Considerations in Using Incremental Facilities to Finance Acquisitions

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One key feature of many modern credit agreements is the so-called "incremental" or "accordion" provision, which allows a borrower to increase the aggregate amount of financing available under a credit facility, assuming it can find a willing lender and subject to certain terms and conditions. A common use of these incremental facilities is to finance an acquisition. Where it is available, an incremental facility allows the borrower to add financing neatly within its existing capital structure, without the need to refinance or "backstop" a required consent from other lenders under the existing loan agreement, or to develop separate credit or collateral documentation and enter into complicated intercreditor arrangements. It can therefore be a very quick and cost-effective way to structure an acquisition financing. The use of incremental facilities to finance acquisitions by sponsor portfolio companies in particular has increased dramatically in recent years, and has been accompanied by further innovation in terms designed to maximize the flexibility and utility of these provisions. In this note we explore certain key features of incremental provisions, from the perspective of a borrower and lender looking to finance a potential acquisition.

Incremental Debt Capacity

The typical incremental facility in top tier sponsor leveraged credit facilities includes three components: (i) the fixed dollar amount (the "freebie" or "free and clear" basket), (ii) the "prepayments prong" and (iii) the "ratio prong".

The "free and clear" basket is a fixed amount that the borrower is permitted to incur without having to demonstrate pro forma compliance with a financial ratio. This basket is often set at the greater of (x) the dollar amount set at 1.0x the borrower's trailing four-quarter EBITDA on the date the credit agreement was originally executed and (y) a percentage (often 100%) of the borrower's EBITDA for the then most recent four fiscal quarters.

The "prepayments prong" permits the borrower to incur incremental debt in an amount equal to the principal amount of certain kinds of debt that has been voluntarily prepaid (to the extent not financed with the proceeds of indebtedness). Originally, this prepayment prong simply allowed the "free and clear" basket to be replenished – i.e., to reverse the impact of any voluntary prepayments of loans incurred pursuant to that basket. However, over the years these provisions expanded in some important ways. First, many transactions allow credit to be given for prepayment of debt incurred pursuant to the "ratio" prong described below. This may allow a borrower to convert debt incurred during a low-leverage period through an interim prepayment – into permanent first lien debt capacity which can be utilized in the future, even if the borrower is no longer in compliance with the applicable ratio. Second, some facilities give credit for prepayment of junior lien or unsecured debt. The effect of this is to convert unsecured or junior lien debt capacity to first lien debt capacity and is typically closely scrutinized by lenders. Third, credit is often given for the amount of debt "bought back" by the borrower (pursuant to Dutch auctions or otherwise), on the theory that this represents deleveraging in the same way that a voluntary prepayment does (albeit a non-pro rata form of deleveraging). Traditionally the amount of the credit was tied to the amount of cash paid in connection with such buyback, but increasingly, credit is given for the full par value of the loans bought back, since this reflects the amount of the deleveraging.

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The “ratio prong” permits the borrower to incur incremental indebtedness subject to pro forma compliance with a financial ratio. This provision typically allows the borrower to incur (i) first lien secured indebtedness subject to pro forma compliance with a maximum first lien leverage ratio, (ii) junior lien indebtedness subject to pro forma compliance with a maximum total secured leverage ratio and (iii) unsecured indebtedness subject to pro forma compliance with either a minimum fixed charge (or interest) coverage ratio of 2.00:1.00 or a maximum total leverage ratio. Many recent credit facilities also add to each test what is commonly referred to as a “no worse than limb” or “accretive prong”, which would permit the borrower to incur the applicable type of indebtedness so long as the applicable ratio after giving effect to the incurrence of the debt, and the pro forma addition of any acquired EBITDA acquired with the proceeds, is no higher (or, in the case of the fixed charge coverage ratio, no lower) than the applicable ratio immediately prior to the incurrence of such debt. Typically, but not always, the “no worse than limb” is limited to incremental indebtedness incurred to finance an acquisition or other similar permitted investment.

In most credit facilities, often hidden in unexpected places, there are some important rules that will be critical in calculating aggregate incremental debt capacity. First, the ratio and basket capacity are typically required to be calculated on a “pro forma basis”. That means both the debt being incurred and the additional EBITDA attributable to the acquired assets are taken into account. Depending on the credit facility, it may also mean that cost saving and synergies expected in connection with the acquisition can also be taken into account. Second, the borrower can typically elect which basket or limb to use, and can allocate (and later reallocate) portions of the incremental debt to different limbs to maximize availability. Third, and perhaps most importantly, most modern credit agreements would permit the borrower to ignore any concurrent borrowing under the free and clear basket in calculating availability under the ratio basket. So for example, if the full free-and-clear capacity is borrowed simultaneously with the full amount of available ratio debt, actual capacity can be one turn of EBITDA in excess of the ratios set forth in the ratio limb.

Conditionality

Incremental facility provisions allow the borrower to request that existing or new lenders either increase an existing tranche of loans or provide a new tranche of loans. Importantly, incremental facilities are themselves uncommitted, meaning that, while the existing lenders are agreeing to permit additional loans to be incurred under the credit agreement, they are not themselves committing to provide those additional loans. That means that, in the context of an acquisition financing, the borrower will still need to identify lenders willing to commit to provide the incremental financing on customary, limited conditionality terms, and to document that commitment in a form that will be acceptable to the applicable seller or target.

Ratio Calculations

Relying on the ratio prong to finance an acquisition, where certainty of funds is paramount, can be problematic. If the borrower signs an acquisition agreement one day, how can it be sure that on another day many months in the future the same amount of debt will be available since perhaps the borrower has had several bad quarters resulting in reduced EBITDA and reduced debt capacity under the ratio limb? In the recent past, borrowers and lenders would either need to include a cap in the commitment letter on the amount of indebtedness that would be funded at the maximum amount permitted under the incremental facility on the date the acquisition is consummated (and make up the difference some other way (e.g., a sponsor equity commitment)), or agree to backstop an amendment or refinancing of the existing credit facility. A more satisfactory solution has developed in recent years. So-called “limited conditionality transaction provisions” allow the ratios to be tested as of the signing date of the acquisition agreement (and not re-tested at closing). Accordingly, when a commitment letter is executed that relies on availability under the ratio limb of an incremental facility, the borrower will typically “elect” upon signing

the commitment letter (and the acquisition agreement) to test the applicable ratio on such date of execution.

Representations and Default Conditions

Credit agreements typically include certain conditions that the borrower is required to satisfy in order to incur the incremental debt. It is customary for the incurrence of an incremental facility to be conditioned upon the absence of any event of default and, less frequently, the material accuracy of the representations and warranties set forth in the credit agreement, in each case tested at the time of the incurrence of the incremental debt. This level of conditionality is incompatible with an acquisition financing. Accordingly, incremental facilities will often limit the “no default” condition to an absence of payment or bankruptcy event of default, and the representation condition, if there is one, to the accuracy of certain “specified representations” (typically fundamental corporate status and authority, compliance and regulatory, enforceability, no legal conflicts, solvency and status of liens representations). Furthermore, credit agreements will often provide that the borrower is permitted to satisfy at least the default condition at the date of signing the definitive documentation for the acquisition (rather than on the closing date of the acquisition). One practice tip: in circumstances where the representations that are being made are those set forth in the credit agreement, it is important to review those representations carefully to ensure they are appropriate. For example, the “disclosure” or “10b-5” representation and the “solvency” representation in the credit agreement will often speak only as of the date of original execution of the credit agreement. If those representations are intended to be brought down in connection with the acquisition, they must be adjusted to speak as of the date of consummation of the acquisition and, in the case of the solvency representation, give effect to the acquisition and related transactions.

Documentation

One of the advantages of financing an acquisition using an incremental facility is that the documentation itself can be very streamlined. Typically the term sheet can be a few pages rather than the all-too-common 100 or more pages, because many terms are simply stated to be “same as the existing credit facility”. Similarly, the incremental amendments used to implement the incremental itself are relatively short and can be negotiated quickly. One question that often arises is: who is required to sign the incremental documentation? Credit agreements typically require that incremental amendments be signed by the administrative agent, the borrower, the guarantors and the incremental lenders. However “SunGard” style commitment papers now routinely, at least in the leveraged space, only require execution by the borrower and the guarantors as a condition to funding. This is a feature that grew out of the 2007 financial crisis and, borrowers argue, is necessary to ensure lenders do not seek to avoid their lending commitments by refusing to sign the credit documentation. While rarely an issue in practice, if the parties are unable to agree upon the incremental documentation such that borrower was willing to sign but the incremental lenders were not, an interesting question would arise as to the effectiveness of the incremental amendment (given the execution requirements of the credit agreement) and whether the borrower requiring the incremental lender to fund the loans in these circumstances (as required by the commitment papers) would trigger a default under its existing credit facilities.

Fungibility

What is “fungibility”?

New incremental loans may simply be created as a separate class of loans having their own pricing, amortization, maturity and other terms and designated as a separate “series”, “tranche” or “class” (e.g., the existing loans being designated as “Tranche B-1 Loans” and the incremental loans being designated

as “Tranche B-2 Loans”). However, there may be advantages to having the incremental loans be treated as an increase to the existing loans (i.e., more “Tranche B-1 Loans”). Chief among those advantages is liquidity. There are often price and syndication advantages to having a larger single tranche that is widely held and therefore can trade more freely than two smaller tranches that trade separately. Fungibility has two components. “Trading fungibility” is simply a matter of ensuring the terms of the new incremental tranche match the terms of the existing tranche exactly, so that the borrower and the agent has no need to distinguish between the separate tranches or lenders. It will also necessitate a single CUSIP to ensure that the original and additional debt tranches can trade together. “Tax fungibility” is somewhat more complicated.

Tax Fungibility

If the existing and incremental debt tranches are not fungible for tax purposes, then the borrower will need to distinguish between the existing and the incremental tranches so that it can provide appropriate reporting to the holders of that debt for OID accrual purposes (and in fact, for that reason, will need to maintain separate CUSIPs). Generally speaking, the existing and incremental debt tranches may not be fungible if, subject to certain limited exceptions, one or both tranches are issued with OID. The most commonly relied on exception to this general rule is that the tranches will be fungible, in general terms, if the incremental facility is issued with not more than de minimis OID (i.e., less than 25 basis points times the number of complete years until the facility matures). Other exceptions include where a “significant modification” is being made to the existing tranche, or where the incremental tranche is being incurred within six months of the existing tranche and has a yield of not greater than 110% of the yield of the existing tranche on is issue date. The contours of these rules are beyond the scope of this note. However, the question that the borrower and the lender will want to answer early in assessing the attractiveness of an incremental financing is: what is the maximum amount of OID that can be charged on the incremental tranche that will still result in the incremental tranche being fungible with the existing tranche? It is time to call the tax attorneys.

Amortization

In order to establish an incremental facility as a fungible tack on to an existing facility, the incremental loan must amortize at the same rate as the existing loans. In addition, the parties must ensure that the amortization rate after giving effect to the incremental facility results in the existing lenders receiving no less on each amortization payment date than the dollar amount they were receiving prior to giving effect to the incurrence of the incremental indebtedness (otherwise, the establishment of the incremental facility would likely require the unanimous consent of the existing lenders). In calculating amortization for the new fungible tranche, it would be tempting to simply aggregate the outstanding amount of the existing and the incremental tranche and apply the amortization rate (0.25% per quarter in the typical term loan B) to that aggregate amount. However, to the extent there has been any amortization payment on the existing tranche, this would result in the existing lenders receiving a smaller amortization payment on each repayment date than they received prior to giving effect to the incurrence of the incremental facility (a function of the amortization being paid pro rata among all the lenders and the existing lender’s pro rata share having been reduced by prior amortization payments).

When determining the new amortization rate, the following steps should be taken:

- Determine the dollar amount of amortization that the existing lenders were entitled to on each amortization payment date based on the aggregate principal amount of the loans on the closing date and the agreed amortization rate established on the closing date (the “Minimum Amortization Payment”);

- Determine the outstanding principal amount of the existing loans as of the date of incurrence of the incremental indebtedness, taking into account the amortization payments that have been made prior to such date (the "Outstanding Principal Balance");
- Determine the Outstanding Principal Balance as a percentage of the sum of the aggregate principal amount of the proposed incremental term loans plus the Outstanding Principal Balance (such resulting percentage, the "Existing Lenders' Pro Rata Share"); and
- Divide the Minimum Amortization Payment by the Existing Lenders' Pro Rata Share (the result, the "New Amortization Payment").

As a percentage matter, the New Amortization Payment will be a higher percentage of the original principal amount of the term loans borrowed on the closing date than the initially agreed amortization rate. The foregoing ignores the possibility that future amortization on the existing term loans has been reduced or eliminated by voluntary prepayments, which will further complicate the analysis.

Pricing and Soft Call

If the incremental lenders providing an incremental facility require the inclusion of a prepayment premium with respect to prepayments or repricing amendments, the existing facility must be amended to include a corresponding provision (for a corresponding period) in order to maintain fungibility. Unless the underlying credit agreement includes express language permitting this, the addition of the "soft call" provision to the existing facility may, counterintuitively, require the consent of the existing lenders constituting the required lenders (i.e., lenders holding more than 50% of the aggregate outstanding principal amount of the existing loans). Similarly, if market conditions require the pricing on an incremental facility to be higher than the pricing on the existing facility, a borrower may elect to increase the pricing on the existing facility in order to create a single, fungible tranche (rather than two separate tranches with different pricing). This repricing is independent of the MFN discussed below and again, unless the credit agreement specifically provides otherwise, an increase in pricing may require the consent of the existing required lenders. These anomalies have caused some facilities to include language that allows the existing facilities to be amended without the consent of the existing lenders in order to add conforming terms from an incremental facility that are more favorable to the existing lenders (sometimes limited to the extent necessary to achieve fungibility).

The MFN

The Borrower and the incremental lenders are typically free to determine pricing, interest rate margins, rate floors, discounts, premiums and fees for incremental facilities. However, the vast majority of incremental provisions will include a most favored nation "MFN" provision, which provides that the "effective yield" on any incremental facility that is incurred within some period following the closing date (a "sunset", usually 12 to 18 months) and is pari passu with the existing facility cannot exceed the "effective yield" on the existing facility by more than an agreed upon amount (often 50 or 75 basis points). To the extent that the "effective yield" on the incremental facility would exceed the effective yield on the existing facility by more than such amount, the "effective yield" on the existing facility will be increased by an amount sufficient to eliminate the gap above the pre-agreed differential. The "effective yield" is usually defined to include the interest rate, upfront fees paid to the incremental lenders, original issue discount and any other fees paid generally to the incremental lenders. It will also typically take into account the effect of any interest rate floor. The "effective yield", however, will exclude structuring, arrangement and other fees paid solely to the lenders engaged to arrange and syndicate the incremental facility.

Although the formula for calculating MFN can be simply stated, it comes with several hidden complexities. One of the most common lies in "hidden" OID—fees paid through to the market in the form of fees that

are excluded from the yield calculation, such as commitment or underwriting fees. Another, less common, potential complexity arises in circumstances where the borrower has previously incurred a fungible incremental but with different OID from the then-existing tranche. In that case, the borrower may have a single tranche with two separate yields. Should the borrower take an average of the yields on that existing tranche and calculate the MFN that way? Or calculate MFN on each piece of the existing tranche separately (and risk breaking fungibility of that existing tranche if one part is repriced and the other is not)? The former is likely the more sensible result but the answer may depend on the exact language of the credit agreement.

The purpose of the MFN is to provide existing lenders some protection from the issuance of a new, better priced but otherwise comparable loans, reducing the relative value of their existing loans in the secondary market. But as important as this is to investors, the MFN has proven very unpopular with borrowers, who have therefore sought ways to limit the applicability of the MFN protections. Common exclusions from the MFN pricing provision in top tier sponsor deals, in addition to the "sunset" noted above, include: (i) any incremental unless in the form of a "term loan B" syndicated loan, (ii) incremental facilities incurred under the free and clear basket or utilizing the prepayments prong, (iii) any incremental incurred in a currency other than U.S. dollars, (iv) a dollar basket pre-agreed with the lenders (which will often include a grower component based on the borrower's EBITDA or total assets), (v) incremental facilities that mature after some period of time after the maturity of the existing facilities (often one or two years) and (vi) incremental facilities incurred to finance an acquisition or other similar permitted investment. The vast majority of deals will include flex provisions for the arrangers to eliminate some, if not all, of the carve-outs from the MFN, and that is one of the flex items that is routinely exercised.

Other Terms

Incremental facility provisions include other limitations that may impact the attractiveness of the incremental facility as a source of acquisition financing. Typically, the credit agreement will require that secured incremental facilities may not be secured by any assets that are not included in the collateral package provided to the existing lenders and that they may not be guaranteed by any entity that is not a loan party under the existing facilities. Incremental facilities are also typically permitted to participate on a pro rata or less (but not greater) than pro rata basis with the existing term loans in respect of mandatory prepayments. While historically incremental facilities were required to have covenants and events of default that were identical to or not materially more restrictive to the borrower than those under the existing facilities (except to the extent that such more restrictive terms only apply after the latest maturity date of the existing facilities or to the extent the existing facilities are amended to conform to or add the more restrictive terms), sponsors in more recent deals have been pushing, with varying degrees of success, for a provision that would permit the incremental facility to contain "market terms". Finally, it is often a requirement that an incremental facility mature no earlier than, and have a weighted average life to maturity no shorter than, the latest maturity date of the existing facility. It is not uncommon, however, for top tier sponsor deals to permit the borrower to incur an agreed amount of incremental debt (often with a grower component based on the borrower's EBITDA or total assets) that is not required to comply with these restrictions. And importantly in the acquisition context, it is often the case that customary bridge facilities are carved out of these maturity limitations so long as the bridge contains a customary extension feature.

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