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FUND FINANCE FRIDAY

Lenders Showing Muscle with 'Flex'

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In recent months, as lenders in the fund finance market have been more selective and demand for financing from fund borrowers remains high, we have seen a number of instances of lenders considering the use of and actually incorporating "market flex" provisions into their deal documents. Any term sheet that goes out either has these provisions incorporated − or there was at least a conversation about them. In light of the events of late last week with two major sources of financing in the subscription market under FDIC control (see our commentary here), we have seen a major focus on these provisions from other lenders in the space.

What exactly are these provisions? How do they work? What exactly do they say and where do you put them? We break that down to the basics here.

The Background

First, a bit of a primer. As is typical, many creative solutions come from the leveraged loan market, and market flex is no different. These provisions are a typical feature in commitment papers in the leveraged loan market.

Flex provisions are intended to give arrangers a degree of flexibility on certain terms of a financing during the syndication process to help ensure successful syndication. A market flex is a provision that gives the arranger flexibility on certain terms of the financing after the credit documents have been signed − meaning that the terms of the financing can be changed to improve the economic and structural terms for the lenders if these changes will help the arrangers achieve a successful syndication.

What Flex Provisions Say and Where Do They Go

In a leveraged finance deal, these terms are found in the fee letter, which is delivered in connection with a commitment letter whereby the arranger provides a borrower with a financing commitment. The terms of the commitment letter will cover a number of features of the financing (including attaching a term sheet for the financing), the relationships between the parties, confidentiality, as well as the marketing process for the arranger to put together a lender syndicate. In addition to a description of the fees payable in connection with the closing of the transaction, the fee letter will include market flex optionality for the arranger in order to help it achieve a successful syndication. These provisions will allow for the borrower and the agent to bilaterally update the credit agreement for lender-favorable changes related to pricing, amortization, tenor, other financial terms (including covenants), the collateral package, and allocation or structure where the financing contemplates multiple facilities. While most leveraged finance fee letters contain a litany of potential changes, pricing flex is the ultimate hammer – particularly in a rising rate environment, a borrower will almost always choose to make structural changes (*e.g.*, reducing the tenor of the loan by a year) rather than raising its interest expense. Any pricing flex in a leveraged deal would be applicable to all lenders. In a syndication, the arrangers may not provide the full fee to all incoming lenders, potentially "skimming" some for themselves (*e.g.*, they may get 200 bps in upfront fees but be able to sell the paper for 150 bps so the arranger gets to skim the additional 50 bps for its own benefit).

Similarly, in a fund finance deal, these flex provisions are found in the agent and lender fee letters. The flex in a fund finance transaction generally just relates to pricing and fees, but it could in theory encompass a number of the other options listed above. Right now we are specifically seeing an ability to increase pricing. The other thing we are seeing is that an agent may negotiate an upfront fee with the borrower and then reserve its rights such that if another lender that comes into the deal is given an upfront fee that exceeds the upfront fee that the agent has negotiated for itself, the agent will be entitled to receive an additional upfront fee in an amount equal to the difference between the upfront fee negotiated and the increased upfront fee, accruing from the date such other lender receives such amount. We see some skimming in the market, but it is on a fairly limited basis and for a smaller amount (generally 5-10 bps).

Keep in mind that fee letters are confidential among the arrangers and the borrower, so those parties (and only those parties) will decide whether the flex is necessary to syndicate the loan(s). (The borrower will not want the arranger giving any prospective lenders a "shopping list" of terms that would otherwise be more restrictive to the borrower, so it is an important consideration that any market flex terms remain confidential between the arranger and the borrower. An incoming lender will not be privy to the document and will not see the economic terms that the agent had before they joined. Likewise, it is possible that a lender may end up with different terms than another lender if the first lender in the deal didn't reserve rights to have their fees and margin matched to any incoming lender who may benefit from better terms.

Best practices indicate that the credit agreement should have an exception to the amendment section that allows the agent to amend the credit agreement terms for market flex provisions without obtaining the level of consent one would typically need to amend the economic terms of a credit agreement.

Switch It and Reverse It

Finally, we note that in some markets, you may see what's called "reverse flex." This isn't something that has made its way to the U.S. leveraged finance market with any consistency and is largely just found in European markets. The concept is exactly as it sounds. If the marketing process for a loan is so successful that lenders are willing to commit for larger amounts than are available, in certain circumstances, the loan may be "reverse flexed" or "flexed down" and close on terms more favorable to the borrower.

The typical change is to the spread, and that can take the form of a reduction to the applicable margin or involve a step down to the applicable margin if the borrower meets certain financial covenants. Unlike market flex, reverse flex won't be in the commitment papers, and thus the arranger isn't obligated to pursue these better arrangements. This is frequently relationship-driven when a strong credit sees higher demand for its loan that originally expected.