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# Client Alert

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# FORWARD START FACILITIES

Borrowers faced with uncertainty on whether they will be able to refinance existing debt at maturity if the credit crisis continues now have a new product to consider: the "forward start" facility (an "**FSF**"). This Client Alert considers the key features of an FSF and particular issues that may arise when FSFs are used.

## *What is a Forward Start Facility?*

An FSF is a facility under which lenders under an existing credit facility (the "**Existing Facility**") commit, well in advance, to provide financing to repay the Existing Facility at its maturity. On the date that the Existing Facility matures, the FSF can be drawn to repay it.

Lenders who participate in an FSF (the "**FSF Lenders**") provide commitments at least equal to their commitments under the Existing Facility. In exchange, they receive payments representing incremental increases over the interest margin and the fees payable under the Existing Facility. These top-up payments are designed to ensure that FSF Lenders enjoy an immediate "marked to market" increase in the aggregate amount paid for their existing commitments (funded and unfunded) under the Existing Facility without increasing their overall exposure to the borrower. The borrower, in turn, locks in the terms and pricing of a committed longer term facility, in essence refinancing itself by extending its existing facilities.

The FSF is an elegant tool because it bypasses the unanimous lender consent that normally would be required to extend an Existing Facility. An FSF is flexible because it can "grow" as existing lenders choose to participate in it. Of course, until the aggregate commitments under the FSF equal amounts due at maturity of the Existing Facility, the borrower faces an unfunded shortfall at maturity. However, the expectation is that existing lenders will migrate into an FSF given the obvious benefit of an immediate uplift in aggregate pricing for the Existing Facility with the topup from the FSF. As they do so, the FSF grows into a full refinancing.

## *Who are the parties to an FSF?*

The initial parties to an FSF are the borrower and some of the lenders under the Existing Facility. FSF Lenders' commitments are effectively stapled to their commitments under the Existing Facility. If an existing lender does not wish to participate in the FSF, FSF Lenders may assume increased overall commitments or new banks may be invited to participate in the FSF to fill the refinancing gap.

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## *What are the key features of an FSF?*

- **Interest:** FSF Lenders receive an additional payment under the FSF which effectively tops up, from the effective date of the FSF, the interest margin payable in respect of amounts drawn under the Existing Facility. Given the increase in pricing for risk, this feature can bring the aggregate margin into line with current market pricing. In a recent example, a European company agreed to a seven-fold increase in its current margin to allow it access to a revolving credit facility in 2011.

- **Upfront and Commitment Fees**

  - **Upfront Fees:** In effect, FSF Lenders will be rolling over their commitments (or providing new commitments) on the date the FSF is drawn (i.e., at maturity of the Existing Facility). Accordingly, they will expect to receive an upfront fee. A borrower may offer an additional "early bird" fee to existing lenders that commit early as FSF Lenders.

  - **Top-Up and Additional Commitment Fees:** To the extent that FSF Lenders have un-funded commitments under the Existing Facility, they expect to receive for their commitments under the FSF an additional or top-up commitment fee to reflect the difference between current market pricing and commitment fee levels under the Existing Facility. To the extent the commitments of FSF Lenders exceed their funded commitments under the Existing Facility, those FSF Lenders receive commitment fees under the FSF in respect of the excess commitments.

    Once the FSF is drawn and the Existing Facility repaid, interest and commitment fees are payable solely under the FSF.

- **Other features**

  Other terms of an FSF typically are based on the terms of the Existing Facility but may be more onerous in certain respects such as financial covenants. An FSF is structured so that it is:

  - available on and from the date that the Existing Facility matures;

  - subject to documentary and other conditions precedent at least as complete as the conditions precedent under the Existing Facility. FSF Lenders may seek additional conditions. It will be interesting to see whether market practice develops to allow FSF Lenders to refuse funding, under so-called "MAC clauses", due to materially adverse changes in market conditions or borrower-specific circumstances;

  - used only for the purpose of refinancing (in whole or in part) the Existing Facility; and

  - cancelled to the extent of any mandatory cancellation or reduction of the Existing Facility.

## *What issues arise in relation to an FSF?*

- **Non-Conflict:** An FSF must not conflict with the Existing Facility. In particular, obligations of the borrower in respect of the interest and commitment fee topups described above could result in a breach of the Existing Facility. One solution is to document these uplifts as fees, payable quarterly. Whether such fees infringe the terms of the Existing Facility requires careful consideration. The treatment of these amounts under financial covenants in the Existing Facility also needs to be considered.

- **Amendments and Waivers:** During the term of an FSF, FSF Lenders are likely to require the right (but not have the obligation) to make amendments to the FSF that match amendments, if any, to the Existing Facility. Alternatively, or in addition, the FSF may prohibit the FSF Lenders from agreeing to amendments under the Existing Facility unless corresponding amendments are made under the FSF.

- **Timing of drawdown and security:** Typically, the full amount of the FSF is drawn at the same time to repay the Existing Facility when it matures.

  In some instances, it may be possible for the FSF to be drawn to refinance a single tranche of maturing debt under the Existing Facility. The remainder of the Existing Facility and the FSF would then continue to exist side-by-side, with terms that ensure that both facilities are *pari passu* obligations of the borrower. This would typically require at least a two-thirds' majority approval under the Existing Facility (to approve the incurrence of debt by the borrower under the FSF). If the Existing Facility is secured, partial drawings of the FSF on a secured basis will be challenging, though not always impossible, unless intercreditor and security documents are capable of being amended without unanimous lender consent to accommodate the FSF. The most significant challenges are identified in the highlighted section below.

***Partial Refinancing of Leveraged/Secured Financings***

- Partial refinancing of a senior secured facility using a secured FSF presents a number of challenges, because the FSF needs to be integrated into the existing intercreditor and security framework.

- Most leveraged transactions do not contemplate a separate *pari passu* and secured facility which shares in existing security. To implement such a facility normally requires amendments to the intercreditor agreement and, most likely, junior lender consent.

- In order to avoid such amendments and consents, an FSF would need to be incorporated into the Existing Facility. Principal challenges to doing this are as follows:

  - The Existing Facility must permit "structural adjustments". Pursuant to a typical structural adjustment provision, the majority lenders plus all lenders assuming a new commitment (i.e., the FSF Lenders) may approve the incurrence of a new facility (i.e., the FSF) within the Existing Facility.

  - If the intercreditor agreement protects junior or mezzanine creditors by restricting the incurrence of additional debt, consent of the majority junior creditors will be required, unless the amount of the FSF debt falls within the agreed amount of "senior headroom".

  - In many jurisdictions where security has been granted, amending the Existing Facility to accommodate the FSF will result in the security being deemed to have been released as a result of the amendment. Accordingly, it will be necessary to re-take security and existing lenders will need to accept new "hardening" periods.

  - Security for new debt usually automatically ranks behind security held by existing secured creditors. This is a particular problem where junior creditors hold security. Although it may be possible to resolve this by amending the intercreditor agreement, in all likelihood, junior creditors will need to release their security and re-take it to facilitate the process. Releases of security typically require 85% to 100% lender consent, making it difficult to achieve as a practical matter.

**Conclusion:** Given the above issues, except in the case where the Existing Facility is the only secured facility in the group, it can be very difficult to partially refinance the Existing Facility by integrating FSF debt on a secured basis into the Existing Facility.

In light of these issues most, if not all, of the initial FSFs to date have been implemented either in an unsecured (investment grade) context or are designed to result in a full refinancing of the Existing Facility in a single drawing, allowing FSF Lenders to take security over assets released from the security for the Existing Facility.

- **No double-exposure**: It should be clear, assuming the FSF is constructed as described above, that lenders with commitments under the FSF and Existing Facility do not have a double credit exposure to the borrower prior to the refinancing date. Nonetheless, capital treatment will need to be considered by banks to ensure that no additional capital costs arise for them. As is the case in any refinancing, particularly in a secured context, refinancing mechanisms and the application of proceeds will need to be considered carefully to ensure that FSF Lenders are not exposed to intervening risks on the funding date.
- **Defaulting Lenders**: Even if the Existing Facility does not contain provisions dealing with insolvent or defaulting lenders, borrowers will expect the FSF to contain provisions which mitigate the risk of FSF Lenders defaulting on their commitment to refinance the Existing Facility.

### *An FSF for bonds?*

Borrowers face refinancing risk with respect to bonds, just as they do for syndicated loans. Given the logistical difficulty of entering into bilateral agreements between an issuer and individual bondholders, an FSF in the bond world most likely would take the form of an exchange offer of new bonds, with terms equivalent to an FSF, in exchange for existing bonds. Like an FSF, an exchange offer well in advance of a bond maturity leaves the issuer with more potential leverage to negotiate pricing and terms than likely will be the case if the maturity date of existing bonds is imminent.

### *Will the FSF take off in Asia?*

The FSF concept has gained in popularity in the US and European markets. FSF transactions have successfully closed despite criticism from some financial institutions that FSFs dissuade borrowers from deleveraging, and serve to sweep under the carpet the issue of over-leveraged borrowers. Critics have also argued that FSFs are generally underpriced, and that to lock in pricing for, say, three years from now comes with too great an uncertainty.

In view of the generally positive European experience, it remains to be seen whether FSFs will be utilized beyond Europe. In the Asian loan markets, lenders appear to be split down the middle as to whether FSFs will become standard market practice. At the time of writing, we understand that only one borrower in the Asian loan markets (Wesfarmers from Australia) has entered into forward-start arrangements with its lenders.

Commentators have noted that as the Asian financial markets are less mature than their European counterparts, lenders may be less willing to take a long-term outlook on pricing and market conditions. It has also been noted that Asian borrowers are skeptical as to why they should pay more on a facility already in place. If the current liquidity crisis evolves into a longer term problem, however, Asian borrowers may be forced to realize that higher pricing is a small cost to pay for the certainty of committed funding.

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