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LOAN DOCUMENTATION TERMINOLOGY

At Broadoak Consulting we firmly believe that the more knowledge our clients and businesses have, the more empowered they will feel when negotiating with lenders. Understanding formal loan documentation terminology will help to "demystify" the process.

We hope this article helps to translate highly technical legal & accounting terms into straightforward English. We have also deliberately avoided the temptation of providing a narrow list of terms and their definitions but have focused on why such terms are included and whether they materially impact a borrower or not.

While a Facility Agreement is a formal legal document, and therefore terminology often has little room for interpretation, understanding the terminology will ensure any borrower understands their responsibilities and legal protection. Accounting terms are also prescribed under Accounting standards so have a clear meaning and calculation as well as convention.

Many areas (such as pricing and structure) are however, negotiable. Like any negotiation, leverage will rest with the party in a stronger position. A successful business with stable historical cash flow generation will be in a far stronger position with their lender than a business facing headwinds.

While it is admirable for businesses to maintain long standing relationships with both lenders & equity investors, banks face considerable competitive pressures to not only grow their loan book but minimise risk & satisfy compliance requirements. A well advised borrower will, we believe, be in a strong position to take advantage of the post financial crisis environment.

Loan pricing and interest rates

The pricing of variable rate loans will invariably be determined by a base rate (Bank of England Base Rate, LIBOR, Fed Funds rate) plus a margin. The Bank of England base rate is set by the Monetary Policy Committee of the BoE and is the rate that the BoE will charge UK regulated banks & financial institutions for loans with a maturity of 1 day. In reality this has an indirect influence on a bank's cost of funding, it is therefore used more as a convention because it is widely published & fully transparent.

Furthermore it is worth noting that the BoE's MPC primary objective is the management of price stability as opposed to economic growth adding further to the disconnect between the "real world" economic activity and loan pricing. Ultimately there are numerous variables and sensitivities which influence funding costs (or treasury pricing) which are incorporated into a lender's margin.

Tangible & intangible security

Tangible assets are assets that take a physical form; land, property, plant, equipment or vehicles. **Intangible assets** include goodwill, patents, trademarks, copyrights & brands.

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A **debenture**[1] provides a charge over a debtor's assets as security for money loaned by the debenture holder, usually a bank or another financial institution. The most common type of debenture comprises both a fixed and a floating charge.

A **fixed charge** generally attaches to specific assets that a company cannot dispose of without the consent of the debenture holder even in the normal course of business. They tend to be larger and more durable items including property and book debts and are often listed in a schedule. However a fixed charge may also extend to 'all plant, machinery and vehicles'. The most common being a legal mortgage over freehold or leasehold property.

A **floating charge** provides a charge over assets that, due to their nature, move in & out of ownership in the normal course of business. The most common examples are inventory, trade debtors & farm machinery where it would simply not be practical to advise your bank every item an asset changed hands.

Valuation - under a secured facility, tangible securities will be valued by a lender in order to calculate the Loan to Value (LTV) ratio. The values of intangible assets are not. It is not uncommon that borrowers feel this undervalues their business and leads to the perception that traditional banks are overly conservative. It is a position with which we would not disagree.

We would however note that determining the value of all assets which do not have a liquid market is notoriously difficult and often depends on the manner in which the value of the asset is realised. Both charges will be executed as a deed and registered at Companies House.

<u>Pre-drawdown conditions or Conditions Precedent (CP)</u>

Following the negotiation of a Term Sheet and execution of the Facility Agreement, final funding or drawing down of the facility may be dependent upon the completion of a specified event or events by either party.

Common CP's include valuations, perfection of security and finalisation of documentation. Legally, once satisfied a borrower can only then request a drawdown and the lender is then obliged to lend, subject to all conditions being met.

<u>Undertakings & covenants</u>

Affirmative covenants (undertakings) are actions a borrower must complete, e.g. provide quarterly or monthly financial and operational information, maintain certain ratios, maintain collateral or ensure insurance is valid.

Negative covenants are actions a borrower must not take. They may limit additional debt, dividend payments, share repurchases, M&A, sale of assets or business units or new debt issuances. While such clauses may limit a business they do ultimately reduce default risk & lower borrowing costs for the borrower.

<u>Financial covenants</u>

No other area of the lending process occupies more time than negotiation of financial covenants, when in fact it should be a relatively straight forward process. We would recommend that a borrower first prepares a financial model for the business over the period of the loan and then sensitise their projections for any adverse possible influences.

Any financial covenants should then allow for a slight deterioration in performance (15-20%), however larger movements in key financials will rightly wish to be addressed by the lender. If the business is highly seasonal or cyclical this should also be considered. Essentially if either party is perceived as "pushing too hard" it may damage the relationship in the long term.

If headroom is too tight, too much management time & bank monitoring will hamper the business. If headroom is too loose it may be too late before management begins discussions with their lender. From a borrower's perspective, if the business is not performing as you would like, it is far better to be proactive and open with your relationship manager. In over 20 year of professional practice and banking the vast majority of lenders will work with you if you work with them.

There are broadly 4 categories of financial covenants: operational, profitability, cash flow generation & capitalisation. Many lenders will focus on the latter two, however experienced Relationship Managers will be able to identify the interdependence between numerous factors that influence businesses in different ways in different sectors.

<u>Information undertakings</u>

[1] HMRC Guidance DMBM655260

A balance should be struck between the quantum & frequency of MI provided and accounting information should be compared to the prior year and budget with relevant commentary.

Naturally the information provided and the amount required should reflect the nature & size of each business. Put simply, it is not reasonable to expect a business that generates £2m pa to provide the same level of information as a business that generates £100m. As with most things in life quality is far more important than quantity!

Ironically year-end audited financial accounts are considered to be of most importance to lenders, even though they are usually 6-9 months out of date at the time of publication!

<u>Other common terms</u>

A **negative pledge** is usually defined in the facility agreement but requires a borrower to not take any action that would disadvantage existing lenders or further encumber security already pledged, e.g. issue an additional mortgage or charge.

In highly profitable years, a **cash sweep** will require the borrower to make additional loan repayments as “the cash is swept away”. This is usually set as an absolute amount or a percentage above a certain threshold. From a lender’s perspective this reduces risk as the facility will be repaid earlier. From a borrower’s perspective, early repayment may significantly reduce interest costs over the term but also reduces the flexibility of a business to those funds for other purposes. Again, whether the clause is included will depend on relative strength of either at the negotiating table.

The savvier of you may have already noticed that this effectively penalises borrowers in good years as well as in poor years when businesses may be subject to a covenant breach. I will leave it up to you to decide whether this is equitable!

Under a **cross default clause**, a default by any entity in the group is considered to be a technical default by other entities or other facilities. This highlights an important structural consideration.

If a group of companies wishes to access funding it is not uncommon for the parent company to borrow funds & then on-lend or invest those funds with operating subsidiaries. Often they will be defined as part of the Borrowing group. Consequently the only assets of the Parent company may be shares, loan notes or hybrid investments in subsidiaries which hold tangibles assets and generate revenue. As such the lender is said to be structurally subordinated.

In order to reduce credit risk a **restricted payments covenant** will restrict the flow of funds outside the group & requires upstream dividends & guarantees from subsidiaries.

<u>Prepayment fees</u>

Prepayment fees are another often misunderstood clause. When providing a 5 year term loan a bank will need to set aside capital for a period of 5 years. Along with arrangement and documentation (in part offset by the arrangement and/or commitment fees) a lender will incur substantial expenses. This will be recouped over the full period of the loan.

Prepayment fees are primarily designed to compensate the original lender if a borrower wishes to refinance with another finance provider. If businesses prepay your loan from cash flow generation or refinance your loan with your existing provider it is unlikely to be triggered. It should be a set percentage of the amount outstanding on the loan, rather than the full commitment.

<u>Renegotiation clauses (or break clauses)</u>

Often buried in the minutiae of documentation, renegotiation clauses are often over looked. They enable both a borrower & a lender to re-negotiate the loan (and nearly all facets of the loan) generally every 3 or 5 years. In the majority of cases the clause is often waived.