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Incremental Facilities – The LMA Approach

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Incremental Facilities

Once the preserve of large cap deals and top tier sponsors, incremental facilities (which can otherwise be known as accordion or additional facilities) have become a permanent feature of the leveraged loan markets and are becoming increasingly common in the corporate loan space. In respect of leveraged loans, incremental facilities have become embedded to such a degree that of all the European deals tracked by DebtXplained in 2015, only 1 per cent did not contain an incremental facility. The frequency with which incremental facilities are being included within facilities agreements led to calls from some stakeholders for the Loan Market Association ("**LMA**") to include a set of optional incremental facility provisions (the "**LMA provisions**") in its recommended form of leveraged facilities agreement. Having now done so, here we briefly consider some aspects of incremental facilities and review a few key elements of the LMA's template language.

Incremental facilities exist to provide relatively quick access to liquidity by building in pre-approval of additional uncommitted term or revolving facilities without the need for lender consent, which can be utilised provided that the borrower group, and the incremental facility which is being established, are in compliance with certain pre-agreed parameters. Incremental facilities may be required for a specific purpose, such as for bolt-on acquisitions (essentially being uncommitted acquisition lines) or capital expenditure, or to cover general working capital requirements. The increased flexibility provided by incremental facilities has been particularly welcomed where borrowers have identified a growth or corporate strategy which requires future debt funding before the maturity of their primary facilities. For example, in the context of a fast moving and highly competitive M&A market where suitable potential targets have become more limited and bidders are expected to act increasingly quickly to submit their funds certain bids, having quick access to incremental debt without the need to go through a lengthy amendment and/or consent process with the existing lender group makes incremental facilities an attractive option for borrowers to negotiate up front.

The LMA provisions

The basic structure of the LMA provisions will be, in essence, familiar to many; broadly, the provisions begin by establishing the incremental facility lender group, proceed to detail the mechanical process of establishing the incremental facility, and then go on to set out the conditions and restrictions governing the incurrence of such incremental debt, before finishing with the boilerplate provisions concerning the implementation of the incremental facility on the relevant establishment date.

When looking at the LMA provisions in a bit more depth, some themes which are common to the majority of incremental facility clauses emerge, such as the inclusion of restrictions on maturity dates (which cannot be inside the maturity date for the equivalent existing facility) and amortisation profiles (incremental facilities should have bullet repayment profiles, unless the amortisation profile has a weighted average life of equal to or greater than the equivalent existing amortising facility), all of which broadly track the current market. Equally, however, in some cases the market has long since moved on. Below, we examine a few such provisions.

Creation of the incremental facility lender group / existing lenders' right of first refusal[1]

The LMA provisions offer two mutually exclusive options for establishing the identity of the incremental facility lender group:

- option one: the existing lender group has a right of first refusal in determining whether to participate in the incremental facility, subject to scaleback provisions in the event of an oversubscription and a wider invitation process in the event of an undersubscription; and
- option two, the borrower group is free to select its incremental facility lenders as it sees fit, subject to the inclusion of optional restrictions on members of the group and/or, in leveraged facilities, sponsor affiliates acting in this capacity.

In practice, of course, a borrower may well approach its existing lender group first when attempting to raise incremental debt, as its existing commercial relationships, and the lenders' familiarity with the credit, will aid negotiations as well as the speed of execution. However, this is largely a moot point as specifically requiring borrowers to seek incremental financing from their existing lender group prior to being permitted to go out to a wider market, and then only if sufficient debt can't be raised from the existing lenders, has become increasingly rare in recent years, given the potential impact that this process may have on the speed of both execution and commercial negotiations. Whilst this aspect of the LMA provisions may be of relevance to some borrowers in the corporate lending space, one suspects that the sponsor-led borrower market is unlikely to embrace it.

Restriction on quantum

The LMA provisions simply envisage a hard capped basket amount of incremental debt that can be incurred, perhaps owing to the inherent difficulty faced when attempting to draft language to cater for different methods of determining the basis on which incremental debt can be incurred. In practice, many incremental facility clauses now permit the borrower group to incur different tranches of debt subject to compliance with different tests. For instance, it is common for a borrower group to be able to incur:

- an unlimited amount of *pari passu* senior secured debt provided that, *pro forma* for the incurrence and application in full of any such debt, the group would be in compliance with a senior secured leverage ratio;
- an unlimited amount of junior secured or unsecured debt provided that the group would be in *pro forma* compliance with a total debt leverage ratio (in both cases, leverage is often determined on a net basis, with the leverage levels frequently being set at or slightly inside closing date levels) and/or, in some cases, a fixed charge cover ratio (which would typically be set at 2.00:1.00 and compliance with such a test may also be an additional condition to the incurrence of *pari passu* senior secured debt); and
- any kind of debt pursuant to a free-and-clear (or "freebie") basket, free of any leveraged based conditions.

The size of the freebie basket is a key commercial consideration and, whilst in the leveraged space top tier sponsors in particular will often push for it to be sized in an amount equivalent to a turn or more of EBITDA, the freebie basket amount is more likely to be in the region of a quarter to a half turn of EBITDA. Frequently, the freebie basket can be utilised after the group has reached its limits under the ratio debt tests described above. Given the extent to which strong borrowers are aggressively seeking to increase the debt-raising capability of the borrower group, in some cases this freebie basket may be subject to a grower element dependent on the level of EBITDA. In addition, sometimes the freebie basket may also be increased by taking account of certain add backs, such as amounts returned to the lender group pursuant to voluntary prepayments, debt buy backs, any repayment following the exercise of a "yank the bank" provision and/or any other commitment reductions of the existing senior debt made prior to the date of the incurrence of the relevant incremental facility. In addition, there is often an ability for the borrower group to be able to incur all or part of its incremental debt capacity outside the parameters of the facilities agreement as sidecar debt, and/or as refinancing debt, neither of which is contemplated by the LMA provisions.

[1] Such rights of first refusal may be banned if the FCA proposals in its October 2016 consultation paper, *"Investment and corporate banking: prohibition of restrictive contractual clauses"* (CP16/31) are brought into effect.

Whilst there is often push back by investors on the amount of incremental debt that can be incurred, particularly in relation to the size of the freebie basket and the ability to increase this basket by way of add-backs and grower elements, the general construct set out above will continue to be seen in the market and, as such, for those borrowers that seek to include this kind of flexibility, the LMA language will require negotiated amendment.

Yield cap / 'most favoured nations' provisions

It is common for incremental facility clauses to contain most favoured nations provisions ("**MFN**"), pursuant to which the pricing of incremental facilities is restricted from exceeding a prescribed level as compared against the relevant existing facility unless any additional pricing benefit is also given to the existing relevant facility to the extent that it exceeds such prescribed level. The primary purpose of an MFN is to protect the value of the initial debt in the secondary market and, given that such provisions act to protect the existing lenders and are prevalent in the market, it is perhaps unsurprising that the LMA provisions include limits on the pricing of any incremental facility. A few points stand out, however, when looking at the LMA provisions. Firstly, on a true construction, the LMA provisions do not contain an MFN provision at all, as there is simply a cap on the total yield that can attach to any incremental debt. Whilst this has the benefit of simplifying the LMA provisions, borrowers could find such a construct restrictive as it places specific caps on the pricing of any incremental debt, which may limit the ability of a borrower to raise incremental debt. Secondly, whilst the MFN is typically linked to yield rather than solely the margin (although it is not uncommon for the MFN to be linked just to the margin), a borrower is typically free to negotiate the make-up of that yield as it sees fit. The LMA provisions, by contrast, are very prescriptive in that they not only restrict the weighted average yield (which encompasses margin, all fees other than commitment fees, and primary syndication original issue discount) that can be generated by the incremental facility, but also separately seek to cap commitment fees and arrangement fees, something that no longer tends to feature in current incremental facility provisions. Finally, it is now increasingly common for any MFN provisions to include a sunset period of 6 to 24 months following which such pricing limitations will cease to apply, although this sunset may well be extended or removed during primary syndication, and increasingly for the MFN provisions to apply only to incremental term facilities raised in the same currency as the relevant existing facility. However, the LMA language does not cater for any of the aforementioned MFN conditions. In summary, therefore, whilst the LMA's pricing protection wording is not completely off-market, it may not reflect certain elements of current market practice and some optionality dealing with the points detailed above, particularly the possibility of including a sunset period and the ability of the borrower group to incur incremental debt priced above the yield cap, would have been welcomed.

Conclusion

It has to be remembered that, whilst the LMA suite of documentation could safely be described as representing the possible requirements of banking institutions, conversely, the LMA will not include purely market or potentially transaction specific provisions in its documentation. It is also worth noting that the LMA has adapted its recommended form of leveraged acquisition finance (senior / mezzanine) intercreditor agreement to incorporate some required revisions in the event that the relevant senior facilities agreement contains an incremental facility; such intercreditor amendments are certainly useful and, one suspects, will be utilised by the market in general.

Given the prevalence of incremental facilities in recent years, many sponsors and corporate borrowers that make use of incremental facilities (or at least negotiate the optionality of including incremental facility provisions within facilities agreements) will, subject to the agreement with the lender group of certain key commercial terms, have a preferred form of incremental facility provisions with which they are comfortable and, accordingly, which they use on the bulk of their loan financing transactions. Against this backdrop, whether or not the LMA wording will be taken up by the loan market in whole or in part remains to be seen as, whilst the incremental facility provisions which the LMA has included in its recommended form of leveraged facilities agreement do not attempt to cater for all potential relevant variables which can be seen in today's incremental facilities, they do form a useful starting point, particularly for a number of corporate borrowers and the small and mid-cap spaces.

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