

End of the business cycle: protections and early warning signs in LMA documentation

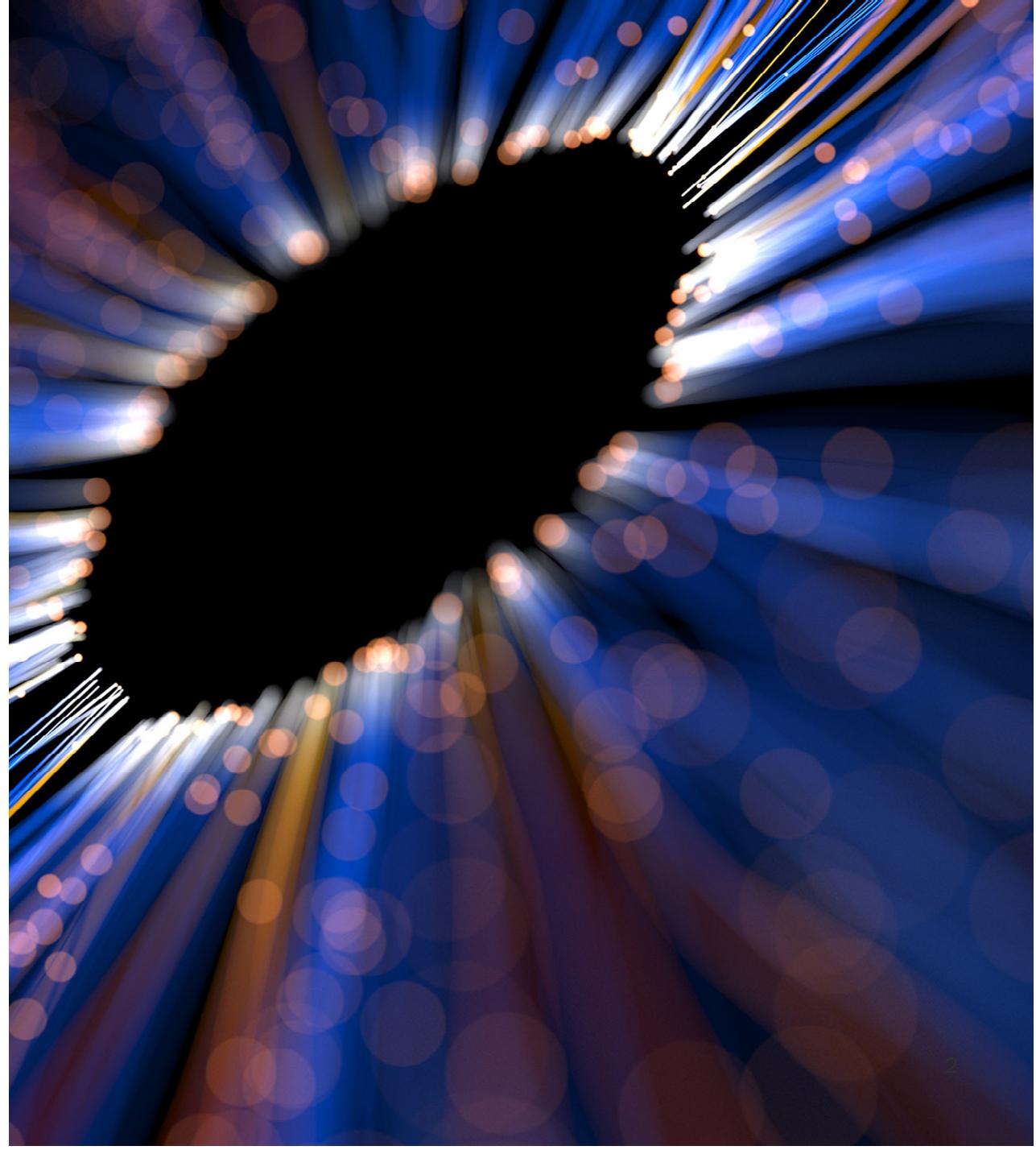
Financial Markets Legal
Update – the webinar series

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Agenda

- 1 Introduction
- 2 Current state of the market
- 3 Pre 2007/2008 financial crisis documentation and the LMA and market responses
- 4 Early warning mechanisms in current LMA documentation
- 5 Other relevant provisions in a market downturn
- 6 Restructuring considerations: WHOA (Please join the 9:30 webinar for this)



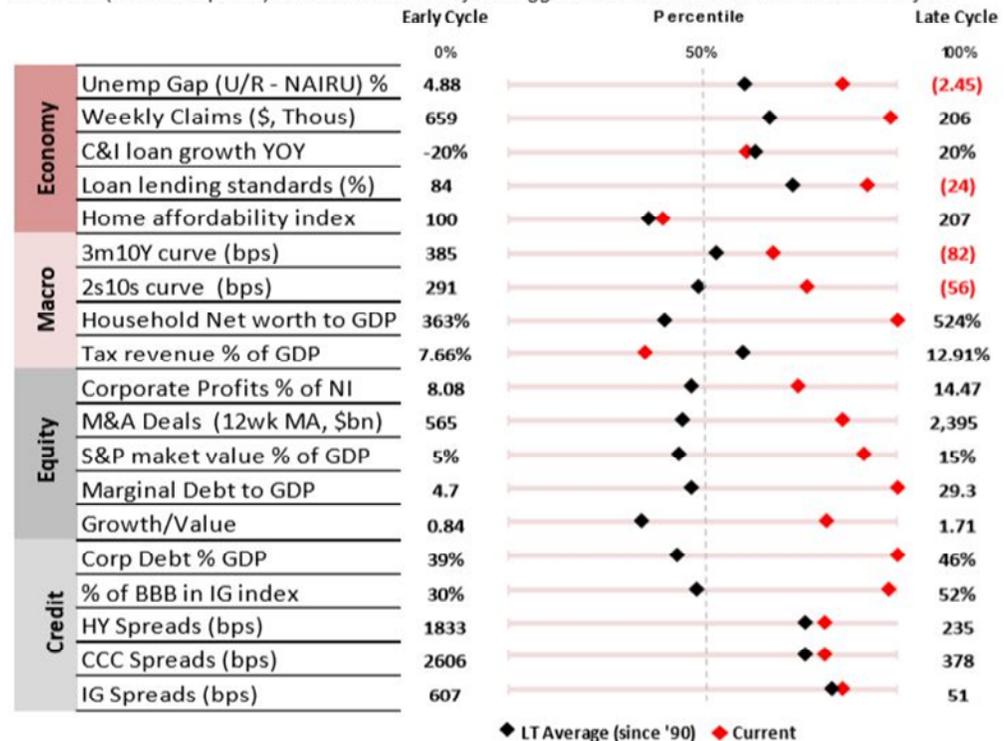
The Economic Indicators – US Economy

February 2019

December 2019

Fig. 1: US late cycle signals (historical percentile grid comparison)

Financial (credit & equities) based metrics nearly all suggest that we are closer to the end of a cycle



Source: Bloomberg, Haver, Dealogic, Nomura. For a complete list of tickers and charts please refer to this [link](#)

	Start of cycle	Early cycle	Mid cycle	Late cycle	End of cycle	Recession
Inventories		●	○			
Consumer durables		●	●			
Housing			●	●		
Prices			●	●		
Bonds			●	●		
Monetary policy			●	●		
Equity profitability			●	●		
Leverage			●	●	○	
Economic trend			○	●	○	
Credit			○	●	○	
Sentiment				●		
Business investment				●	○	
Employment				●	○	
Equity direction			○	●	●	
Economic slack				●	●	
Volatility				○	●	
Cycle age					●	
Votes for each stage of business cycle	0	2	9	13.5	6.5	0

Source: RBC Wealth Management – Global Insight 2020 Outlook

Pre 2007/2008 Financial Crisis Documentation and the LMA and Market Responses §

- Defaulting Lender / Impaired Agent provisions
 - New provisions included in standard leveraged finance documentation.
- Liquidity Costs
 - In the absence of liquidity in the market, borrowing costs exceeded the interbank rates.
- Re-focus on Financial Covenants
 - Shift from value based covenants (LTV) to cash based covenants (e.g. ICRs).
- Restrictions on Debt Purchases by Sponsor Affiliates and the Disenfranchisement of voting by Sponsor Affiliates.
- Mechanism for subordinated debt cancellation
 - Security Agent permitted to release subordinated debt. This allows for a disposal of pledged shares without being constrained by shareholder debt.

Early Warning Mechanisms in current LMA Documentation



- **Financial Covenants**
 - Forward looking and backward looking tests measuring the “financial health” of the Borrower.
 - Deviations from standard definitions may result in early warning signs not being identified promptly.
 - Equity Cure: Shareholder intervention is/was required to comply with the covenants. Indicates either a one-off breach of covenants or financial difficulties.
- **General Undertakings**
 - Detailed provisions providing a wealth of information to the Finance Parties.
 - Borrowers generally view these undertakings as an administrative burden and will try and limit their reporting obligations.
- **Note: Cov-Lite / Doc-Lite might have ameliorated these protections.**

Early Warning Mechanisms in current LMA Documentation



- Cash Traps/Cash Sweeps
 - Not standard LMA but an option to consider when structuring a transaction. More likely to apply to asset based transactions such as real estate, shipping, commodities and aircraft. Less likely in Leverage and Investment Grade loans.
 - Usually, a pre-default trigger which either “traps” cash from being distributed out of the structure or “sweeps” it into a blocked account to be applied in prepayment.



Convenant Level E.g. Required DSCR: 135% Cash Trap DSCR: 150%	Actual Covenant Level: 165% EXCEEDS BOTH Required Financial Covenant Level and the Cash Trap Level	Actual Covenant Level: 140% Covenant Level EXCEEDS Required Financial Covenant Level BUT NOT the Cash Trap Level	Actual Covenant Level: 120% Covenant Level DOES NOT MEET Required Financial Covenant Level NOR the Cash Trap Level
Accelerate / enforce security?	No	No	Yes, if default not remedied
Cash sweep/ cash trap activated?	No	Yes	All flows from accounts usually blocked on default
Operation of relevant accounts?	Usually with borrower	Usually still with borrower	Usually passes to security agent on default

Other provisions relevant in a Market Down-Turn



- Transferability
 - Usually transfers are subject to some restrictions (black lists, white lists, borrower consents), however, an event of default usually means Lenders can transfer freely.
- Intercreditor positions
 - The “Instructing Group” (usually the **Majority** Senior Creditors) hold the cards as to enforcing security and giving instructions to the Security Agent.
- Change of Control
 - Investors with dry powder may look to take advantage of lower valuations.
- Right to access / Right to Valuation
 - Leverage: Right of access to books, management presentations etc.
 - Real estate: Right to access the property and call for Valuations (accurate information for LTV testing).



Thank you for joining

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