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Before you sign... part 2

After last month's first instalment in our coverage of debt facilities, we've now come to the really exciting bit: the documentation. There are a number of areas to keep your eye on to make sure you get a deal you can live with. The list given here is by no means exhaustive but it gives a flavour of the sort of issues you should be aware of.

Executive summary

- The second and concluding article in our consideration of what FDs and treasurers need to know about their facility agreement in the present harsh economic climate. If you negotiate the documentation properly, the management team can concentrate on running the business; but if you do not, you may not know that the business has breached its covenants until it's all far too late.

PERMITTED TRANSACTIONS These may be permitted acquisitions, disposals, investments, joint ventures and so forth. As the first half of this feature last month explained, lenders are looking to control their risks much more carefully now and one way they can do that is to require consent before a business spends the bank's money on a new corporate jet.

But it is still up to management to manage the business. Being constrained can be extremely uncomfortable not least because it can mean missing out on transactions that management and shareholders feel is in the shareholders' best interests but the lenders don't view as being in theirs. As a result, shareholders may end up feeling disgruntled that management signed up to such a restrictive facility and the CEO will not be best pleased when you explain that he or she will first have to ask the young lady or gentleman at the bank very politely whether a deal to buy some small business can proceed. If your CEO was not aware of this constraint before the facility was signed, or had not accepted it, however reluctantly, then your accepting the constraint will undoubtedly prove a poor career move.

You may also need to set up communications lines around the business to pick up transactions that need consent before they take place. A divisional MD who previously could dispose of part of the business may now require consent, depending on the value of the transaction and what security the lenders have over the assets within the disposal.

And be careful of how broadly the term 'investment' is drafted. The documentation could extend the meaning to the extent that it limits which institutions you place deposits with. Although such a control on counterparty risk may not be a bad thing, just consider right of offset if you allow your company to be restricted to placing deposits only with lenders (although the internecine battling of the inter-creditors, see below, should ensure this doesn't happen).

When considering anything in the area of permitted transactions, have a good hard think about de minimis levels and cumulative "pots" to make sure your business can genuinely live with them.

CAPEX Again, capital expenditure is a form of permitted transaction but one of a more day-to-day nature. If there is a cumulative cap on capex, how are you communicating that cap and controlling it within the business? Are you sure you won't find out only when it's too late? Do you have to go for a waiver and confess to inadequate controls? Capex may also be picked up as its own financial covenant and the depreciation side will certainly be a factor in other covenants.

Again, can your business live with any constraints that the lenders want? Make sure you build these into all projections. If you need more headroom, then say so, but it's either going to cost or you've got to give ground on something else (look at it as getting the extra jalapenos on your pizza but giving up the spicy mince in return).

LEASES Finance leases will probably be picked up within the financial indebtedness clause and you need to make sure that the levels you require are carved out. It is also more than possible, though, that there will be constraints on operating leases in levels of annual payments or capital value, or both.

In a downturn and at times of constrained cash, op-lease can become an attractive option in terms of cashflow but make sure you

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IN THE SECOND PART OF HIS FEATURE ON WHAT EVERY FINANCE DIRECTOR SHOULD KNOW ABOUT DEBT FACILITIES, **GARY SLAWTHER** LOOKS AT THE FACILITY DOCUMENTATION.

do not trip your facility through their use. Again, controls will need to be in place to ensure this is communicated and managed within the business. If the logistics manager at one of your sites wants to lease 200 forklift trucks to replace older ones owned by the business, then you need to know about it BEFORE the deal takes place even if it is with an approved counterparty and within the manager's authority.

Also, be careful on the definition of a lease and ensure it is in line with the company's definition; alternatively, and this is probably better, make sure that the classification of a lease into operating and finance follows the treatment in the company's books. The key here is consistency: you don't want something to be one thing for management accounting purposes, another for lending purposes and something else altogether for financial reporting purposes.

CREATION OF SECURITY Lenders have three ways of getting their loan back: a company generates sufficient cash to repay the debt and interest; its assets are sold off to raise sufficient cash to repay the loan; or the debt can be refinanced at or before the end of its term. Let's discount the last option for the time being.

Lenders much prefer repaying debt through cash generated by the business rather than by selling off assets for the reason that if the assets turn out to be worth less than the debt then the lender has a shortfall. By then, it's usually a bit too late as either it will be insolvent or at least approaching a forced sale. Despite many people's views to the contrary, lenders do not want to enforce their security because they don't really want to find out how much it is or – more importantly – isn't worth.

But if push does come to shove, then the lenders will have to realise their security. Note "their" security: it is the lenders' position, not yours, and they want to protect it. So if anything happens to erode that security, such as the company permitting suppliers that are also customers a right of set-off over receivables, then the lenders' position is put at risk. When assets were worth squillions and the likelihood of having to realise them was low, many lenders will confess, probably anonymously, that they took their eye off the security ball.

But just because they weren't interested in it in the past doesn't mean they are not interested now. Lenders are very interested in their security as the chances of them having to rely on it are so much higher now. Expect documentation to contain a lot more to prevent the company from eroding the value of the lenders' security: conditions will include lower limits on disposals, maintaining properties in good condition, and ensuring that patents and other intellectual property is properly registered and fully protected at all times.

You will also now find a higher volume of representations to confirm the company has complied with the above conditions, and proof that assets are still held may be required. You will need to ensure that adequate systems and processes are in place to monitor and comply with such requests. If that, for whatever reason, is impractical, then (and this piece of advice should be shouted into every treasurer's ear) negotiate before you sign the documentation.

FIXED CHARGE OVER RECEIVABLES We are probably straying into asset-backed lender territory here, but if lenders want to take proper security over receivables, then you need to get used to the concept of blocked accounts and the mechanics required as a consequence of the Spectrum Plus ruling, with which I am sure everyone is fully familiar but will rehearse here for the sake of completeness: a standard bank debenture will only create a floating charge on book debts.

Basically, the effect is that all receipts from charged debts have to go through the lender or agent and the company has to reborrow the funds if it requires cash. On each drawing, which can be daily, certain representations have to be repeated. Do not get blasé. These representations mean something and you need to be sure each time you do so you are making a true representation to the best of your knowledge and that your knowledge is the best. That means having the appropriate systems and communications processes in place. Going for a waiver on something when you have made a contrary representation is not good for credibility.

If there is a fixed charge over the company's receivables, there may be further restrictions:

- **terms of trade:** often these cannot be allowed to differ materially from either those used when the facility was put in place or normal or standard for the industry or market;
- **credit notes:** there will normally need to be regular reports on credit notes such as why they are being issued, to which customers, and whether they are reinvoiced or not;
- **customer concentration:** for example, no more than x% may be with a particular customer;
- **granting of credit:** lenders may require certain credit controls, scores and restricted granting of credit limits before they lend on certain invoices, and you need to make sure your credit control and salesforce are aware of this and can live with it – in particular if it could lead to a significant volume of sales opportunities being missed due to such restrictions; and
- **bad debt write-offs:** again these may be outside your control and changes in provisions will be scrutinised to ensure the lender remains properly secured.

I am not in any way discouraging anyone from using asset-based lending. On the contrary, it can be an excellent and lower cash cost method of financing and I have found asset-based lenders to be among the most pragmatic and commercially aware I have ever met. But it is to the absolute benefit of both borrower and lender that you fully understand what is required before entering into the facility.

ACCELERATION The time when the gloves really come off for lenders is not with borrowers (I know it may not feel like it) but

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between themselves. Inter-creditor battles will be the fiercest, as everyone creditor wants to be in pole position and none wants to feel like they are coming off second best. If I make it sound like a no-holds-barred sporting contest or some Ealing comedy about beastly relatives trying to outdo each other to get the old man's money, that's because it is.

So why should companies be concerned? Why not just sit back and watch the lenders scrap over what will happen to the remains of the company? The reason to be aware of this is because a lender likes to be in control. If there is another lender that should rank behind them but has the ability to accelerate (literally, force the issue), then that can force a lender's hand because they have lost an element of control. It matters not whether they would have taken the same course of action anyway: it is the principle.

So if you are looking to bring in additional junior, subordinated or unsecured debt and propose it to the lenders, make sure you are comfortable with the acceleration rights before putting yourself in the firing line of World War Three.

EVENTS OF DEFAULT Just like pizza toppings, these can be virtually anything and in any combination. However, also as with pizza toppings, what to one party may seem perfect may not be so for the other. I will let this potentially infinite area rest by just repeating the mantra: whatever is agreed, make sure you can live with it commercially and operationally; if you can't, change toppings for something you and the lenders can live with.

UTILISATIONS Again, seemingly arcane but these can give some discomfort. The past 18 months have seen one-month Libor generally – and sometimes significantly – below three-month Libor and much more stable. This is in some ways counter-intuitive as the longer interest periods should be more stable as they are less prone to liquidity impacts. Of course, the past 18 months have been out of the ordinary and one-month Libor has been lower and more stable than three-month Libor.

However, lenders tend to fund on a three-month, not one-month, basis and so are out of pocket on the deal. So watch out for utilisations restricted to only three, six or 12-month periods. It's not a major issue as you can change exposure with a basis swap but it is another chip away at your position as shorter drawing periods can give more flexibility and avoid being over-borrowed for periods of time.

THE WORST POSITION TO BE IN IS NOT KNOWING WHO OWNS YOUR DEBT, ALTHOUGH IT SHOULD AT LEAST KEEP YOU ON YOUR TOES

HEDGING I must confess to personally finding this practice invidious but it is becoming the norm. Lenders will require the borrower to have certain hedges in place, usually interest rate hedges, with permitted counterparties, generally those that are lenders or which will accede to the relevant financing agreement. This then means that a hedging policy and changes to it are no longer under the direct control of management and generally ensures that the lenders get a good slug of the ancillary business.

At this point, who exactly is running the business? The constraints mentioned earlier that restrict what management can do have some logic in protecting the lender – it's not unreasonable – but this clause subtly shifts the ground. The lenders are no longer saying what management must not do; they are saying what they must do. But interest is part of a company's cost base, as are the purchase of goods and services and staff remuneration, so where do things stop? Will the lenders start to require companies to enter into fixed-price supply agreements, and will they start to control companies' remuneration and employment policies? This is why I find such a clause unpalatable.

Again, though, such a clause may come as a cost of doing the deal as it effectively forces a borrower to give lenders some good, non-capital intensive income.

To go back to the pizza analogy, let's say that the price of dough has always been expensive but has now gone through the roof. Pizzas include dough, but desserts do not. Pizzas, the borrowing facility, are the main course; desserts, or the hedging instruments, are the fluffy bit and are non-capital intensive as they contain no dough and so make better profits for the lender and keep their dough in reserve.

However, corporates may ultimately be to blame for the current position on this one. What some less scrupulous corporates have done over the past few years, when dough was much cheaper, is come into the City pizzeria and ask for a 20-inch, deep-pan meat feast and quattro staggione pizza for 50bp. "That's impossible," cries the waiter (the relationship director). "Don't worry," says the corporate. "We'll be ordering your finest chocolate and cream-laden dessert afterwards." So the waiter persuades chef (the credit committee) to cook the pizza at the price offered in the sure and certain knowledge of a very profitable profiterole afterwards.

Unfortunately, some corporates have wolfed the pizza down and then said: "Actually, I'm too full for a pudding. I'll just pay the bill at the agreed price, but don't worry, I'll definitely have dessert next time." So what banks are doing now is to make sure that dessert is ordered with the pizza.

What the above is really intended to demonstrate is that neither corporates nor banks have acted in a particularly edifying manner. I remain genuinely confident that no member of the ACT would ever act in such a disingenuous and duplicitous manner and that is why I am convinced that managing bank relationships through a qualified treasurer is so important.

TRANSFERABILITY Again, a fairly arcane clause and one where lenders are increasingly unwilling to be fettered in their dealings. Basically, transferability is the ability of a lender to sell their debt to another lender. Lenders do not want to be constrained because they need an exit route to cut their perceived losses. Why should this matter to the borrower? As long as you are complying with the

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facility and not breaching your covenants, what is the problem?

Remember that earlier on I mentioned that lenders don't normally actively want to see you breaching terms? Well, some purchasers of debt do. They want a breach so that they can engineer a position of power and generate a very good return from what someone else thought was a bad debt. They may look to renegotiate terms or margins for the most seemingly innocuous breach, especially where waiver requires all lender consent. Fenton Burgin's article in the March 2006 issue of The Treasurer magazine, page 34, explained the yank-the-bank provisions that let a borrower replace a dissentient lender with one more commercially aligned with the business; unfortunately, white knight lenders are rarer than a Betamax video of a unicorn driving a Sinclair C5 these days.

Whatever you like to call them – vulture funds, corporate raiders, whatever – these types of debt purchasers definitely do exist. And before you get all moral and start tutting, that is the market and that is capitalism. If your pension or ISA or whatever is invested with such funds and they make you a killing, will you be handing your cash back saying it is just not cricket? Probably not.

As ever, protecting your own company's position has to be your prime concern. Can you negotiate a restriction on transferability? This is beyond unlikely. Can you have consent required, not to be unreasonably withheld, so that you at least have a fighting chance and have a few days to organise? Possible, but unlikely. However, you should attempt at least to be notified before debt is transferred: forewarned is forearmed and you may be able to check that the house is fully in order before Rachman becomes your new landlord.

The worst position to be in is not knowing who owns your debt, although it should at least keep you on your toes as the bogeyman could be scanning your management accounts as we speak, with his calculator out checking your capex!

I have not even touched financial covenants in this article, which on its own should be enough to give most FDs sleepless nights. However, what must always be remembered is that it is within your control to ensure compliance with the documentation and the only thing you should have to worry about is ensuring the business performs well enough to not breach its financial covenants.

Negotiate the documentation properly, with a good understanding of your business and ensure that the controls, systems and processes are in place to manage the requirements, and you can concentrate on running the business. But if you do not, and you don't know what is in the documentation, how do you know you have not already breached and that Nosferatu the debtholder is not planning to make you his next pizza topping?

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