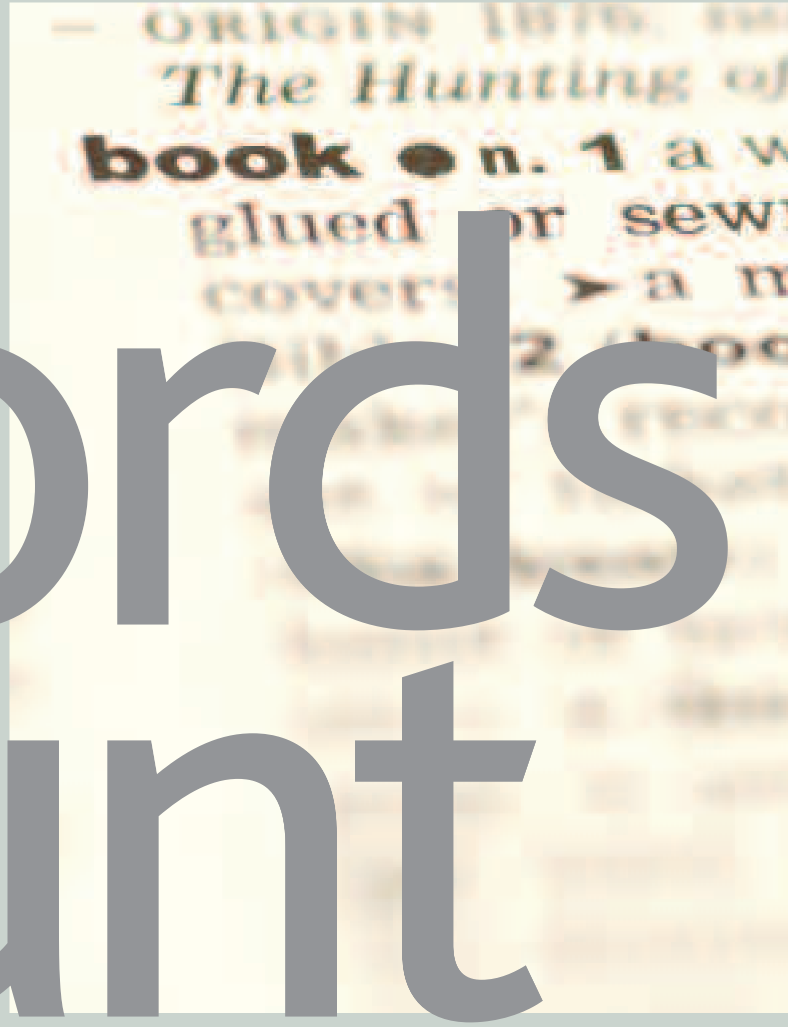
FENTON BURGIN BRINGS TREASURERS UP TO SPEED ON YANK THE BANK, SNOOZE AND LOSE AND OTHER INNOVATIONS IN LOAN DOCUMENTATION.



Words count

The frenetic activity seen in the UK loan markets last year continues apace. In 2005 euro market loan volumes for UK borrowers were in excess of a record £120bn. Much of this borrowing was corporate refinancing and financial sponsor-led buy-out activity, with notable landmark leveraged buyout deals for names like Gala, NCP and Somerfield combining with large corporate-led transactions for BAE, Imperial Tobacco, Tesco and William Hill.

Buoyed by continued low interest rates, a wall of investor money looking for asset allocation (much of it from non-bank investors including collateralised debt and loan obligation funds, specialist mezzanine investors and hedge funds) and historically low credit default rates, UK companies have taken advantage of market liquidity to borrow at historically high levels. In the leveraged market, average debt levels in the closing months of 2005 exceeded 5.6 times, compared to a full turn lower in 2004 and close to multiples not seen since the technology boom.

However, in addition to taking advantage of favourable market conditions to borrow more money, a number of UK companies have quietly sought to build greater protection and flexibility into their loan agreements.

In an environment where many commentators in 2005 questioned when the credit bubble would burst, 2006 is likely to see some of last year's excesses being reined in, but no fundamental readjustment. Nevertheless, any finance director contemplating a major financing exercise this year should consider carefully recent market developments in documentation; the credit issues remain there in the medium term when some of the deals completed in 2005 start to hit aggressive repayment schedules.

EQUITY CURE In a situation where a company may breach a financial covenant, an equity cure provision allows shareholders (typically, a private equity sponsor) to inject further cash into the capital structure as earnings, thereby improving the company's financial ratios and avoiding a default event. Historically, lenders have resisted this type of innovation as it effectively allows shareholders to drip-feed cash into an underperforming company, limiting its lenders' ability to take action. The more sophisticated of UK banks have sought to limit the application of 'equity cure' rights to one or possibly two occasions in any 12-month period. However, recent evidence suggests that this sort of provision will become more widespread this year in transactions backed by private equity.

PRICING REVERSE-FLEX Historically, banks have generally retained the right to increase the pricing and change the structure of a loan if they failed to achieve their target hold level in syndication. Market liquidity in 2005 saw borrowers turn the tables on lenders with a number of loan structures being 'reverse-flexed' or the pricing lowered in response to over-subscription in syndication. Importantly, this trend was not confined to larger transactions such as Gala's £2.8bn facility for its acquisition of Coral Eurobet or BC Partners' £597m acquisition facility for Fitness First. In October 2005, the

Executive summary

- UK companies may be taking advantage of market liquidity to borrow at historically high levels but some are also quietly attempting to build greater protection and flexibility into their loan agreements.

- Equity cure, pricing reverse-flex, yank the bank, minimum hold levels, snooze and lose, and covenant mulligans are ideas that treasurers may find worthwhile exploring.

£210m refinancing facility for UK vehicle remarketer British Car Auctions were flexed down by 12.5 basis points on all tranches in response to substantial over-subscription in syndication. In 2006, this trend may continue, with more borrowers incentivising arranging banks to secure reverse pricing flex in syndication.

YANK THE BANK Historically, it was standard in the UK for major amendments to banking documentation to require “all bank consent” in order to become effective. In 2005, with a developing secondary loan market, a number of ‘active’ investors built successful businesses by opportunistically purchasing relatively small amounts of a company’s underperforming debt to exploit their negotiating position in the capital structure. In one of 2005’s most high-profile instances of this trend, Jarvis, the embattled UK support services company, was reported to have seen all its original lenders trade their debt out to US hedge funds under the terms of the company’s financial restructuring.

In recent months, a number of UK private equity companies have responded to the possibility of future active investment through the development of documentary protections. Minimum hold levels have been increased and in banking circles lenders are increasingly being asked to agree so-called ‘yank the bank’ provisions that potentially allow a borrower to unilaterally prepay a dissenting syndicate lender. There are a number of variants, but, typically, the clause allows a borrower to prepay any ‘hold out’ institutions if a lender has secured consents to specific amendments exceeding two-thirds of the loan by commitments. Lenders have also reported that a number of private equity sponsors have documented provisions in recent transactions that seek to prohibit any primary syndication or subsequent sell-down to hedge funds or other ‘active’ investors.

MINIMUM HOLD LEVELS The second line of defence for a company seeking to protect itself against the potential for an active investor to take a position in its debt facilities is for finance directors to exploit present market conditions to increase a lender’s minimum required participation. Eighteen months ago, a UK mid-market borrower might have a minimum hold level equivalent to about 5% of the total deal size. Today that level is more likely to have doubled and more transactions are being arranged on a club basis with little or no subsequent syndication or sell-down in the secondary market.

SNOOZE AND LOSE Historically, in a syndicated transaction, UK companies could find that it took considerable management time to secure lender consent to amendments to a facility structure. In response to market liquidity, more experienced market participants have included so-called ‘snooze and lose’ provisions in their loan agreements. Under this provision, lenders are required to respond to the company’s amendment requests within a short, specified time period or their consent is deemed to have been given. Such provisions combined with a general trend towards all but fundamental amendments requiring consent by the majority of banks rather than all of them, serve to protect the borrower in circumstances where a financial restructuring may be required.

COVENANT MULLIGANS When is a default not a default? Covenant mulligans is another catchy phrase for a clause that lenders probably do not wish to become market standard. While in the investment-grade plc arena, 2005 saw the return of highly rated borrowers securing transactions with no financial covenants and maturities being pushed out up to seven years, recent mid-market transactions have seen lenders agree that a breach of a financial covenant must occur on two consecutive quarterly testing dates prior to the lender being able to call a default and to accelerate. Effectively, if secured, this innovation enables the borrower to secure breathing space to address underperformance or to negotiate with its lenders.

We are unlikely to see a rapid unwind in market liquidity this year, but the signs are there that some of the highly leveraged structures arranged over the last 18 months will not survive in their current form to maturity. It remains to be seen whether lenders will continue to allow borrowers to benefit from some of the most favourable market conditions for a decade.

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