

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