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In The Know

Leveraged Finance Newsletter

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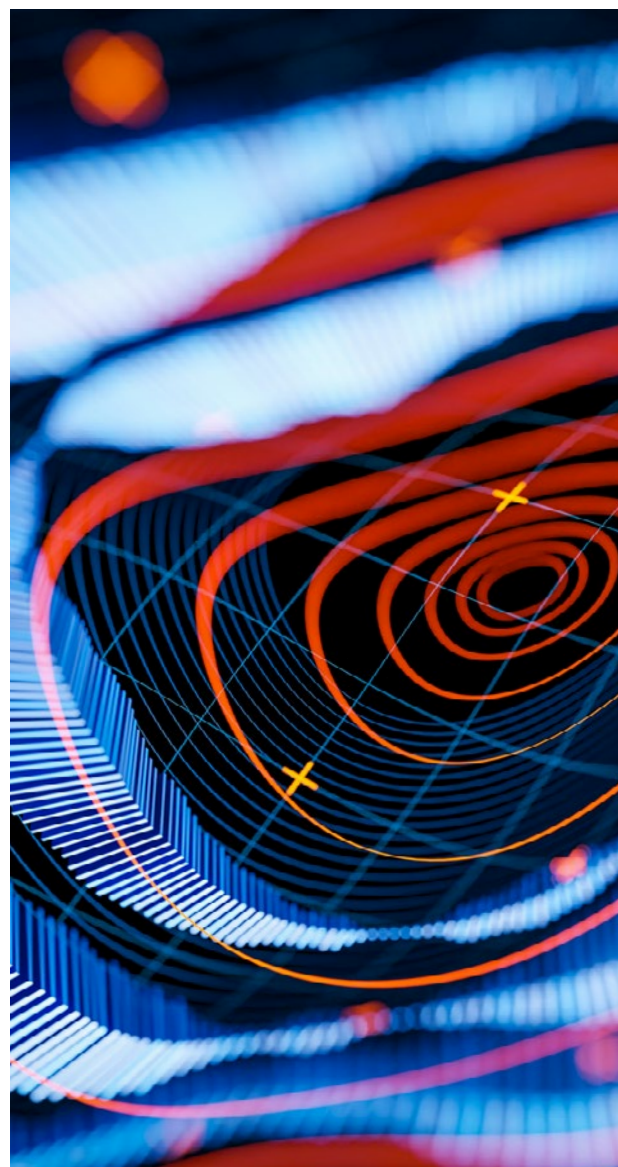
Debt financing UK P2Ps in a challenging market



Whilst M&A activity has generally been subdued over the last 12 months or so, there has been a steady and perhaps increasing number of acquisitions of UK public companies with a view to take them private (UK public to private or "UK P2Ps"). This has been driven in part by the favourable US dollar to GB pound exchange rate, and in part by flat valuations in certain sectors.

Corporates and sponsors looking to debt finance those acquisitions have faced the same challenges as issuers for private M&A, in particular the higher cost of capital and more cautious underwriters not wanting or willing to take lengthy balance sheet risk in committed financing. Nevertheless, a number of UK P2Ps have been debt financed in recent months, taking a variety of different approaches to find financing solutions.

UK P2P financed in US dollars

Overseas corporates, particularly those based in North America, have been able to access US dollar denominated financing from their relationship banks. Whilst this creates a currency mismatch for the acquisition of UK companies in sterling, this is overcome for "certain funds" purposes either with the use of hedging or (perhaps more cost effectively) by having an excess of US dollar commitments such that a possible "buffer" or "headroom" amount of commitments are

created (typically two standard deviations, or in the region of 15%-25%), in case of a depreciation of the US dollar against sterling. With the buffer/headroom approach, if the exchange rate were to move significantly in the wrong direction, the bidder would be required to "top up" the financing amounts (either through additional equity or debt financing acceptable to the financial adviser providing the cash confirmation).

Certain funds – drawstops and syndication

Additional challenges for lenders outside the UK include less familiarity in ensuring that their finance documentation (recent examples the Baker McKenzie team have been involved with include finance documents governed by New York, Canadian and French law) is compliant for UK "certain funds" purposes, and in understanding how UK Takeover Code rules affect the way that they are able to syndicate the debt. Effectively, "certain funds" financing in the UK is driven by a combination of the UK Takeover Code rules, as well as highly evolved market practice it requires the bidder to be "good for the money" prior to the announcement of a firm intention to make an offer, with extremely limited and customary condition precedents (or CPs) to receiving the money. Likewise, there can only be extremely limited "drawstops".[1]

Syndication during the "certain funds" period is generally also limited to ensure the sanctity of the financing and to ensure compliance with Takeover Code rules, as well as due to concerns around the sharing of inside information. The risk here is that a large syndicate of smaller or less credit worthy lenders may put the certainty of the financing at risk (in the event that one or more lenders were not to fund when asked/required to do so). With recent market volatility, market participants have been especially focused on this.

A challenging but striving UK P2P market

For borrowers accessing the UK markets, options may have felt limited in recent times. A number of banks have been constrained in their appetite given an overhang of unsyndicated commitments on their books from deals underwritten last year. Both the headline interest rates and the discount at which new debt needs to be priced at to compete with secondary trading levels will have given borrowers more than just pause for thought. In some cases, banks have been willing to provide short-term bridge financing. Private credit funds have also been able to provide unitranche financing although the pricing is now naturally considerably higher than historic levels.

For a bidder that is a sponsor portfolio company or corporate borrower with a loan agreement already in place with lenders, one option we have recently utilised is making use of the incremental/additional facility mechanism (an uncommitted facility within a loan agreement that allows an existing or new lender(s) to provide further debt finance under the terms of the existing loan agreement). The establishment of such incremental facilities typically does not require the consent of existing lenders under the loan agreement (as long as the borrower has the necessary debt capacity under the loan agreement), only the willingness of the lender(s) providing the new financing. It typically also does not require an amendment to the loan agreement, just the delivery by the borrower of a notice of establishment of the new facility, setting out the specific terms of the new facility. Whilst incremental facilities are fairly commonly used for financing private M&A, it is much less common to see them used for public M&A, particularly in the UK.

1 A drawstop in a loan or financing agreement is an event that gives the lender the right to refuse to fund the facility. These include limited events (other than failure to deliver CPs) such as illegality or events of default. For the facility to be "certain funds" compliant, these must be extremely narrowly tailored.

This is because of the additional parameters that are needed to ensure that the financing is on satisfactory "certain funds" terms and the inclusion of additional protections for the lenders in respect of a public offer or scheme of arrangement to give effect to the acquisition. However, with careful drafting and consideration of the issues, these could be accommodated in the incremental facility documentation.

In certain scenarios, the financing also takes different forms (or a combination of these). Equity is often a large component (as lenders often prefer not to fully debt finance an acquisition) that is then levered up using one or more debt facilities. These debt facilities can be longer-term financing arrangements (intended to be left in place after the acquisition) or shorter-term (bridge-style) financing arrangements that are intended to be refinanced or repaid in full shortly after completion of the acquisitions. These bridges may be in the form of a bridge to target cash (if the target group has a significant amount of cash on its balance sheet) or a bridge to a credit facility or bond issuance at the target level (if the target group has an existing but undrawn credit facility that may be drawn upon post-acquisition).

Each case may allow for a post-completion upstream of funds from the target group to the bidder (by way of dividend or loan) to repay amounts drawn under the acquisition facility. Careful tailoring of the transaction structure not only from a tax but also local law (financial assistance, etc.) perspective is critical in these situations, especially in cross-border transactions involvin several jurisdictions.

Conclusion

Although markets have been challenging in the realm of private and public M&A in the past year due to geopolitical unrest in the world and inflationary/interest rate pressure, opportunistic M&A activity continues to take place (despite being at lower levels than the historic highs observed during 2021). With higher interest rate leading to sometimes prohibitively high cost of funds, bidders and sponsors have had to come up with creative solution-based structuring approaches to finance their deals. More so in UK P2P than ever, careful structuring and consideration needs to be given to the deal structure and financing documentation to ensure best execution.

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