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In Practice

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Commitment issues: debt financing solutions for competitive auctions

In this In Practice article, the authors consider the variety of debt financing solutions which can determine the quality of a bid in a competitive auction process, together with a focus on the use of interim facilities.

WHAT CAN DETERMINE THE QUALITY OF A BIDDER'S DEBT FINANCING PACKAGE IN A COMPETITIVE AUCTION?

Record levels of private equity fundraising and a persistent low interest rate environment have each contributed to intense competition among sponsors and corporates for target assets. This in turn has prompted many sellers to favour running auction processes to achieve optimal pricing. However, price is often not the sole determining factor for a successful bid. Sellers place a strong emphasis on bid deliverability and will regularly dictate the required status of any debt component of a bid package. The appropriate strategy for debt financing solutions will vary across transactions, but it will typically be heavily influenced by:

- the seller's process requirements;
- the deadline for exchange and completion under the acquisition agreement;
- the number and relative credibility of competing bidders;
- a bidder's appetite to incur costs and secure pole position in the auction; and
- a bidder's perceived risk of losing the auction.

THE SPECTRUM OF FINANCING SOLUTIONS

Whilst the most compelling financing package is a committed and unconditional acquisition facility (including an obligation on lenders to fund on a "certain funds" basis), its merits are often outweighed by a bidder's reluctance to incur significant costs. Furthermore, the auction timetable simply may not allow adequate time to deliver that package. The various alternative forms of financing solutions are as follows.

Comfort/support letter

A "comfort" or "support" letter from the potential lender(s) merely demonstrates interest in financing the acquisition. Financing is therefore uncommitted, so the bidder (and by extension, the seller) is largely relying on a relationship with the supporting lender(s) to fulfil the necessary funding requirement. The letter will usually specify that financing availability is conditional on:

- obtaining final credit committee approval;
- approval of due diligence; and

- execution of definitive finance documents and satisfaction of all conditions precedent to utilisation.

Such conditionality results in support letters only being appropriate to advance a bidder through a preliminary stage in the auction, or where the bidder has otherwise agreed to fully equity-underwrite their bid.

Commitment letter

If the bidder requires a stronger commitment from its lenders, a commitment letter can be a credible alternative. To improve bid quality and accelerate the prospect of certain funds, a commitment letter may:

- include confirmation from lenders that they have obtained final credit approval and satisfaction of certain key conditions precedent (eg KYC, due diligence);
- annex a detailed financing term sheet; and/or
- oblige lenders to promptly negotiate and execute the long-form financing documentation.

Given the potential delay for concluding long-form documentation, in order to demonstrate certainty of funds, a creditworthy bidder may also require that the commitment letter obliges the lenders to execute an "interim facility agreement" (IFA) at the bidder's request. The IFA then functions as a bridge to utilising the primary facilities specified in the financing term sheet.

Such usage of IFAs was popular in the run-up to the 2008 financial crisis but has recently experienced a revival. The benefits of an IFA are:

- **Speed of negotiation:** In contrast to the LMA template facilities agreement for leveraged acquisition finance transactions (LMA Template), an IFA is a significantly shorter document (often 30-40 pages) and therefore can often be quicker and cheaper to negotiate.
- **Committed funding:** If a bidder is awarded exclusivity, the necessary debt proceeds can be borrowed under the IFA to complete the acquisition at the required time.

In practice, the interim loan is rarely borrowed but merely functions as a backstop, as the acquisition timetable may allow sufficient time for long-form financing documents to be executed prior to completion.

INTERIM FACILITIES: OUTLINE ARCHITECTURE

At the time of writing, the LMA has not yet published a recommended template IFA, so their shape and content can vary dramatically between practitioners. However, an accepted norm is to only include the bare minimum terms in order to utilise the interim loan and to provide necessary protection to the interim lender(s) (eg

availability, Major Default drawstops, repayment, tax gross-up, facility agent/security trustee appointment, amendments, lender transfers and conditions precedent). To expedite negotiation and facilitate comparison, an increasingly market approach on drafting an IFA is to start with the LMA Template, but to delete (or incorporate by reference from that template) non-core provisions. The IFA conditions precedent are usually similar to those in the LMA Template and, to emphasise certainty of funds, the bidder would expect the commitment letter to confirm satisfaction of all IFA conditions precedent.

Which interim facilities?

The facilities under an IFA will usually comprise:

- a non-amortising facility for the purposes of funding the acquisition consideration and repayment of existing target indebtedness; and
- (if required by the bidder) a revolving facility in order to fund the target's working capital requirements during the period from completion until utilisation of the primary revolving facility.

Due to the brief tenor of the IFA (see below), it is not common for it to include an acquisition/capex facility or an incremental facility.

Tenor

Whilst the protections afforded to interim lenders under an IFA are not as robust as those under a conventional leveraged facilities agreement (eg as the latter would include more extensive representations, undertakings and events of default), interim lenders derive comfort from the short tenor of the interim loan(s), being typically repayable in full on the earlier of:

- 30 to 60 days post-completion; and
- the date of initial utilisation of the primary facilities envisaged by the commitment letter.

Interim lenders are therefore incentivised to promptly negotiate and execute long-form financing documents and borrowers are equally incentivised to do so in order to avoid a non-payment default under the IFA.

Parties and security package

The bidder's acquisition vehicle (Bidco) is often the only party to an IFA and the few "certain funds" representations, undertakings and events of default are commonly limited to Bidco. However, in keeping with the LMA Template, interim lenders may require that Bidco's holding company also be party (or accede) to the IFA as an obligor, principally in order to grant security over its shares in Bidco. Transaction security is otherwise minimal, being limited to either a Bidco debenture or a share charge granted by Bidco over its shares in the target. Finally, in order to subordinate any junior debt during the interim period, interim lenders may also seek to include some key intercreditor provisions in the IFA.

CONCLUSION

The increasing sophistication of sellers and proliferation of competitive auctions have resulted in the quality of a bidder's debt package often being of critical importance. Along with price, sellers may also emphasise deliverability, so bidders regularly need to demonstrate their ability to complete quickly if awarded exclusivity. Reduced conditionality can dramatically enhance the quality of a debt financing package and interim facilities can be a compelling solution. ■

Biog box

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