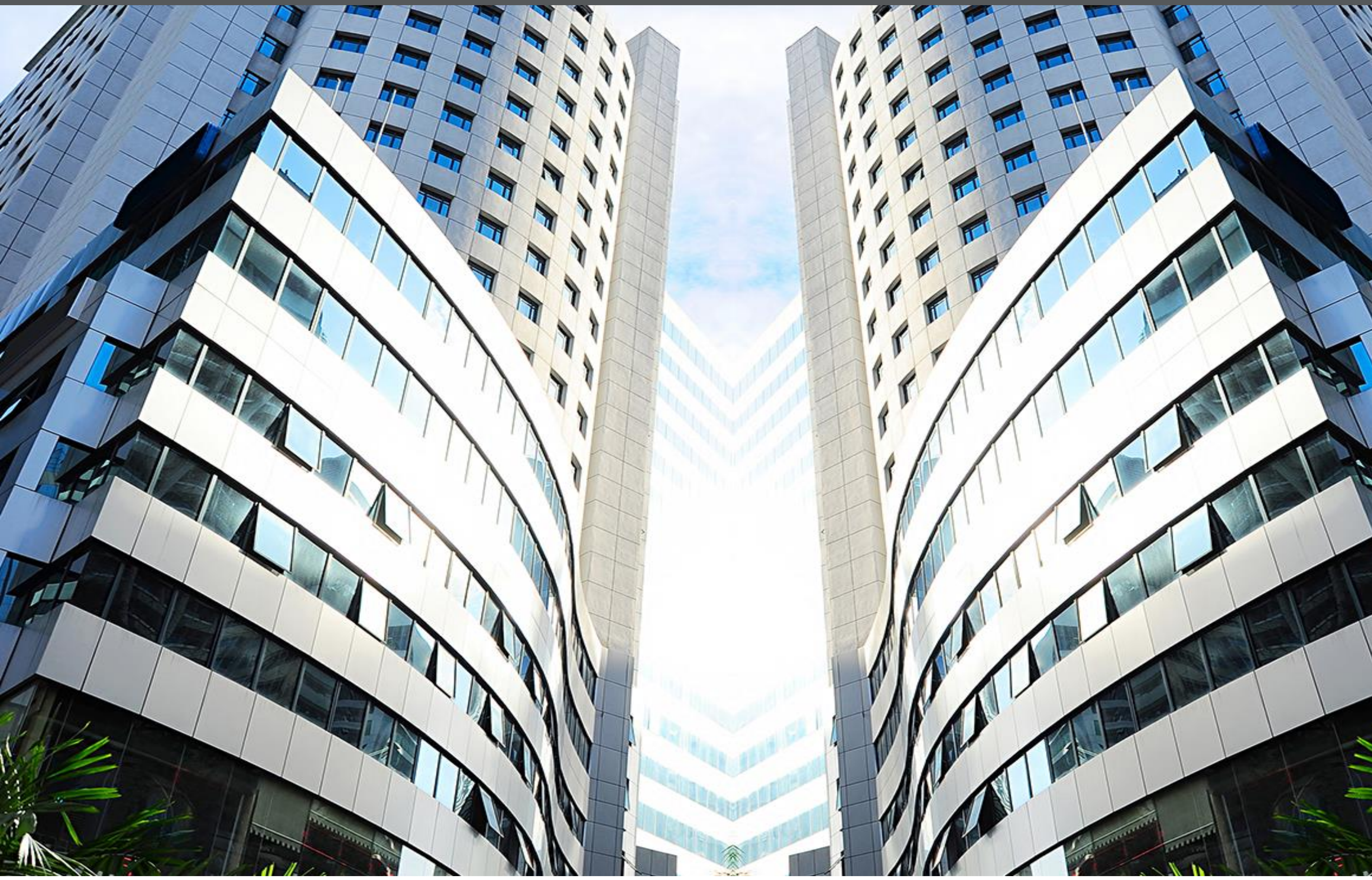
February 2017

CORPORATE BORROWER UPDATE



INTRODUCTION

Welcome to the February edition of the Addleshaw Goddard Corporate Borrower Update.

It has been a busy start to the year, with lots of activity in our corporate banking team.

We announced in Q4 of 2016 our combination with Scottish firm HBJ Gateley. This combination, which we anticipate will take effect in Q2 of 2017, will enable us to field a larger and more flexible team and provide a seamless service to clients and advisors on deals which involve a Scottish element. We also look forward to working much more closely with corporate borrowers headquartered in Scotland in the future.

The last 12 months have brought a number of major geopolitical events, notably the Brexit referendum in June 2016 and the US presidential election in November 2016. Both of those events served as a reminder of the impact which political events can have on the financial markets and, more broadly, the economy. With that in mind, we take a look at hedging strategies from page 1 onwards.

The Loan Market Association recently published changes to its form of facilities agreement for leveraged finance transactions. A number of these changes will be of particular interest to borrower clients. For that reason, we take a closer look at the changes from page 4 onwards.

We do hope these articles are of interest – do not hesitate to contact any of the team if you would like to discuss (see page 7 onwards) or there are topics which you'd like us to tackle in future editions.

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HEDGING YOUR BETS

As readers will know, effective hedging strategies can help mitigate the risks associated with market volatility and help stabilise cashflows.

The last 12 months have seen significant market volatility as a result of major geopolitical events, such as the UK's referendum on leaving the European Union on 23 June 2016, the US presidential election and continuing uncertainty over certain European banks.

Interest rates in the major advanced economies, such as the UK and the US, are also at historic lows (and have been at those lows for some time) however the US is widely expected to increase interest rates at a faster pace this year.

In addition to FX and interest rate movements, derivatives can also hedge against inflation or other risks which could impact a company's cashflow stability.

For these reasons, we thought it worth taking a closer look at the various types of derivative products which are typically entered into in respect of hedging strategies.

DOCUMENTATION

Bilateral derivatives contracts, or "over-the-counter" derivatives, are usually documented under an ISDA Master Agreement and an accompanying schedule in which bespoke party and deal specific provisions are documented. There may also be a Credit Support Annex if a form of credit support is required for the underlying derivatives transactions. The derivatives transactions themselves are documented under a trade confirmation, which ultimately forms part of the ISDA Master Agreement. This suite of documentation has become market standard over decades of use. It is important that borrowers and other hedge counterparties fully understand and negotiate such documentation so that their particular interests are protected. This is particularly important for corporates entering into ISDA documentation which directly hedges FX or interest rate exposures connected to a bilateral or syndicated financing arrangement.

If there is a hedging requirement in a corporate banking deal, the level of interest rate hedging and the time period by which it must be put in place (e.g. 90/120 days post-signing) will be documented in a hedging strategy letter. It will be important for the borrower to have the ability to obtain alternative quotes, i.e. test the market, when agreeing the economics of the interest rate derivative post-closing. Lenders will usually obtain a right to match in the hedging strategy letter.

PRODUCTS

Swaps

Swaps are bilateral contracts which allow parties to trade future cashflow obligations. They are most commonly used in relation to interest rate swaps which allow borrowers to obtain a fixed interest rate and with it certainty of outgoings in relation to their loans. Furthermore, it brings a level of comfort to banks who may otherwise be unable to provide funding where an increased interest rate would call the borrower's ability to repay the loan into question.

Caps

Under a cap arrangement, a maximum level of interest is agreed upon between the borrower and the hedge provider. If the interest rate rises above the pre-agreed cap, the hedge provider will make payments to the borrower (calculated by reference to a notional principal sum over an agreed term). In return, the borrower pays an upfront premium for entering into the cap. Entering into cap arrangements allows borrowers to mitigate the risk of interest rate increases without surrendering the benefits of lower borrowing costs if the interest rates should fall. In contrast, under swap arrangements the borrower must pay the hedge provider the difference should the floating interest rate fall below the fixed interest rate.

Futures

A futures contract is a bilateral agreement to sell goods at an agreed upon price. Under a futures contract the parties are obliged to buy and sell, irrespective of the price of that asset on the date of settlement. Forward contracts operate in the same manner, but allow for further customisation and are often referred to as "over-the-counter" instruments as they are not traded on a centralised platform. Futures contracts are centrally traded and as such are standardised to facilitate onward trading. Futures contracts are commonly used to hedge the price of commodities such as oil and gas.

Options

An option is similar to a futures contract, but with an option the buyer or seller has the "option" to buy or sell and is therefore not obliged to complete the transaction. An option gives the holder the right to buy (or "call") or sell (or "put") the asset at an agreed price. The timing of exercising the option depends on its type, which can be categorised as:

- European style option under which the holder can only exercise the option on a specified date.
- American style option under which the option holder has the flexibility to exercise the option at any point during the term. There are often certain conditions which will need to be met.
- Bermudan style option under which the option holder can only exercise the option on certain dates during the term of the option contract.

Swaptions

Swaptions are a combination of swaps and options which give swaption buyers the right (but not the obligation) to require swaption sellers to enter into interest rate or other types of swap. In return, swaption buyers pay swaption sellers a premium (typically charged as a one-time up-front fee). Unlike swaps, swaption buyers have the flexibility of deciding whether to exercise their swap if they anticipate favourable interest rates.

WHAT CAN YOU BE DOING?

Review current currency and interest rate risks and associated hedging strategies. Explore such hedging strategies with hedging experts and legal advisors.

Review existing hedging documentation to consider the remaining term and whether it needs to be renewed or alternative hedging arrangements entered into. This should be considered in terms of currency risk, fixing the price of goods which are integral to the business and participants' views on interest rate changes.

Review representations given under banking documentation to ensure they are/will still be achievable. Financial covenants and other financial tests and thresholds should also be tested, to see if they are impacted by exchange rates. New banking facilities should ideally, include provisions whereby undertakings, representations, baskets and events of default are not tripped solely as a result of exchange rate fluctuations.

Incorporate a review of FX exposures on future due diligence exercises, and tailor the ongoing banking requirements of any new investments accordingly.

Consider cash pooling arrangements and other treasury arrangements where currencies are automatically converted into GBP.

Conclusion

The value attributed to a currency will always be prone to fluctuations as markets react to news and business events. Borrowers who take a proactive approach to managing the risks associated with such fluctuations, and have sufficient flexibility to exploit opportunities in a changing market, offer themselves the best chance of surviving (and thriving) in the market.

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CHANGES TO THE LMA FACILITY AGREEMENT

On 18 November 2016 the Loan Market Association (**LMA**) made a number of changes to the standard form facilities agreement for leverage finance transactions, which is the most common precedent document used in mid-market corporate lending and acquisition finance transactions.

The changes have been made to take into account changes in regulation as well as in response to feedback from market practitioners in relation to movements in market requirements.

Summary of changes

In summary, the main changes relate to:

- the inclusion of an option for the establishment of additional term loan facilities (referred to as incremental or accordion facilities) (**Incremental Facilities**);
- an option providing for free transferability by lenders to pre-approved entities so called 'White Lists' (with other transfers requiring consent);
- the inclusion of protections to address the new UK Persons with Significant Control (**PSC**) regime (which is relevant where security is taken over shares in UK companies); and
- general updates in response to market developments, including the removal of alternative reference bank provisions. To the extent appropriate, changes of a more general nature have also been incorporated across the LMA suite of facility agreements. This includes a change to the definition of "Reference Bank Rate" to reflect the new ICE LIBOR submission methodology.

Incremental Facilities

Incremental Facilities are commonly referred to as "accordion facilities" in the market.

The LMA now includes a new optional mechanic for additional term facilities, broadly subject to the same terms as the initial facilities with certain specific terms (such as the margin and the repayment profile (subject to any caps or restrictions contained in the credit agreement)) agreed at the time of establishment between the borrower and those lender(s) which agree to provide the Incremental Facility.

The Incremental Facilities wording applies to term facilities only and so bespoke amendments will still need to be made to the LMA document should the accordion be offered on an RCF basis (or a mixture of term loans and RCF).

Intercreditor agreement – the Intercreditor Agreement has also been updated to reflect the potential establishment of Incremental Facilities, most notably to include a facilitation clause. However, requirements under the Intercreditor Agreement, in particular relating to any potential requirement for the release and retaking of transaction security and guarantee, are likely to be transaction specific.

Transfer provisions

The transfer clauses have been updated as follows:

- ***Free transferability to pre-approved entities –*** commonly referred to as a "White List", the new option allows lenders to transfer to entities specified on a pre-agreed list without the requirement for consultation with/consent of the parent company.
- The wording contemplates that the list is agreed between the lender(s) and the borrower prior to signing and is provided to the lender as a condition precedent to signing, with the lender also being under an obligation to provide a copy of the list to any party which reasonably requests one. Borrower consent is not required for lenders to transfer loans to persons on the agreed list notwithstanding any borrower consent provisions. Borrowers will want to ensure that there are no banks or funds on the agreed list which the borrower would not be comfortable having as a lender.

- ***Transfer fee* –** the drafting has been refined to make clearer that the affiliate / related fund exception to a transfer fee being payable applies only to a transfer by a lender to one of its affiliate or related funds.

PSC Regime amendments

On and from 6 April 2016 a company's PSC register (i.e. the register of those persons with significant control over a company) cannot be blank but if a company is not in a position to complete its register on that date then it must include some standardised wording in the register to reflect the progress of the company's investigations.

A new undertaking and condition precedent has now been included to ensure that the group complies with the obligations under the "people with significant control" regime in the UK, required under Part 21A and schedule 1A to the Companies Act 2006 (**CA06**) and which came into force on 6 April 2016 requiring that every company to which Part 21A CA06 applies is required to keep and maintain a dedicated register of people with significant control over that company. Failure to meet an obligation imposed by Part 21A CA06 may constitute an offence by the company and every officer in default.

The new undertakings ensure that the each member of the group will comply with any notice it receives pursuant to Part 21A CA06 within the applicable timeframe and with promptly provides the security agent with a copy of that notice.

The condition precedent requires evidence that either:

- every member of the group has complied within the relevant timeframe with any notice received under Part 21A CA06 and that no "warning notice" or "restrictions notice" has been issued together with a copy of the PSC register for each company in the group which is providing security; or

- no member of the group providing security is required to comply with Part 21A CA06.

Voting

- ***All lender matters* –** the list of amendments that require all lender consent now also include:

  - the utilisation timetable;

  - the illegality protections;

  - borrower and guarantor accession/resignation mechanics; and

  - a number of options for the extent to which amendments to mandatory prepayment provisions require all lender; consent.

- ***Pro rata interest voting* –** a new provision clarifies that a lender which has transferred its commitment but remains entitled to receive its share of interest on the next interest payment date does not have any voting rights.

Interest rate fall backs

Amendments to the definition of "Reference Bank Rate" have been included which reflect the new ICE LIBOR submission methodology and the "Alternative Reference Bank" mechanic, which acted as additional intermediate fall back by determining interest rate benchmark by reference to quotations provided by wider group of reference banks than the lenders, has been removed.

Other Amendments

In addition to some minor updates to the jurisdiction and tax provisions the following amendments have been made:

- ***Information undertakings* –** the KYC provisions have been expanded to allow the lenders to refresh KYC checks on a change of circumstances or ownership in a borrower or guarantor's holding company which is not itself a borrower and/or a guarantor

- ***Acceleration* –** amendments have been made to clarify that no notice of security enforcement is required to be given to a borrower or guarantor in order to accelerate under the facility agreement.

- ***Clean-up –*** a new option allows the existing 'Clean-Up' provisions to be extended to apply to permitted acquisitions. Clean-up periods are the period during which the borrower can remedy certain events relating to a target group which would otherwise breach the terms of the facility agreement. Broadly speaking, such events will not be an event of default if they are capable of remedy, steps are being taken to remedy the breach and the breach was not procured or approved by the borrower.

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