

September 2016

Q3 2016 CORPORATE BORROWER UPDATE



INTRODUCTION

Welcome to the Q3 2016 edition of the Addleshaw Goddard Corporate Borrower Update.

In the eyes of many, Q3 saw a return to 'business as usual' following the 'Brexit' referendum, and an end to some of the uncertainty which had built up in the market, particularly in the month or so leading to the referendum.

Whilst activity levels have varied across sectors, July and August saw some of the busiest periods in the corporate banking department in recent times, with strong deal flow in our leveraged finance practice in particular keeping us busy. As we move into the Autumn and the run up to Christmas, we look forward to continuing to support clients on new and existing financings.

Unitranche facilities have increased their foothold in the UK mid-market over the past year. For this reason, we revisit a topic which last featured in the Q2 edition of 2014, and take a closer look at some of the emerging trends. We do so from page 2 onwards.

A perhaps less well known topic relates to the National Guarantee Loan Scheme run by HM Treasury. We have seen some recent examples of borrower clients availing themselves of this Scheme on corporate deals. We take a closer look from page 4 onwards.

We do hope this edition is of interest – please do not hesitate to contact any member of the team (see page 6 onwards) – if you would like to discuss. We look forward to working with you over the coming months.



Amanda Gray – Head of Corporate Banking

020 7160 3433

07720 544070

amanda.gray@addleshawgoddard.com

UNITRANCHE

Introduction

Frequent readers of the Addleshaw Goddard Corporate Borrower Update may recall our previous summary of unitranche financing, which featured in the Q2 edition of 2014. According to Deloitte's Alternative Lender Deal Tracker (which tracks primary mid-market deals), 47% of UK transactions over the twelve month period to Q1 2016 were classified as unitranche structures, compared to 32% senior transactions. Further, the data from Deloitte indicates that alternative lender deals, in the first quarter of 2016 totalled 63 - an increase of 8% in deal flow on a LTM basis in comparison with the previous year. As unitranche deals continue to dominate, we thought it might be useful to revisit the topic in this Q3 2016 update.

What is unitranche?

Typically, a unitranche loan is characterised as being a non-amortising, single tranche of term debt, provided by a credit fund. The range of potential providers is ever increasing and it is key to highlight that the term "credit fund" can be used to describe an extensive range of lending institutions with varied strategies, from large organisations akin to the more traditional clearing bank to hedge funds. However, in terms of deal volume, commentary on mid-market transactions from last year suggests that the unitranche offering is dominated by the more mature funds.

Advantages

Commonly cited advantages to corporate borrowers include:

- ▶ **Flexibility of terms.** Looser restrictions on permitted transactions, covenant-lite / covenant-loose (often with only one financial covenant (typically leverage)) and with a longer tenor. It has also been suggested that a fund's credit committee is likely to be more receptive to borrower requests than a traditional lender. However, arguably the clearing banks and their credit functions are starting to respond to that challenge in light of increasing competition from alternative lenders.
- ▶ **Cash retention.** The non-amortising nature of the debt also presents a significant advantage for certain borrowers, allowing borrowers to preserve cash in the business for permitted acquisitions, capital expenditure or general working capital.
- ▶ **Lower execution risk.** It is not uncommon for there to be a sole unitranche lender or a small club of lenders which, it is often claimed, promotes a more streamlined, cost-efficient approach. In the context of an acquisition finance transaction, the ability to move quickly with regard to negotiation of documentation can be a distinct advantage to the borrower, particularly if it is embroiled in a competitive bidding process for the target entity. Delays associated with a large club of lenders, each with its own policy concerns and due diligence requirements, are also mitigated. In practice, such advantages may be diluted by prolonged intercreditor discussions (especially where intercreditor principles are not agreed in advance between the super senior lender and unitranche provider).

Potential disadvantages

- ▶ **Pricing.** Flexible terms come with a price. Deloitte's Alternative Lender Deal Tracker from the final quarter of 2015 categorises unitranche debt as senior only deals with pricing of LIBOR plus 650 bps. This is approximately 200 bps higher than the margin that might be attributed to TLB facilities in a traditional senior structure.
- ▶ **Uncertainty in a default.** There are few well publicised examples of how an alternative lender would deal with a default or distress scenario under a unitranche loan, although there is much market speculation. Whilst some providers have large portfolio management teams akin to the clearing bank's relationship functions, others may not be in a position to offer support when times get tough. A credit fund may not have capacity to provide additional credit in a distressed scenario, and as readers will be aware, a direct lender cannot usually provide a revolving credit facility. The debate continues as to whether unitranche lenders are more likely to call a default immediately and/or potentially sell the debt, or take a more flexible approach provided interest payments are made on time. For this reason, borrowers are likely to focus in particular on the extent to which the lender is able to transfer its debt.

Future projections

With an increase in borrower demand for fairly priced, flexible debt, the modern lending market is looking for opportunities to develop its product offering to meet the shifting demands of corporate borrowers. As such, the use of unitranche structures is evolving in the following key areas:

- ▶ Traditionally reserved for large cap transactions, we are increasingly seeing the unitranche product become more prevalent as a financing option in the lower mid-market. In the Spring of this year, the Addleshaw Goddard corporate banking team advised on a structure involving a £500k super senior revolving credit facility, alongside unitranche debt of just £24m.
- ▶ A number of financial institutions which would typically provide the super senior RCF are working towards the development of alternative working capital solutions, based on a committed invoice discounting facility sitting super senior to a unitranche loan. Such blended product is a natural alternative to a revolving credit facility if invoice financing would complement the business, particularly if the borrower group is asset rich and/or experiencing rapid growth.

Conclusion

As alternative lenders become increasingly mainstream and continue to add to their deal flow, borrowers are likely to consider unitranche products as well as the traditional senior-only financing options. As the year continues, it will be interesting to observe the reaction from the traditional clearing banks and how the market will adapt with various innovative product offerings. As always, it will clearly be a case of finding the right lender, at the right price and on terms that fit your particular requirements.

AG contact

If you require any assistance, or would like to discuss the above in more detail, please contact your usual Addleshaw Goddard contact or:



Laurie Keel
Partner
0207 160 3063
07545 605640
laurie.keel@addleshawgoddard.com



Laura Moss
Associate
020 7160 3344
07709 332432
laura.moss@addleshawgoddard.com

NATIONAL GUARANTEE LOAN SCHEME

Introduction

The UK government has implemented a number of initiatives designed to boost economic growth in the years which followed the onset of the financial crisis. These have ranged from schemes to increase capital available to small and medium-sized businesses (**SMEs**), to measures to boost infrastructure investment and to provide credit support for UK exporters.

We recently advised on a UK acquisition where the borrower availed itself of the National Guarantee Loan Scheme (**Scheme**) to obtain cheaper funding in relation to a non-sponsor backed corporate acquisition facility.

What is the Scheme?

The Scheme was launched on 20 March 2012 to help smaller businesses obtain lower cost of finance. When originally launched a business could only have a maximum turnover of £50 million to be eligible under the Scheme. That threshold was subsequently increased to £250 million.

The Scheme provides for government guarantees of up to £20 billion on unsecured borrowing by banks, enabling participating banks to borrow at a cheaper rate. Participating banks pass on the entire benefit that they receive from the guarantees across the UK through cheaper loans. The Scheme is run by HM Treasury. The provision of guarantees is administered by the UK Debt Management Office (**DMO**).

The Scheme is now closed to new participating banks, although the DMO website notes that in the event that stressed market conditions re-emerge, HM Treasury would consider whether to reopen the scheme.

What is the upside for Borrowers?

Businesses that take out a loan which benefits from the Scheme will receive a 1% discount compared with the interest rate that they would otherwise have received from the bank outside of the Scheme. This can however vary as each bank operates on its own pricing model. This is clearly a material reduction in the interest rate which would otherwise be payable by a borrower on a loan.

Eligibility

For a business to be eligible to apply for a loan which has the benefit of the Scheme it must meet the following 3 criteria:

- ▶ The annual turnover of the company does not exceed £250 million in the most recent set of financial accounts or management accounts;
- ▶ The company is a UK business (specifically, a material element of the business's activity takes place in the UK). The relevant bank will be able to confirm whether the business meets the criteria; and
- ▶ The company is not in financial difficulty.

Documentation

From a borrower's perspective, there is little documentary impact if a loan is made by its bank with the benefit of the Scheme. The facility agreement will simply need minor amendment in order to accommodate Scheme specific requirements. For example, there will be a representation that (i) a material element of the borrower's economic activities are in the United Kingdom and (ii) that the borrower has an annual group turnover not exceeding £250 million (as at the date of the borrower's last financial accounts or management accounts).

State Aid

If the rate offered to the business is at or above the relevant state aid reference rate then there will be no state aid implications. If the offered interest rate is below the relevant reference rate, some or all of the benefit received under the scheme will qualify as de minimis state aid. Where some or all of the benefit of a Scheme loan qualifies as state aid, the amount of aid will be clearly stated in a letter to the business from its bank. If the business is already receiving state aid help then they may not receive more than €200,000 over any three year period.

Conclusion

Although we understand that some of the participating banks have now reached the limit of the guarantees which they signed up to under the Scheme and are therefore closed to new loans under the Scheme, there is still capacity within the range of participating banks to provide loans benefitting from the Scheme.

The Scheme offers obvious benefits to eligible borrowers from a pricing perspective. From our experience, the process is also relatively straightforward from a documentary and process perspective, which is always good news for borrowers.

AG contact

If you require any assistance, or would like to discuss the above in more detail, please contact your usual Addleshaw Goddard contact or:



Angus Gill
Partner
0207 160 3432
07802 719687
angus.gill@addleshawgoddard.com



Ronan Armstrong
Managing Associate
020 7160 3320
07921 284445
ronan.armstrong@addleshawgoddard.com

SENIOR TEAM CONTACTS

We advise corporate clients on the full range of financing matters. If you would like to discuss your financing, or any of the issues raised in this update, please contact any of the Addleshaw Goddard individuals listed below.

London

firstname.surname@addleshawgoddard.com

AMANDA GRAY

Partner

0207 160 3433
07720 544070



ALEX DUMPHY

Partner

0207 160 3221
07709 332374



MIKE DAVISON

Partner

0207 160 458
07738 023412



ANGUS GILL

Partner

0207 160 3432
07802 719687



LAURIE KEEL

Partner

0207 160 3063
07545 605640



SARAH STOKES

Legal Director

0207 160 3147
07789 070218



RONAN ARMSTRONG

Managing Associate

0207 160 3320
07921 284445



RICHARD STANBROOK

Managing Associate

0207 160 3362
07738 023334



JAMES TARLETON

Managing Associate

0207 160 3461
07809 594153



"I admire them for their sector product knowledge. They seem to have a huge depth of resources to assist with all the connected issues we might have."

CHAMBERS UK 2016

Leeds

firstname.surname@addleshawgoddard.com

DAVID HANDY

Partner

0113 209 2432
07720 350326



ROSALIND MASON

Partner

0113 209 2046
07834 570309



MICHAEL KIDD

Managing Associate

0113 209 2684
07725 734912



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*'Proactive and commercial'...
'good market knowledge'*

LEGAL 500 2015

Manchester

firstname.surname@addleshawgoddard.com

MARTIN O'SHEA

Partner

0161 934 6403
07775 586372



ANDREW MASKILL

Partner

0161 934 6343
07775 586375



RICHARD OMAN

Partner

0161 934 6739
07709 332429



SIMON PRENDERGAST

Partner

0161 934 6027
07912 395312



REBECCA WILLIAMS

Partner

0161 934 6291
07809 594262



RICHARD CHANDLER

Legal Director

0161 934 6352
07738 144072



PETER JONES

Legal Director

0161 934 6346
07872 675592



LOUISE JONES

Managing Associate

0161 934 6316
07720 999789



CAROLINE GRAY

Managing Associate

0161 934 6695
07841 080565



NATALIE HEWITT

Managing Associate

0161 934 6311
07725 732068



BEN EDWARDS

Managing Associate

0161 934 6745
07710 857891



BEN TRAYNOR

Managing Associate

0161 934 6773
07725 353110



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Doha, Dubai, Hong Kong, Leeds, London, Manchester, Muscat, Singapore and Tokyo*

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