Introduction to Raising Bank Finance & The Term Sheet

by

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Introduction

- Two types of private capital
  - Bank borrowing or
  - Private placements
- Private placements (US)
  - Exempted from SEC registration requirements
  - Offer limited to fewer than 35 offerees
  - Minimum income and wealth requirements
  - Sophisticated investors include insurance companies, pension funds and wealthy individuals
- Focus of this talk is on bank borrowing process

Bank's Perspective

- Assess credit risk of borrower:
  - Pay interest ("service loan") and
  - Repay capital
- If credit risk is small, then total costs (fees and profit margin charged) are driven down
- Conversely, credit risk may be so great that transaction is too expensive for bank to carry out

Due Diligence of Bank

- Due diligence = fact finding exercise of potential borrower
- Generally, due diligence is a two stage process:
  - (1) Initial investigation
  - (2) Subsequent Investigation

Initial Investigation - Scope

- Scope of initial investigation includes:
  - Size of loan
  - Type of loan (committed, uncommitted, purpose)
  - Is loan secured or unsecured?
  - Is borrower known to the bank?
  - Is loan part of a larger transaction? E.g. flotation or acquisition.

Initial Investigation – Account Officer

- Account officer (or relationship manager)
  - Provides potential borrower with a continuing point of contact within the bank
  - Makes preliminary determination of potential borrower's requirements based on personal knowledge of client
  - Sets out a preliminary proposal containing:
    - Amount requested
    - Term
    - Repayment dates
    - Major financial covenants

Initial Investigation – Credit Analysis

- **Credit department or credit committee**
  - Separate department in big Japanese and US banks
  - Reviews credit officer's initial report and conducts analysis based on checklists and policy guidelines (such as mandatory material adverse change or cross-default clauses)
  - Borrower's most recent published accounts are reviewed
  - Since public company has 7 months after its year end to publish accounts
    - A London listed company has 6 month
    - A private company has 10 months
    - This information could be up 18 months old.

Initial Investigation – Credit Clearance

- Credit clearance is the process whereby the credit analysis report is sent to credit department or credit committee for approval by senior member of bank
- Credit committee
  - Reviews all credit requests
  - Has overview of entire lending book
  - Checks internal limits and policies
  - Checks external exposures
  - May defer to particular industry department or area credit officer
- Decision of credit committee: either approve or reject proposal
- If approved the account officer drafts the term sheet or if the transaction is particularly complex, then a solicitor drafts the term sheet

Subsequent Investigation

- Borrower may accept or negotiate slightly the term sheet (any major change will require approval by credit committee)
- Once accepted by borrower, second stage of due diligence occurs.
- Bank involves advisers:
  - Instructs solicitors to draft loan agreement based on term sheet
  - Instructs accountants to report on borrower
- Solicitor's activities may include:
  - Obtaining copies of memorandum and articles from Companies Registry
  - Interviewing borrower to obtain current information
- Ongoing investigation after loan agreement signed
  - Check on performance of borrower
  - See whether representations and covenants in the loan agreement are being complied with

What is a term sheet? (1)

- It is a written proposal singed by both parties where principal terms of the transaction are recorded
- Not intended to be contractually binding
- Usually attached as Appendix to a “Commitment Letter” containing legally binding terms, such as:
  - Confidentiality undertakings
  - Market Flex (allowing banks to change terms of the loan under certain circumstances)
  - Clear Market—preventing borrower from raising other funding during syndication

What is a term sheet? (2)

- Bank gives potential borrower the term sheet which reflects the major terms on which the bank is prepared to offer the loan.
- Bank specifies a date by which potential borrower must accept the terms by counter-signing the term sheet (“granting the bank a mandate”)

Purpose of Term Sheet

- Main purpose is to help focus the minds of the bank and borrower on the fundamental points of the transaction
- If the broad points of pricing and structure of the loan are not agreed, then further documentation and due diligence are useless.
- When the proposed facility is syndicated, it is useful to have an accurate summary of the main terms to sell the deal to syndicate members (e.g. lead managers), before an information needs to be produced.

Other Functions of Term Sheet

- Summary of main points in complex transaction for parties and advisers
- Should help establish basis for estimate of solicitors' fees or even a "fee cap"
- Helps solicitor determine sophistication required and thus the amount of fees
- Acts as an outline from which bank's solicitor extracts key information necessary for a first draft loan agreement

Scope of Term Sheet

- Specify *type* of financial covenants, but not necessarily the specific clauses
- E.g. "Guarantees will be given by all material subsidiaries of the borrower." It is not necessary to define material subsidiary now. Later, the parties will negotiate which companies will need to give guarantees.
- Use "…including, but not limited to…" in order to avoid exhaustive list interpretation
- Specify 'unusual provisions'—any conditions precedent should be stated. "That the borrower must win a particular contract before loan facility can be utilized should be referred to specifically in the term sheet."

Problems

- What types of questions would you expect an account officer to ask?