ADDLESHAW GODDARD

October 2017

Q4 CORPORATE BORROWER UPDATE

INTRODUCTION

Welcome to the Q4 2017 edition of the Addleshaw Goddard Corporate Borrower Update.

It has been a busy summer for our corporate banking team with a real uptick in corporate activity. Whilst so far this year it has been the leveraged market that has experienced most of the activity, this quarter has seen a shift in the balance. In the current environment of political uncertainty, businesses which appear to have been sitting on cash, seemed to have regained sufficient confidence in the market to pursue acquisitions and consider long term financial plans.

Whilst we typically see quieter levels of activity throughout the summer, this quarter seems to have proffered the perfect moment for borrower activity and a renewed "let's get on with it" attitude. The initial shock and uncertainty following the Brexit vote has passed and borrowers seem to be taking the view that we are sufficiently distanced from the ultimate implementation of Brexit. In our experience, this middle ground has provided ideal conditions for a flurry of corporate financings. It will be interesting to see whether the trend continues following the Prime Minister's announcement of a two year transition period, which may see Brexit delayed further.

Only time will tell how much of that activity will involve debt funding, who will provide that debt and what form it will take. This edition we look at an alternative to traditional bank debt and comment on a development which has ensured the continued incidence of longer term financial planning through the use of accordion or incremental facilities.

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 4 onwards) or if there are topics which you would like us to tackle in future editions.

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BOND ISSUES – AN OPTION FOR YOUR BUSINESS?

Frequent readers of the Borrower update will recall our Q2 article which cast a spotlight on the rise in borrower friendly terms in the debt market. In this article we will explore alternative options for borrowers, focussing on the issuance of bonds as a method of raising finance.

Bond issues are often seen as the exclusive remit of large multinationals as a result of the typical issue size. However, post-2008, the increasing regulation of the bank lending market and introduction of Basel III capital requirements have led many borrowers to look to the capital markets as an alternative funding option, whether by means of a large public listed issue or a smaller private placement to a single investor or a small number of investors.

Many have pursued financing opportunities in the private placements market which allows the direct issue of debt securities to a small number of investors directly.

Typically, the revenue required to access the private placement market is significantly less than that of companies seeking to issue bonds in the public market, allowing this method of raising finance to be considered as a genuine alternative to bank financing for SMEs and mid-market corporates.

WHAT IS A BOND?

A bond is a transferrable debt security used by a variety of corporates and governmental bodies who act as "issuers". They can be issued in 'definitive' form directly to investors or in 'global' form transferrable via domestic or international clearing systems. Issuers typically pay interest to bondholders during the term of the bond and repay the capital sum invested, usually at a fixed maturity date. Interest can be fixed, floating or linked to a variable rate, such as RPI.

Bonds can be listed or unlisted, secured or unsecured, rated or unrated. On their initial issuance, bonds will usually be issued at or around par with the coupon (or interest rate) being determined by reference to the perceived credit of the issuer and the then current market conditions (being calculated as a margin above the then prevailing yield on an appropriate Government gilt). In the secondary market, the trading price will be determined according to a range of different factors; including the coupon, the length of time until the maturity date, any specific early redemption features and the credit rating of the issuer.

As mentioned above, bonds can also be issued either on a "public" or "private" basis. A public issue, which will involve inviting bids from a large group of potential investors to subscribe for a portion of the issue (often by means of an investor roadshow), will usually be the preferred option when issuing bonds in excess of £100 million as this will attract the number of investors necessary to fund the larger issue size and will typically generate better pricing. Where issuers are looking to raise less than £100 million, they will often consider doing this by means of a private placement (i.e. offering the bonds directly to a single institutional investor or a limited group of institutional investors; typically mutual funds, pension funds and insurance companies). Private placement investors will usually not require the bonds to be listed or rated.

Bond issues are also often referred to as either retail or wholesale issues. The main difference relates to the intended investor base, though the distinction is also relevant for listing/regulatory purposes where it is also used to distinguish between bonds with low or high denominations (i.e. sub-€100,000 (or equivalent) or €100,000 (or equivalent) and above). Retail bonds (in the sense of bonds where the investor base is not limited to institutional investors) are typically unsecured and have a higher coupon over a shorter term.

ADVANTAGES AND DISADVANTAGES

Appetite to lend in the banking market is high, which has encouraged borrower friendly terms in bank loans, and there is no doubt that bank debt and equity finance are still the preferred methods of raising finance for SME and mid-market corporates. That being said, raising financing by means of bond issues comes with substantial advantages.

In relation to public issues:

- Issuers are often able to secure terms which banks may not have the appetite or ability to match, as a result of the different investor base.
- Bonds allow additional operational freedom, as they are largely free from restrictions which are often associated with loans, such as limits on further acquisitions.
- Issuers who choose a fixed rate can escape the variable interest rates of some long term loans by setting a fixed interest rate for the duration of the term.

As with any method of raising finance, there are some drawbacks which companies should be aware of, such as:

- Unlike long term loans the scope to refinance is limited, with issuers having to trigger optional redemption provisions the cost of which will be determined by reference to the then current gilt yields.
- With respect to public issues, the listing and rating requirements will add additional costs and have timing implications.

- In contrast to dealing with bank lenders who tend to maintain a close relationship with the company, ongoing contact with bondholders will be limited (and issuers will have no right to be able to identify the current holders) making changes to the terms and conditions or waivers harder to obtain (and there is often a cost implication to encourage delivery of requested consents).

In the context of the advantages and disadvantages of public bonds, private placements create a middle ground, providing solutions to some of the disadvantages associated with public issues. Direct issues create access to a new investor base whilst retaining investor certainty, as issuers know who the bondholders are (both on issue and during the term of the bonds). To the extent that issuers require consents, knowing your investor base brings a layer of comfort that is lacking in the public market, where consent requests can be burdensome. This should allow for ease of transaction between the parties, who have a vested interest in maintaining a working relationship.

Investors in the private placement market are often happy for terms to be longer than typical bank loans. They are also free from the requirements of listing or obtaining a rating, which create additional cost and regulatory requirements that some first time issuers may find onerous. The conditions will typically include more covenants than in the public market, but less than in a typical bank loan, and remain relatively free from operational restrictions.

In many ways, private placements overcome the disadvantages of traditional bank debt and of public issues, providing a genuine alternative method of raising finance to SMEs and mid-market corporates.

CONCLUSION

In the current market, where the view is that bank lending terms simply cannot get much better from a borrower's perspective, suggesting a possible shift in balance back in favour of lenders, the creation of long term stability and predictability in a company's financing portfolio is undoubtedly advantageous.

There is no doubt that the mid-market is diversifying. A clear example of this is the proliferation of unitranche loans which have competed head to head with more traditional sources of financing and the movement of debt funds into a space that was previously the exclusive remit of banks. Bond issues provide another example of an alternative, or addition, to bank debt. They are free from maintenance and operational covenant requirements that are typically associated with bank debt, allow for a fixed rate of interest without the added cost of hedging and allow borrowers to lock in financing costs over longer terms.

We hope that this article has provided useful examples and highlighted ways in which the bonds market can be accessed by SME and mid-market companies. Please do not hesitate to contact our debt capital markets team with any queries you may have.

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ACCORDION FACILITIES & HEDGING – A "RIGHT OF FIRST REFUSAL" FOR EXISTING LENDERS?

Earlier this year the Financial Conduct Authority (FCA) launched a market study which looked into, among others things, whether certain "right of first refusal" clauses (i.e. clauses which require a borrower to first look to its existing lenders for certain financial services before going to the wider market), should be subject to a proposed ban as they act as a barrier to other potential funders and are anti-competitive.

One area of confusion and concern that came out of this study was the potential impact that such a ban would have on "accordion facilities" or "incremental facilities". These facilities are an increasingly popular optional mechanic included within many loan agreements which allow a borrower to request an increased facility (or new tranche of debt) in addition to the current facilities on terms that have already been agreed between the borrowers and the lenders (allowing a borrower to obtain additional debt finance smoothly with no requirements to amend the loan documents). As these provisions typically include a right of first refusal in favour of the existing lenders there was concern that a ban would impact on these facilities. For similar reasons, provisions requiring borrowers to offer a right of first refusal to existing lenders in respect of any future interest rate hedging would potentially also have been caught by such a ban. As a result of this confusion some lenders have recently been reluctant to include such facilities or provisions in their loan agreements.

Following consultation and feedback, the FCA has clarified the scope of the proposed ban and confirmed that the final ban (due to come into force on 3 January 2018) is limited to future primary equity or debt capital market or M&A services only and will not apply to rights of first refusal in accordion or incremental facilities (or similarly most types of bridging loan). Additionally as the ban only applies to rights of first refusal in relation to "future" services, many commentators agree that the proposed ban would only apply to a right of first refusal in relation to hedging where such hedging services are not specified or certain at the date of the loan agreement. As in most instances hedging is already contemplated by the parties at the time of the loan document, provisions in loan documents or hedging letters which provide for a right of first refusal are therefore not expected to be subject to the scope of the ban.

The FCA's policy statement on the scope of the ban has helpfully clarified a number of areas that were previously unclear and means that when the ban comes into force it should have little impact on most debt finance transactions. That being said, the FCA has been clear that if right of first refusal provisions have the effect of adversely affecting competition, it may revisit this issue.

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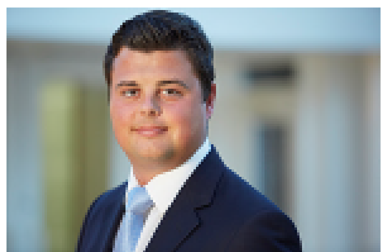

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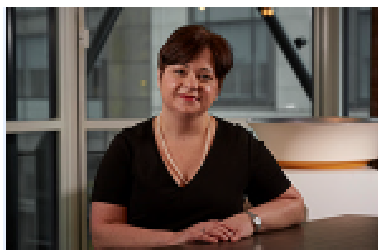

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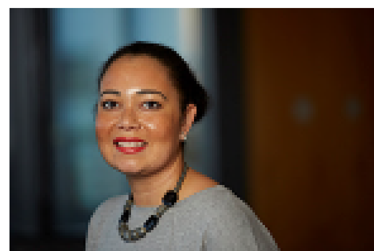

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