KEY POINTS

- The Loan Market Association's (LMA) template incremental facility wording may be in need of a revamp to bring it in-line with actual market practice.
- Debt incurrence levels are typically governed by an adjusted leverage test, with sponsors and borrowers frequently pushing for documented incremental timetables to be collapsed and more dynamic pricing.
- Lenders' rights of first refusal are increasingly being diluted or removed.
- The Loan Market Association's recommended drafting only provides for the ability to establish a term incremental facility, but including additional flexibility to establish a revolving incremental facility has become relatively common on sponsor-backed deals.

Feature

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LMA incremental facility wording: one size fits all?

In this article the authors examine the process of establishing an incremental facility using the steps prescribed by the Loan Market Association's (LMA) template wording and consider whether it represents common practice in the mid-market. An incremental facility (otherwise known as an "additional" or "accordion" facility) is an uncommitted facility (usually capable of being made available for acquisition, capex or general working capital purposes) which can be established by a borrower without the need to seek lender consent or amendments to the finance documentation provided that certain pre-agreed parameters are complied with.

INTRODUCTION

First introduced in the Loan Market Association's (LMA) precedent senior multicurrency term and revolving facilities agreement for leveraged acquisition finance transactions in November 2016, the presence of largely uniform incremental facility provisions in the European mid-market have since become commonplace. For many borrower groups, pre-baking an uncommitted facility into a facilities agreement represents a win-win scenario; providing added flexibility without the day-one cost, with no commitment or arrangement fees payable until the establishment of the incremental facility at the earliest.

From a private equity perspective in particular, many sponsors are increasingly targeting buy-and-build strategies to accelerate revenue growth and generate higher investor returns versus organic growth. Platform businesses are often able to acquire complementary target companies for a lower multiple of earnings than that expected to be achieved upon a sale of the combined group, and so the presence of an agreed incremental debt funding framework and its ability to provide a competitive edge in a bidding process from a speed of execution perspective has become a real focus for sponsors in recent times.

THE LMA PROCESS

The LMA's template drafting prescribes a structured roadmap to establishing an incremental facility, consisting loosely of four stages:

- **The incremental facility proposal**: The company is required to first deliver to the existing lenders a formal incremental facility proposal detailing the proposed terms and inviting each lender to participate.
- **The lender offer:** Prior to the expiry of the solicitation period – typically between five and ten business days after the date of the incremental facility proposal – each lender must decide the level of commitments (if any) it is willing to offer. In the event of a shortfall, the LMA prescribes two wider invitation steps. The first effectively grants the incumbent lenders a second bite at the cherry. At the second, the borrower group is permitted to reach out to the wider debt market in respect of the shortfall. In the event that the incremental facility is over-subscribed, the LMA wording includes a scaleback provision.
- **Incremental facility notice:** The form of incremental facility notice (IFN) is contained as a schedule to the facilities agreement. It sets out the terms agreed between the company and lender(s) at the proposal stage and is delivered by the company to the agent for the purpose of establishing the new facility. A further timing element is added in the LMA drafting at this stage, by requiring the IFN to be delivered by the company not less than an agreed amount of time – usually three business days – prior to the proposed establishment date.
- **Establishment date**: Following the delivery of an IFN which is in compliance with the requirements of the facilities agreement vis-à-vis incremental facilities, the agent is directed to execute the IFN and confirm once the establishment date has occurred. At this stage the facility will become committed and available for drawing by the borrower.

Such a complex and administratively burdensome timetable has the potential to prejudice the type of competitive bid process that uncommitted acquisition lines are, in many cases, designed to assist. It is therefore no surprise that sponsors and borrowers frequently push for incremental facility timetables to be collapsed.

Despite this – with the exception of removing the initial shortfall step and a couple of more benign tweaks – the LMA drafting is generally adopted. However, the actual practice of establishing a new facility tends to depart significantly from the documentary framework; begging the

question whether the LMA's prescriptive drafting is in need of a revamp to bring it in-line with wider market practice.

THE REALITY

In the majority of cases the borrower will want to continue working with its incumbent lender group when looking to establish an incremental facility given that existing commercial relationships and the lenders' familiarity with the credit tend to help accelerate matters and avoid protracted negotiations. For a sponsor-backed group of companies, the sponsor will have also likely secured a relationship-style lend, benefitting from informal assurances as to the availability of "dry powder" to help facilitate a buy-and-build strategy that it may wish to tap into.

Consequently, stage one – the incremental facility proposal which starts the clock ticking on the solicitation period – is often commenced by way of informal email communications at a principal level, with any formal solicitation period largely ignored. Lenders and borrowers instead seek to swiftly agree the additional debt levels and terms (which are usually a mirror-image of those agreed in respect of the existing acquisition/capex line) and will instruct legal counsel to produce an IFN based on the agreed position well within any documented timeframe. The parties will look to proceed as quickly as possible to the establishment date on the date of the IFN, often disregarding any notice period requirement; again an example of the practice of departure from the carefully calibrated timetable in the facilities agreement.

From a lender perspective, it is helpful to have a set process which affords additional wriggle room to make a decision and to speak with internal committees before relaying the outcome to their customer. However from a borrower/sponsor perspective, having a set timeframe lurking in the background creates unwanted deliverability risk and could also result in a significant setback in a competitive environment if, upon the expiration of the solicitation period, the incumbent lenders politely decline their option to participate. This would mean the borrower having to start afresh and go out to the market to seek new debt providers willing to participate which would almost certainly sabotage any possibility of success in a swift moving auction process.

Thus, the reality is that parties will often ignore the shackles of the facilities agreement and adopt a more commercial, pragmatic route to working together to deliver the borrower's debt requirements as soon as possible. Borrowers and sponsors are therefore starting to push for documentary terms that sit closer to reality instead of dogmatically following the LMA drafting which could, potentially, come back to bite them at their time of need.

CURRENT TRENDS

"Right of First Refusal" or "Right of First Look"?

In order to preserve the autonomy of a borrower's decision-making when it comes to who it wishes to partner with, and to also avoid the time-consuming structure proposed by the LMA template language, some borrowers and sponsors are pushing to remove the lenders' right of first refusal (often termed a "ROFR") when it comes to incremental facilities. It is relatively rare in the US market to see the presence of a ROFR and many sponsors with links across the pond are striving to achieve this in Europe as well.

If the removal of the ROFR is agreed with lenders at term sheet stage, a "right of first look" is often agreed as a middle-ground. This preserves the existing lenders' right to receive an incremental facility proposal (whether formal or otherwise), but the ability to participate takes the form of a right to pitch as opposed to a binding right to lend, whilst also allowing the borrower to essentially collapse stage 2 into one step (by removing the shortfall provisions) and merge it with stage 1.

This has benefits from a timing perspective, but also ensures that the borrower is able to achieve the best terms by keeping the incumbent lenders on their toes, with the lender protection in this regard coming from the "most favoured nation" (MFN) provisions discussed below. It could also be sensibly argued by a borrower in a day-one unitranche deal wishing to have the ability to establish a revolving incremental facility that, given most debt funds' inability to provide debt on a revolving basis, it would make little sense to include a ROFR in this regard in any event.

Another option in a unitranche or single-lender scenario is for a lender's ROFR to be triggered only if the incumbent lender's commitments would be reduced to less than 66⅔% as a result of the establishment of the proposed incremental term facility. This formulation protects that lender's majority position, but provides flexibility to the borrower not to have to first go through the process of seeking the participation of the incumbent lender in every proposed incremental facility.

Incremental revolving credit facilities

Another quirk of the LMA drafting is that it only provides for the ability to establish a term incremental facility as opposed to a revolving facility.

Having the ability to establish a revolving incremental facility offers an alternative, or even additional, route to the "traditional" RCF establishment provisions that have become relatively common in the mid-market. These provisions are particularly prevalent when there is timing pressure to sign debt documents in short order, with it being agreed that a super senior RCF lender (typically a traditional clearing bank) will be brought in shortly thereafter.

An RCF is usually cheaper debt and, as COVID-19 has materially impacted business over the past 12 months, has proven its importance from a liquidity preservation perspective. It also has its benefits for a borrower group where a listing might be on the horizon, meaning that listing rules and capital requirements, particularly access to ongoing working capital facilities, will need to be considered. Having the ability to establish a revolving incremental facility can potentially ease a lot of administrative hassle from a company perspective by avoiding the need to restate the facilities agreement to

Biog box

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include a new revolver and the associated drafting that goes with it.

Non-call protection

Whilst sponsors continue to try and push market terms in their favour, lenders (particularly in the direct lending space) continue to seek protections against early repayment of their debt to encourage their cash to be put to work harder and for longer. It is not uncommon for lenders to push for the same non-call protection as applied to the original acquisition/capex facility in respect of the incremental debt.

Freebie baskets

Sponsors looking to achieve incremental terms at the more aggressive end of the scale may also push for a certain amount of debt (typically between 0.5x and 1x turn of EBITDA) to be capable of incurrence without the need to meet any sort of leverage test (see below). This is what is known as a "free and clear" or "freebie" basket, and it is another example of a US concept percolating into European deals and something that readers can expect to see a lot more of over the next 12-18 months, despite it being omitted from the LMA's template wording.

Other important Incremental Facility Terms

- **Cap on incremental debt incurrence:** The standard LMA drafting provides for a monetary cap to be agreed and incorporated into the facilities agreement. Market practice has now largely moved to an incurrence-based regime, meaning that the capacity for additional debt is tested at the time of incurrence in accordance with an adjusted leverage test, often linked to opening leverage. This acts as a potentially expanding cap and allows the borrower to continue to acquire businesses in-line with its current scale and debt profile.
- **Aggregate Yield/"most favoured nation" provisions:** Most facilities agreements now contain MFN wording designed to preserve and protect the integrity of the incumbent lenders' pricing by ensuring that – absent a corresponding increase in its own yield – pricing on any incremental facility remains within a prescribed level, ordinarily 1%, of the aggregate yield enjoyed by the existing lender group.

Whilst the LMA template wording does include an effective cap on the yield, it is not a true yield protection for the existing lender group and has the effect of potentially restricting the borrower from going out to the market to find a willing lender. It is for this reason that MFN wording has now become an established amendment to the LMA recommended form, by continuing to preserve the value of the initial debt in the secondary market (usually for a 12-18 month sunset period), whilst also allowing the borrower to seek the best additional lending partner.

- **Certain funds:** Against the backdrop of the buy-and-build strategies adopted by many sponsors, it is often important to also include drafting to allow for the possibility of incremental facilities to be made available on a "certain funds" basis. This means that a lender will only be able to refuse to make available a loan in the event of a major default (including non-payment and insolvency related events) such that an auction bid can be placed with the minimum amount of risk of the bidder finding itself with an unwelcome funding gap the day before completion.

CONCLUSION

The LMA drafting, for all of its gaps and quirks, remains a useful starting point in many cases despite the reality of establishing an incremental facility in practice being somewhat different. With that said, it would be welcomed by borrowers and sponsors alike for there to be a shift in the template wording closer to the now commonly negotiated position.

Perhaps the LMA provisions – like the accordion itself – simply require some light squeezing to be applied in order to avoid striking the wrong note as market practice continues to develop apace. ■

Further Reading:

- Accordion features in syndicated credit facilities (2012) 7 JIBFL 441.
- The evolution of "soft cap" covenant baskets in the European loan market (2016) 5 JIBFL 285.
- Incremental facilities: another example of European and US loan market convergence (2017) 3 JIBFL 151.

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