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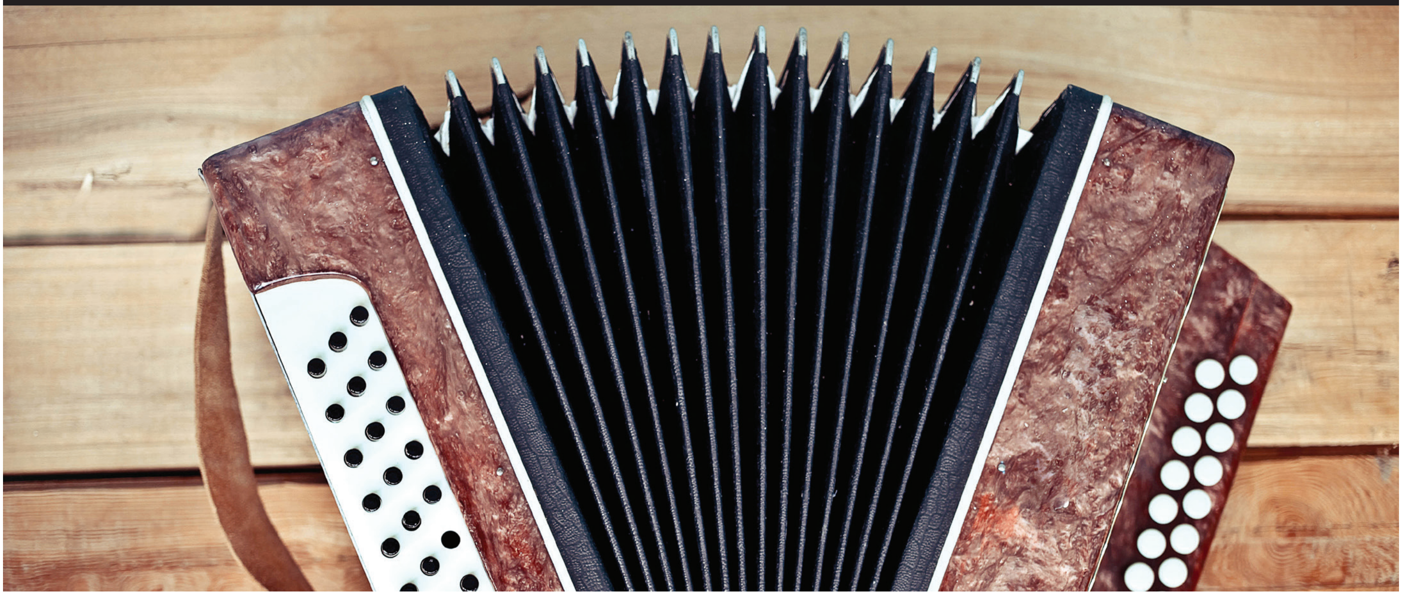

Latest in European Leveraged Finance – Incremental Facilities and MFN

Introduction

The basic principle behind an uncommited incremental facility is simple: the borrower can request that one or more of the existing facilities be increased (an 'accordion' feature), or that a new facility be provided under its existing loan agreement at any point in the future. Incremental facility clauses tend to be some of the most heavily negotiated provisions in a leveraged financing, as they determine how much leverage the borrower can add on the same collateral on which the initial lenders rely. The key negotiation points here are:

1. How big can the incremental facility be?
2. What controls do the lenders want to impose on the terms of any incremental facility (the so-called 'most-favoured-nation' provision)?
3. What other conditions must the borrower satisfy at the time of incurrence (e.g. certain funds)?

1. How big's your basket?

In a covenant lite deal the borrower is permitted to incur additional debt if, at the time of incurrence, its financial performance meets certain threshold levels. Typically the borrower has the option to choose whether to incur that additional debt under the existing loan document through an incremental facility, or under a separate document (a so-called 'sidecar' financing) which would, through the intercreditor agreement, rank pari passu with the existing facilities. There is often the flexibility to incur incremental debt on either a pari passu or junior basis (though note that the intercreditor agreement will need to be adapted to ensure this optionality tracks all of the way through the documents).

But how much can the borrower incur? There are a range of ways to limit the basket size. Often incremental facility baskets are split into two:

The 'free and clear' basket:

— This sets out the amount of incremental facility loans that may be borrowed without having to demonstrate pro forma compliance with a financial ratio.

— It will either be 'hard capped' at a set amount, or can be 'soft capped' as a percentage of EBITDA. A common formulation is for this basket to be the greater of (a) a fixed amount (which can be the equivalent of up to 1X EBITDA at closing) and (b) a set percentage of EBITDA (again, up to 100% for top tier sponsors but more often it is a lower proportion). Note that typically in calculating this amount EBITDA will be determined using the (usually) adjusted numbers, incorporating any negotiated addbacks and exclusions.

— The free and clear basket is usually the subject of adjustments, so that it will be increased by the amount of any voluntary prepayments or debt buybacks made by the borrower post-closing. The argument here is that this basket sets a limit on the additional debt the borrower may incur over and above what is outstanding at closing. If the borrower has paid down term loans after closing but before incurring an incremental facility, it should be entitled to add the amount prepaid to the free and clear basket, and by doing so it will not be making a net increase in the total amount of additional debt the lenders are prepared to allow. The same goes for amounts of the loans the borrower has bought back, as that has a similarly de-leveraging effect.

The ratio test:

— This allows the borrower to utilize incremental facilities in any amount in excess of the free and clear basket, provided that on a pro forma basis for the incurrence of that additional debt, the leverage ratio is below a certain fixed level. Sometimes the test is split, so that if the security for the incremental facility is pari passu with that of the existing facilities, the test is based on first-lien secured leverage, and if the security for the incremental facility to be incurred is junior to that of the existing facilities the test is based on total secured leverage.

— The leverage level is often set at the opening leverage level. If there is a springing financial covenant in the deal, other formulations are possible. For example the ratio test could be set at the lower of (a) opening leverage and (b) the covenanted level at the time the incremental facility is established, possibly with some headroom (i.e. it would be set at 90% of the covenanted level). In recent deals, where the accordion is to be used for an acquisition, a "no worse off" concept has often been included, which enables the borrower to incur the additional debt so long as its leverage ratio would not increase as a result (irrespective of how high its resulting leverage ratio is in absolute terms).

— The devil as always is in the details: one tricky aspect here is when a borrower seeks to combine availability under the free and clear basket with the ratio test: under a plain formulation of these provisions, any incurrence under the former would be picked up by the latter, such that the two buckets might not be additive in practice. Borrower-friendly formulations often make it clear that the ratio will be tested without taking into account any portion of the accordion that is simultaneously incurred under the free and clear basket.

2. Other points to look out for

Certain funds

— Frequently, an incremental facility will be used to fund an acquisition. If that acquisition is of a listed company, the financing will need to be on a certain funds basis from the time the offer is made until it is completed. Even if the acquisition is of a private company, bidders often require their lenders to make any acquisition financing available on a certain funds basis because there will not usually be a financing condition in the sale and purchase agreement.

— So it is critical to ensure that any conditions relating to the incurrence of an incremental facility are tested at the time the incremental facility is committed to, and not when it is drawn. Otherwise, the borrower could be faced with a situation where the amount of the proposed incremental facility does not cause a breach of the pro forma leverage test at the time the facility is committed to, but it would when the facility is drawn and the acquisition is closed. At best, that would require the borrower to use other funds to bridge the gap. At worst, it could mean that the borrower does not have enough funding available to it to complete the acquisition. To manage that risk the borrower would have to draw down the facility as soon as it is put in place, and pay the interest on those amounts until the acquisition is closed. In order to address this, so called "limited conditionality acquisition" provisions have often been included, which enable the borrower to test these conditions when the purchase agreement is signed (or the offer is launched); upon such election the transaction (and the related debt incurrence) is typically given pro-forma effect to for all other purposes under the credit agreement until it actually closes.

Who gets invited to the party?

— Sometimes the incremental facility clause will impose on the borrower the obligation to offer the existing lenders the opportunity to provide any future incremental facility in either an auction or an open offer process. In part this is because the lenders would like to be included in the opportunity to lend new money (and to earn a fee for doing so). But this can also be thought of as a pre-emption right – the introduction of an incremental facility would alter the balance of voting power in the lending syndicate. Lenders also have an interest in ensuring that they have the opportunity to avoid having their position in the syndicate diluted by the introduction of a large new facility.

3. Most-favoured-nation

If an incremental facility provision is included in a loan agreement, in most cases so will a 'most-favoured-nation' clause be. By allowing the borrower to incur additional pari passu debt under the same loan agreement, the lenders run the risk that the terms of that additional debt are richer than the original LBO financing. That will make the existing loans harder to sell in the secondary market, and cause the underwriters of the original deal a certain degree of professional embarrassment.

The solution for the lenders is to allow incremental facilities to be put in place only if certain key terms of the incremental facility fall within set parameters so as to prevent the incremental facility from being significantly more attractive to lenders than the existing facilities. Typically those parameters are:

Provision	Explanation
The 'yield' payable on the incremental facility cannot be more than the 'yield' on the existing facility by more than a certain buffer amount, typically 1%, but sometimes more. If the yield on the incremental facility is going to be more than that, the yield on the existing facility is automatically increased to the relevant level (being the yield on the incremental facility minus the buffer amount).	Yield is usually defined to include not just interest rate, but also up-front fees and original issue discount. The latter are converted into an annual interest rate using an assumed life to maturity of 3 or 4 years. Often the effect of any LIBOR or EURIBOR floors are also factored in. A more favourable formulation from the borrower's perspective would be to calculate MFN protection on the margin rather than the all-in yield, and is something that has been seen in the market in Q1 2018. Many European leveraged loans will have margin ratchets, and for the purposes of working out the MFN, the margin applicable to the TLB will be deemed to be the highest possible rate, regardless of the level that is actually being paid at the time the incremental facility is put in place.
The maturity date for the incremental facility cannot be earlier than a specified date, which will be either the maturity date for the existing facility or a date falling sometime after that (6 months is not uncommon)	If the incremental facility matures before the existing facility, it will effectively become senior to the existing facility and therefore more attractive to lenders in the secondary market.
There can be no amortization of the incremental facility (or, if there is amortization of the existing facilities, the weighted average life to maturity of the incremental facility must not be shorter than the existing facility).	This prevents the borrower from working around the restriction on final maturity by having the incremental facility subject to amortization.

Clearly the MFN clause imposes constraints on the borrower's ability to use its incremental facility basket, especially if market circumstances change during the life of the loan which would require a higher pricing for the new debt. Because of that, borrowers have typically insisted that the yield protection in the MFN clause fall away within a certain period (the 'sunset period') after closing. The theory behind this is that after the sunset period it would be unreasonable to require the borrower to raise incremental facilities at yields similar to the original deal, because the circumstances in the debt markets will have changed.

The length of sunset periods is the subject of negotiation, but they are usually in the range of 12 to 18 months. Recently they have shortened and 6 months is being seen more often.

4. Exclusions

The other way for borrowers to limit the effect of the MFN clause is to narrow the scope of its application, and to negotiate for certain exclusions. A standard market practice on this has not yet settled, but two trends can be observed:

— Borrowers are increasingly negotiating for the MFN clause to apply only to incremental facilities which are substantially similar to the initial term loan facility. So for example we have seen provisions that specify the MFN should not apply to incremental facilities which:

- are in a different currency from the existing loans;
- mature a certain amount of time after the final maturity of the existing loans (usually in the range of 12 to 24 months);
- do not rank pari passu with the existing loans.

Where a facility agreement allows incremental debt to be incurred under a sidecar arrangement or in the form of bonds, we regularly see the MFN limited only to incremental debt which is in the form of 'senior secured loans', on the basis that other types of financial product issued by the borrower will not compete with the existing loans in the secondary market. Some facility agreements go even further, and impose a requirement that any incremental senior secured loans be 'widely syndicated' for the MFN to apply.

— We have also seen a number of borrowers seek to exclude the application of the MFN clause altogether. This is a matter for negotiation, and can be used to allow the borrower to raise an incremental facility to finance a 'transformative acquisition' without having to comply with the MFN. Alternatively, a borrower might ask the lenders to allow it to incur a certain amount of incremental facility debt that matures earlier than the existing facility without having to comply with the MFN.

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DEAL CHECK LIST

Incremental facility

1. Can it be used to extend the existing facilities? ☐
2. Can it be used to introduce a new facility? ☐
3. Can it be incurred under sidecar arrangements? ☐
4. Does it allow pari and junior debt to be incurred (NB make sure the intercreditor allows this)? ☐
5. Can the incremental facility be used for acquisitions? ☐
   - If so, can it be committed on a certain funds basis? ☐
   - Is the ratio tested at the time the facility is established (not when it is drawn)? ☐
6. Is there a free-and-clear basket? ☐
   - Is it hard capped? ☐
   - Is it soft capped? ☐
   - Is it subject to adjustment through voluntary prepayments and debt buyback amounts? ☐
7. Is there a ratio test? ☐
   - At what level is the ratio set? How does that level compare to opening leverage? ☐
   - Is there a different test for junior incremental facilities? ☐
   - How does the ratio test combine with the free-and-clear basket? ☐
8. Is there a right of first refusal for the lenders to provide the incremental facility? Does that also apply to sidecar financings? ☐

MFN

9. Is the MFN calculated based on 'yield' or margin? ☐
10. What are the components of 'yield'? ☐
11. Is the MFN buffer set in the range of 0.5-1.5%? ☐
12. What is the sunset period? ☐
13. Are there any exceptions? ☐

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