The rise of

"WHITE LISTS" IN EUROPEAN LEVERAGED FINANCE

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by Roger Lawrence
Head of Legal (Special Situations and Liquid Credit) at Alcentra

As distressed debt markets grew in the wake of the GFC private equity sponsors became increasingly focussed on protecting their investments against so called "loan-to-own" investors, who would use a company's debt as a means to acquire its business.

In the US, sponsors responded to this threat by seeking to bar certain institutions from joining the lending syndicate who they would name on a "Disqualified Lender" list.

In Europe, where leveraged finance markets are significantly smaller, sponsors have sought to control entry by stating from the outset which institutions can become a lender. This regulation is achieved by admission to the "White List". A recent study found that 92% of European leveraged loans incorporate the use of a White List.[1]

Who makes it onto the White List?

All major investment banks along with all established European CLO managers would ordinarily expect to be invited to participate in every new leveraged financing, and so it is common for them to be included on any White List.

That said, their inclusion does not necessarily guarantee full access across their institution.

Some White Lists will stipulate that a lender may not transfer its holdings to any affiliate, if that affiliate is itself a "Loan-to-Own Investor" (being an investor whose primary purpose of its business is investing in distressed debt with a view to owning the equity or gaining control of a business).

The intent of this restriction is ostensibly to prevent CLO managers that have a distressed debt business from building positions in a borrower's debt via this investment strategy. The matter is further complicated by the fact that, in today's market, such managers themselves (the most natural buyers of discounted or non-performing debt) engage in a host of strategies of which loan-to-own may only be a small part. To that end, some may argue (successfully) that this restriction therefore ought not to apply to them.

By contrast, any investment manager which is not regularly engaged in the primary financing of European leveraged buyouts is at risk of not making it onto the White List.

In reality, admission is ultimately governed by manager reputation and the strength of their relationship with the private equity sponsors that typically back most European leveraged finance issuers.

What impact do White Lists have?

The chief aim of sponsors is to protect their investments against unsolicited or unwanted interest. Sponsors agree that this makes good business sense but this approach has potentially significant downsides for borrowers (as explained further below) as well as lenders.

The key issue for CLOs and other par lenders is the inability to trade out at a time when the financial condition of the borrower becomes stressed and/or when prices decline.

As loans suffer credit ratings downgrades and their price drops below 80 cents on the dollar, the pool of (non-distressed) buyers diminishes due to the typical inability of managers to add CCC-rated risk. In that situation an incumbent lender may prefer to exit the position and take a loss if the likely alternative would involve having to provide fresh capital or negotiate a restructuring.

But, unless the sponsor is willing to lift the restriction, there may be little option but to remain in the syndicate or accept a steeply discounted bid (as witnessed in the case of GenesisCare, see separate box below).

CLOs are rarely willing or natural owners of overindebted or underperforming businesses, and, knowing this, a sponsor has greater leverage to negotiate restructuring terms which are more favourable for them. For example a final deal may involve the sponsor writing a smaller equity cheque and making fewer concessions to lenders as to how it operates the business.

This opens up an opportunity for those experienced investors who can access a syndicate (because they are included on the White List or can leverage a relationship with the sponsor) to propose alternative solutions and exert a greater influence over any restructuring transaction.

1 Source: Reorg Research Sep 2022 "Borrowers' Grasp on European Leveraged Loans Transfer Provisions Make Lender Exits Difficult - Part 1".

Are there any workarounds?

Aside from obtaining the consent of the borrower, non-White List parties have limited options at their disposal:

Sub-participation agreements and **total return swaps** entered into with White List lenders offer a route to gaining an economic exposure, but the drawback is that the lack of a direct contractual relationship often denies the investor a voice in any restructuring discussions.[1]

Following a **payment default** White List restrictions are usually suspended, though in most cases this often signals either a failed restructuring process or occurs to serve as the trigger for a pre-negotiated deal to be implemented. Either way, for potential new entrants, it often comes too late to be of much value.

The borrower will usually be **deemed** to have provided its **consent** to a transfer within a prescribed time frame (1 or 2 weeks under the terms of most syndicated credit agreements). Borrowers may sometimes be subject to a requirement not to withhold consent "unreasonably".

Will there be a shift away from White Lists?

Recent experiences have sparked debate around the market about whether it is time to reconsider White Lists. That said, sponsors continue to seek them in new financings and the primary syndication market continues to adopt an accommodative stance. Despite the pitfalls of White Lists in the event of issuer underperformance, many leveraged loan investors seem willing to tolerate them, especially since they continue to safeguard their preferential access to primary deal flow. We therefore expect the White List regime to continue in Europe for the foreseeable future.

GenesisCare

GenesisCare, a global healthcare provider specialising in oncology care, suffered from falling revenues and deteriorating liquidity as a result of ambitious expansion plans and disruption caused by the COVID pandemic. In response, the company initiated a turn-around strategy with the aim of deleveraging the business and also secured an equity injection in October 2022 from one of its co-sponsors which, together, was hoped would allay concerns regarding financial underperformance. However, the decline continued and the group's loans (largely held by European CLOs), which had started the year trading in the secondary market in the 90s, went on a rapid downwards trajectory plummeting to the 30s by the autumn. Despite a number of distressed investors expressing an interest in joining the syndicate and providing fresh capital, a White List was kept firmly in place. A downgrade to CCC swiftly followed as the group continued to consume its cash reserves and default loomed.

Subsequently, the sponsors lifted the trading restriction in order to facilitate the implementation of a restructuring of the group. The result was an immediate 10-point bounce in the price (which by May 2023 had drifted down to the mid-teens) into the high 20s as replacement lenders agreed to inject new liquidity and provide their support for a recapitalisation which was carried out under Chapter 11 in the Texas bankruptcy court.

1 Sponsors are also very alert to the possibility of outside influences and may therefore seek to limit the right of sub-participants to "elevate" themselves to lender of record status or otherwise prohibit sub-participation entirely.

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New York

9 West 57th Street
Suite 4920
New York
NY 10019
USA

New York

1345 Avenue of the Americas
Suite 32A
New York
NY 10105
USA

London

Cannon Place
78 Cannon Street
London
EC4N 6HL
UK

Boston

399 Boylston Street
Suite 901
Boston
MA 02116
USA

West Palm Beach

360 South Rosemary Avenue
Suite 1510
West Palm Beach
FL 33401
USA