

# A world of convergence?

Are common financing terms becoming the norm in the world's main credit markets?

The credit agreement has served a central function in the operation of international finance and the development of global capitalism. The loan agreement (in one form or another) has existed since early humans moved from a pure barter-economy to one involving aspects of credit and futurity and both preceded and necessitated the invention of currency.

The earliest examples of lending derive from Mesopotamian farming activities in the Fertile Crescent some 4,000 years ago, where grain seeds for crop-growing were borrowed on the basis of a repayment of a multiple of the borrowed grain at the next harvest. Animals were loaned on a similar basis, yield taking the form of lambs and calves. It was reported recently that archaeologists working in the City of London had unearthed a waterlogged wooden tablet recording a loan made on January 8 57 AD between a borrower named Atticus and a lender named Ingenuus. This agreement – undoubtedly the earliest London credit market loan to have been identified – related to an advance of 105 dinarii (around £10,000 today) on terms pursuant to which the borrower *'properly, truly and faithfully promised'* to repay such loan, together with interest, *'in genuine coinage,'* in what could only be described as a covenant-lite transaction.

We will explore how the credit agreement for leveraged (ie non-investment grade) borrowers and its terms have evolved in the 21st century by reference to its key markets in London, the US and Asia and whether global convergence is inevitable or desirable.

## The London credit market

The London leveraged loan market has seen a distinct and accelerating evolution in credit agreement terms throughout the last decade. This evolution has focused primarily around the financial and behavioural covenants applicable to borrowers and the universe of credit participants and their sources of capital on the lending side of the transactional equation. An additional factor has been the much commented on realignment of the relationship and negotiating power between borrower and lender.

## 1 MINUTE READ

The line between the London and the US debt finance markets is becoming increasingly harder to draw. The distinction between loans and bonds in these markets has also blurred, with bond-like features replacing traditional loan terms. The Asia-Pacific loan market has been somewhat slower to adopt the sponsor-friendly credit innovations of Europe and the US though the more established markets in some countries are evolving rapidly. This article explores how the credit agreement for leveraged borrowers and its terms have evolved in the 21st century by reference to its key markets in London, the US and Asia.

Traditionally, the London leveraged credit agreement premised a transaction led by traditional banks and which provided a range of tranches of varying risks, where the pricing reflected the credit risk being undertaken. For example, a credit agreement circa 2005 might be expected to have contained (in addition to a revolving working credit line) an amortising term loan tranche, requiring periodic repayment, and a more expensive interest-only term loan facility repayable on maturity. In addition to these senior term and revolving loans, debt financing structures often included first and second lien debt in the form of loans or notes, mezzanine term debt and payment-in-kind (PIK) loans or notes. Such a facility would be supported by a raft of fairly restrictive positive and negative covenants designed to ensure that the borrower group did not incur or grant security in respect of additional third party indebtedness and other means of ensuring, from a behavioural perspective, that the borrower group did not undertake any business or operational activities that could create material risk for the financing banks. Such facilities would also contain financial maintenance covenants, non-compliance with which would result in an event of default and the ability of the lenders to renegotiate the facility or demand repayment. These maintenance covenants would typically include requirements to uphold agreed ratios relating to leverage, interest coverage, debt service coverage and capital expenditures.

Standard & Poor's Global Market Intelligence service, representing an increase of €45.5 billion as against figures for 2016. Such statistics are frequently reported in the media with reports of hand-wringing and woe is me on the part of the financing community at the perceived loss of protections and control, but the statistics speak for themselves – the traditional London credit agreement is, apparently, no longer a marketable option for borrowers and sponsors with any degree of negotiating leverage.

### European and US credit market convergence

The line between the London and the US debt finance market is becoming harder to draw. The US loan market has, for more than a decade, promulgated the term loan B structure (TLB), which premises a credit agreement governed by New York law and provides for a non-amortising bullet-repayment facility with no maintenance covenants and the flexibility and capital sources typical of the high yield bond market. These TLBs have been core to the financing strategies of major private equity firms in recent years and the covenant-lite structures in Europe have been becoming increasingly aligned to the terms of their TLB cousins. Furthermore, the geographical and jurisdictional boundaries between Europe and

are able to raise capital in both the debt and high yield bond markets, cherry-picking the best pricing and terms across the instruments. There are both push and pull factors at play in this convergence of terms and the relative preferences a borrower or sponsor may have at any given time for TLB/covenant-lite financing versus an issuance on the bond markets. However, whilst bond financings are not subject to US and EU leveraged lending guidelines, they rely on the potential issuer having recent publicly available financial data, and become unavailable to putative issuers whose financials have become stale. The bond market is also highly sensitive to perceived geo-political influences, such that issuing windows open and close, often unpredictably, which creates execution uncertainty. The private nature of the credit agreement operates to reduce this type of execution risk and does not require the degree of disclosure on the borrower group that the bond market would require.

Having regard to the US and European debt markets, at least, one might conclude that there is a steady march towards essentially common financing terms, irrespective of where debt is originated, its governing law or the nature of documentation under which it comes into existence.

### The Asia-Pacific credit markets

The US credit markets are largely domestic and the Uniform Commercial Code and Bankruptcy Code governing US secured lending markets and restructuring results in a significant degree of homogeneity. Similarly, despite differing legal systems throughout Europe, homogeneity is seen in European leveraged financings as deals above a certain size are generally syndicated through London. It is however, much more difficult to generalise about the Asia-Pacific credit markets as, rather than being a single market, they comprise a number of distinct markets. Each jurisdiction presents a different legislative and regulatory framework (including around currency controls) and unique structural challenges (including around ability to service the debt and the nature of and extent to which guarantees and security can be granted). This, combined with vastly differing degrees of certainty around the court/enforcement processes from jurisdiction to jurisdiction and greatly differing geopolitical risk profiles, result in an entirely different credit analysis and requirements for

---

## The covenant-lite structures in Europe have been becoming increasingly aligned to the terms of their US TLB cousins

---

The London market has, however, been moving steadily towards less stringent controls. There has been a significant reduction in the number of financial covenants: first the so-called covenant-loose package, limited to interest cover and net leverage covenants and now, increasingly, covenant-lite packages with a single springing net leverage covenant for the benefit of the lenders under the revolving credit facility and no term loan maintenance covenant. These covenant-lite facilities have become increasingly prevalent, and in 2017 accounted for €78.6 billion (\$91.5 billion approximately) in total for 2017, according to

the US have proved entirely permeable and, with banks, institutional investors and credit funds in the US with large pots of capital to deploy, borrowers and their private equity sponsors are now routinely accessing financing for European deals from the US debt markets under TLB structures directly.

Traditionally, term loans and high yield bonds were distinct debt products. However, both TLB and covenant-lite financings increasingly ape the high yield market, with bond-like features such as permissive incurrence-style covenants, ratio baskets and minimum creditor interference replacing traditional loan terms. Sophisticated sponsors

protections in the loan agreement depending on the jurisdiction.

That being said, there are some common themes. The Asia-Pacific loan market has been somewhat slower to adopt the sponsor-friendly credit innovations of Europe and the US and could be construed as being somewhat old-fashioned. In terms of participants, the Asia market has traditionally relied on major banks to fund acquisition and corporate finance activity in the region. While bank lenders continue to provide the lion's share of capital for Asian borrowers, the identity of these banks has been changing. Major US and European banks, with longstanding business credentials in the region, used to dominate the market. However, local Asian banks are increasingly taking the lead, supplemented by aggressive new market entrants from China which are offering narrow spreads to win market share and are able to price more competitively than banks subject to more stringent capital maintenance regulatory regimes.

The terms of these bank-led transactions have, by and large, been reflective of the traditional London bank finance market. Credit terms in Asia-Pacific would typically contain financial maintenance covenants and the lender group would typically continue to include the borrower's relationship banks throughout the life of the credit agreement, and not merely at the underwriting stage. The continued involvement of trusted relationship banks has been a central feature of the Asian loan market model and informs to a significant degree the relative absence of innovation in local credit structures. The concept of the trusted bank relationship, as was the case in London historically during the times of the London Club, has historically persuaded regional borrowers to accept financial maintenance covenants in the belief that the strength of the relationship will provide adequate protection should the borrower experience turbulence and fail to comply with its obligations.

Historically the appetite of funds to lend in the US and European markets has resulted in transactions with significantly higher leverage in these markets compared to the bank dominated Asia-Pacific markets. However, this gap has undoubtedly narrowed due to a combination of the regulatory scrutiny of US and European banks, the rise of Asian lenders and alternative capital providers in Asia-Pacific leveraged buyouts (LBOs), evolving credit structures and market conditions. It should be noted that overall

statistics for leverage in Asia-Pacific loans can be somewhat misleading. This is because there has been a substantial increase in the volume of leveraged loans in China and India which, because of structural impediments, generally have lower leverage (although there have been some highly levered exceptions to this in China). In contrast, the rise and domination

and ability to be aggressive on fully underwritten terms and structures and to execute on aggressive timeframes in order to win mandates ahead of international banks in certain markets. A number of Taiwanese banks have also become increasingly active in the leveraged space. Similarly, large Chinese asset managers have been increasingly active

---

## In Japan, South Korea or Taiwan, international banks cannot compete with the pricing and structures available from the domestic banks

---

of the domestic banks in markets such as Japan, South Korea and Taiwan, which are not subject to the same type of regulatory constraints as the US and European banks, has resulted in a number of highly levered deals (around seven times and higher).

Private equity fund sizes have increased dramatically across the region and in response many funds have shifted their focus from growth to control transactions. The resultant increase in deal size has greatly enhanced the importance of using leverage on transactions and investors have quickly developed an appreciation of the benefits of obtaining sophisticated advice and sponsor-friendly terms, understanding that the right financing package can be a competitive advantage in auctions and can help drive returns as well as providing protection in a downside case. Many large private equity investors in the region now have dedicated debt professionals on the ground, leveraging their global lending relationships and experience of sophisticated terms from the US and Europe, pushing hard to obtain them in Asia and relying less on the trusted bank relationship (though exceptions to this are Japan, South Korea and Taiwan where the highly attractive pricing and leverage on offer from local banks is often determinative). This has created an opportunity for credit providers who are able to be more flexible and provide bespoke debt financing solutions.

In response to this opportunity there have been a number of new entrants to the leveraged lending market. As mentioned above, over the last few years a number of the large Chinese banks have demonstrated (particularly where the sponsors/funders have strong relationships) both willingness

in providing additional leverage on a subordinated basis (whether on a contractually subordinated second lien basis or structurally subordinated through holdco financings). In markets such as Japan, South Korea and Taiwan, international banks simply cannot compete with the pricing and structures available from the domestic banks. Finally, as investors seek opportunities to deploy capital, many of the largest asset managers, already active in the US and Europe, have entered the Asia-Pacific market as alternative lenders and, in particular, have had made a significant impact in the Australian market.

Australia is the best example in Asia-Pacific of loan terms beginning to converge with US and European terms. Whilst terms are still generally more conservative than in the US and Europe, there has been a very significant shift. TLB structures (on both covenant-loose and covenant-lite terms (with a pricing differential)), nominal amortisation and favourable excess cash sweep compared to traditional Australian LBOs), unitranche (with only a net leverage covenant, no amortisation and no excess cash sweep) and holdco PIK structures are increasingly prevalent in the Australian market. This frequently increases opening leverage from the post-financial crisis levels of ~4.5x to six times (or higher with some holdco PIK structures). From a documentation perspective, most of the Australian TLBs have followed recent US precedents (allowing maximum flexibility) whilst the unitranche have generally followed the more typical Australian leveraged loan agreement which is more akin to the Loan Market Association style.

Although the Asia-Pacific markets are

fragmented and it is difficult to generalise across the region, sophisticated sponsors are exploiting increased competition between lenders to aggressively push greater convergence in most markets (taking into account the pricing, leverage and trusted bank relationships in certain markets as noted above) and are having significant success. For

Limited (previously Wharf T&T, WTT) which was acquired by MBK Partners and TPG Capital in 2016 and the issuance by Hexaware Technologies (71% owned by Baring Private Equity Asia). The covenant packages in high yield bonds in Asia-Pacific are not generally as sponsor-friendly as those seen in the US and European markets and

drum and in certain other markets (particularly in parts of South East Asia) leveraged finance is still relatively uncommon.

The concern that the covenant-lite structure depletes controls and renders creditors under-protected has been frequently voiced since covenant-lite financings first appeared in the first decade of the current century. Nevertheless, the appetite for participating in such financing structures has grown exponentially and covenant-lite financings have become the rule rather than the exception in major private equity-backed acquisitions in recent years and are deployed for an increasing number of corporate financings and refinancings. Loan markets – like any market – operate competitively and operate to match the expectations and requirements of its participants. For the time being, and judging from recent transaction volumes, there seems to be little appetite on either side of the credit bargain to revert to more traditional credit terms and retreat from this convergence. It is tempting to wonder where the vanishing point may be.

## The covenant packages in HY bonds in Asia-Pacific are not generally as sponsor-friendly as those in the US and EU markets

example, we are regularly seeing fewer maintenance financial covenants, pro forma adjustments to EBITDA for cost savings and synergies, equity cures being added to EBITDA with no requirement to prepay the debt, incremental facilities, grower or scalable baskets and fewer restrictions around permitted acquisitions.

Whilst there has traditionally been a place for high yield in certain sectors in particular jurisdictions (such as real estate in China and commodities such as oil and gas in Indonesia), many bond issuances in Asia-Pacific are corporate issuance and access to the high yield bond markets for private equity sponsors in leveraged transactions has been very limited. This is particularly true in the acquisition finance context. For example, the acquisition of Pactera by Blackstone in 2014 remains the only China take-private to have been financed by a high yield bond.

There have been some recent examples of sponsors accessing the bond markets to refinance acquisition loans such as WTT HK

from a leveraged finance perspective high yield bonds in Asia-Pacific are in the nascent stage.

### The future

Having begun with the history of the loan, we end with some consideration of its future. The European and US loan markets continue to converge with the bond market (both in terms of market standard covenants and participants). The Asian-Pacific loan market, however, remains fragmented (and the extent of this fragmentation becoming amplified): established markets, such as Australia, Hong Kong and Singapore, with a mix of participants including international banks, Chinese lenders and alternative lenders, are now evolving at speed and heading directionally towards convergence with the US and European markets whereas markets such as Japan, South Korea and Taiwan are beating to the sound of the domestic bank



**Greg Campbell**  
Partner  
Gibson Dunn (London)



**Michael Nicklin**  
Partner  
Gibson Dunn (Hong Kong)



**Anne MacPherson**  
Senior Transactional PSL  
Gibson Dunn (London)