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In The Know

Leveraged Finance Newsletter

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Portability Features in Leveraged Acquisition Financing in Europe

What is portability?

The ability for a private equity sponsor to sell a company or group without triggering a "change of control" under its financing arrangements — known simply as "portability" — is an attractive option in a post-pandemic market, where many sponsors are actively considering how best to retain flexibility on when and how to exit their investments while taking advantage of today's borrower-friendly market terms. It is even more favourable in a rising interest rate environment and/or when credit terms in the market are tightening, as this allows the existing debt (with lower costs) to be "ported" along with the group in an acquisition or other exit.

A sale that meets all the applicable conditions required to exercise portability avoids the following:

- The automatic repayment of outstanding amounts (plus applicable premiums) and any right of individual lenders/investors to have their loans/notes repaid at the time of the sale
- The need for the buyer to obtain replacement financing at the time of an acquisition, which broadens and enhances appeal to potential purchasers and reduces execution time

Portability is a well-understood concept and is routinely found in the European high-yield bond market, appearing in around 50% of deals in the first half of 2024.[1] This figure in sponsor-driven transactions would likely be even higher, as corporate borrowers are less willing to pay a premium on the coupon for such features. While, to date, it remains a relatively uncommon feature in the leveraged loan market, its prevalence has been increasing (trebling from around 4% of deals in the first half of 2024, predominantly in refinancings and amendments/extensions[2], to 12% of deals in Q3 2024[3]).

As the data shows, portability is widespread in the European bond market. This is mainly because bonds are usually fixed rate, which feeds into the redemption (and non-call/make-whole) provisions. Due to the higher cost of early redemption/prepayment in bonds, the portability features of these instruments have received more focus (from the perspective of both the borrower/sponsor and the investors) given the material economic impact they can have on a transaction. In addition, an alternate form of portability based on a ratings-downgrade trigger has historically been commonly implemented in the international Eurobond market, and thus portability as a general concept is more familiar to international bond investors.

Portability in the current market

In a rising market where the majority of participants are expecting a significant increase in activity, the value of pushing for the inclusion of portability ahead of an exit is becoming more compelling.

Coupled with the existing prevalence of this feature in the European high-yield bond market, the inclusion of portability features in the European leveraged loan market is likely to become a more commonly accepted request as market terms converge.

In pre-COVID-19 times, portability was starting to find its way into the unitranche market. The commercial rationale for a single lend-and-hold creditor to engage with a request to include portability is easy to understand. In a competitive financing scenario, it builds goodwill on an existing credit with a sponsor looking to exit in the near term and provides the creditor itself with a double deployment opportunity — first with the original loan and then through a rollover to the buyer upon sale (provided that the pre-agreed conditionality is met).

Some market participants are also exploring opportunities to deploy portability-style financing as a proxy for staple financing. Amid a flurry of repricings and amendments, borrowers are considering adding committed undrawn tranches to existing facilities. These tranches would be available in the event of a qualifying change of control, i.e., to be drawn down to partially fund the acquisition as part of the exercise of portability. Such innovation potentially offers buyers an oven-ready financing solution in the context of a competitive auction. However, in Europe, this would need to be considered on a case-by-case basis to take into account financial assistance and other local law considerations.

1. Data published by Octus (formerly Reorg) in the European Leveraged Loans 2024 Half-Year Wrap, July 2024. Note that leveraged-based portability is less prevalent in the US high-yield bond markets to date. **2.** Data published by Octus (formerly Reorg) in the European Leveraged Loans 2024 Half-Year Wrap, July 2024. **3.** Data published by Octus (formerly Reorg) in EMEA Covenant Trends Alert, 4 November 2024.

What are the key discussion points?

As with the European high-yield bond market, private equity sponsors are unlikely to negotiate unconditional portability in their loans. The traditional lender argument is that the direction of management (and ultimate beneficial holder or "sponsor") is fundamental to their investment decision. Lenders believe they should be allowed to revisit that decision if the "management" or overall strategy changes. In contrast, portability is a pre-recognition/consent that, within certain parameters, their original investment decision stands.

When negotiating the inclusion of portability into loan documentation, the following factors must be considered, among others:

- **Timing:** Recent market trends suggest that lenders are concerned about both the **duration** of portability features and the **number** of times they can be exercised. In the first half of FY 2024, loans and most bonds that included a portability feature were limited to one-time use, with either a 24-month or 18-month time limit.[4] These conditions likely stem from balancing private equity sponsors' desire for maximum flexibility against lenders' risk management requirements and the practicalities involved in transferring debt arrangements. Notably, the length of time needed to conduct a sales process, coupled with the uncertainty of future market conditions and the intervening performance of the sale group, could impact the feasibility of transferring the debt financing arrangements of the sale group. Investors and lenders will view it from the other side, noting that their initial investment was not a blank cheque into the business. They believe a change of ownership should be considered holistically, based on the state of the business at that time (which may be quite different after one or more changes of control and/or several years).
- **Leverage ratio:** Compliance with a pro forma leverage ratio has crossed over from high-yield bond documentation into loan documentation featuring portability. As with financial covenants in general, key discussion points will involve the inputs used in the computation and the testing date(s). A private equity sponsor might argue that an improved leverage ratio (or, potentially, a "no worse" ratio) can address lenders' concerns about the continued viability of their investment. The level at which the leverage ratio test is set is also critical to this analysis, i.e., is it tighter than when the original investment was made or more lenient, providing flexibility down the road?
- **Ratings:** Credit ratings, especially in the corporate bond market, play a critical role in an investor's decision to invest (or not) in a credit. Rating downgrade triggers are a customary feature of bond portability in corporate transactions. The rationale behind this is that if a group, having gone through a change of control, retains its rating before the change of ownership, an investor should "pre-agree" to remain in the credit (or not require the change of control put option). Loans and loan borrowers are less likely to receive credit ratings in the market, so we expect this feature to be less prevalent in the loan market despite its pervasiveness in the bond market.
- **Purchaser identity:** The parties may also want to consider the potential benefits of agreeing on a pre-approved list of entities to which they could sell the borrowing group. From a sponsor's perspective, this minimises money-laundering/KYC risks, as lenders will have agreed upfront on acceptable potential buyers. From a lender's perspective, a pre-agreed list maintains a form of quality control over the ownership of the borrowing group, helping to mitigate the risk that the credit profile of the new sponsor and borrowing group (as a whole) will negatively change from that of the group/sponsor prior to the sale.

4. Data published by Reorg in the European Leveraged Loans 2024 Half-Year Wrap, July 2024.

The obvious drawback of including a pre-agreed list is that the sponsor must know the potential buyers, which, depending on the exit timeline, may not be possible at the time the portability feature is agreed upon. Where it is not possible to agree on a list of specific entities, the parties may instead agree on other characteristics or conditions that the buyer must satisfy. This approach aims to balance the private equity sponsors' ability to exercise the portability feature with the lenders' risk appetite. These requirements may include the purchaser having a minimum amount of assets under management and maintaining a minimum equity cushion. Due to the public nature of bonds and their terms, these features are generally not included in bond deals, as the lists would become public, potentially interfering with M&A strategies.

- **KYC and other compliance steps:** As with any transfer or accession related to credit documentation, important legal and compliance steps must be completed by the lenders and facility agent, such as "know your customer" checks. Private equity sponsors may be concerned about conditions outside their control, particularly those requiring the buyer to provide requested information and the time needed for the lenders' and facility agent's KYC processes to be completed. To mitigate these risks, they may include procurement provisions in the sale documentation, obliging the buyer to provide information reasonably needed to complete the finance parties' KYC checks. Likewise, the parties may include specific time-frames in the credit documentation within which the finance parties agree to complete the checks (particularly where there is a pre-agreed sponsor list), e.g., by expanding on the traditional lender replacement mechanics should KYC not be completed within the specific agreed time frames. Individual lenders may find that a change of control makes it illegal for them to remain in the syndicate. In those cases, typical loan documentation provides for these lenders to be prepaid. However, it is important for private equity sponsors to identify any such lenders ahead of time, as this would necessitate a (partial) prepayment, which portability aims to avoid.

- **Other conditions:** These may include the absence of a default or event of default and, in the case of loans, the completion of financial or legal due diligence.

- **Drafting considerations:** One of the benefits of including a portability feature is that it aims to "future-proof" the documentation, avoiding the need for further amendments before the sale. Careful consideration will need to be given to the consequential changes (outside of the portability feature itself) that may need to be made to the credit documentation, ensuring that if the portability feature is exercised, the documentation does not require further amendment. These include avoiding any inadvertent implication that the buyer is responsible for historic obligations under the credit documentation and ensuring that the seller does not remain liable under the credit documentation post-sale.

Conclusion

Portability has been a key feature in sponsor financing in the European bond market for the past decade, being a focus for both sponsors (looking to facilitate M&A and other exits) and investors (wanting to protect their investment). Although lenders have been slower to agree to its inclusion in European loans, we see this feature being increasingly requested in the market. We predict that, especially as M&A activity picks up, this will become an area of focus for borrowers and lenders in the loan market as well. Commercial discussions around timing, leverage/ratings triggers and other conditionality will be crucial for incorporating this feature into loans (where KYC, compliance and other change-of-party considerations may not apply to bond markets). While portability enhances flexibility for borrowers and existing shareholders, careful drafting is essential to ensure that the documentation can survive a change of control without requiring further waivers, consents or amendments upon exercise. As portability features become more mainstream, acquisitions or other exit-based transactions will be facilitated and costs will be reduced, since the financing will remain in place and will not need to be refinanced.

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