The Deal WEBCAST

Trends & Developments in Acquisition Finance for M&A

Presented By pillsbury

A roundtable of experts in the world of both bank syndicated loans and private credit discussed the developments that ensued in 2021 in the wake of the Covid-19 pandemic and how those developments may further evolve in the year ahead.

As dealmakers have been preparing themselves for what is to come in 2022, it's clear the uncertainty that plagued buyers, sellers and lenders throughout 2021 did not magically fade away once the clock struck midnight on New Year's Eve.

During the past 12 to 18 months, the ease of obtaining deal financing helped fuel record levels of M&A, even as market participants also grappled with some challenging dynamics.

Determining the proper financial valuation metrics for a business has never been more difficult than in the face of Covid, with businesses in various industries experiencing both positive and negative effects. The popular valuation metric of earnings before interest, taxes, depreciation and amortization, or EBITDA, has become EBITDA-C to take into account the various effects Covid has had on businesses.

Other add-backs to EBITDA (unrelated to Covid-19) have become more common and intricate as buyers try to rationalize elevated valuation multiples.

Meanwhile, an increasing investor focus on environmental, social and governance issues, or ESG, has crept into the debt markets, seeing lenders provide incentives and penalties linked to sustainability in acquisition and other financing.

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Now, with fiscal and monetary stimulus set to recede in the face of seemingly rampant inflation, the challenges of the past year are set to take new twists and turns as the latest variant of the coronavirus upends back-to-office plans and threatens to temporarily reverse progress made in reopening markets across all industries.

"I think [what is most challenging] is where you're trying to figure out where there has been permanent change in consumer or customer behavior," Bain Capital Credit managing director Carolyn Hastings said during a Dec. 7 web panel presented by leading international law firm Pillsbury Winthrop Shaw Pittman LLP and The Deal. "And trying to parse out what a completely different landscape looks like versus something that is truly temporary.

The so-called "Covid bump" that many industries are experiencing has led to complex conversations between buyers and lenders over what the latter group is actually set to underwrite, Hastings explained.

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Frequent questions include, "Do you think there should be a negative adjustment to account for the fact that this particular company may be enjoying a big bump in revenue as a result of one-time temporary interest in their product or services?"

For the most part, Hastings said the private equity buyers she is often working with are like-minded in that neither she nor they are seeking to work off a peak EBITDA figure.

"Where it gets a little more dicey, and there is more interesting conversation between sponsors and lenders, is when they're doing a follow-on acquisition and the company is trying to get lenders to debt-finance that acquisition," she added. "Then I'm looking at the target and saying this is the highest EBITDA has ever been, I don't know if I should leverage it to the platform company's leverage. That's one thing we're spending a lot of our time thinking about – what is a run-rate EBITDA number, what's normal for this company and how should we adjust our leverage or our pricing to reflect the fact that there is a little bit of uncertainty in that number."

"Specifically in regard to M&A financing, we're seeing a lot of financing with ESG elements in it."

In the lower middle-market, Saratoga Investment Advisors LLC vice president Marissa Mann Andrews said they're trying to understand and consider when the opposite dynamic is playing out with a business that needs financing and is working through EBITDA add-backs.

"On the flip side, we're also seeing in the lower middle market a number of businesses that have been negatively impacted by Covid, and either they're in the market for a new ownership transaction or refinancing because there is either lender fatigue or some other external factor why a lender needs to be brought in for the first time or the existing lender needs to be replaced," Mann Andrews said. "I think there is a much higher bar for credits with these add-backs and often there are those who can have a difficult time finding a corporate financing.

"Similar to those who have seen a huge lift from Covid, on the flipside, we want to understand what normalized EBITDA levels are while still providing flexibility for everything that's transpired since March 2020, and give credit for what we think a return to normal might look like. I think lenders are open and flexible to that but need to provide a greater level of diligence to dig into it."

While businesses have been grappling with how to account for Covid when seeking financing, they've also increasingly been encountering lenders who want to infuse the capital they dole out with sustainability metrics.

"Specifically in regard to M&A financing, we're seeing a lot of financing with

ESG elements in it," Barclays Capital's head of loan capital markets and acquisition finance Claire O'Connor said during the panel.

O'Connor pointed to an $8 billion, five-tranche bond sale, announced on Dec. 7 by Merck & Co. (MRK), that will help fund its $11.5 billion acquisition of Acceleron Pharma Inc.

"One of those tranches, in particular, is linked to sustainability," she said. "In certain instances where a company is doing financing that may be related to M&A, and it's a large transaction, putting a sustainability-linked tranche alongside of that M&A may be a very efficient way to not only get the financing for the M&A but also provide the sustainability link."

There are also cases where O'Connor is seeing financing with sustainability features that may be used for things other than M&A.

"We've seen a couple of sponsor-related transactions that are sustainability-linked where the use of proceeds is not specified," she explained. "It can be for M&A; it can be for ESG, but there are coupon steps – if a company does not meet certain key performance indicators (KPIs) that are identified in those bonds. There are different ways of doing it, but we are seeing a lot more of it on both the bond and the loan side."

Along with the syndicated bond markets that O'Connor spoke about, lenders in some regions are incentivizing sustainability in similar manners in the illiquid credit markets as well, Hastings noted.

"One trend we're starting to see in Europe – in a handful of deals that we've done over the past 12 months in Europe, the sponsor in the deal has included a clause in our credit agreement to say 'If this borrower hits specific ESG KPIs, the coupon will be reduced,' " Hastings said. "Right now it is on the order of five to 10 basis points of spread reduction as a means for achieving those KPIs, but I look at that trend and say (a) we'll probably see that clause more often and (b) over time, you wonder whether those step-downs Claire mentioned in the syndicated markets end up growing and just becoming more frequent in the illiquid market."

"As you look at the environment that we've been through – it's been arguably one of the most active M&A markets that we've seen in the last 10 to 15 years."

Another unique lending dynamic to develop in the wake of the white-hot M&A market of late is the increasing use and importance of delayed draw term loans, which allow a borrower to withdraw predefined amounts of a total pre-approved loan amount, often to finance future acquisitions, the panel's members explained.

"As you look at the environment that we've been through – it's been arguably one of the most active M&A markets that we've seen in the last 10 to 15 years, and as part of that, there are a lot of companies, particular sponsor-backed companies, in the middle market that are going through a buy-and-build strategy," Hamilton Lane managing director of direct credit investments Nayef Perry said. "For the lender community, it used to be that you provided delayed draw and it was sort of that extra thing you would provide. Today it's almost a requirement."

In many instances, the percentage of a total financing commitment that a delayed draw term loan represents has climbed to 25% or more, Perry added. Meanwhile, the duration of how long the delayed draw will remain outstanding has been pushed out to between 12 and 24 months.

"I think you even see situations where you put a delayed draw in place and you're getting up against the shot clock expiring, and then the sponsor will come back and say, 'Hey can we extend this by six months because we've got this really attractive pipeline, and oh look here it is,' " Perry continued. "Usually folks are pretty accommodating."

An additional element to this developing trend is a push from borrowers to seek term loans with no provisions around lender approval for use of the

delayed draw, versus a few years ago when you'd primarily see full lender approval requirements, Saratoga's Mann Andrews added.

These developments are clearly related to the lightning-quick pace of deals in today's market, evidenced by how fast sponsors are drawing down the funds in a delayed draw, Bain's Hastings said.

Where once the biggest fear for lenders was they would be tying up capital that would never be used by borrowers, now the delayed draws are being pulled upon so often and so quickly that they're leading to even larger commitments for lenders.

"Nowadays the pace at which those delayed draws are being drawn down is often, at least in our part of the market, in less than 12 months," Hastings continued. "It's not uncommon for us to get a request from a sponsor that says 'Hey, I'm closing three acquisitions at once, and I'm going to use up the entire delayed draw. So I'd like to draw the committed capital and also refresh the delayed draw. You're basically doubling, sometimes tripling, your initial commitment in the span of a year to support that add-on activity for the sponsor."

This may in fact lead lenders to go into deals with a different mindset than in years past or avoid certain financing deals altogether.

"When you enter a deal, when you think about sizing your position, you really do need to think about the eventuality that this position size could triple in the next 12, 18, 24 months," Hastings explained. "So as much as I like the deal today, I actually have to hold back because I want to be able to grow with the company."

"I can see it morphing into an extended and larger delayed draw commitment to avoid the whole incremental architecture built into the documentation."

Pillsbury finance partner Joel Simon drew a comparison between this developing trend in the delayed draw term loan market and incremental loan facilities, noting that borrowers would likely still use incremental facilities if they weren't immediately preparing to be acquisitive but wanted flexibility.

"I can see it morphing into an extended and larger delayed draw commitment to avoid the whole incremental architecture built into the documentation," he commented.

Sponsors love the delayed draw concept because it allows them to convince the seller they have committed financing essentially a click away, Hastings responded.

"I think that's why you're seeing the shift between an incremental [facility], which still carries commitment risk with it and isn't necessarily guaranteed, versus the delayed draw, which is committed capital," she explained.

Pillsbury M&A partner David Ingles explained during the panel that this is reflective of buyers' and sellers' increased focus on enhancing deal certainty and ensuring that financing aspects of a transaction will not inhibit the ability to get a deal across the finish line in today's market.

This trend also is evidenced by recent movements in acquisition agreement terms related to syndicated facilities, where the concept of a marketing period increasingly has been replaced with that of an inside date to simplify the closing process and hopefully decrease the amount of time to close. Ingles doesn't expect this trend to trickle off in 2022, as sponsors are even now pushing back on the concept of an inside date at the commitment stage, "[so] when they turn to negotiating the acquisition agreement, they've got the most favorable terms possible."

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