Baker McKenzie.

# IN THE KNOW

Leveraged Finance Newsletter

By Matthew Smith, Nick O'Grady, Robert Adam and Joe Denyer of Baker McKenzie London

November 2019

## CONSIDERATIONS FOR PRIVATE DEBT FUNDS ON PUBLIC TO PRIVATE TRANSACTIONS

While European M&A activity has so far tracked lower this year compared to last (a 29.4% reduction in value against year-to-date 2018), figures for public to private transactions ("P2Ps") have been the exception. Recent market data has shown 25 P2Ps being completed so far in Europe this year, valued at a combined €33 billion, which amounts to the highest ratio of public deals by value and volume in Europe since the financial crisis.

Private Equity ("PE") houses have been at the forefront of this trend as they have looked to deploy resources in public markets rather than more typical secondary and tertiary private acquisitions. There is an economic logic behind this: with European public companies now increasingly trading at lower valuations relative to the private multiples, P2Ps are now being seen as offering value - even taking into account the additional cost and complexity of a public bid versus an auction.

While debt financing packages backing P2Ps have traditionally been the preserve of investment banks and the syndicated debt market, private debt funds are now becoming a viable alternative to a bank underwrite in PE backed bids; across private and public deals, direct lenders were the debt provider of choice for close to half of all European PE backed buy-outs last year. This is no coincidence; the

increasingly mature private debt market offers sponsors access to higher leverage than is available in the syndicated loan market, and potentially, a single lender process. Although this can come at a cost vs. the syndicated bank market (both from a pricing and a documentary perspective) it seems this is a price sponsors are willing to pay in order to increase their chances of securing a winning offer. And it's not just the loan market that is being squeezed. A select group of larger European debt funds have underwritten in excess of €1 billion over the last year, bringing private debt funds into direct competition with the high yield bond market.

As PE houses continue to look to the public markets for investment opportunities, we expect private debt funds to be increasingly involved in these transactions.

In this article, we look at key issues for consideration when financing P2Ps with private debt. This includes a particular focus on issues in the UK market and compliance with the UK Takeover Code (the "Code") (which applies to offers for not only UK registered companies listed in the UK but also some UK registered companies who are deemed to have their place of central management and control in the UK, e.g. unquoted public companies and private companies who have previously had quoted securities).

### 1. Managing the "Rule of 6"

A takeover of a quoted company is of course hugely price sensitive, and there are strict rules as to when an announcement is required, even where there has been no leak. In particular, an announcement is required where negotiations or discussions relating to a possible offer are about to be extended beyond a very restricted number of people. This is generally interpreted by the UK Takeover Panel (the "Panel") as six parties and is known in the market as "the Rule of 6". Parties falling within this will include potential providers of equity and debt finance, shareholders in the bidder or target, pension fund trustees, potential management team candidates and other third parties, but not those who need to know within the bidder and target nor their immediate advisers. Early consultation with the Panel is needed and there can be

scope for the six to become a "rolling 6" over time, e.g. if one debt provider is approached and is not interested, in time (allowing the Panel to get comfortable there has not been a leak) the Panel may allow them to fall out of the six and be replaced by an alternative potential debt provider.

Historically, PE sponsors using underwritten bank debt to fund their transactions need not use up more than one or two spots of their six on their debt provider(s). However, with the number of private debt providers increasing exponentially over the past decade, the field compared to the syndicated market is much wider (into the hundreds) and more diverse. As a result, sponsors have been taking great care when choosing which funds to use up one of their six on. Key focuses include fund size, track record and being able to provide certainty around terms early in the process (to avoid the issue of terms / quantum being subsequently pared back / reduced during late stage credit committee decisions) and funding mechanics (see below).

It is also worth noting that private debt deals generally require the appointment of independent third party facility agents and security agents, and this should also be factored in when sponsors are considering who to bring in the tent and when.

## 2. Cash confirmation and certain funds

As many PE sponsors will be aware, the Code requires that for any bid (whether made by takeover offer or scheme of arrangement) that is made wholly or partly for cash, a "cash confirmation" is required to be provided by the bidder's financial advisor confirming that resources are available to the offeror sufficient to satisfy full acceptance of the offer. This principle operates so that, if the offer is subsequently declared unconditional or the scheme declared effective, the shareholders can be near certain that they will receive their consideration. In giving this confirmation, the financial advisor is required to act responsibly and take reasonable steps to assure itself that the cash is available. And it takes its role seriously - failure to discharge its obligations here may result in the Panel requiring the financial advisor to make up any shortfall if the bidder does not have enough cash to pay for the shares. This cash confirmation exercise will focus on the source of the funds being used to finance the acquisition (i.e. the equity proceeds and, if the bid is to be partially debt financed, the debt package) and will ensure that conditionality is minimised and potential risks (e.g. currency / volatility) are mitigated.

*Structure*

On the equity side, the corporate structure of most PE sponsors dictates that they will rely on capital calls from their limited partners ("LPs") to satisfy the equity element of the cash offer. The financial advisor will therefore examine in detail the sponsor's investment and constitutional documentation as well as its investor base. This diligence is further supported by the provision of a "representation letter" in which the sponsor confirms to the financial advisor (broadly) that it will do everything required to ensure that the buyer receives the equity proceeds by the time it needs to in order pay the target's shareholders under the Code.

For the debt financing, the financial advisor and its legal counsel will need to be satisfied that the acquisition funding is provided on a "certain funds" basis for the period for which it is required under the Code (the "Certain Funds Period"). Historically, with bank funded transactions, the focus of this exercise has been primarily on the documentation itself; all conditions to the financing must be either satisfied or waived (subject to certain limited exceptions (for example, conditions within the control of the bidder or conditions relating to the target group)) and there must be a very limited set of circumstances in which the lender(s) cannot be obliged to fund.

In contrast, as private debt funds are generally structured in the same way as PE sponsors, and rely on capital calls from their LPs in order to fund their participations in loans, it is often necessary for a financial advisor to conduct a PE-style cash confirmation exercise on the fund(s) themselves. This can often come as an unwelcome surprise for the notoriously private lenders in question. Any diligence process here is likely to involve requests for constitutional and other corporate capacity documents (including limited partnership agreements, issuing documents and commitment / subscription agreements etc.) as well as details of their LPs and the signing of "representation letters". GPs will need to check whether there are any contractual restrictions on the disclosure of LP information in these circumstances and should look to obtain appropriate confidentiality undertakings from financial advisors before disclosing. That is, to the extent, that disclosure to the financial advisor itself is necessary at all - often disclosure can be limited to their lawyers only (who themselves are subject to professional obligations of confidentiality).

As discussed in more detail below, many private debt funds also lend through a number of different vehicles, meaning this diligence can be time consuming (and costly). It is therefore important for funds to be aware of what may be required of them here, ideally with appropriately redacted "cash confirmation packs" ready to go when requested.

*Funding timetable - Certain Funds Period*

During the Certain Funds Period, a lender's ability to cancel acquisition facility commitments or rely on a drawstop to funding will, for all intents and purposes, be suspended. In a P2P, the Certain Funds Period is typically at least six months (taking into account the maximum amount of time that is allowed under the Code for an offer or scheme to be completed plus some leeway) but may be longer.

From a pricing perspective, banks will generally charge a commitment fee (called a "ticking fee") during the Certain Funds Period to compensate it for having to reserve capital for this period of time, with the level of this ticking fee being determined by market precedent. In contrast, private debt funds can often be flexible in determining the level of / requirement for ticking fees. That being said, there can be additional complications for private debt funds who are looking at longer than usual Certain Funds Periods. In particular, a number of private debt funds lend via a large number of different vehicles and determining the allocation of commitments between vehicles can often be challenging even without having to factor in a Certain Funds Period of over six months. A delay in finalising which vehicles are in / out, and their respective allocations, can also have a significant impact on the cash confirmation/ diligence exercise outlined above, as swapping vehicles in / out will result in further diligence needing to be started and/or completed.

*Funding timetable - utilisation*

The Code requires that a bidder must pay the first amounts of cash consideration due to shareholders not more than 14 calendar days from the date that an offer is declared unconditional or scheme declared effective. As mentioned above, private debt funds typically rely on capital calls from their LPs to obtain funds and it is not unusual for a fund's capital call period to be in excess of 10 business days, so it is essential that consideration is given as early as possible as to whether there may be any issues hitting this deadline.

This is not necessarily straightforward; in particular, thought should be given to when the final financing condition precedent will be satisfied and utilisation request delivered. For example, the final CP is often receipt of the equity proceeds, which itself may take some time to draw down from investors, with sponsors often reluctant to call funds prior to knowing the scheme or offer is effective.

Debt funds will often offer to bridge any timing gap through the use of their own leverage / capital call facilities with a third party debt provider. However, such facilities are usually not themselves provided on a certain funds basis and therefore reliance on this facility to bridge a timing gap could undermine the cash confirmation.

We are increasingly seeing these matters being flushed out by debt advisors / lawyers at term sheet stage in an effort to avoid any last minute complications. As such, private debt funds considering P2Ps should discuss these issues with their advisors as soon as possible to ensure their standing in a competitive situation is not diminished as a result of execution risk when the time comes.

## 3. Disclosure of financing documents

The Code requires that copies of all documents relating to the financing of an offer are published on a website no later than noon on the business day following the publication of the bidder's announcement of a firm intention to make an offer and that they must remain available on the website until the end of the offer. This also includes any refinancing or supplementary financing agreement or an amendment to any of the existing finance documents.

This gives the market instant visibility into the terms on which the offer was underwritten and could undermine efforts to sell down participations in the facilities on less favourable terms. This problem is exacerbated in P2Ps where syndication typically happens later than for private company acquisitions (usually only once the bid has been declared unconditional or the scheme declared effective and the certain funds period has ended).

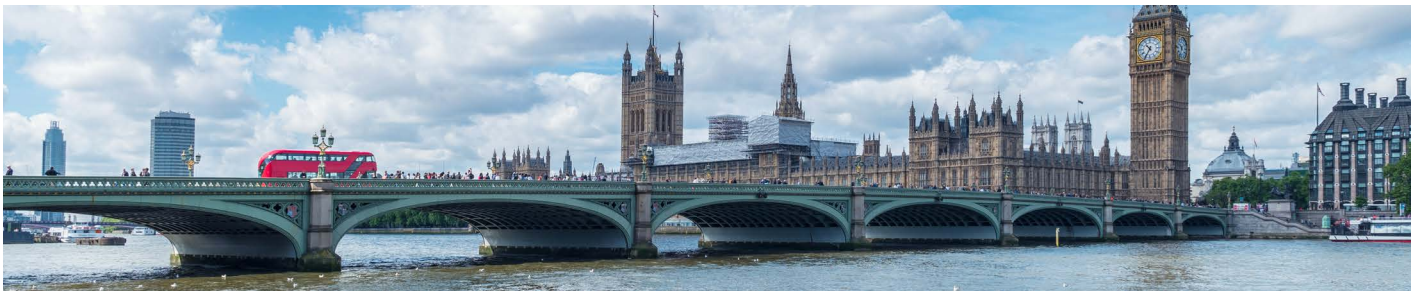
While lenders in the syndicated market may be familiar with this obligation, debt funds that have historically operated in the private sphere on a 'lend-and-hold' basis may find it more challenging to get comfortable with their terms being shared widely. Debt funds that become more active in the public market will need to be able to accept that the commercial terms of their financing which they may previously have seen as confidential and proprietary will be publicly available.

While the general rule is that any documents must be disclosed unredacted, underwriting funds can take some limited comfort from the Panel's previous decisions to allow (after consultation with them) certain commercially sensitive information including headroom extensions, equity structures (e.g. leverage within funds or information on LPs) and market flex terms to be omitted from the disclosed documents and kept in separate side letters that are not disclosed (at least for a limited period - for example market flex terms must be disclosed following publication of the offer document if syndication has not taken place by then).

## 4. Post-announcement revolving facility syndication

In contrast to bank-funded deals, private debt funds are generally unable to provide (or at least efficiently provide) undrawn revolving credit facilities or ancillary banking facilities. As such, fund transactions will more often than not require the appointment of a bank to step-in and provide these (usually on a super senior basis).

Generally speaking, there is often not enough time pre-announcement to bring both the private debt fund and the bank together and agree documentation, so we typically see the fund underwrite any required revolving facility commitments with the intention being to sell them down to a bank post-announcement. These transfers can give rise to additional legal work between the announcement and the effective date, particularly in relation to the documentation of agreed senior / super senior intercreditor terms (which generally vary from institution-to-institution / fund-to-fund). Any delays in syndication could result in a working capital shortfall / expensive working capital debt for the borrower or the target and so should become a priority once the announcement has been issued.



**TO SIGN UP TO RECEIVE OUR NEWSLETTER, PLEASE CLICK HERE**

**TRANSACTIONAL POWERHOUSE**

Leading and closing three deals a day

## CONTACTS


**Matthew Smith**
Partner | London
matthew.smith@bakermckenzie.com

**Nick O'Grady**
Partner | London
nick.ogrady@bakermckenzie.com

**Robert Adam**
Partner | London
robert.adam@bakermckenzie.com

**Joe Denyer**
Associate | London
joseph.denyer@bakermckenzie.com