**Types of facility, due diligence and credit approval**

This element introduces different types of loan facility and the initial stages of a loan transaction namely due diligence and credit approval.

**Introduction**

Following on from the induction session, this knowledge stream will focus on corporate borrowers. There are many different borrowers with diverse financing needs, but companies are the most prevalent.

Equally there is a wide variety of debt providers (see slide below), going beyond traditional 'banks'. This knowledge stream will focus primarily on bank lending.

As mentioned in the induction session, the initial stage of raising money through a corporate loan will involve the borrower approaching its relationship bank to discuss its financing needs with its relationship manager. For the borrower, the person making this approach may be the finance director (for a small company), or the corporate treasurer (in a large company).

This initial stage will determine the type of facility the borrower requires and will initiate the carrying-out of due diligence by the lender and seeking internal credit approval for the loan. These points are considered below.

**Lending overview**

**Bank Lending:**

• 'Traditional' bank lending from clearing and high street banks.

• Examples include Barclays Bank, HSBC, National Westminster Bank.

• Bank lending will be the main focus on this knowledge stream.

**Alternative Lenders (i.e., lenders that are outside of the bank lending system):**

• Credit Funds – credit funds usually have shorter investment periods with the option to recycle/reinvest investments. These are an increasingly popular choice of lender in the market.

• Institutional Asset Managers -examples such as Legal & General and M&G plc.

• Challenger Banks.

• Funds will be explored further in the Asset and Investment Management module.

**Types of Facility**

One important part of the early negotiations is for the borrower to identify what type of debt facility it requires and that the lender confirms that it is prepared to proceed on such a basis. Which form of debt is suitable for a borrower will largely depend on the purpose for which the money is required and the size of the capital sum required.

We will consider the following loan facilities:

• Overdraft

• Term loan

• Revolving credit facility ('**RCF**')

**Overdraft**

The corporate overdraft is similar to the personal overdraft (which most people are familiar with) in everything but size.

An overdraft permits the borrower to borrow (or literally overdraw from its account) up to a specified limit and interest is charged on the daily overdrawn balance.

The borrower can repay the loan (or repay part of it) and then redraw the money – again up to the specified limit.

It is normally an ‘**uncommitted**’ facility – i.e., the bank is not committed by any contract to continue lending the money and may decide to withdraw the facility at any time and for any reason.

An overdraft is usually granted on the bank’s standard terms and conditions, so there is little room for negotiation of these.

Any overdrawn amount is legally repayable on demand. This means a bank does not have to wait for a breach of the overdraft agreement by the borrower, to require repayment of an on-demand facility.

Little formal documentation is required – often merely a ‘facility’ letter.

An overdraft is a tool to assist cash flow, i.e., to keep the business liquid.

It provides a reserve of easily accessible money to meet any shortfalls in working capital. An overdraft is sometimes known as a working capital facility.

Whilst most companies will have access to an overdraft facility, it is not intended to be a core source of funding but rather a means of dealing with short term funding requirements (e.g., resulting from irregular cash flow due to seasonal fluctuations of the business). Companies which have specific reasons for raising further finance will do so through one, or a combination, of the types of debt facility described below (term loan and revolving credit facility). We will concentrate on these in this knowledge stream.

**Term loan**

This is the most inflexible facility of the three we are looking at. Again, most people will be familiar with a term loan (e.g., student loans are effectively term loans).

A term loan provides a fixed sum for a fixed period.

The borrowed amount may be fully drawn down in one lump sum or in several ‘tranches’, depending on the terms of the loan agreement.

It is usually a ‘**committed**’ facility, i.e., the bank is bound (subject to the terms of the loan agreement) to lend the money and can only demand repayment before the agreed repayment date(s) if there is an event of default under the loan agreement (events of default will be considered in Workshop 3).

It is repayable by the end of the term according to an agreed repayment schedule set out in the loan agreement.

Any prepayments (repayments made earlier than due) are usually final (i.e., they cannot be redrawn by the borrower).

A term loan is most suitable where the borrower needs a specific sum of money for a medium to long period, i.e., for the purchase of property, acquisition of a company, start-up costs.

Repayments can be structured in a variety of ways including:

• ‘**Amortisation’** – repayment of amounts at regular intervals;

• ‘**Balloon repayment’** – repayment in several instalments where the final payment is bigger than the rest; and

• ‘**Bullet repayment’** – repayment in one instalment at the end of the term.

**Revolving credit facility**

A revolving credit facility ('**RCF**') is a commitment by a lender to lend on a recurring basis on predefined terms.

The bank makes a specific amount of capital available over a specific period, typically three to five years.

Unlike a term loan, the RCF allows a borrower to draw down and repay (and draw again) amounts of capital during the availability period (see below), subject to the terms of the loan agreement.

**There are limitations to such drawing down and repayment to ease the administrative burden on the lender:**

• The capital is made available for a set availability period (e.g., 5 years) and, within that period, individual loans (subject to a minimum size (e.g., £500,000)) are borrowed for an ‘Interest Period’ (generally 1, 3 or 6 months at a time) and repaid at the end of that Interest Period.

• Typically, a loan agreement would specify that a borrower can have no more than a certain amount of loans outstanding (e.g., 5 loans) at any one time. The borrower usually has to give a number of days' notice to draw down (this depends on the currency).

• Each loan will have its own Interest Period, so it is common for more than one loan, perhaps with differing Interest Periods, to run concurrently. Different loans under a facility can be drawn down at different times.

• It is usually a **committed** facility so, provided there is no default, the bank is bound to lend the money and cannot demand early repayment.

• The RCF will cease to be available, and any outstanding drawings will be repayable in full at the end of the **Availability Period** (period during which loans may be drawn down).

• The RCF allows a borrower to draw down loans only when it needs the capital and only for the period it needs the capital, thereby keeping interest costs to a minimum.

• A bank will charge a fee called a ‘**commitment fee**’, which is a percentage of the undrawn amounts of the facility from time to time. A bank charges a commitment fee because it has had to put aside a certain amount of capital based on the total committed facility available to the borrower in order to comply with capital adequacy rules.

• Each time funds are drawn down (or ‘rolled over’, which means the same amount is deemed repaid and re-borrowed on the same day), the borrower is deemed to repeat certain representations (‘**Repeating Representations**’) which it originally gave to the lender in the loan agreement.

• Representations in a loan agreement are considered in Workshop 2.

• Consequently, borrowers under an RCF need to check that the Repeating Representations can be given immediately prior to any further drawdown, or they run the risk of triggering an Event of Default (considered in Workshop 3). This would apply equally to a multi-tranche term loan. Also, a bank will have the right to temporarily suspend any further lending ('**drawstop**'), if the borrower is in default.

• A Clean Down provision is often included in an RCF in order to ensure that the RCF is used to manage cash flow and does not become long term core debt. The lender may achieve this, for example, by requiring the borrower to repay the whole of the facility and retain a ‘nil’ balance for at least five business days in any 12 month period (i.e. ‘cleaning down’).

• RCFs are often used for working capital (i.e. to provide liquidity for a company’s day to day operations). An RCF combines the:

• flexibility of an overdraft facility (allowing the borrower to withdraw capital only when it is required); and

• certainty of a term loan (an RCF is usually a committed facility).

• A syndicated RCF can be very large in size.

• The borrower can draw down when the money is needed and pay it back when it is not, thereby saving interest.

• The documentation, timing and negotiation required for an RCF will be very similar to that of a term loan.

• Syndicated facility agreements may include a term loan and an RCF in one document.

**Capital markets instruments**

Instead of taking out a loan, a borrower may decide to raise finance by issuing a capital markets instrument. The term ‘capital markets’ here refers not to a physical or even a single electronic marketplace, but to the whole global market in which investors provide finance to corporations, governments and other types of issuer in the hope of making a profit on the investment.

Bonds are the form of capital markets instrument which we will consider on this knowledge stream (in Workshops 8 and 9).

**Overview of the stages of a loan transaction**

**(NB: This is a general overview for a syndicated loan, by way of an introduction. This structure may differ depending on the transaction)**

Commonly a borrower will approach its **relationship bank** with a need to raise finance.

The arranger bank will commence an initial **due diligence** process (investigation and credit analysis) with the relationship manager putting together an initial package of terms for the loan.

The lender’s **credit committee** will then be consulted for approval of the lending terms.

A**term sheet** will be agreed between the lender and the borrower. Solicitors will be instructed by both parties. (NB: in some circumstances a formal term sheet will not be used).

Solicitors commence **due diligence** & drafting / negotiation of documentation.

Signing and completion. Provided any conditions precedent are satisfied, the borrower can **draw down** funds.

**What is the purpose of due diligence?**

**Due diligence by the lender** is simply a fact-finding exercise. The purpose of collecting information is to ensure the company's financial information is as accurate as possible and to focus attention on factors in the business that will be critical to its future success. The lender will want to ensure that the company will be able to pay the principal amount requested and the interest payments payable under the loan. Due diligence is an exercise carried out by or on behalf of the lender.

The aim is to assess the overall risk of the borrower and any other entity providing security or giving a guarantee for the payment of the loan. Together we call the borrower any such security/guarantee provider the 'Obligors'. This will be a defined term in the loan agreement.

**Legal due diligence** will be carried out at a later stage by the lender’s solicitors. This will involve carrying out a number of searches on the obligors and, if the loan is to be secured, searches on the assets that will be subject to security.

At some point, the information may reveal that the **risk** is too great for a bank to lend unless it is able to take **security**.

In such cases, due diligence would extend to ascertaining what assets are available for the lender to take as security and the value of those assets.

The higher the chance of **default**, the larger the **fees** and **margin** a lender will charge to compensate for this risk and the more stringent the documentary provisions it will seek.

**Due diligence: initial investigation and credit analysis**

**Credit analysis**

There is no ‘standard’ due diligence procedure. The format and extent of due diligence will vary with the identity of the lender and other factors including:

• Size of the loan;

• Type of loan (committed / uncommitted);

• Whether the loan is to be secured;

• Identity of the borrower (credit rating, jurisdictions involved, whether the borrower is known to the lender) ; and

• Whether the loan is part of a larger transaction.

• The lender will then put together a 'basic package' with the borrower, including the headline terms of the deal such as amount and term, repayment dates and main covenants to be given by the borrower in the loan agreement.

• For the purposes of this knowledge stream , this ‘basic package’ will be set out in a term sheet, but other formats could be used by lenders in practice.

**Credit approval**

The Credit Department or Credit Committee of a lender sees all credit requests and takes a view on the overall lending outstanding. It will have the ultimate say as to whether or not the lender is prepared to lend funds on the proposed terms. Credit approval is not automatic and will be viewed within the context of other risks the lender is exposed to in its lending, for example:

• industry sectors;

• geographical / political risks; and

• types of corporate borrowers

The lender’s internal limits and policies on exposure must not be breached.

• The Credit Committee will wish to see as a minimum the company’s annual audited accounts. It may also request to see interim figures, management accounts (i.e. unaudited accounts prepared for internal purposes) and possibly any future business plan.

The Credit Committee may approve, amend or reject the lending proposal.

**Legal due diligence**

Once the lender has instructed solicitors, they will start to carry out detailed due diligence on the borrower (and any other company granting security / giving guarantees).

This will involve carrying out searches (including at Companies House) on all of the companies involved in the transaction.

As a minimum, the lender will want to ensure that there are no restrictions in the relevant company’s constitution on its ability to borrow or give guarantees/grant security (as applicable).

In particular it will be necessary to ensure that a company can grant security over shares in its subsidiaries.

Crucially, if the legal due diligence does reveal any restrictions in the constitutional documents of any relevant company on borrowing and/or giving security/guarantees, the lender will want to ensure such restrictions are removed prior to the lender agreeing to lend (i.e., by the relevant company amending its articles). The lender ensures a borrower does this by requiring that evidence of such steps are listed as 'conditions precedent' in a schedule to the loan agreement. The importance of conditions precedent is discussed further in Workshop 2.

**Further considerations**:

Where the borrower/guarantor is incorporated overseas, local lawyers will be instructed to carry out equivalent due diligence.

If security is to be taken, further due diligence will be carried out in relation to the relevant assets: e.g. report on title (property), review of key contracts and licences, etc.

Lenders will also need to consider the value of the assets over which they will take security and will usually require a valuation report.

**Summary**

• Part of the initial stage of a corporate loan transaction will involve determining what type of facility a borrower requires.

• Overdrafts, term loans and revolving credit facilities have specific features.

• The lender’s initial due diligence and credit analysis will result in proposed lending terms.• Initial terms will be subject to credit committee approval.

• The proposed terms on which a bank is prepared to lend will be set out in a term sheet (though other formats may be used in certain transactions).

• Solicitors will be instructed for both parties and legal due diligence will commence alongside the negotiation and drafting of loan documentation.