

# *Deleveraged buyouts*

## *How to manage and rollover debt in target companies in a credit crunch environment*



In the first of a series of briefings that looks at financial management in a downturn, this note considers how you can best manage and rollover debt in target companies in a credit crunch environment.

The credit crunch has resulted in new acquisition financing drying up for all but the best credits and the right sectors and geographies, leaving many buyout houses and trade buyers with little option but to fund new acquisitions solely with equity and/or subordinated debt. However most target companies will already have an element of indebtedness on their balance sheet which a buyer will need to roll over or refinance (and possibly pay down) as part of the acquisition. This debt could be comprised of term debt from a previous buyout and working capital facilities. If the target's debt level is significant and, possibly, already impaired, this could well be the reason why the target has come on to the market and an element of deleveraging may therefore be required in order to put the business on a more sustainable basis going forward. Such "rollover loans" or "deleveraged buyouts" are likely to become more common during 2009, but they present several new challenges for buyers:

1. **Standstill arrangements:** The target could well be in default under its banking facilities, possibly because of a financial covenant breach or maybe because of an even more fundamental problem. In this case it will be important to make sure that a standstill is in place with the target's principal creditors in order to provide stability and continuity of funding during any offer period (in the case of public companies) or during any exclusivity / pre-completion period (in the case of private companies). Absent this certainty, the purchaser cannot be confident that the creditors will not take any enforcement action that could thwart an offer.
2. **Financial covenant reset:** Whether or not the target company is in distress or the debt is being paid down as part of the transaction, a buyer will want to be comfortable with the financial covenant headroom and testing arrangements under the facilities going forward. It is likely that these covenants will need to be re-set to reflect the new financing structure and the target's anticipated performance levels. The financial covenant definitions should also be scrutinised as part of this process.
3. **Key terms of the facilities:** The incumbent lenders are likely to have a degree of control over any such buyout, not least because a waiver of the usual requirement to mandatorily prepay the existing facilities in the event of a change of control will be required from them. This may provide them with a lever to seek to require an update of the key commercial terms of the facilities - in the main this is likely to involve proposals to change the margins to reflect current pricing, re-setting the amortisation profile and maturity dates and requiring payment of a fee. Against this, the acquisition could be seen as offering a solution for the incumbent lenders, as an alternative to a continuing underperforming loan or worse, making a potentially substantial loss, in the event of any insolvency of the target. As such, the respective bargaining positions of the incumbent lenders and the purchaser will depend on the particular circumstances.

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4. **General terms of the facilities:** Some lenders may attempt to go further in "updating" the general terms of the facilities – for example by not accepting an equity cure right or by insisting on standard lender-friendly "LMA" documentation. We have recent experience of pushing back successfully on such attempted re-positioning by lenders, such that buyers can retain borrower friendly documentation on a par with what might have been achieved in 2006 (and in some cases better than what was achieved in early 2007). As mentioned above, one reason why this position can be retained for buyers is because in many cases a "rollover loan" or "deleveraged buyout" will be removing a problem for the lender (including by paying down debt, putting in new equity, improving the incumbent management team and being a more supportive investor). Further, and in any event, the underlying logic and reasoning for these borrower protections has not changed and they are, in our view, more important than ever in the current climate.

## Timing and Process

In a private company acquisition, the restructured or refinancing facilities will need to be agreed and documented prior to execution of any sale and purchase agreement ("SPA") and be conditional upon completion occurring under the SPA. In a public deal, the facilities will need to be agreed and documented prior to launch of the offer, again conditional upon the offer being completed. In either case, given that no acquisition debt will be used, there is unlikely to be a regulatory requirement for "certain funds" other than from equity providers. However, as a commercial matter, any purchaser is likely to require that the restructured or refinancing facilities will be made on a certain funds basis, involving limiting the events of default under the facilities to a small number of key events relating (only) to the purchaser (and not the target) and ensuring that all conditions precedent to first utilisation are either satisfied or, as applicable, in agreed form and under the control of the purchaser, at the time the facilities documentation is signed. As such, it is very important to initiate the discussions with the incumbent lenders at an early stage, with a view to agreeing the commercial terms and documenting the facilities as quickly as practicable, in parallel with negotiation of the SPA or offer/scheme document.

## How we can help

We can assist you in structuring acquisitions where there is existing debt that is being rolled over or deleveraged, primarily to ensure that the acquisition is deliverable (and not put off course by any creditor action) and that the target company retains appropriate facilities with sensible protections going forward.

## Disclaimer

Please note that the contents of this note provide an overview only. It is intended as guidance only and should not be relied upon as legal advice. Clients' circumstances will differ in each case.

If you would like to discuss any of the issues covered by this note, please contact any of the following members of our Banking Department:

Travers Smith LLP  
10 Snow Hill  
London EC1A 2AL  
T +44 (0)20 7295 3000  
F +44 (0)20 7295 3500

[www.traverssmith.com](http://www.traverssmith.com)



**Jeremy Walsh, Head of Banking**  
jeremy.walsh@traverssmith.com  
+44 (0)20 7295 3217



**Andrew Gregson, Partner**  
andrew.gregson@traverssmith.com  
+44 (0)20 7295 3206



**Matthew Ayre, Partner**  
matthew.ayre@traverssmith.com  
+44 (0)20 7295 3304

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