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Credit Crunch One Year On: Key Changes to Loan Documents

Background

The last year has seen a period of unparalleled volatility in the financial markets. Across the globe the deep and liquid pool of lenders competing vigorously for deals that typified the market prior to summer 2007 has been replaced with one in which financial institutions are much more reluctant to lend. Where banks will lend they do so on terms which are much less borrower/sponsor friendly than a year ago.

This briefing note explains some of the key changes in loan documents which have taken place in the global financial markets. It outlines some areas where we think borrowers, sponsors and lenders are likely to focus their negotiating efforts in this new credit environment.

Pricing

Interest, fees and flex

As the perception of risk in the global credit markets has changed there has been an increase in pricing. Lenders want broader flex rights allowing them to change not just the interest rate on a loan but the fundamental structure of the facilities to be provided and, of course, the level and type of fees payable. Borrowers and sponsors, in the quest for certainty, will want to nail down elements of the financing package such as the amount and tranching of facilities and will be nervous unless parameters for all aspects of the exercise of these flex rights can be agreed. Reverse flex where arrangers are obliged to reduce the costs of the borrowing now comes at a price for borrowers and sponsors by way of enhancement fees. Arrangers are less ready to commit in this regard. "Pay If You Can" and "Payment in Kind" deals are less common. Warrants for the mezzanine are making a come-back in certain markets.

Market Disruption

Market disruption clauses are being looked at by lenders whose cost of funds have risen as the interbank market has all but frozen. These clauses allow lenders in certain circumstances to substitute for the LIBOR element of the interest calculation

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the actual cost to them of the funding. When and how these types of clause apply is becoming a key issue for all market participants. Lenders are anticipating a cost of funds higher than LIBOR and trying to introduce as an alternative to LIBOR a reference bank rate if higher.

Regulatory costs

Other aspects of the pricing of loans are now less clear cut than one year ago. As bank regulators around the world gear up for fundamental changes to the way in which lenders use their capital mandatory costs may become more of a live issue. Lenders will think hard before they let borrowers off the hook for any increased regulatory costs.

Structure and documents

Simpler structures

The trend now is towards fully documenting deals at an early stage. Funding on the basis of term sheets is uncommon. Interim loan agreements if used at all will be of shorter duration - 30 days or less. Deals are simpler now than a year ago as lenders seek certainty and more traditional senior/mezzanine structures. There will almost always be an amortising Facility A in deals. Lenders are likely to look upon requests by borrowers and sponsors for flexibility in redenominating the currency of loans with one eye on the ability to syndicate that type of debt.

Shorter availability

To avoid being caught by a market adjustment lenders will want shorter availability periods, which may prove problematic or unworkable in public to private transactions.

Less leverage more security

Lenders look at deals now knowing they may have to take and hold a greater portion of the debt because of the harsher conditions that prevail. That changes the dynamic of the negotiation with borrowers and sponsors. Needless to say where there is to be an equity element to funding the desire to reduce leverage levels dictates that the proportion of equity goes up. Lenders will require faster amortisation where the business plan permits and effectively channel money to prepayment if the ability to make acquisitions and investments is curtailed. Lenders also now seek security over operating assets not just the shares in operating companies. They want that security in place earlier than a year ago. Furthermore, guarantees are likely to be required from more group companies accounting for an increased proportion of group earnings as lenders try and reduce risk.

Vendor perspective

Vendors need to look not only at the legal quality of "committed financing" but also which banks form the arranging group. Lenders' obligations are several. If one falls over there will be a funding gap.

Syndication and debt transfer

Consents and consultation

Lenders are no longer willing to tie their hands to obtaining borrower consent to the identity of the syndicate members or transferees for the debt. An obligation to consult borrowers and sponsors on these issues may not provide all the protection borrowers and sponsors require from institutions seen as potentially hostile to their interests.

Debt buy back

Recently the Loan Market Association inserted language into its recommended form of leverage facility agreement to regulate borrower and sponsor debt buy back at a discount. Two mutually exclusive options are provided for in the document. One option prohibits buy backs altogether. The second option provides two processes to facilitate the debt buy back but strives to maintain equality of treatment between lenders willing to sell. The technical uncertainties surrounding borrower debt buy back are largely solved by these new provisions. It remains to be seen how heavily the new terms will be negotiated by borrowers and sponsors. In particular will borrowers and sponsors agree to be disenfranchised on important votes taken by lenders? Will they agree to the prohibitions on the provision of information to borrower and sponsor affiliates that are contained in the document? Will they agree to the pro rata principle? Why should they be prohibited from negotiating to purchase debt at a discount with a particular lender; who might accept a lower price if being fully taken out.

The covenant package

General covenants

Tighter covenant control is likely over borrower and sponsor execution of the business plan. There will be more limited freedom to make additional acquisitions or otherwise change the original business model. Committed further acquisition facilities will be smaller. Uncommitted acquisition facilities may disappear or become prohibitively expensive if any enhanced economics that apply to them have to be applied to committed acquisition facilities too. Reinvestment of proceeds in the business will be subject to more control. In some instances proceeds may have to be parked in a blocked account rather than used in the business pending reinvestment. There is a fine balance to be achieved in constructing these controls in jurisdictions where lender liability is an issue such as in the United States. Lenders want more information earlier in deals and grace periods for the production of accounting information are likely to be much shorter than a year ago. "*Yank the bank*" clauses are less likely to be agreed at least without increasing the thresholds attached to them. Borrowers may be forced to replace any bank that is "yanked" rather than simply pay it off. "*Snooze you lose*" may become more popular as agents realise that they need a quick response from syndicates.

Financial covenants

Covenant-lite deals are unlikely to reappear in the foreseeable future. Lenders are looking for more traditional financial covenant packages. Flexibility in connection with financial covenants are down from the heady days of headroom of 30% seen last year. Synergies from acquisitions that are supposed to add to EBITDA are likely to be looked at more sceptically and may not be capable of immediate use by borrowers and sponsors to increase earnings. Negotiating carry forward and carry back of capex - always tough - is likely to get tougher as is the discussion over how flexible borrowers and sponsors can be in using “equity cure” clauses that allow breaches of financial covenants to be remedied by a fresh injection of shareholder funds. Deemed cures or “mulligans” are less readily available to help borrowers where there have been breaches of covenants.

Borrowers, sponsors and lenders have some interesting times ahead.

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