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This article first appeared in the February 2011 issue of *International Financial Law Review*.
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German Leveraged Finance in 2011 – Bouncing Back But Not As You Might Expect

By Dr Michael H. Meissner, LLM

For the first time since the beginning of the global financial crisis and credit crunch in July 2007, the prospects for the leveraged finance market in Germany, Europe's largest economy, are positive again. For completed German loan transactions for the year 2010, the volume of leveraged buyouts (LBOs) was back up to 11 % of the total German loan volume, and the spread for 3-month EURIBORs—the mark-up on EURIBOR as the variable refinancing interest rate for EMU interbank lending reflecting risk—is now back at levels where the interbank market can function again. The volume of LBOs and private equity-related exits in the fourth quarter of 2010, as well as current mandates from private equity sponsors to arrangers for leveraged financings, demonstrate that there is liquidity again in the German loan market, resulting in a somewhat promising deal pipeline for 2011. While refinancing was still leading the tables in 2010 with 52% of the total 2010 German loan volume (in 2009 refinancing accounted for 51%), followed by strategic M&A with 18 %, corporate lending with 16 % and 3% for other loan purposes, the increase in LBOs from the 2009 historic low of 1% of the total German loan volume back to 11 % in 2010 seems significant enough to expect more to come in 2011.

However, this will not predominantly be the long-awaited return of large-cap buyout M&A activity with purchase prices of at least €750 million, but rather mid-cap M&A in the €200 million purchase price range or small-cap M&A with purchase prices of less than €100 million.

The German economy with the *Mittelstand* as backbone for German industry, including primarily mid-sized, privately held companies in traditionally strong German industry sectors such as automotive, chemical, engineering and manufacturing, seems ideal for the small to mid-cap M&A segment. Most importantly, it should be noted that loans for LBOs will be structured differently going forward in light of lessons learned during the credit crunch and collapse of interbank lending. In analyzing what might happen here, it is imperative to examine market developments and transaction structures pre-credit crunch versus post-credit crunch before outlining what to expect in 2011.

Pre-Credit Crunch Transaction Structures and Market Development

When the M&A market started to boom in 2005, lenders were no longer entirely in control of pricing and financing documentation. Banks in particularly were competing for LBOs—traditionally the domain of private equity funds. The result was transaction structures offering favourable terms to borrowers. In addition to the senior facility as senior secured loan with a variable cash-interest rate plus margin and fees, financing structures also included various layers of subordinated debt like second lien, mezzanine, payment in kind (PIK) loans and high-yield bonds. The order of priority, the process of demanding repayment from the borrower and other matters regarding the relationship among creditors would be set

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forth in a separate intercreditor agreement or be part of the relevant finance agreements. Further, a security trust agreement would set forth the process of realising security interests in the assets provided by the borrower as collateral pursuant to the order of priority.

Second lien loans primarily attracted institutional investors such as insurance firms and pension funds as lenders, and were subordinated to the senior facility while having priority over any mezzanine loan. Therefore, a second lien loan would have a variable cash-interest rate plus margin with a longer term than the senior facility but with a shorter term than the mezzanine loan; its security interest in the assets provided by the borrower would rank second to the senior facility as first lien. The mezzanine loan as hybrid instrument between equity and debt capital would include a variable interest rate plus two margins—a cash margin and a PIK margin accruing interest until maturity (often a challenge due to the prohibition of compounded interest under the German Civil Code). Mezzanine loans could also grant warrants for shares in the target company ("equity kicker"). PIK loans are unsecured loans without any cash-flows from borrower to lender between utilization of the loan and maturity, thus, cash-pay lenders qualify PIK loans usually as "equity" or "quasi-equity". Other "quasi-equity" instruments often used during the boom are vendor loan debts which essentially constitute extension of purchase price payments by the vendor to the buyer with a fixed interest rate.

After the closing of loan documentation, and the funding of the acquisition, the arranger would syndicate the loan by way of invitation and information memorandum to various interested lenders. If a bank had committed to an underwriting, it would bear the risk of the arranger's syndication efforts failing. However, this was almost never the case until mid-2007, on the contrary many leveraged finance transactions were oversubscribed in the syndication process.

Major characteristics of pre-credit crunch structures included the following: high leverage multiples, often 6.0 to 8.0 times EBITDA debt multiples (with high-yield bonds issued by the borrower as additional financing one could even reach EBITDA debt multiples in the range of 10), low margins and fees, covenants "light" on financing documentation and relatively moderate equity requirements for borrowers (on average less than 25% of the entire debt capital). The demand for debt capital to finance leveraged, as well as strategic, M&A transactions was enormous and led to record deal volumes from 2005 to 2007 with each of those years surpassing the previous year. Remarkably, the German LBO market for the first half of 2007 was so strong (with a LBO debt volume of €27.8 billion) that 2007 was still an all-time record year despite a weak second half (with a LBO debt volume of €5.8 billion, totaling 2007 at €33.6 billion, compared to LBO debt volumes of €21.9 billion in 2005 and €17.3 billion in 2006).

Global Financial Crisis and Post-Credit Crunch Challenges

By the time the impact of the US subprime crisis reached the German financial markets in the early summer days of 2007, it was apparent that what was initially perceived to be temporary instability in the US credit market had grown into a global financial crisis and credit crunch. German banks had also invested in securitised, collateralised or otherwise "repackaged" subprime mortgaged loan products originating from the US credit market, causing serious instability in the financial markets. Thus the interbank market, one of the most important mechanisms of the credit business, was no longer functioning; banks already had significant losses on their books and simply stopped lending to each other, which made it almost impossible to syndicate new loans or refinance existing ones. This had a severe impact on the

financing of M&A transactions, resulting in the upturn in the German M&A market which began in early 2005 ending abruptly in July 2007.

The German leveraged finance market now faces two challenges. First, the existing leveraged facilities did not necessarily provide for mechanisms to maneuver through the crisis: second, projected cash-flows for the performance of portfolio companies of private equity sponsors were ambitious as were financial covenants; finally, if intercreditor agreements were put in place, they did not always give proper weight to potential insolvency scenarios.

Lenders were faced with the option to either accelerate their loan upon payment default or covenant breach (likely resulting in the portfolio's company insolvency) or to agree to debt restructurings through covenant resets (often imposing an additional fee on the borrower), loan amendments and maturity extensions.

Second, if new leveraged transactions were to be financed, terms and conditions needed to change drastically to the detriment of borrowers. Banks only offered significantly lower leverage multiples and requested higher margins as well as fees. Underwriting in mid-sized to large deals had practically vanished.

What to Expect When the Market Returns in 2011

The fourth quarter of 2010 saw the strongest activity in the German leveraged finance market since mid-2007, with, for example, Triton's purchase of Wittur from a consortium of Goldman Sachs/Cerberus/Credit Suisse, Carlyle's acquisition of various mail-order businesses from subsidiaries and affiliates of Arcandor and the purchase of Amor Group from Pamplona Capital by 3i. The debt capital for all these transactions came from banks, further substantiating the expectation that in 2011 the leveraged finance groups of German banks will be back in business.

That should not exclude the possibility of high-yield bonds becoming a more sought after instrument in German leveraged financings. High-yield bonds would usually be issued as subordinated debt to the senior facility provided by banks. With second liens having disappeared in the European markets after the credit crunch, so far mezzanine loans have typically been used to finance the subordinated debt portion. However, the European high-yield bond market continued to increase making 2010 a record year in issuances and high-yield bonds have partially already replaced mezzanine debt (outside Europe, obviously in the US high-yield bonds are a customary route for private equity sponsors to access the debt markets). While up to now such issuances were primarily observed in the UK and France, it may well be that this uptick in high-yield bond issuances for leveraged financings will extend to Germany, particularly if the relatively expensive pricing structures for mezzanine continue. Such development could be facilitated by German legislation, i.e. the Act to Reform Collective Bond Offerings and Enforcement of Investors' Rights of August 4, 2009 which had the primary goal to provide a legal framework for German-law governed bond offerings reflecting customary international practices and attracting more bond offerings from companies in need for financing.

Other recent legislation which could become relevant to the return of the German leveraged finance market, is the German Limited Liability Company Modernization Act of November 1, 2008 which essentially liberalises the German law capital preservation rules for a GmbH (the German law equivalent

to a privately held corporation with limited liability). This Modernisation Act now permits, among other things, certain asset transfers from a GmbH to its shareholders which can include upstream security interests to secure loan liabilities of the shareholder of the GmbH, for instance in a leveraged finance transaction where the shareholder is the borrowing special purpose vehicle established by the private equity sponsor to effect the acquisition and the GmbH is the target company. Thereby, the lenders can now accept broader security interests from the borrowers which will facilitate the conclusion of leveraged loan facilities.

An important lesson learned from the credit-crunch in terms of structuring leveraged financings will be insolvency issues at the target company to be acquired by the private equity sponsor as purchaser and borrower of the loan facilities. While the major reforms of insolvency law in the 1990s resulting in the German Insolvency Code of 1999 instituted an insolvency plan-proceeding to enable an initially court-supervised restructuring as well as a US Chapter 11-like debtor-in-possession proceeding, the liquidation of the debtor company under the insolvency administrator's power of disposal remained the standard insolvency procedure in Germany. Under the Insolvency Code, the insolvency administrator will be appointed by the insolvency court without the creditor's consent with the creditors having more of an advisory role through the creditors' meeting and a creditors' committee than actual power to influence the insolvency proceedings. Thus, similar to initiatives in other major European jurisdictions, the German legislator is presently pursuing additional reform of the Insolvency Code to further strengthen creditors' rights. For the time being, the finance documentation in German leveraged financings must consider the current rules under the Insolvency Code and ensure that out-of-court restructurings will not be complicated by certain provisions. In the case of multiple lenders, the preparation of an adequate intercreditor agreement will be of utmost importance dealing with the pre-default issues of priority, payments and amendments as well as with the post-default issues of acceleration/enforcement, insolvency and recoveries, i.e. how to share proceeds. The Loan Market Association (LMA) had identified this issue and produced a form for a LMA intercreditor agreement designed to fit with the primary leveraged facilities agreement in March 2009 and then revised it in November 2009 to include various mezzanine friendly options.

Generally, German leveraged finance transactions in 2011 will primarily be structured with senior facilities plus subordinated debt in the form of mezzanine or high-yield bonds. Second liens or PIK loans will not play any significant role but vendor loan debts will possibly be included in the financing structure. For two reasons, it seems unlikely that banks will agree to a relevant number of covenants "light" again in the foreseeable future: first, to protect themselves; second, because covenant "light"-transactions will be extremely difficult to syndicate.

Regarding EBITDA debt multiples per LBO, it can be expected that on average they will be in the range of 3.5 to 5.5. Equity requirements for the borrower will probably still commence with a minimum of 30% up to 50%.

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