

# AMT Training

Wilmington Professional

LBO financing issues

Debt structuring in an LBO

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- Debt capacity
- LBO financing options
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  - Debt at the OpCo level
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  - Equity, shareholder loan and mezzanine finance at the HoldCo level

Debt capacity

Cash flow lending



## Debt capacity

How much debt can a firm support?

- A core issue for professional lenders like commercial banks

Most commonly used techniques to establish debt capacity

- As a % of asset value (collateral)
- Using credit ratios
- NPV of cash flow forecasts

# Estimating debt capacity

## Credit ratios

- Lender identifies some key credit ratios and establishes a maximum level for each
  - Leverage
    - Example: Debt / Equity not to exceed 50%
  - Interest coverage
    - Example: EBITDA / Interest expense minimum 5 times
  - Cash flow adequacy
    - Example: Debt / EBITDA not to exceed 3 times
- Debt capacity is calculated using the given ratios
- Lenders may also take a 'haircut' on the theoretical capacity (to reduce risk)
- Structuring ratios used are often used as financial covenants

# Estimating debt capacity

## Cash flow lending

- The higher the cash flow that a business is expected to generate, the higher the debt that can be supported
- The maximum debt capacity can be estimated using NPV approach
- Assumptions needed
  - The term (length) of the financing
  - The cost (interest rate) of the financing
  - Cash flow projections covering the whole financing term
    - Cash flow available to service debt
- The present value of the cash flows available to service debt represents the maximum debt that those cash flows can repay
- Lenders usually take a 'haircut' on the theoretical capacity (to reduce risk)

# Cash flow lending

## Example

Assume:

- Term = 7 years, cost of debt post-tax = 5%

Year	1	2	3	4	5	6	7
Discount factor*	95.2%	90.7%	86.4%	82.3%	78.4%	74.6%	71.1%
Cash flow available to service debt	314.8	359.8	389.1	418.4	439.4	456.2	475.0
PV of cash flows	299.8	326.3	336.1	344.2	344.3	340.4	337.6

Present value = max debt **2,329.8**

# Cash flow lending

The term structure of LBO financing

- Extending the term (maturity) of the financing increases the debt capacity of a business
  - Borrow against cash flows further and further out in time
- For the lender, extending the term increases risk
- The term profile of an LBO financing structure is built in order of seniority
  - The more senior the debt, the earlier the cash flow claim, the shorter the debt maturity



# Debt capacity

How much debt?

- Most LBOs are funded with a significant amount of debt in the form of leveraged loans, mezzanine finance, high-yield bonds and/or seller notes
  - Debt as a share of total sources of funding for the LBO can range from 50% to upwards of 75%
- Issuer credit quality matters
  - Issuers with large, stable cash flows usually are able to support higher leverage
  - Issuers in defensive, less-cyclical sectors are given more latitude than those in cyclical industry segments
- Finally, the reputation of the private equity sponsor also plays a role, as does market liquidity
  - Stronger markets usually allow for higher leverage; in weaker markets lenders want to keep leverage in check

# Debt investor market

Where does the money come from?

- There are three primary investors in leveraged loans:
- Banks:
  - A bank investor can be a commercial bank, a savings and loan institution, or a securities firm that usually provides investment-grade loans
  - For leveraged loans, banks typically provide unfunded revolving credits, letters of credit (LOCs) and – less and less, these days – amortizing term loans, under a syndicated loan agreement
- Finance companies:
  - Finance companies have consistently represented less than 10% of the leveraged loan market, and tend to participate in smaller deals – \$25 million to \$200 million
  - These investors often seek asset-based loans that carry wide spreads. These deals often require time-intensive collateral monitoring
- Institutional investors:
  - Hedge funds, high-yield bond funds, pension funds, insurance companies, structured vehicles known as collateralized loan obligations (CLOs) and loan participation mutual funds and other proprietary investors also participate in loans focusing usually on wide-margin (or ‘high-octane’) paper

# LBO financing

The financing structure



## Setting up the financing structure

- Financial sponsors aim to maximize the amount of debt used in the acquisition, and minimize the equity
- This is achieved through:
  - Creating debt products whose terms are tailored to the needs of debt investors
  - Tapping into different segments of the credit market
  - Allocating debt within the corporate structure according to a ‘structural subordination’ logic
  - Liquidity to operate the business
- Reach out to capital markets and internal credit teams for input on likely financing structure

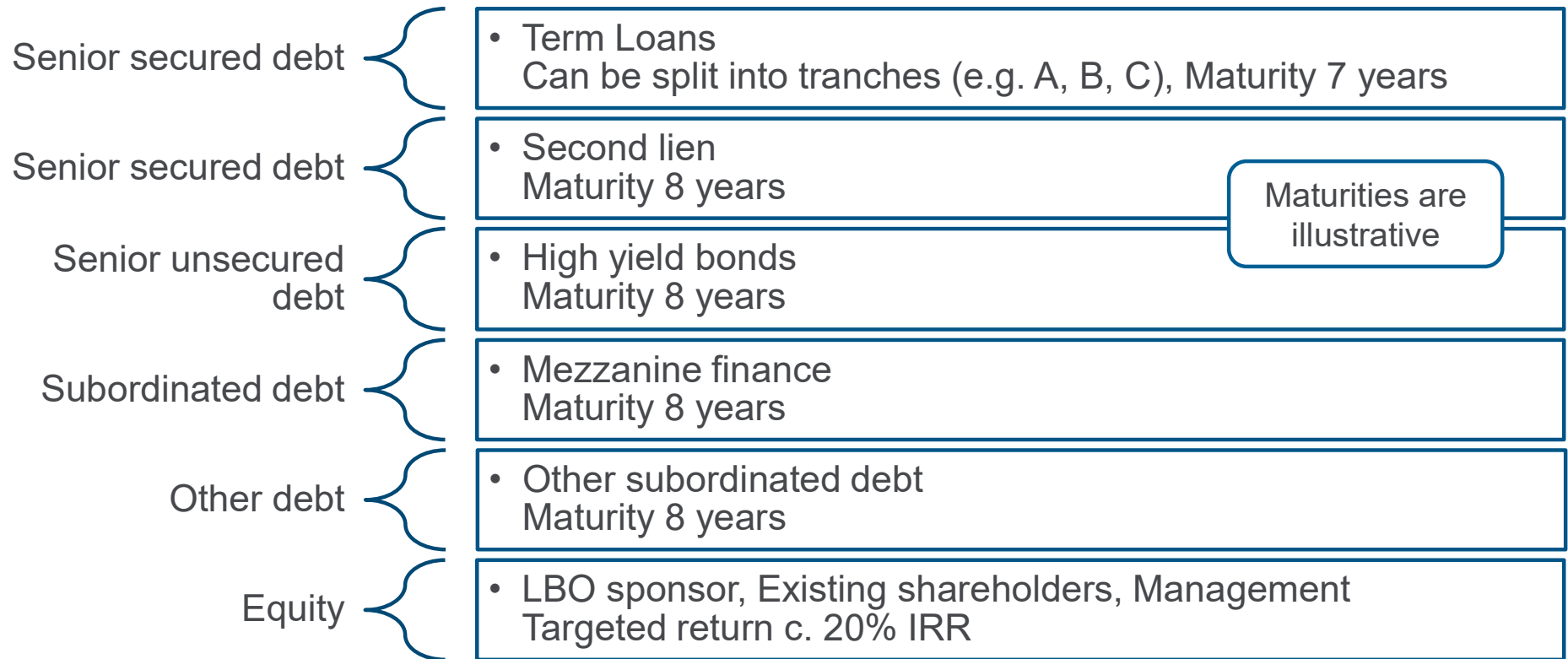
# Debt instruments

## General characteristics

- Amount borrowed and principal
- Cost: interest
  - Cash interest vs. PIK interest
- Repayment date: maturity date
  - Bullet repayment vs. amortizing
- Security: collateral
  - Secured vs. unsecured
  - 1st lien vs. 2nd lien
- Priority of payment: seniority
  - Senior vs. junior; subordinated vs. unsubordinated
- Covenants
- Op Co. vs. Hold Co.
- Other features (convertible, callable, cum-warrants, etc.)

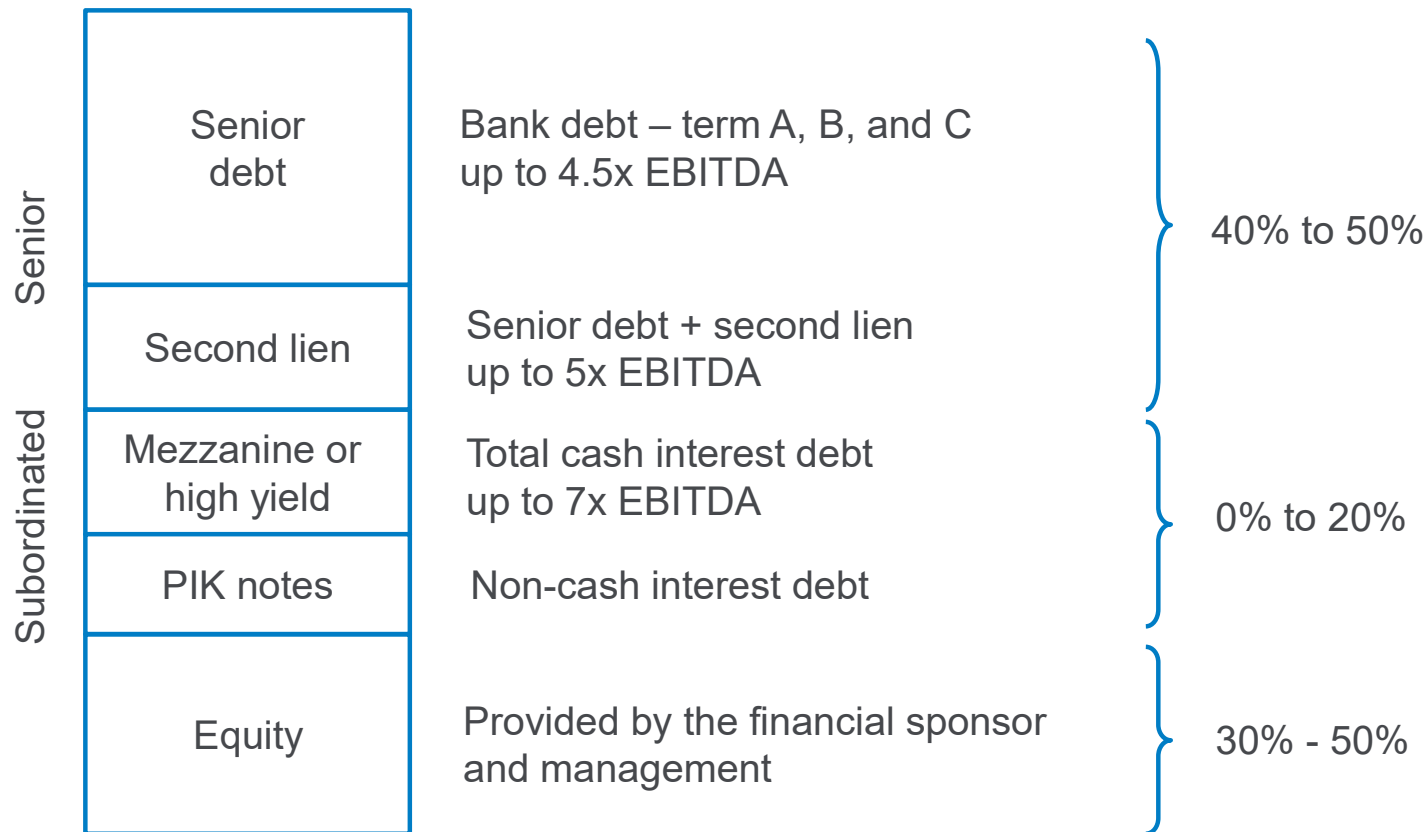
# LBO financing

Sources of funds in detail; term structure



# LBO financing options

Some indicators



# Senior secured debt

## Term loans

- Typically split into three tranches:

Term	Maturity (Years) <sup>1</sup>	Repayment	Spread over LIBOR <sup>1</sup>
A	6	Amortizing	400
B	7	Bullet	450
C	8	Bullet	500

- Floating interest rate (often partly swapped into fixed rate)
- Has the lowest cost of debt because of lower risk due to:
  - Security – via fixed and floating charges
  - Covenants – financial rules the company must abide by
  - Ranking – repaid ahead of all other financing
- Used to be a large liquid market before credit crunch, but its liquidity has reduced significantly since

<sup>1</sup> indicative values only – actual terms depend on market conditions and deal structure



# Senior secured debt

## Second lien

- Helps to extend secured debt and therefore reduces the overall cost of funding
- Secured via a second ranking fixed charge
  - ‘Lien’ is a legal word that means a security charge like a mortgage
  - The claims on collateral of second-lien loans are junior to those of first-lien loans. The lender only gets what is left over after the first ranking charge has been satisfied (the revolving credit facility and term loans)
  - Second-lien loans also typically have less restrictive covenant packages, in which maintenance covenant levels are set wide of the first-lien loans
- Floating interest rate, bullet repayment
  - Second-lien loans are priced at a premium to first-lien loans
- Minor financing source
- Investor base is primarily hedge funds

# Senior secured debt

Establishing the senior debt capacity of the target

## Cash flow lending

- The maximum debt capacity can be estimated using cash flow projections and some financing assumptions
- Cash flow available for debt servicing is calculated
  - The cash flow that can be used to repay the principal plus the interest
  - Equal to the free cash flow (FCF)

## EBITDA multiple as a proxy

- EBITDA is often used as a quick-and-dirty benchmark for cash flow
  - Debt financing is often quoted as a multiple of EBITDA
- LTM EBITDA used as key reference point
- EBITDA measures earnings not cash flow
  - Check cash conversion ratio:  $FCF / NOPAT$

# Senior unsecured debt

High yield debt

## Features

- Publicly traded securities (bonds) rated BB+ or lower
  - Can be placed via private placement to specific bond investors (under rule 144A)
- Traditionally pay fixed interest (priced over government bonds or swaps)
- Usually 10 years maturity with bullet repayment and may be 'callable' by the company (with pre-payment penalties) from year 5 onwards
- Typically minimum size of \$100m / £100m / €100m

## Advantages / Disadvantages

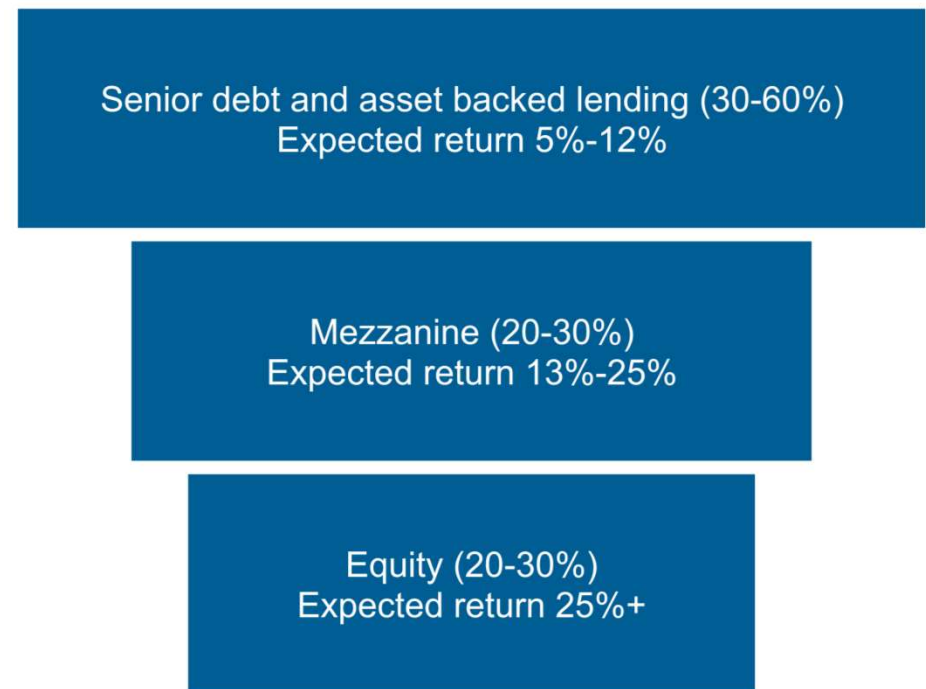
- Advantages
  - More flexible
  - Less restrictive covenants (incurrence basis)
  - No amortization
- Disadvantages
  - Higher cost
  - Usually cannot be called until after 3 – 5 years

# Subordinated debt

Mezzanine debt – what is it and why issue it?

- Mezzanine debt capital generally refers to that layer of financing between a company's senior debt and equity, filling the gap between the two
- When mezzanine debt is used in conjunction with senior debt it reduces the amount of equity required in the business
  - As equity is the most expensive form of capital, it is most cost effective to create a capital structure that secures the most funding, offers the lowest cost of capital, and maximizes return on equity

Typical private equity structure



# Subordinated debt

## Mezzanine debt features

### Features

- Maturity of around 8 – 10 years with bullet repayment
- Interest may be PIK (paid in kind i.e. the interest is accrued onto the balance of the loan) or maybe a combination of part cash part PIK
- Sometimes with warrants attached
- Return measured as an internal rate of return
  - a blend of the return on the loan plus the value of the warrants
  - typically mid-teens, but will vary through the cycle

### Advantages / Disadvantages

- Advantages
  - Few covenants
  - Maximizes leverage
  - PIK allows cash to be conserved
- Disadvantages:
  - Significantly higher cost
  - Dilution of equity returns
    - Via warrants

# Subordinated debt

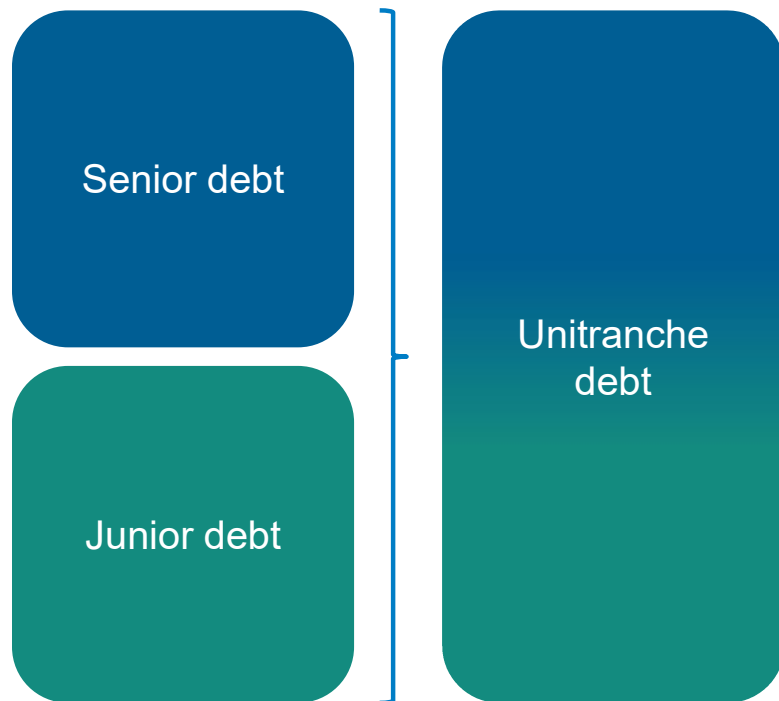
## Mezzanine debt flexibility

- The basic forms used in most mezzanine financings are:
  - Subordinated notes
  - Preferred stock
- Mezzanine lenders look for a certain rate of return which can come from four sources:
  - Cash interest (fixed or floating)
  - PIK interest: interest payment is not paid in cash but rather by increasing the principal amount of the security by the interest amount
  - Ownership: an equity stake in the form of attached warrants or a conversion feature
  - Participation payout: instead of equity, the lender may take an equity-like return in the form of a percentage of the company's performance, as measured by total sales, or EBITDA as a measure of cash flow, or profits
- Mezzanine financings can be made at either the operating company level or at the holding company level (also known as structural subordination)

## Capex facility

- Capital expenditures (CapEx) are funds used by a company to acquire, upgrade and maintain physical assets such as property, plants, buildings, technology, or equipment – where the life of the asset/investment is more than one year
- Capex facility means any loan agreement for the purpose of financing capex
- Capex loan can also be an asset backed loan (ABL) where the asset is used as a collateral for the loan

## Unitranche debt



- Hybrid loan structure
- Combines senior and subordinated debt into one debt instrument
- Debt-financing terms flexible and increase access to capital for companies
  - Typically, 5 – 7 years bullet debts
- Used in acquisition finance and middle-market lending
- Single lender, single set of documents
- The main providers are non-traditional lending entities such as debt funds and other institutional lenders



## Seller notes

- A portion of the purchase price in an LBO may be financed by a seller's note
  - Seller's receipt of proceeds from the sale is delayed
- The buyer issues a promissory note to the seller that it agrees to repay over a fixed period of time
- The seller's note is attractive to the financial buyer because it is generally cheaper than other forms of junior debt and easier to negotiate terms with the seller than a bank or other investors
  - The acceptance of a seller's note by the seller signals the seller's faith and confidence in the business being sold
- However, seller financing may be unattractive to the seller because the seller retains the risks associated with the business without having any control over it

## Debt terms & conditions

- Loan agreements have a series of restrictions that may dictate how borrowers can operate and carry themselves financially
- More extensive in bank debt than bonds
- The worse the credit risk, the more restrictive the terms

Categories of terms	Example(s)
Limitation on indebtedness	<ul style="list-style-type: none"> <li>• Allowed additional indebtedness [\$XXX m]</li> <li>• Debt / EBITDA &lt; or = 4.0 X</li> <li>• EBITDA / Interest &gt; or = 4.7 X</li> </ul>
Limitation on security	<ul style="list-style-type: none"> <li>• 'Negative pledge'</li> <li>• Liens as of date of closing</li> </ul>
Limitation on asset sales	<ul style="list-style-type: none"> <li>• Unless proceeds used to repay Senior debt or Total debt [XXX]</li> <li>• Tangible assets / Total debt &gt; or = 120%</li> </ul>
Limitation on mergers & acquisitions	<ul style="list-style-type: none"> <li>• 'Change of control'</li> <li>• Lender's put upon change of control</li> </ul>
Limitation on cash outflow	<ul style="list-style-type: none"> <li>• No dividends except to service debt in other parts of the organization</li> <li>• Capex &lt; = or = [\$XXX m]</li> </ul>

# Debt terms & conditions

## Ratios & financial covenants

- Debt ratios are used to analyze the development of the financial structure in time, and are also useful to compare this transaction to other deals
- Debt ratios are used to establish covenants designed to protect the lenders
- Leverage and coverage ratios should be calculated
  - May include capping leverage:
    - Debt / EBITDA  $< \text{ or } =$  XXX
    - Debt / Total capital  $< \text{ or } =$  XXX
    - Debt / Assets  $< \text{ or } =$  XXX
  - May include debt service / coverage ratios:
    - EBITDA / interest expense  $> \text{ or } =$  XXX
    - EBIT / interest expense  $> \text{ or } =$  XXX
    - EBITDA / (interest expense + capex)  $> \text{ or } =$  XXX

# Debt terms & conditions

## Common covenants

### Coverage ratios

- $\text{EBITDA} / \text{Interest expense}$
- $(\text{EBITDA} - \text{Capex}) / \text{Interest expense}$
- $\text{FCF} / \text{Total debt}$

### Leverage

- $\text{Senior debt} / \text{EBITDA}$
- $\text{Net debt} / \text{EBITDA}$
- $\text{Total debt} / \text{EBITDA}$



Whilst these covenants are typically used, remember that EBITDA does not equal FCF

# Debt terms & conditions

## Breach of covenants

- Typically, creditors can 'accelerate' the debt
  - All debt immediately due and payable
- In practice:
  - Can choose not to take it up
  - Can waive the breach once (w/ or w/o fee)
  - Can negotiate a change of the term (w/ or w/o fee)
  - Can effectively force a business restructuring
    - Especially if breach due to fundamental deterioration of the company
  - Can exercise the right, but how will the borrower pay the money back?!

Debt structuring

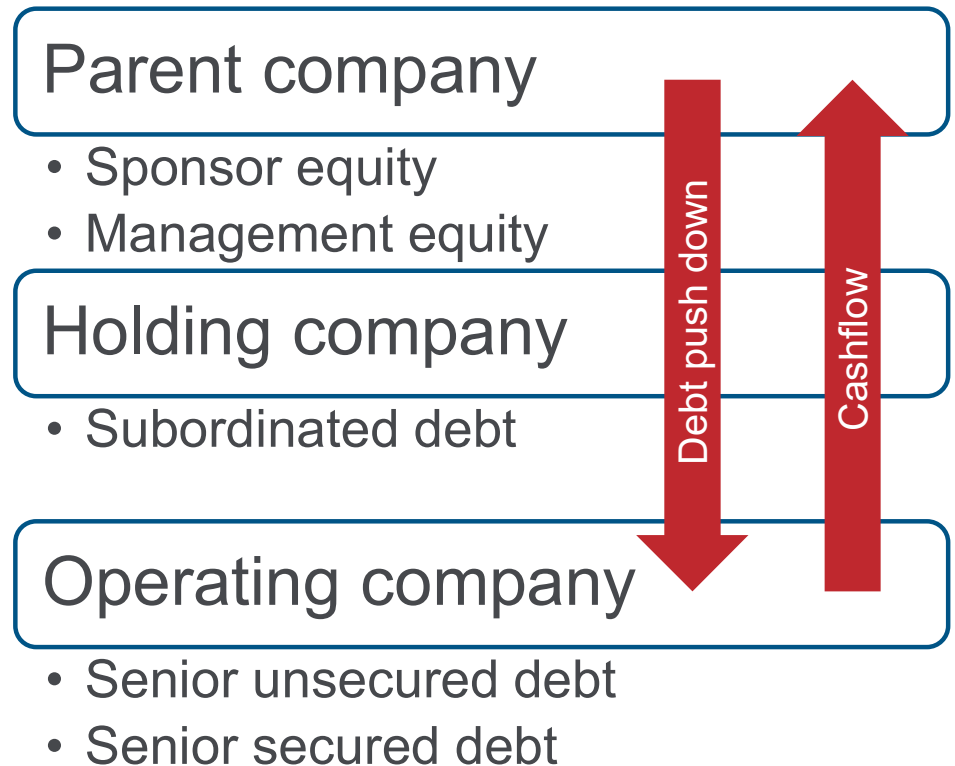
Structural subordination



# Structural subordination

## Debt push down

- Debt investors want to be as close as possible to the operational cash flows and prefer to lend to operating companies if possible
- If not possible, will lend to holding companies which receive dividends from the operational business
- Equity investors will invest at the parent company level



# Structural subordination

## Holdco

- In a holding company structure, as there are no operations and hence no cash flows, the structural subordination of the security and the reliance on cash dividends from the operating company introduces additional risk and typically higher cost
- The advantage to the company is that the debt at the holding company level is not normally included in assessing the leverage or coverage ratios that constrain how much a company can borrow
- Holdco PIKs offer financial sponsors the ability to raise additional capital to increase leverage, reduce the equity component of acquisition consideration and increase the yield available to creditors to a level greater than returns associated with senior loan financings



# Holdco PIK

## Features

- Fixed or floating rate instruments structurally subordinated to any senior or subordinated debt incurred by the operating group but ranking ahead of all equity contributed by the financial sponsor
- They permit the relevant debtor to pay interest 'in kind'
  - This feature allows a financial sponsor to increase group leverage, without triggering any cash-pay interest obligation on the operating group
- Have a final maturity date beyond that of any senior debt incurred by the operating group
- They contain covenants and events of default that substantially mirror the senior debt in its then-current form (usually without the financial covenant(s), or, if included, with additional headroom to the covenant levels for the senior debt).
- Any debt service or repayment of principal on a Holdco PIK will be contingent on distributions being made from the operating group which will be subject to:
  - Terms and conditions of the senior debt
  - Availability of distributable reserves
  - General desire of the shareholders to make such payments

# Holdco PIK

## Types

Depending on investor appetite or requirements, a Holdco PIK may fall into one of four broad categories, comprising the following:

### 'Traditional' PIK

- Interest payment structure is established upfront and is required to be paid solely 'in kind' and/or with cash interest at a certain point in time

### 'Pay-if-you-can' PIYC

- Required to pay cash interest, but under certain circumstances can pay interest in kind

### 'Pay-if-you-want'

- The borrower can, in its sole discretion, elect to pay interest in any given period in cash

### 'PIK Toggle'

- The borrower can, in its sole discretion, elect to pay interest in any given period in cash, in kind and/or a certain percentage in cash and 'in kind', depending on the amount of 'cash available for debt service'

# Equity

## Different types of equity contribution – shareholder loans

- At entry, the equity is contributed by the institutional investors and perhaps by management
- At exit, the institutions maybe diluted by the mezzanine warrants and the management share of the equity
- The equity contribution is split between two components. Split is primarily driven by the need to incentivize management
  - Preferred stock (or shareholder / vendor loan notes)
    - Institutional investors
    - Usually PIK dividends
  - Common stock/ Sweet Equity
    - Institutional investors and management
    - Often pays no dividends (prevented by debt covenants)
- Target IRR for institutional investors c. 20% <sup>(1)</sup>

(1) Market currently sees deals with equity up to 50% and target IRR at 15 to 20%

# Equity

## Why have two types of equity?

### Why have two types of equity?

	One type of equity		Two types of equity	
<b>Entry</b>				
Equity value at entry	300.0		300.0	
Shareholder loan	0.0		200.0	
Ordinary equity - Institution	290.0	90.0%	90.0	90.0%
Ordinary equity - Management	10.0	10.0%	10.0	10.0%
<b>Total</b>	<b>300.0</b>		<b>300.0</b>	
<b>Exit - Fire sale</b>				
Equity value at exit	250.0		250.0	
Shareholder loan	0.0		200.0	
Ordinary equity - Institution	225.0	90.0%	45.0	90.0%
Ordinary equity - Management	25.0	10.0%	5.0	10.0%
<b>Total</b>	<b>250.0</b>		<b>250.0</b>	
<b>Analysis - Loss / Gain experienced</b>				
Shareholder loan	0.0		0.0	
Ordinary equity - Institution	(65.0)	Loss	(45.0)	Loss
Ordinary equity - Management	15.0	Gain	(5.0)	Loss
<b>Total</b>	<b>(50.0)</b>		<b>(50.0)</b>	

- If only one type of equity is used, management may be incentivised to induce a fire sale
- By using two types of equity, the institutional investor ensures it makes a minimum return before the management benefit from their investment
  - Management would not be incentivised to induce a fire case

Appendix



# Fees

## How does an investor make money on these loans?

- Fees are an essential element of the leveraged/syndicated loan process. Prominent fees associated with syndicated loans are:
- Upfront fee
  - Paid by the issuer at close. Often tiered, with the lead arranger receiving a larger amount for structuring/underwriting the loan
- Commitment fee
  - Paid to lenders on undrawn amounts under a revolving credit or a term loan prior to draw-down
- Facility fee
  - Paid on a facility's entire committed amount, regardless of usage
- Usage Fee
  - Paid when the utilization of a revolving credit is above, or more often, falls below a certain minimum
- Prepayment fee
  - Generally associated with institutional term loans. The fee may be applied to all repayments under a loan or specifically to discretionary payments
- Administrative agent fee
  - Paid to administer the loan
- Letter of Credit (LOC) fee
  - a fee for standby, typically same as LIBOR margin

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