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Introduction
Maura O'Sullivan, Michael Chernick, Shameer Shah and Shawn Dogra
Shearman & Sterling

INTRODUCTION

Contributed by: Maura O'Sullivan, Michael Chernick, Shameer Shah and Shawn Dogra, **Shearman & Sterling**

Shearman & Sterling is a global law firm that partners with corporations, major financial institutions, emerging growth companies, governments, and state-owned enterprises to provide the legal and industry insight needed to navigate the challenges of today and achieve their ambitions of tomorrow. For 150 years, Shearman & Sterling has built strong and long-lasting relationships with clients around the world by advising on groundbreaking, precedent-setting matters across industries and sectors. The firm has over 700 lawyers around the world speaking more than 65 languages, and nearly half of its lawyers practice outside the United States. The firm is committed to forging long-term relationships with its clients by providing genuine insight and practical advice as they navigate the challenges of the 21st-century global economy.

Contributing Editor

Maura O'Sullivan is a partner in the finance practice at Shearman & Sterling. She focuses on acquisition financings, leveraged lending, restructurings, debtor-in-possession financings and asset-based finance. Maura has extensive experience representing financial institutions and direct lenders in structuring and executing acquisition financings, leveraged lending, first- and second-lien structures. She also has significant expertise in restructuring transactions, debtor-in-possession financings and asset-based finance. Maura has also worked extensively in cross-border financings (including in connection with cross-border acquisitions).

Co-authors

Michael Chernick is a partner in the finance practice at Shearman & Sterling. Michael has over 25 years of experience in the US leveraged finance market, representing leading investment and commercial banks, alternative capital providers and other financial institutions in bank financing and debt capital markets transactions. He has extensive experience in public and private leveraged and investment grade acquisition finance (including bridge financings), refinancings and recapitalisations, second-lien and asset-based lending. Michael also advises on securities, capital markets, bank finance, and corporate transactions representing corporations and financial institutions in bank financings, public and private offerings and high-yield debt offerings.

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Shameer Shah is a partner at Shearman & Sterling in the leveraged finance team in London. Shameer's principal focus is acquisition financings, rescue or stress financings and restructurings, working with a range of clients across financial sponsors, private credit, major investment banks and other financial institutions. Shameer has advised on all major financing structures, including unitranche, senior, second lien and mezzanine, PIK debt financings, as well as preferred equity and warrants.

Shawn Dogra is a senior associate in the finance practice of Shearman & Sterling. Shawn represents leading financial institutions and private capital providers as lenders and arrangers in a broad range of finance transactions, including complex syndicated loan transactions, acquisition and other leveraged financings, direct lending transactions, asset-backed financings, investment grade financings and in and out-of-court restructurings. Shawn also has significant experience advising corporate borrowers in finance matters.

Shearman & Sterling

599 Lexington Avenue
New York
New York
10022-6069
United States of America

Tel: +212 848 4000
Email: Shawn.Dogra@Shearman.com
Web: www.shearman.com

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Overview: Muted Activity in a Challenging Environment

Leveraged finance activity in 2023 has followed in the footsteps of a difficult 2022 as we have continued to see muted overall activity globally amidst a challenging backdrop for the leveraged finance market. Macroeconomic factors, including rising inflation rates that have caused central banks across the globe to increase their benchmark rates and stoked fears of recession for most economies and significant bank failures or near failures, including Credit Suisse and Silicon Valley Bank, have created substantial challenges to returning to a more robust financing market. As a result of these and other factors, borrowers have faced elevated borrowing costs and generally tight credit conditions. There has been weaker M&A activity as these aforementioned factors have created a market where there are valuation gaps as buyers are reducing their valuations to take these dynamics into account and peak valuations from 2021 and 2022 are still top of mind for sellers who do not want to settle for less.

A dearth of new transaction supply in the US and EMEA primary markets is evident: the rise of borrowing costs and corresponding decline in M&A activity (and the private equity-backed leveraged buyout/acquisition financing pipeline) which began in 2022 has been exacerbated by a more selective lender base and by particular weakness in the broadly syndicated loan markets (with the overhang of several "hung" financings only beginning to clear in the first half as less than half of 2022's unsold debt remained at banks by mid-year (Wall Street Journal)). With syndicated loan markets virtually frozen and financing sources focused on leverage levels and tightening documentation, some acquisitions that traditionally would have been financed by the syndicated loan markets were financed by buyers (both strategic and private equity) through the private credit markets or simply without initial reliance on debt. Primary issuance in general has been dominated by maturity-driven refinancings and "amend-and-extend" transactions as companies have focused by necessity on repaying debt and extending maturities, while signs of market stress have grown with moderate increases in default rates, out-of-court restructurings and bankruptcy filings.

The market outlook remains uncertain but recent developments have provided some basis for cautious optimism. Resilient economic fundamentals, including cooling inflation figures, have helped to quell recessionary fears and concerns over the pace of central bank rate increases in the US in particular. It is a similar tale in Europe, with activity starting to pick up in the Nordics, Benelux and continental Europe in general, although the UK is still lagging somewhat behind. Secondary markets have shown significantly less volatility than in 2022 amidst positive returns and a gradual reopening of the broadly syndicated loan markets has become apparent, with successful syndications of opportunistic refinancings and "green shoots" of LBO activity by mid-year. Impending maturities remain likely to spur market activity: stronger borrowers may look to further capitalise on reopening markets, while companies struggling with higher borrowing costs (of which there is an increasing number) will need to turn towards alternative financing options or restructuring of their existing debt. Private credit lenders have also increasingly provided a valuable source of liquidity for borrowers, particularly through underwriting larger transaction sizes in the LBO market in the absence of syndicated options and seem poised to offer flexible financing options to borrowers across the risk spectrum.

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Some of the predominant themes seen so far this year are set out in further detail below.

Trends in a Selective and Shifting Market

The first half of 2023 has seen arrangers and issuers in the syndicated markets opportunistically launch refinancings and focus on "amend-and-extend" transactions while new acquisition financings (other than small add-ons) and other primary issuance have been at a virtual standstill, with a recovery in market confidence negatively affected for a period by the collapse of Credit Suisse and US regional bank collapses in March. However, market confidence was shored up by positive secondary market movements in subsequent months. Overall US institutional leveraged loan issuance volume at mid-year was down 35% year-over-year, with volume excluding refinancings at its lowest level since 2009 (Refinitiv, LCD). M&A financing was severely impacted by high borrowing costs and valuation disconnects: sponsors primarily executed opportunistic public-to-private acquisitions or small platform acquisitions for existing portfolio companies, and even when factoring in add-on financings, new M&A transactions accounted for only 18.5% of institutional leveraged loan activity (LCD). Syndicated market conditions favoured well-rated borrowers (with a pronounced shift in terms and pricing spreads at B3/B-, reflecting CLO concerns of downgrades below minimum acceptable levels) and favored conservative LBOs, with underwritten syndicated LBOs featuring lower leverage levels and higher equity contributions from sponsors than in prior years. Average equity contribution for US broadly syndicated LBOs had reached 67% by mid-year with average pro forma adjusted total leverage ratio at only 4.3x, matching levels last seen in 2017 (LCD, Covenant Review). Meanwhile, in EMEA leveraged loan issuance declined by 41.9% year-over-year, with new M&A transactions also down 42.75% year-over-year (Debtwire). Loan extensions are however running at a record high of EUR25.7bn (LCD).

Primary issuance noticeably shifted from institutional leveraged loans to high-yield secured bonds and private credit. A 17% year-over-year increase in US-secured notes issuance was seen by mid-year (CreditSights). This may have been driven by structural characteristics and market participant preference in this interest rate environment: secured bonds carry fixed-rate interest which provides both a level of borrowing cost certainty for borrowers and a certain coupon for investors relative to the floating-rate nature of bank debt. Secured bonds are also typically more expensive to call and are subject to call protection for a longer period than term loan B bank debt.

Private credit markets provided vital liquidity in the absence of syndicated options and expanded their presence across the risk spectrum during the year. Private credit providers took an increasingly larger share of the private equity LBO market pipeline globally, underwriting large public-to-private LBOs (notably including at least one major financing with borrower-friendly payment-in-kind functionality) and the majority of committed acquisition financings in the US and EMEA at mid-year (LCD). Financing these transactions in such periods of uncertainty meant that private credit lending syndicates grew larger, with sponsors forced to rely on a wider set of private lenders as lenders remained selective. Private credit lenders notably also provided various financing solutions to distressed or lower middle-market borrowers, including junior debt, but also expanded towards higher quality borrowers: a number of publicly-traded investment-grade borrowers globally turned to private credit for sizeable bespoke financing transactions. As market confidence grew over the last few months, several

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sponsor-backed acquisition processes included dual-track syndicated and private credit options, suggesting a borrower-friendly return to competitive tensions as the syndicated markets reopen. Moreover, the depth and scale of the private credit market and the relative dearth of new-money private equity acquisition financings, further exacerbated borrower-friendly terms.

LIBOR cessation (with the last USD Panel LIBOR rates published on 30 June 2023) was a source of significant activity in the leveraged loan market during the first half of the year with Term SOFR implemented as the new market standard reference rate. Market consensus for the credit spread adjustment necessary to reflect the difference between LIBOR and Term SOFR at relevant tenors settled on the ARCC-recommended spread adjustments of approximately 11, 26 and 43 basis points for one, three and six-month tenors for existing facility transitions despite some successful borrower-pushed variations as CLOs and other lenders co-ordinated in support of the ARCC-recommended adjustments. The credit spread adjustment for new SOFR facilities varies and remains unsettled, including options such as no spread adjustment, 10 basis points across tenors, 10/15/25 basis points or the ARCC-recommended spreads. Synthetic LIBOR (effectively Term SOFR plus the ARCC-recommended spreads) will be published by the IBA until 30 September 2024, providing additional time to transition "legacy" contracts that do not contain the "fallback" provisions contemplated by loan documentation in recent years.

Sustainability-linked leveraged loans, which typically tie the interest margin charged to compliance with certain key performance indicators (KPIs), continued to grow not only in the EMEA (where they have traditionally been more commonly seen) but also in the US. Standard practices emerging include independent third-party verification of compliance with KPIs and fixed timeframes for KPI implementation when flexible ESG amendment features are included (where KPIs are set at a later date following closing). Pricing structures tied to KPIs allow for both margin increase and decrease. The EU's Corporate Sustainability Reporting Directive (CSRD) – a mandatory framework requiring companies to file annual sustainability reports prepared in accordance with the European Sustainability Reporting Standards (ESRS) that were released mid-year – will further impact market practices towards measurement, verification and reporting. Advisory bodies such as the Loan Market Association and the Loan Syndications and Trading Association have also helped guide developments in standard provisions with updates to their sustainability principles and guidelines.

Restructurings and Defaults

Restructuring activity, loan defaults and bankruptcies have seen a pronounced uptick as signs of stress have continued to grow, although distress remains below historical highs. Covenant relief amendments were seen more frequently than in 2022. Continuing a trend dating back to mid-year 2022, loan rating downgrades continue to outpace upgrades. The US leveraged loan default rate was measured at 1.71% by amount by mid-year, an increase of 143 basis points from the same period last year (LCD). Chapter 11 filings in the United States, as tracked by FTI for facilities over USD50 million, doubled in the first half of 2023 year-over-year, while Debtwire reported a comparable year-over-year trend in the number of restructuring advisory mandates. Both metrics remained below recent high-water marks set in 2020.

Out-of-court restructuring activity has also grown rapidly relative to statutory proceedings

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in recent years: by the start of the year 72% of defaults were reported to have resulted in exchange transactions globally, up from nearly 50% in 2020 (Moody's). Leaving aside more typical exchange offers, borrowers have increasingly turned to "liability management transactions" to address capital structure concerns: these transactions generally include up-tiering transactions (where selected existing debt is up-tiered in priority and/or senior debt is inserted on a priority basis above an existing stack), drop-down/unrestricted subsidiary financings (where unencumbered assets or unencumbered subsidiaries are used to generate additional liquidity) and "double dip" transactions (where new lenders receive the security of both a direct claim against a company group and an additional claim from an intercompany financing arrangement of the loan proceeds). These transactions have been seen more frequently in the United States than Europe, and although not limited to sponsor-backed companies, have been more frequently utilised by sponsor-backed companies as a method of preserving the sponsor's equity investment that would otherwise be jeopardised in a statutory proceeding. Europe is, however, now starting to see liability management transactions being executed, or at least threatened, to coercively push through amendments by borrowers, as the impact of rising interest rates begins to take hold.

Future liability management transactions may find guidance from the US bankruptcy court's June ruling in Serta that upheld a contested up-tiering financing, particularly as the decision was the first of its kind on the use of "open market purchase" provisions to effect such transaction. The court affirmed that Serta's actions when entering into a financing transaction where certain lenders exchanged their existing first- and second-lien debt for second-out superpriority debt and also provided new first-out superpriority debt fell within the credit agreement's definition of "open market purchase" and thus Serta was not required to extend the exchange of first- and second-lien debt to excluded lenders. The court's focus on contractual language may encourage borrowers to be more aggressive in relying on the loose contractual provisions found in many recent credit agreements. Similarly structured up-tiering transactions were seen during the year and can be expected to increase if market stresses continue.

Conclusion

The past twelve months have seen a continuation of the challenges that first enveloped the global leveraged finance market in 2022, with the backdrop of a lack of confidence by market participants and tighter credit conditions reflected in both market activity and market documentation standards. An optimistic view is that improving macroeconomic fundamentals during the year, already reflected in secondary market valuations, may propel more primary activity as market confidence grows and M&A activity returns. Syndicated markets have signaled reopening and private credit lenders have become an increasingly crucial liquidity source, suggesting more competition will return to the benefit of borrowers. The market picture over the next twelve months may ultimately prove to be a tale of two markets – robust borrowers and acquisitive sponsors may be able to access primary markets and resume loosening documentation as in prior years while an increasing number of borrowers struggling with high borrowing costs, especially those operating under the shadows of looming maturities, will need to seek out alternative financings leveraging existing documentation flexibility or turn towards restructuring options.

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