Leveraged Finance
The Intercreditor Dynamic

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1. INTRODUCTION

1.1 Consistent with the theme of the Leveraged Finance presentation at the Conference this paper has been prepared as a commercial guide to the dynamics of the intercreditor regime that generally applies in a leveraged finance MBO transaction rather than a legal analysis of subordination or priority issues. This paper should be read in that context and should not be regarded as a definitive legal analysis of the enforceability or effectiveness of the concepts and issues discussed.

1.2 This paper is also intended only to be an introduction to the concepts and key issues associated with intercreditor arrangements that have been applied in the Australian market. There are many variables and different transactions will require different triggers and considerations, however the concepts and issues below will almost invariably arise in a leveraged finance transaction and this paper seeks to provide an introduction only as to how the intercreditor dynamic may be addressed.

2. THE CREDITORS

2.1 As discussed during the presentation, one of the key components of many recent buy-out transactions, particularly the larger, bid process sales, has been the ability of the successful bidder to enhance leverage so as to deliver the maximum price to the vendor. The enhancement of leverage has been achieved by the use of subordinated debt combined with bank senior debt.

2.2 Subordinated lenders in the Australian market are almost exclusively institutional or retail. The institutional market is dominated by 2-5 institutions whilst the retail market will necessitate an underwriting. There are a number of institutions that have the capability to underwrite and distribute a retail subordinated note.

2.3 There is increasing interest in the institutional high yield and mezzanine markets but liquidity is thin. The high yield market is almost exclusively limited to issues in the United States. This is only practically achievable if there are US earnings to create a natural currency hedge as the cost of buying any foreign currency hedge for the term of the high yield debt is prohibitive. The mezzanine market is small and has not been involved in any substantial transactions.

2.4 In addition to the external senior and subordinated financiers, most MBO structures will involve the use of significant shareholder debt.

2.5 Accordingly there are 3 principal creditors - the senior lenders, the subordinated lenders and the shareholders - whose interests need to be addressed as part of the dynamic of an intercreditor arrangement.

3. SHAREHOLDER DEBT

3.1 Shareholder debt is widely utilised for the following reasons:

(a) Subject to satisfying the debt/equity rules, the interest accrued on the shareholder loans is deductible even though, as discussed below, it may not be paid. The deductibility advantage is able to be enhanced in some transactions where the loans are made from offshore entities that reside in jurisdictions where interest income is not assessable until received or in some cases not assessable at all.

(b) In the event of liquidation the shareholders will, in respect of the shareholder loans, receive distributions pari passu with other unsecured creditors rather than claiming as equity after all debt has been repaid.

3.2 Repayment of principal is deeply subordinated. There will be no ability to make any principal repayment until all senior and subordinated debt is repaid unless consent is provided.

In the Pacific Brands transaction, after just over a year and the repayment of a significant amount of senior debt, the business was re-geared to increase leverage. Although the gearing multiples were slightly less than at the time of the original funding, the earnings of the business had improved so significantly that the new debt was permitted to be distributed to shareholders.

3.3 Payment of interest on shareholder loans is ordinarily only permitted where normal equity distributions would be allowed, for example where:

(a) the gearing ratio has been reduced to an acceptable level, usually between 2.5:1 and 3:1;

(b) the interest suspension covenants (these are the subordinated lender interest lock-up covenants) would not be breached;

(c) the payment is out of 'excess cashflow'.

(d) there is no default; and

(e) in total with any other distributions will not exceed net profit after tax.

3.4 It is important to be aware that where shareholder loans are provided by offshore entities it is almost certain that Australian withholding tax will apply. The withholding tax will be payable on interest accrued and accordingly the distribution regime must allow for the business to pay a sufficient amount to cover the withholding tax regardless of whether any interest on shareholder debt is permitted.

3.5 Shareholder debt will almost always be unsecured and will have no right to accelerate or demand repayment until all senior and subordinated debt is repaid other than where instructed to prove in a winding up at the instruction of the senior or subordinated lenders.

4. SENIOR DEBT

4.1 Repayment of senior debt is achieved through an aggressive scheduled amortisation regime and a cash sweep.

4.2 Simplistically a cash sweep is where a proportion of 'excess cashflow' is applied to reduce senior debt at quarterly or annual intervals. The percentage of excess cashflow that needs to be applied in a sweep will be based on the gearing ratio at the time.

Excess cashflow is simplistically the cash available in the business at the end of a period calculated as the EBITDA of the business after deducting tax, capex, interest and finance lease payments, scheduled and permanent voluntary principal amortisations and allowing for changes in average working capital and other cash gains and losses in the business.

Remaining excess cashflow after the sweep can then be applied to pay interest on shareholder debt if the other criteria are satisfied.

4.3 In large senior debt fundings there will ordinarily be two tranches of term debt - one will have a maturity of 3-5 years and the other a maturity 1-2 years longer. The term of the debt will have a significant bearing on the interest margin that will apply to each tranche.

Senior debt will comprise the term lenders, the working capital lender, hedging banks and banks that provide transactional facilities. All of these lenders will have equal ranking first priority rights under the security package.

4.4 On enforcement it will be the senior lenders only that have voting entitlements. Despite subordinated lenders having the benefit of security they will have no right to vote on the nature of the enforcement action to be pursued.

5. SUBORDINATED DEBT

5.1 The most interesting part of a debt package is the subordinated debt. As noted above it may be institutional or retail. It is generally regarded that the retail subordinated debt market currently has the most favourable terms from a borrower's perspective. Michael Tierney's paper identifies some of the advantages of this product.

5.2 The key disadvantages of a retail issue are:

(a) It will require the implementation of a bridge facility and an underwrite. The bridge facility will ordinarily be 6 months. This will therefore require the retail note issue to be completed within 6 months. It will be essential that this note issue is underwritten. The 'material adverse change', underwriting outs and market flex in the underwriting need to be carefully considered. A failure of the underwrite will almost certainly have irreversible dire consequences.

A particularly important commercial leverage that needs to be secured as part of any underwrite is to ensure the subordinated debt underwriter is the bridge provider (which will almost certainly be the case) and importantly that that institution has a significant stake in the senior debt. The senior commitment of the institution will create a commercial if not legal impediment to pulling the underwrite.

(b) A retail issue although being more flexible does have the issue that if a consent is required a noteholder meeting needs to be convened and approval obtained from a diverse group of investors. The most critical aspect is where there is a requirement to increase senior debt for an acquisition. Timing and ultimate achievement of consent will be significant issues in being able to ensure the objectives of the business are met. There are parameters within which new senior debt can be raised but generally the level of leverage will be up to 1 times lower than at the outset of the transaction.

5.3 Subordinated debt will have the benefit of the same security as senior debt and will usually lend to the same entity as senior debt. The subordination and priority regime is therefore based on contractual covenants - subordinated debt will naturally be second ranking.

This arrangement structure has been applied in all Australian senior/subordinated debt leveraged finance transactions. In the European and US leveraged finance markets structural subordination is far more prevalent. Structural subordination involves subordinated debt being lent to a non-operating holding entity above the senior debt borrower. The only distributions subordinated debt then receive are from whatever entity distributions are made by the senior debt borrower which of course can only be made after senior debt has been serviced or repaid.

5.4 Subordinated debt will usually mature a minimum of 6 months after the longest maturing term component of senior debt.

Acceleration and enforcement rights on default will only arise where:

(a) there is liquidation;

(b) the senior lender has accelerated its debt and enforced the security; or

(c) there is a default in respect of the subordinated debt and 180 days have passed since the time of a default in respect of the senior debt and the senior lenders have not commenced enforcement of the security.

In the intervening period whilst a default continues in respect of the subordinated debt, default interest will accrue.

5.5 If enforcement by senior debt involves the sale of shares in an entity that is the borrower of the subordinated debt or whose subsidiary is the borrower of the subordinated debt, the subordinated lenders will be obliged to release the junior debt so that the company being sold can be sold free of debt.

Subordinated lenders will participate in the proceeds of enforcement as if the debt had not been released in accordance with the priority regime.

5.6 Suspension of interest payments on subordinated debt will arise where:

(a) there is a default in respect of the senior debt;

(b) the payment would cause insolvency or otherwise cause a breach of an obligation under law or the senior debt documents; or

(c) interest suspension covenants are not met.

Usually interest suspension covenants will comprise a debt service cover ratio or interest cover ratio. In the Affinity Health subordinated note issue a gearing ratio also applied. The interest suspension ratios are usually set between 0.1:1 and 0.2:1 above the relevant default ratios for each of the covenants.

5.7 Unlike a project finance where locked-up subordinated debt interest is placed in a specific lock-up account, a typical leveraged finance transaction will allow any 'locked-up' interest to be applied to the cash sweep. This means that if the borrower comes out of lock-up there may not be cash available to pay the subordinated debt interest that accrued during the lock-up as it has been applied in reduction of senior debt. As a subordinated lender it is critical to ensure that locked-up subordinated debt interest is preserved and is not able to be applied to the cash sweep.

5.8 For a leveraged business that has both senior and subordinated debt to function cohesively it is essential that the rights of subordinated lenders in respect of waivers and consents is limited. This is also important for senior debt who do not want to be subject to the requirements of subordinated debt. Ordinarily therefore subordinated lenders will be subject to the waivers and consents provided by senior lender except in limited circumstances such as:

(a) waiver of payment defaults;

(b) waiver of covenants in relation to the provision of information;

(c) consents to a substantive change in business; and

(d) consents in respect of material disposals.

6. CONCLUSION

6.1 The development of a cohesive dynamic between senior, subordinated and shareholder debt is complex and will vary from one transaction to another. However what is consistent is that:

(a) access to cashflow is the key element of almost all of the elements of the intercreditor dynamic;

(b) without a cohesive dynamic the debt funding package runs the real risk of becoming unworkable.