LME Predictions and Strategies

Lenders and companies have increasingly turned to Liability Management Exercises (LMEs) to extend companies' liquidity runways. Healthy economic conditions (which are now being put in question by the potential changes to international trade flows and concerns about an impending recession) and the current stage in the credit cycle—characterized by high rates and loose credit documents—have both contributed to this trend. A few years ago, most sponsors would have avoided LME transactions altogether. Today, even the most conservative sponsors are considering these transactions as part of their playbooks for managing stressed balance sheets.

LMEs seem to be here to stay. An economic recession might reduce lenders' willingness to underwrite these deals or make a liquidity shortfall too large for LMEs to be effective. Even in such a hypothetical, both participating lenders and companies retain strong incentives to implement LME solutions. Although the Fifth Circuit's recent decision on Serta makes certain forms of LMEs slightly more difficult to enact, workarounds are already helping to effectuate these transactions.

One remaining uncertainty is how the LME wave will affect private credit capital structures. Tighter debt documents and small lender groups have made LMEs less prevalent, as runway extensions can be negotiated between a smaller set of parties. This may change as the private credit market increasingly resembles the broadly syndicated loan (BSL) market, with larger syndicates and looser documents.

Lincoln's restructuring team has deep experience advising both sponsors and ad hoc creditor groups in stressed situations, and our restructuring bankers are able to leverage Lincoln's Mergers & Acquisitions (M&A) Group's unparalleled industry expertise in each transaction. Companies, sponsors or creditors facing a stressed situation that may require creative solutions, including liability management transactions, can benefit from Lincoln's full spectrum of advisory services.

LMEs are Here to Stay

The market environment has undoubtedly been conducive to LME transactions. Loose debt documents give companies significant flexibility across areas such as Restricted Payment and Permitted Investment capacity, the use of non-guarantor and unrestricted subsidiaries, definitions of EBITDA and even pro-rata provisions—previously considered "sacred rights"—, enabling aggressive strategies that involve priming structures. Given high interest rates and expectations of future improvements in the company's operations or macroeconomic outlook, sponsors have been incentivized to extend companies' runway. Additionally, for existing creditors, the abundant capital available to companies in financial stress, in combination with loose documents, creates the risk of a "deal away" if they refuse to cooperate with sponsors.

It remains to be seen whether the current fears of an economic recession will affect the surge of LMEs. Lenders might find it more challenging to underwrite these transactions in "falling knife" situations, where cash needs will likely be greater and the bridge to operational improvements may be less clear. Technical dynamics, such as CLOs' limited access to certain buckets, might make it harder for them to hold distressed situations through an LME. This could shift investments into the hands of traditional distressed investors, who may seek to gain control of the business through debt-for-equity swaps.

Notwithstanding recession fears, LMEs are here to stay, given their benefits for sponsors and participating lenders, even in different economic conditions.

De-Stigmatizing LME Among Sponsors

The stigma surrounding LMEs has gradually faded away. **LMEs have become a standard part of most sponsors' playbooks, and sponsors who would never have engaged in an LME transaction as recently as two years ago are now exploring—and utilizing—them as a strategic alternative.** In certain situations, boards and even limited partners are asking whether it is a company's fiduciary duty to consider LME transactions as a way to extend its runway.

Sponsors' increasing receptiveness to LMEs has come with a general shift away from more aggressive LME transactions, such as severe non-pro rata or non-consensual deals; however, this does not mean aggressive transactions will disappear entirely. It is reasonable to think the market would penalize sponsors who are "repeat offenders" with more aggressive structures. The credit markets are currently so competitive, however, that funds cannot afford to be overly selective about the sponsors they transact with. Nonetheless, the trend towards more consensual LME transactions will likely continue.

Not All Roads Lead to Serta

On December 31, 2024, the U.S. Court of Appeals for the Fifth Circuit issued its decision on Serta, ruling that the company's debt exchange did not qualify as an open market purchase. On the same day, the New York Supreme Court's First Appellate Division issued a separate decision ratifying an uptier transaction effectuated by Mitel Networks. The key difference between the two cases: Mitel's debt documents did not include an "open market purchase" qualifier in the non-pro rata purchase carve-out.

Mitel's case is one of many examples where debt document language provided an avenue for the implementation of an uptier transaction. More debt documents are expressly permitting privately negotiated transactions, and even among those that do not, it is sometimes possible to amend assignment provisions with a majority of lenders to include language necessary to effectuate an uptier.

While the Fifth Circuit's decision on Serta may have made it more challenging to utilize the open market provision to execute uptiers, workarounds will likely continue to be used to enable these transactions.

LME in Private Credit

The absence of LMEs in the private credit market is unsurprising to industry participants. Private credit documents are significantly more restrictive than BSLs in terms of the loose provisions that allow LMEs. Equally important, lender groups in private credit are not only small, but comprised of lenders who maintain close relationships with sponsors in each credit and with one another. These relationships often deter lenders from taking adverse actions against others in the group. As a result, negotiations to "kick the can down the road" can often be completed without resorting to aggressive transactions.

In private credit markets, runway extensions have typically been effectuated via amend-and-extend transactions. These transactions often involve some form of sponsor equity injection; 26% of all amendments tracked by Lincoln's Valuations & Opinions Group have included a sponsor infusion. Combined with fees and rate increases (often in payment-in-kind, or PIK, form), sponsors have successfully extended runways and bought additional time without turning to complex LME transactions.

Pluralsight's drop-down transaction in June 2024 stood out as a deviation from the norm in the private credit market. It reportedly sought to extend the company's runway via a dropdown transaction of intellectual property (IP) without lender consent. However, even in this case, the transferred IP remained within the restricted group, and the transaction was unilaterally orchestrated and implemented by the sponsor and company. It avoided reliance on non-pro rata provisions or creditor group agreements for execution.

The private credit market is evolving, however. **According to Pitchbook, the percentage of issued private credit deals with five or more lenders grew from 0.5% in 2014 to 7.5% in 2024.** This proliferation of larger syndicate groups within private credit deals, combined with reports of funds relaxing some lender protections (e.g., J. Crew blockers) due to private credit's increasingly competitive nature, suggests LME transactions may become more of a presence in the private credit space in the future.

Lincoln's LME Playbook

Lincoln's team of dedicated restructuring bankers has deep experience advising sponsors and ad hoc creditor groups in stressed situations. In addition to specific restructuring expertise, Lincoln's full suite of services is leveraged for each transaction. Lincoln's Valuations & Opinions Group offers proprietary knowledge of most middle market, sponsor-owned companies, and our M&A industry groups provide unparalleled sector expertise, all of which is invaluable when structuring liability management transactions.

Companies, sponsors or creditors managing a stressed balance sheet can discuss potential creative solutions with Lincoln's bankers today.

Ready to discuss the opportunities ahead for you?
Connect with a senior professional at connect@lincolninternational.com