Both sides of bilaterals

Bilateral facilities enable the treasurer to develop good relationships and offer considerable flexibility with pricing and maturities, says Fred Fisher of bfinance.

Despite the advances in disintermediated debt, there are a number of key features that give the bilateral loan a core role in any treasurer's debt portfolio. In particular, committed lending offers flexibility which is not always provided by the debt capital markets. Funding windows can open and close at extremely short notice and the treasurer will be under intense pressure to meet investor criteria during the limited period the markets remain favourable. Moreover, forays into the debt capital market will not necessarily be accompanied by a trusted long-term partner that understands the company's credit history and business.

Arranging a bilateral, however, can be time-consuming. The treasurer must work hard to achieve the keenest pricing and the most suitable terms.

In addition, the line of credit required might be beyond the volume capabilities of a single relationship bank. Nevertheless, once a committed facility has been agreed, the security of knowing that funds can be drawn down at any time during the term of the loan not only allows for effective and accurate forward planning but can give invaluable peace of mind.

Choosing a bank
In most cases, the first port of call when looking to source a bilateral loan will be the company's core relationship bank(s). Indeed, credit facilities are often a means of establishing a core group which can be tapped for additional services. Banks have long regarded bilateral lending as a means of 'getting their foot in the door' in order to bid for more lucrative business, such as derivatives or syndicated loans. Ironically perhaps, some larger companies have recently been able to demand credit facilities from banks before considering them for more value-added fee-based services. Where a core group exists, clearly relationship banks will have a good understanding of the company's credit history, present cashflow profile and future strategy. This should make negotiation of terms, conditions and pricing far more straightforward.

Tenor
In terms of maturity, it should be possible to match the tenor of a bilateral loan (or series of bilaterals) to anticipated funding needs. Typical tenors are for 364 days, three, five and seven-year periods and the treasurer is likely to make use of this variety of maturity profiles to limit refinancing risk (that is, to avoid all loans maturing at the same time). However, the balancing of obligations toward a variety of loan agreements – or lenders – demands vigilance on the part of the treasurer. Although the tenor is fixed at the start of the loan period, it is subject to renegotiation should the circumstances of the borrower change and the loan can usually be cancelled ahead of maturity without penalty.

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Flexibility
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Defined simply as an agreement between a bank and a client company to provide funding of a fixed amount repayable after a fixed period, there are essentially two funding types that fit the description 'bilateral loan':

- **revolving credit facility:** typically a committed floating rate facility which is drawn down to meet particular funding requirements. Similar to an overdraft, in that the facility may be rolled over or extended if required, it can also be treated as a standby facility. This remains typically undrawn but may be required to provide cover for temporary cashflow shortage (perhaps for seasonal requirements or as a back-stop for a commercial paper programme); and
- **fully-drawn term loan:** the full amount of the loan is drawn down from the bank from the start of the loan period, either on a fixed or floating rate basis.

Between them, these options should enable the treasurer to access funding to meet most [working capital] needs in a cost-effective manner. They impose, however, different requirements on banks, which will price them accordingly.

Fees
The cost of bilateral loan consists of the margin over Libor the bank is prepared to offer and associated additional fees. Apart from the most basic of principles (that is, the shorter the period of the loan, the cheaper the financing costs), fees are a function of supply. Commitment fees are justified as a function of the impact of the loan on the bank's capital ratios, while arrangement and cancellation fees reflect only administrative costs and are therefore more susceptible to market forces.

For example, oversupply and the attempts of new entrants to establish a presence in the market during the late 1980s wiped out front-end arrangement fees in the majority of cases. However, such fees are returning for certain credits, partly as a function of banks tightening their belts ahead of an expected economic slowdown, and partly due to structural

changes in the market as banks focus on more effective uses of their balance sheet, whilst still trying to push up fee income. Borrowers will be charged interest calculated as a margin over Libor on the drawn portion of the loan. In addition, the bank will charge a commitment fee on the undrawn portion, effectively guaranteeing that the company can access the cash at any point. For this, the borrower will pay a fee equivalent to about 50% of the margin, or sometimes less depending on the appetite of the bank and the credit record of the borrower.

Additional fees are payable for an extension of an existing loan but, unlike a syndicated loan, it is likely that the bank will agree to use the same documentation as drawn up for the original agreement. Fees attached to early cancellation of facilities are rare, but this is a function of present market conditions and may change to reflect tighter credit conditions in general.

A final point on pricing is that the bilateral loan is probably the largest facility a company can put in place without the margin being made public. Bilaterals involve only two parties and so attract no publicity and therefore no adverse comment by the press or investors on whether the company paid too much to secure the loan. Additionally, the lack of publicity means the treasurer may be able to secure different pricing from different banks for the same loan maturity. Given the variables that must be factored into the pricing of different bilaterals, it is beyond the remit of this article to comment further on the nature of fees.

Negotiation and loan documentation

Most issues relating to loan documentation and negotiation can be listed in the minus column in the balance of pros and cons for bilateral facilities. This is due:

- to the initial time and effort required to collect the necessary information;
- to negotiation of terms imposed by the bank; and
- to the post-transaction monitoring of obligations.

While it is inevitable that a treasurer will turn to his relationship banks for a bilateral loan, it still takes time to obtain the correct range of pricing information from a sufficient number of banks, perhaps over a range of tenors and amounts, to weigh up the options appropriately. Moreover, the fact that banks will attempt to impose their own standard loan documentation means that, even when pricing differentials are identified, clauses relating to financial and non-financial covenants must be compared for the restrictions imposed on the borrower for the period of the loan.

Covenant clauses are included in loan agreements to ensure that the borrower does not take any action that may prejudice its ability to pay back the loan. But banks work according to different criteria and will each have their own ways of guaranteeing a return on capital. Therefore, it is common for many businesses to have a loan portfolio across a range of maturities and amounts with each loan agreement subject to different covenant clauses. Needless to say, companies may find themselves paying substantial fees to lawyers as well as bankers when negotiating a bilateral.

Most covenants relate to specific yet straightforward ratios such as interest cover, but the treasurer must be constantly aware of the terms and conditions of his or her loan agreements to ensure that their loan portfolio is able to support his or her company's funding requirements, particularly if facilities are negotiated at short notice to meet an unexpected shortfall. There are many examples of companies which have had problems because of differing covenants in their range of bilaterals. In particular, treasurers should be aware of interest cover, tangible net worth, cross-default clauses (a default on one loan automatically translates into a default on the whole loan portfolio) and material adverse change clauses.

This latter clause is usually written out of documentation for loans used as back-stop facilities to commercial paper programmes, but in other circumstances it may give the bank scope to refuse an advance that the borrower had assumed was guaranteed. There is a well known instance of a Continental bank declining a UK drawdown request on the grounds of material adverse change despite not having made any attempt to contact the borrower to discuss the situation. However, if the relationship with the lender is strong then the company may be able to persuade the bank to grant a waiver if it breaks certain ratios or other covenants.

Post-deal communication

If the upfront time investment is considerable, then the post-deal administrative burden of running a portfolio of bilaterals can also be time-consuming. Unlike a syndicated loan where the agent bank takes care of distributing the margin and fee payments to other participating institutions, the treasurer must deal with each individual drawdown, together with separate payments of interest and quarterly commitment fee invoices for any amounts undrawn, from each of his or her relationship banks.

Invoices from banks for margin interest will be calculated according to the definition of Libor agreed at the start of the agreement and usually for interest periods of one, three or six months. However, they are unlikely to fit neatly into the firm's payment cycles and can prove difficult if the treasurer has a number of loans to service. Invoices for commitment fees will be issued quarterly in arrears.

Transferability

Bilateral facility agreements will usually incorporate wording to the effect that the bank may assign its rights under the agreement to another lender with the prior consent of the borrower. However, in such circumstances, companies are rightly concerned about the name and credit rating of the new counterparty and have been known to veto any assignment on these grounds. For both parties, it is worth the time and money spent with lawyers to iron out transferability clauses at the outset.

The final balance sheet

Bilateral facilities form a useful part of the funding arrangements for any company. They enable good relationships to be developed and offer a considerable degree of flexibility with regard to pricing and maturity. Confidentiality is perhaps their most useful asset, although this must be balanced against the time involved in establishing and maintaining these facilities. ■

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