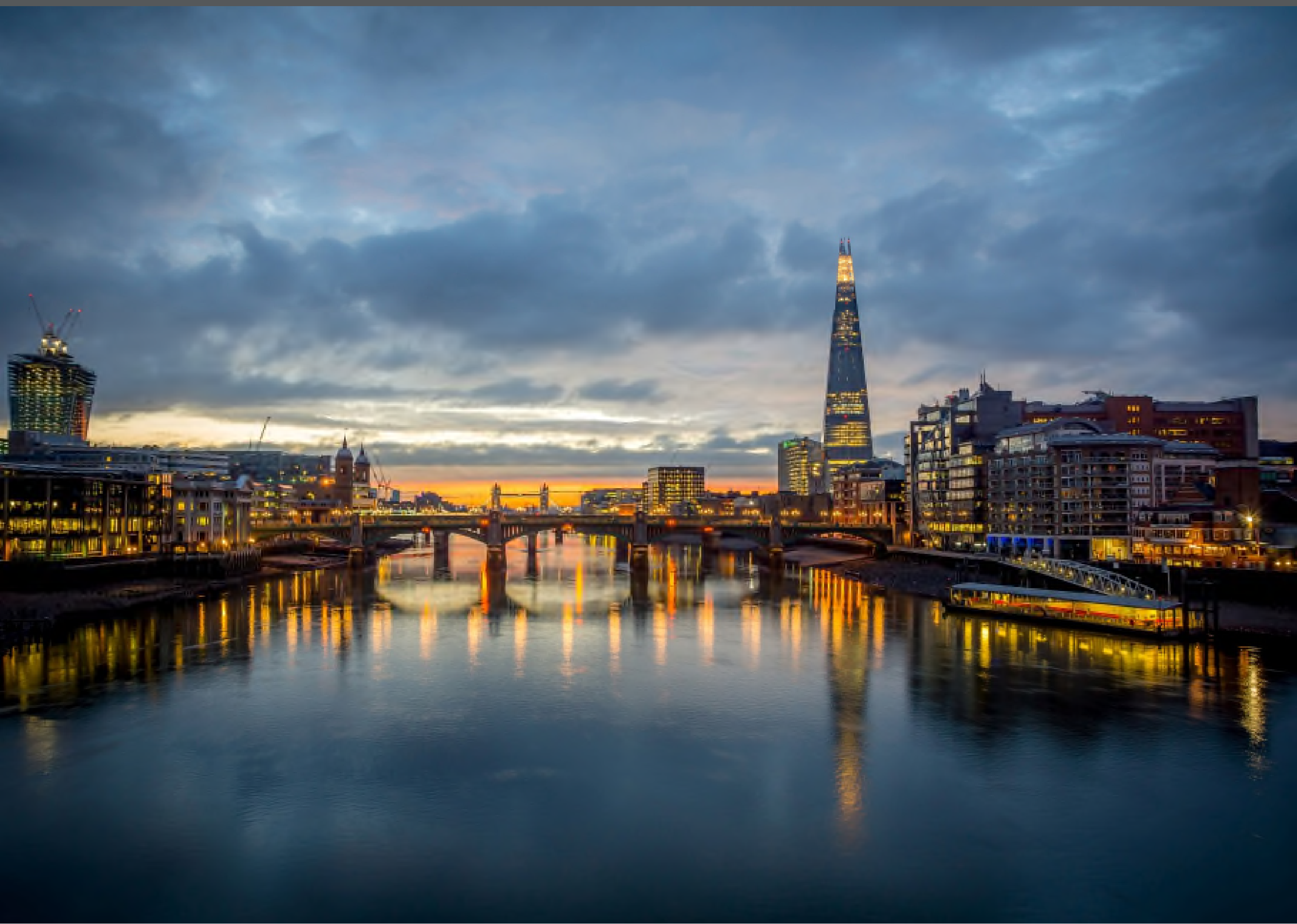
ADDLESHAW GODDARD

June 2017

Q2 CORPORATE BORROWER UPDATE



INTRODUCTION

Welcome to the Q2 2017 edition of the Addleshaw Goddard Corporate Borrower Update.

It has been an exciting quarter for the firm with our combination with Scottish firm HBJ Gateley completing on 1 June. We see this as an opportunity to deliver stronger UK-wide offerings in response to increasing client demand for advisers with a capability on both sides of the Anglo-Scottish border. New offices in Edinburgh, Glasgow and Aberdeen will build on the firm's position in the City, Leeds and Manchester, alongside its growing presence in Hong Kong, Singapore, Dubai, Doha and Muscat.

The combination will enable us both to provide a seamless service to clients and advisors on deals which involve a Scottish element and to offer greater depth and flexibility of resource for the benefit of all of our clients. We are delighted to have already secured new growth opportunities for the combined firm and we look forward to working much more closely with corporate borrowers headquartered in Scotland, or with a Scottish presence, in the future.

It has been a busy quarter in general for the corporate banking team at AG. Not only have we welcomed our new Scottish colleagues but, following a busy year acting on a number of high profile transactions, AG's London banking team has made a number of senior additions to its leveraged and corporate banking team.

Notably, Beth Collett joins us from Allen & Overy, strengthening our debt capital markets offering. Beth's practice includes advising bond issuers, managers and trustees and her experience ranges from advising on government gilt issues, local authority and university financing and issues by corporates. She is described by Chambers and Partners as "*incredibly knowledgeable and very responsive"* as well as being listed as a *'Leading Individual*' by Legal 500. In the next issue of this update we will explore the ways in which corporate borrowers can access public and private bond markets and the benefits of debt capital market instruments in addition, or as an alternative, to bank debt.

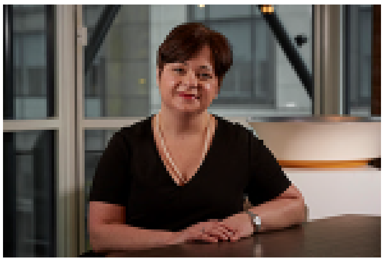
It would be remiss to ignore the result of this month's general election and the impact this will undoubtedly have on Brexit and on the market more generally. We hope to be able to not only support you through the technical thinking around Brexit, but also to help you to get on with running your business during these times of macro uncertainty. Do feel free to contact any member of our team with your queries.

In this issue of the Corporate Borrower Update, we will take stock of market trends and consider the impact this has had on documentation. We are continuing to see high levels of liquidity in the market and, for the time being, pricing and terms remain competitive. At page 1 onwards, we take a look at commonly negotiated topics and discuss changes to previous norms in light of current market conditions.

At page 3 onwards, we also shine a spotlight on the impact of withholding tax for borrowers. At a time when access to international capital is increasingly attractive we hope to highlight ways in which it is becoming easier for borrowers to access overseas sources of funding without experiencing frictional tax costs.

We do hope these articles are of interest – please do not hesitate to contact any of the team if you would like to discuss anything contained in this issue or if there are topics which you would like us to tackle in future editions (see page 5 onwards).

We look forward to working with you over the coming months.



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DEVELOPMENTS IN DOCUMENTARY TERMS REVISITED

Frequent readers of the Addleshaw Goddard Corporate Borrower Update may recall a previous article exploring borrower friendly terms which featured in the Q2 edition of 2016. Causal factors cited included competition between US and EU loan providers and the increasing movement towards US loan market practices.

At that time, we forecast that this trend would continue for the foreseeable future, and in Q2 of 2017 this is certainly still the case.

In this article we review how matters have developed over the past year and explore how market changes have manifested within the loan documentation. We focus on transferability, scalable baskets and margin ratchets. These developments are typically appearing first in the sponsor-backed leveraged market but some are equally relevant to the corporate market. We also review the increasing use of LIBOR floors and remind borrowers to consider the interplay between LIBOR floors and hedging requirements.

TRANSFERABILITY

In this space we have seen borrowers of more leveraged facilities achieve increased control over transferability, with concerns usually centring on transfers to distressed debt or "vulture" funds, hedge funds and competitors. Of course investment grade borrowers typically enjoy more control over transferability.

Some recent trends in transferability provisions are as follows:

- **Industrial competitors and distressed debt funds** – borrowers have increasing scope to limit transfers being made to their industrial competitors and to distressed debt funds. There is often a period after which the lender can then make the transfer to the extent that a borrower-agreeable transferee has not been identified. This has been evident in the retail and hospitality sector where sensitivities regarding the brand name are high.

- **White lists are becoming the norm** – the inclusion of 'white list' optionality in the LMA's revised leverage finance facilities agreement (published 18 November 2016) is indicative of the standardisation of the white list concept.

- **Consent, not consult** – transfers are often to be made only with borrower consent as opposed to non-binding consultation, which has been the usual position in the past. Additionally, these rights are withdrawn only upon the continuance of a payment or insolvency event of default, rather than any continuing event of default.

- **Sponsor pre-emption on transfer** – in the leveraged market, term sheets have provided examples of borrowers and sponsors seeking pre-emption rights on transfer. On a handful of recent deals we have seen borrowers and sponsors successfully negotiating this right, albeit with short timescales to exercise such a right.

GROWER BASKETS

In the Q2 edition of 2016, we reviewed the trend towards "grower" baskets, which are calculated using the greater of a fixed amount and a proportion of a specified variable amount (i.e. the borrower group's total assets or EBITDA).

Borrowers with an acquisition/high growth focus are particularly keen to take advantage of this feature, taking comfort in the fact that the baskets will grow proportionately in line with the business.

Recent trends that we have encountered include:

- **Automatically scalable baskets** – we are seeing a handful of documents in which baskets are increasing automatically each year without reference to audited accounts. Rather, the numbers are reviewed in line with the last compliance certificate of the financial year and the revised percentage is effective from the date on which such certificate is duly delivered.

- **Frequency** – Previously there was often a maximum number of occasions (usually twice) upon which the scaling of the baskets could take place. In the context of automatically scalable baskets, we have seen that such restrictions are being removed in order to accommodate annual change.

- **Application** – Increasingly, grower baskets are being applied throughout the majority of the permitteds and to the excluded acquisition, disposals and insurance proceeds. Lenders are, however, still typically resisting changes to the cash sweep de minimis and permitted acquisition baskets.

MARGIN RATCHETS

Similarly, there is increasing flexibility in borrowers obtaining more favourable margin ratchet terms.

Traditionally, the position has been that the borrower could only profit from one step down per quarter date and that the opening margin applied for 12 months before the benefit of any margin decrease could take effect. We are now seeing changes to this position, including:

- **Timing** – reductions in the duration for which the opening margin applies. In some deals, the opening margin only applies until the first quarter date following closing, which could be a matter of days.

- **Reverting to highest level** – typically whilst an event of default continued the margin would revert to the highest level on the grid. However, strong borrowers have recently negotiated that margin reversion only applies upon the continuance of payment or insolvency-related events of defaults.

As ever, these are not hard and fast rules. We have seen one particular example of a relatively strong credit agreeing to the lender having an ability to increase the margin ratchet above the original level.

LIBOR FLOORS

The market is showing increasing consistency of approach in relation to the use of LIBOR floors. LIBOR floors emerged post-2008 to protect lenders and investors from the risk of negative interest rates. The LMA adopted the concept into their documentation in 2012 by including provisions that in the event that LIBOR drops to a negative, the interest rate payable to the lender becomes the Margin only, thereby disregarding the impact of the negative number on the interest calculation and protecting against any erosion of the lender's return and reflecting the parties commercial intention.

Historically lenders have taken differing approaches to the use of LIBOR floors, but we are seeing the inclusion of zero LIBOR floors being the norm with LIBOR floors above zero also frequently seen.

In such circumstances it is key for borrowers to assess the financial impact of a LIBOR floor in the context of their existing or intended hedging arrangements which have no such floor, during the life of the facilities.

CONCLUSION

As predicted in the Q2 edition of 2016, borrower friendly trends have continued over the last twelve months. There is a large amount of liquidity in the market and conditions have allowed documentary terms to move in a borrower friendly direction. Where matters move from here as forthcoming political events ensue will be revealed in the fullness of time, but at present borrowers are able to raise debt on extremely flexible terms which reflects a market in which debt is cost effective and borrowers are rewarded for strong financial performance.

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RECENT TAX CHANGES BENEFITING UK BORROWERS

Access to international sources of capital is increasingly important to UK borrowers. UK withholding tax on interest payments has sometimes been an obstacle to this access but two recent changes aim to improve this, and should mean that UK borrowers will find it easier to borrow from overseas without concerns about withholding tax.

The withholding tax problem

The starting point is that UK borrowers have to withhold 20% tax from interest they pay on their loans and pay this tax over to HMRC. In practice this usually doesn't apply to payments to domestic lenders, who can effectively self-certify that they meet the terms of an exemption from withholding.

This is not the case for overseas lenders – they may be able to claim relief from withholding under a tax treaty, but each loan needs specific clearance from HMRC before interest can be paid gross. Most lenders entitled to full relief under a treaty will expect the borrower to meet any withholding cost arising on interest paid before clearance is given. Equally, lenders not entitled to full relief (some treaties only reduce the withholding rate rather than eliminating it) may be reluctant to lend in the first place.

Treaty passport scheme

The clearance procedure for treaty relief can be speeded up if the lender has a "passport" issued by HMRC, which will typically produce a clearance in under a month. Until recently this passport scheme was not universally available to all borrowers and lenders (for example, partnership borrowers could not use the scheme, and not all lenders were eligible to apply for a passport). Where the scheme can't be used, lenders and borrowers have to fall back on the old "long-form" clearance approach, which can take several months to produce a result – any interest paid in the interim is subject to withholding and lenders will usually expect the borrower to meet this cost.

HMRC recently announced a significant expansion of the passport scheme, which has already gone live. The main improvements are:

- the scheme can now be used by all UK borrowers, including partnerships, charities and other bodies that could not previously benefit; and
- many more lenders can now apply for a passport (though still not all possible lenders). New eligible lenders will include sovereign wealth funds, pension funds and partnerships whose members are all from the same tax treaty jurisdiction.

As a result, we expect to see more overseas lenders using the passport scheme. This is likely to improve the position for UK borrowers, by making it generally easier and faster to get clearances for gross interest payment.

The new qualifying private placements ("QPP") rules

The other helpful change is the introduction of the QPP rules, a new exemption from withholding tax on UK interest payments. In outline, this applies to unlisted securities with a minimum value of £10 million and maximum term of 50 years, where the holders of the securities have provided "creditor certificates" to the borrower.

To give a creditor certificate, the holder must be:

- beneficially entitled to the interest on the securities (e.g. not acting as trustee or nominee);
- entitled to the interest for genuine commercial purposes and not as part of a tax avoidance scheme; and
- resident in the UK or a jurisdiction with which the UK has a qualifying tax treaty.

There are two main benefits from using QPP:

- it moves overseas lenders closer towards a self-certification process for withholding exemption, that is faster and less cumbersome than relying directly on treaty exemption; and
- it extends entitlement to gross payment – the treaty jurisdictions that qualify for QPP include ones where the treaty only reduces withholding rather than eliminating it. This includes in particular South Korea, Japan and Italy.

At this stage, unfortunately it isn't all good news. The exemption is new and fairly complex, and there is a lot more detail to it than is outlined above. Various technical points about how it actually works are also not entirely clear, and market practice on the use of the exemption is still developing. Unhelpfully, HMRC have also not yet produced their official guidance on QPP.

But notwithstanding all the above, the new exemption is clearly intended to be helpful and to remove barriers to overseas debt funding into the UK. We are seeing the new exemption used in practice, especially by lenders who would otherwise suffer a withholding cost because of their place of residence, and we expect it to grow in popularity with lenders and borrowers.

If you wish to discuss recent UK tax changes affecting borrowers, do not hesitate to contact:

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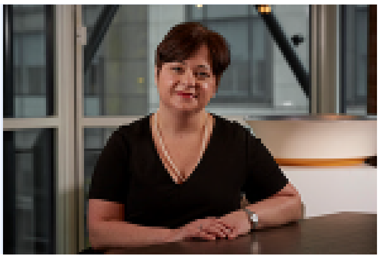

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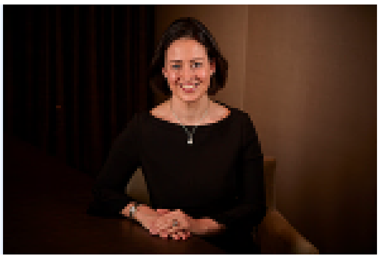

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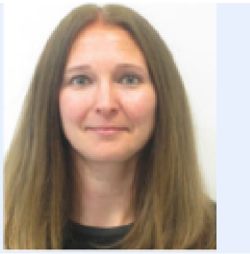

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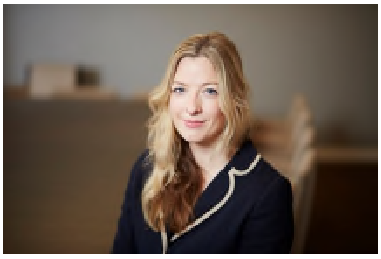

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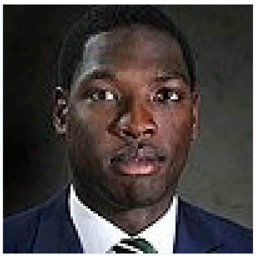

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