Before you sign

Executive summary

■ This is the first of two articles examining what finance directors and treasurers need to know about their facility agreement in the present harsh economic climate. Preparation is all and giving your banks complete and accurate information – while making sure that you yourself have mastered all the facts – is vital if your company is going to successfully refinance in the current credit conditions.

I was recently at a gathering of financial directors hosted by a private equity house when one proclaimed: "Now is the time that FDs really need to know what is in their facility documentation." With hindsight, I will give these FDs the benefit of the doubt as they were mainly interims, had probably not originally been involved in the setting up of their facilities, and just had to live with what they had been given.

At the time, though, I saw red. "No, it's not," I piped up in a voice that felt horribly akin to the little boy in the Emperor's New Clothes. "The time when you need to know what is in your facilities is before you sign them."

I warmed to my theme. "You need to be sure that before you agree to the requirements of a facility the business can live with them commercially and operationally; that you have the systems and processes in place to ensure full compliance at all times, that information deadlines will not be missed, that you know what consents are required for what and that lack of consent will not cripple your business. And if there are requirements in the documentation that are going to cause you severe problems, then do something about it BEFORE you sign."

The answer, of course, should be, "Isn't that what I have a treasurer for?" but since no one responded with that, and everyone just nodded sagely, I decided to quit while I was ahead.

It seemed to me, though, worth setting out for FDs unfortunate enough to be going through a refinancing, and possibly without a treasurer, what they need to be aware of in these straitened times. Many FDs have never been through a credit environment like this and a treasurer's knowledge is invaluable.

If lenders are agreeing to refinancing, including renewal of facilities, then they are going to want to reduce their risk as far as possible, which means better and more information along with tighter constraints on what the borrower can and cannot do. An FD may treat these issues as boring or ignore them at their peril!

HOMEWORK Just putting a copy of a budget prepared six months ago in your briefcase before meeting the lenders and hoping that they will just skim-read it will not cut any ice. You hope that your relationship director (RD) is going to take your request to the credit committee but remember: the committee is now going to be asking a number of awkward questions and the RD will need sound answers.

Further, your RD is very possibly feeling concerned about a sudden and immediate request for "a word" with their HR department and taking a poor case to credit is not a career-enhancing move. So if you can make your RD's life easier by providing a good solid proposal along with the answers before the questions are asked, then the initial approach to the lender is going to be that bit easier.

You're going to need to do the following:

- Draw up up-to-date forecasts for at least three years including profit and loss, balance sheet and cashflow on both a funds flow and receipts and payments basis.

- Furnish actuals for at least the last three years, including comparatives to budgets/forecasts. Be sure you can explain any significant variances within these. Just because a lender might not have asked the question two years ago doesn't mean it can't be asked now. Not being able to explain past variances casts a big cloud over your ability to forecast and foresee the problems and issues that can arise in your business.

- Show sensitivities to the above (put some upside ones in as well, otherwise it may just be assumed that all the upsides are in there already, so the forecasts are viewed as overstated from the start).

- Engage in scenario analysis – and I don't just mean plan B. You will need plans A-Z and then some. Lenders will only want to lend to management who know what they're doing and that means having

WHAT EVERY FD NEEDS TO KNOW ABOUT DEBT FACILITIES BUT IS TOO AFRAID TO ASK: **GARY SLAWTHER** REVEALS ALL.

identified everything that can possibly go wrong and how you're going to protect their position.

- Provide detailed working papers and sources of information to back up the above. Just shoving in a number you thought of into a forecast and subsequently not being able to remember why you did will explode your credibility if it is queried.

- Perform valuations of major assets.

And if you're doing all this on spreadsheets (and I would strongly recommend getting a proper forecasting package or making use of the services of a financial modelling team from one of the advisory firms: it can save so much time, money and grief), then make sure that everything is independently checked, rechecked, double-checked and cross-referenced. Then check it again.

Take it from me, a phone call from the lenders' investigating accountants at half eight at night querying why a formula in a cell works in a particular way as you belatedly realise it doesn't can whip tens of millions of pounds off your forecast cash generation and spoil your beer plans for the rest of the evening (and probably the next two months).

Most of all, be sure you understand your business and that your story hangs together and is credible. Practise your presentation and get colleagues to ask awkward questions: the sneakier, dafter, more confused and full of red herrings the questions are, the better!

Companies have to understand the lenders' mindset and reasoning. Put yourself in their shoes. What is their upside? What is the best they can hope for? Okay, maybe some non-capital-intensive ancillary business from you, but generally they are looking for their interest and capital back on the due dates. They have no other upside, just the downside of not getting a bean back.

When doing forecasts and presenting them, think about:

- which bits of the business deliver solid cashflow, and major on them;
- which bits absorb cash, and determine how you will manage them if the cashflow generator doesn't generate cash;

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- which elements of planned spend will generate something tangible such as a productive asset or intellectual property;
- what your capital spend is really going on – those new premises may say a lot about your business but they may also just say "we went bust spending the lender's cash on a fancy property"; and
- how it all sounds from the viewpoint of a lender rather than a shareholder. When they hear about your multimillion-pound marketing campaign to take the business into new and exciting markets, they will listen in the silence of freezing fear: the vision in their minds will be of their lovely money disappearing to a Kazakh advertising agency without generating a penny of new business and the only cashflow being the money they get from each copy of the Big Issue they sell. So focus on letting them know that the marketing campaign is small in the context of overall cashflows and that the underlying business survives perfectly well if the venture doesn't work; and if you can't say that, think seriously about pulling the plug on the whole idea anyway.

TERM SHEET So, you are through step one. The lenders have agreed in principle to grant or renew your facilities. Don't expect this process to have happened quickly. As a banking contact mischievously recently said about his colleagues at the large clearers: "They're operating a one-day credit decision policy: one day they'll make a credit decision."

While it's still not time to break out the large G&Ts all round, you may require a stiff drink when this one hits you: be prepared for the margin to have gone up. Margin is driven by a plethora of things including the lenders' appetite for risk, the ability to syndicate or sell down the debt, their cost of funds, their security position and so on.

Remember: money is like any other commodity and not only does it cost money but in times of short supply it may not be available at any price. After all your business places capital constraints on capex and investment, so that not all good ideas can be funded however much it would like them to be, and lenders act just the same.

The lenders' views on how risky the company is and how well prepared management is to cope with the risks, only form part of the margin, so don't take the rise entirely personally, only partly. There may just be a number of better investments out there, and maybe ones that generate more of the higher return ancillary business for the same level of risk.

And do not forget risk (as did the UK clearers, US investment banks, Icelandic banks, et al). Lenders will now blind you with terms like RAROC (risk adjusted return on capital) and Basel II. Such notions are not merely arcane jargon; they have a big impact on your ability to raise finance and it might be worth your while to find out what they mean, not least so you can explain them to your board.

But if you are lucky enough to be able to raise finance and you've previously been paying, say, 75bp margin, then your starting point from there is three digits; do not be too confident that the new figure will begin with a 1.

Unfortunately, it isn't going to get any better. Fees will now be a major consideration. The security (oh, you know, fixed and floating charge-type thing) will now be very specific. Lenders will want valuations. Restrictions may be placed on corporate transactions over a particular size or some cumulative total and restrict trading in certain assets.

The funding may now be arranged in tranches to reflect the risk in different levels of lend and the ease of selling that into the market. The company may still be able to provide decent security for £200m but this may be looking slightly less easy now at £400m. So whereas before the credit crunch the full £400m was one price, it may now be two and both substantially higher than before, one of them more so.

Watch out as well for new terms such as a facility that was previously bullet, and therefore effectively never repaid as it just got rolled over on each renewal (Northern Rock), may now be amortising. When does the amortisation happen and how much? If your business cashflow is cyclical, make sure you can cope with it.

There will probably be some new covenants in there. Check how they are calculated and what's in there. If your logistics business has just made the decision to lease vehicles instead of buying them and there is a fixed charge covenant, make sure that you can properly cover it with a much higher oplease charge.

Such things should have been picked up in your homework. If they're not picked up before you sign, then start drafting your resignation letter now and pray it doesn't get into the press and make you completely unemployable.

One crumb of comfort is that most bank lenders don't want you to trip covenants or avoidably breach facilities. If that happens, then the RD has to go back to credit for a waiver, which can be a painful exercise for all concerned. The bank has an interest in having a fully performing loan, not least to avoid making further bad debt provisions, so if a term requested by the lenders is entirely commercially unviable, then with a good case, and probably some horse-trading in another area, many terms may be negotiable.

DOCUMENTATION Although many things are negotiable, some things are not and never have been negotiable – some things were but are no longer. For example, negative pledge is always non-negotiable although lenders may have given leeway on rewording of material adverse change clauses. I wouldn't expect to get much of an amendment to a material adverse change clause now.

Other areas remain negotiable but only if something is given in return. What the lenders are offering is a deal, but it may be more convenient for you if the pizza is sliced in different ways: if it doesn't have pepperoni you are not going to get pepperoni for nothing. You either have to give up something else (say cheese, tomato and base if you are lucky) or pay extra if they let you. Stick with the analogy at 50bp per topping and you are probably not too far away. The days of extra mushrooms and mozzarella for no extra charge because you are a good customer went some time around late 2007.

The second half of this feature, which appears next month, will cover the facility documentation.

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