NOTE ON LOAN CAPITAL MARKETS

FINANCIAL TRAINING PARTNERS

The structure and use of loan products

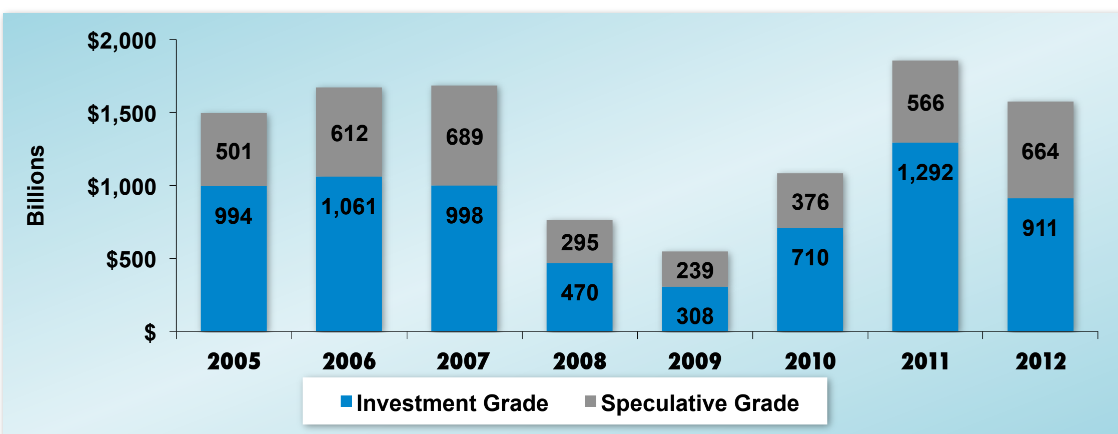
Most businesses use one or more loan products. A company may have a *syndicated loan, backstop, line of credit, standby letter of credit, bridge loan, mortgage,* or *revolver.* These products are all variations on the three basic loan market instruments: *revolving credit, term loan*, and *letter of credit.*

The loan capital market is often referred to as the *bank market* or the *bank loan market*, as commercial banks and finance companies have historically been the primary providers of loan products. Since the 1990s, however, securitization vehicles, mutual funds, and other institutional investors have become important investors in this asset class.

Revolving credits and terms loans up to $50 million are typically negotiated directly between borrower and lender and are referred to as *bilateral* loans. For larger loans, lenders typically join together to form a lending syndicate led by an *agent.* These *syndicated loans* range in size from $50 million to several billion dollars. They may have several parts or tranches, but are generally governed by one contract or *credit agreement.* A syndicated loan with only two or three lenders is referred to as a *club deal.*

Issuance in the loan market varies with the business cycle, mergers and acquisitions activity, and default rates on outstanding debt. Chart 1 shows issuance over time by investment grade and non-investment grade companies.

Chart 1: U.S. Syndicated Loan Market: Investment Grade vs. Speculative Grade



Source: Fitch Ratings

All loan products are private instruments; they do not need to be registered with the Securities and Exchange Commission. Public companies, however, often disclose the terms of their loan agreements in their public filings. Most corporate loans have a floating interest rate, typically set at a spread over either the *London Interbank Offered Rate (LIBOR)* or the *prime rate*. Most corporate loans are senior obligations. Non-investment grade companies are typically required to provide security for revolving credits and term loans, while investment grade companies can typically borrow on an unsecured basis.

LINE OF CREDIT

A *line of credit* is an agreement between a bank[1] and a company by which the company can borrow up to a specified dollar amount, often called the *line limit*. The company has no obligation to borrow. With a line of credit, the company may borrow, repay, and re-borrow, as long as the total of all loans outstanding under the line does not exceed the line limit.

With an *uncommitted line of credit*, the bank has no contractual obligation to make loans. While the line may have a stated maturity or review date, the bank can cancel the line at any time and demand immediate repayment of all outstanding loans. Stated maturity is typically one year. Often, the customer is notified about the terms of the line; this is referred to as an *advised line*. In other cases, the bank may set up internal guidelines for a customer's line, without notifying the customer. This is called a *guidance line*.

Companies of all sizes and credit qualities use uncommitted lines of credit because of their flexibility. A line can be set up quickly, the documentation is relatively simple, and there are rarely any covenants. Lines of credit are not syndicated or governed by a common agreement, and a company can have lines with more than one bank.

The disadvantage to relying on uncommitted lines of credit is the exposure to funding risk. Because the banks have no obligation to make loans, the company may not be able to borrow when it needs the money. For this reason, many companies use lines of credit as part of a larger funding strategy that includes other sources of funding.

REVOLVING CREDIT

A line of credit that includes a contractual commitment from a bank to make the line available for a fixed period of time is called a *committed line of credit*, a *revolving credit*, or a *revolver*.[2] During the *commitment period*, the bank must make loans up to the limit of the revolver as long as the borrower meets certain conditions. In exchange for receiving a commitment, the company must pay the bank a *commitment fee* on the amount of the revolver that is committed but not borrowed. Commitment fees typically range from as low as 6 or 7 basis points to 50 or more basis points per year, depending on the credit quality of the borrower.

[1] Commercial banks are the primary providers of lines of credit and revolving credits. Other investors include finance companies and investment banks.

[2] Not all participants in the loan market use terms in the same way. Here, we will follow the more common usage of *line of credit* for uncommitted facilities and *revolving credit* or *revolver* for committed facilities.

Revolving credits provide companies with significant operating flexibility. As with a line of credit, there is no obligation to borrow. Borrowings under the revolver, called *drawdowns*, can happen on one day's notice, and there is no penalty for prepayment. In addition, many revolvers allow for the issuance of letters of credit.

A revolving credit is typically documented in a lengthy *credit agreement* that sets out the terms under which the bank agrees to advance funds, including covenants and defaults. Higher risk borrowers typically have more covenants with tighter restrictions. Because of the bank's contractual commitment, the company's funding risk is much lower with a revolving credit than with a line of credit.

Maturity

Maturities for most revolving credits in the United States range from 364 days to five years. The amount of the revolver typically stays constant until maturity and there is no required amortization. Some transactions include a *clean-up* provision; this requires the borrower to repay some or all of the revolving loans outstanding and then maintain this lower balance for a fixed period of time each year, typically thirty days. This is appropriate when the revolver is needed to fund a company's seasonal cash uses. The clean-up provision helps to ensure that resulting seasonal cash flows are then used to repay loans.

To reduce regulatory capital requirements, banks may offer companies *364-day revolvers*. The commitment fee on these short-term revolvers is lower than on multi-year facilities, which typically mature in three to five years. The trade-off is funding risk: companies with 364-day revolvers are exposed to the risk that banks will not renew these facilities when they mature. This type of funding risk is called *rollover risk*. To reduce rollover risk, many 364-day revolvers include a *term-out provision*; this allows the borrower to convert the revolver at maturity into a one-year term loan.

Market Segments

The market for revolving credits is divided into three segments based on the credit quality of the borrower:

- ***High investment grade*** companies are rated "A" or higher. They use revolving credits for general liquidity and to backstop their commercial paper programs. These companies are not likely to borrow under their revolvers as they have other sources of funding that are cheaper than the loan market, such as commercial paper and bonds. In order to reduce costs, high investment grade companies often choose 364-day revolvers, or a combination of 364-day and multi-year facilities.

- ***Cross-over credits*** have a long-term credit rating of "BBB" and may have commercial paper rated "A2/P2". As with high investment grade companies, these companies use revolving credits for general liquidity and to backstop their commercial paper programs. Depending on market conditions, however, they may also borrow under their revolver. For example, if there is a disruption in the commercial paper market or A2/P2 commercial paper rates increase above historic norms, loans may provide cost-effective funding for these companies. In addition, if a company loses its A2/P2 commercial paper rating, it would likely drawdown on its revolver to repay maturing commercial paper that could not be otherwise refinanced. Since cross-over credits are usually more concerned about funding risk than high investment grade companies are, they usually rely less on 364-day revolvers and more on multi-year facilities.

- ***Non-investment grade*** companies are rated "BB" or lower. Because these companies do not have access to commercial paper, they will borrow under their revolving credits for seasonal needs and, often, for longer-term cash needs. Because they are very sensitive to funding risk, non-investment grade companies rarely use 364-day revolvers, preferring five-year facilities.

TERM LOAN

A *term loan* is a loan with a set repayment schedule and maturity. The entire amount is borrowed when the loan is established and, unlike a revolving credit, amounts repaid cannot be re-borrowed. Term loans are often made in conjunction with a revolving credit; these two types of facilities may share one credit agreement, have the same set of covenants and defaults, and share in the same security agreement and collateral. Maturities in the term loan market range from a few months to approximately seven years, although most mature in three to five years.

Term loans are used primarily by middle-market and non-investment grade companies to finance capital expenditures and acquisitions, or as a permanent part of their capital structure. Larger investment grade companies rarely use term loans as they typically have less expensive financing alternatives.

Term loans are structured differently depending on the target investor.

- ***Term loan A.*** A loan structured for bank investors is called a *term loan A (TLA)* or, often, just a term loan. This type of loan is typically designed to be fully repaid using cash generated from a company's operations; bank investors do not want to rely on the company's ability to refinance its debt as the primary source of repayment of the loan. The repayment schedule, or *loan amortization*, is designed to match the borrower's forecasted free cash flow.

  A term loan A is often marketed to banks along with a revolving credit. Typically, if a bank chooses to buy part of one of these facilities during the original syndication, it must take an equal, or *pro-rata*, share of the other facility. For example, if a lender agrees to take 25% of the revolver, it must also take 25% of the term loan A. In the loan market, a revolving credit and term loan A that are syndicated together are often referred to as *the pro-rata* tranches.

- ***Term loan B.*** A loan structured for institutional investors, such as securitization vehicles and mutual funds, is called a *term loan B (TLB)* or an *institutional term loan.* A term loan B typically shares a credit agreement with a revolving credit and a term loan A, if one exists. All three loan tranches usually share the same covenants, defaults and collateral. TLB investors do not typically participate in the other loan tranches.

The major differences between the two types of term loans are:

- A TLB has a longer maturity, often six or seven years compared to five years for a TLA.
- A TLB has very little scheduled amortization, typically 1-5% of the initial principal per year.
- A TLB may have higher pricing than the pro-rata tranches. Some TLBs also have other types of yield enhancements, such as original issue discount, a LIBOR floor, or a prepayment penalty.

Bridge Loan

A *bridge loan* is a special type of term loan used to finance a short- or intermediate-term need. For example, a company planning an asset sale or bond financing may need cash immediately. Since a bond issuance may take six months to complete, and the orderly sale of a business division may take a year or more, a bridge loan allows the company to obtain the cash immediately, then repay it later from the asset sale or take-out financing proceeds.

Borrowers typically intend to repay a bridge loan with the cash proceeds of a specific event, such as an asset sale or a bond issuance. The size and maturity of the loan are tied to the expected timing and proceeds of the event. If the sale or financing does not take place or brings in less cash than expected, the bridge loan would need to be refinanced into a longer-term loan.

Investment grade and non-investment grade companies often use bridge loans to finance corporate acquisitions. The long-term financing plan for the acquisition may include bond or equity issuance, or the sale of a portion of the company purchased. The buyer, however, may need a large amount of cash immediately to complete the acquisition. In this case, the company would complete the acquisition with the proceeds of a bridge loan, and repay the bridge loan as the long-term financing transactions are put in place.

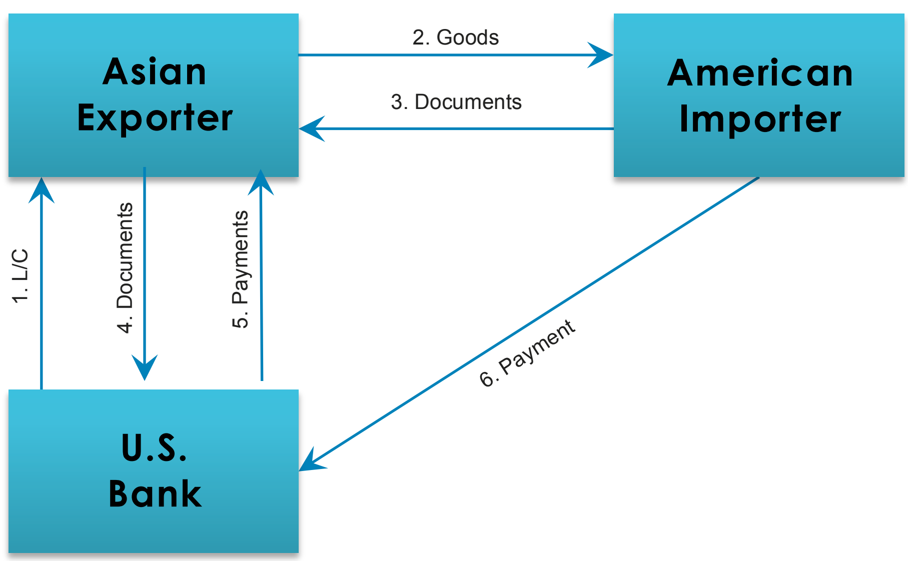
LETTER OF CREDIT

A *letter of credit (L/C)* is an instrument or document issued by a bank guaranteeing the payment of a company's obligation up to a stated amount for a specific period. From the perspective of the beneficiary of the letter of credit, it substitutes the bank's credit for the company's credit. Letters of credit are typically issued as part of an ongoing relationship between a bank and a company, often under a line of credit or revolving credit.

If the company intends to make payment directly to the third party rather than through the bank, the supporting instrument is called a *standby letter of credit* or *performance letter of credit*. These are commonly issued to support rent payments to property owners, potential future insurance claims, and performance under various types of contracts.

If the guaranteed obligation is an invoice for goods purchased, it is called a *trade letter of credit*. In this case, the issuing bank actually makes a payment on behalf of its customer and is later reimbursed. The flows of goods, documents, and cash in a trade letter of credit are shown in Chart 2.

Chart 2: Steps in a Trade Letter of Credit



1. At the request of its client, an American importer, a U.S. bank issues a letter of credit to an Asian exporter.
2. After receiving the letter of credit, the exporter ships the goods to the importer.
3. Upon receipt of the goods, the importer sends an acknowledgement of receipt to the exporter.
4. The exporter presents the letter of credit to the U.S. bank (or its local correspondent bank).
5. The bank pays the exporter for the goods.
6. The importer pays the bank for the goods or converts the amount due into a loan.

ASSET BASED LENDING

Asset based lending (ABL) is a type of finance structured on the value of assets pledged to support the loans. The most common ABL transaction is a revolving credit secured by a borrower's accounts receivable and inventory. This may be paired with term loans secured by equipment and/or real estate. Asset based lenders typically monitor the collateral closely through appraisals, field audits and frequent reporting of asset values. In addition, the lender often has control over the borrower's cash receipts.

Borrowers in the asset based market typically have higher credit risk than companies using other debt products. Asset based borrowers are often small and middle-market companies, but may also be large companies with declining credit quality. These larger borrowers, called *fallen angels*, access the asset based market because they are no longer able to obtain other types of financing. This is more common during economic downturns.

Asset based lenders include commercial banks, finance companies, and investment banks. Institutional investors also participate in the term loan portion of asset based transactions for larger companies.

Borrowing Base

ABL facilities use a *borrowing base* to limit borrowings under a revolving credit to a portion of the collateral's book value. The borrowing limit is often calculated as follows:

Gross value of accounts receivable and inventory
- Ineligible items
= Eligible assets
x Advance rate
= Borrowing limit

Ineligible items are specific assets that cannot be pledged or are of questionable value. They are deducted from the value of assets pledged in order to determine the appropriate borrowing limit. Ineligible receivables typically include past due and disputed accounts, government and non-U.S. accounts, and accounts over concentration limits. Work in process, goods in transit, and consigned goods are usually considered ineligible inventory.

The advance rate provides a general reserve to cover the difference between the book value of the eligible assets and the cash they would generate for the lender in an orderly liquidation. Typical advance rates are 75-85% against eligible accounts receivable and 40-60% against eligible inventory.

Asset Based vs. Cash Flow Lending

The analytical focus of ABL is primarily on a company's asset values, not the cash flows. If there is a cash shortfall, asset based lenders are prepared to liquidate their collateral to repay the loans. ABL is often contrasted with *cash flow lending* (sometimes called *enterprise value lending*) where the analytical focus is on a company's ability to generate free cash flow to repay debt.

There are many variations of cash flow lending, some of which include elements of asset based finance. Cash flow loans may be secured or unsecured, and some even include a borrowing base. Cash flow lenders, however, usually have more lenient collateral monitoring and control procedures, relative to those of asset based lenders. Table 1 shows the main differences between cash flow lending and asset based lending.

Table 1: Asset Based vs. Cash Flow Lending

	Asset Based Lending	Cash Flow Lending
Security	Revolving credits: 1st lien on accounts receivable and inventory Term loans: 1st lien on equipment and real estate	Investment grade companies: unsecured Non-investment grade companies: secured by most of the borrower's assets, including accounts receivable, inventory, equipment, real estate, and intangibles
Loan Size	Determined by the value of the pledged assets using a borrowing base	Determined by the borrower's forecasted free cash flow
Financial Covenants	0-1 financial covenants, often fixed charge coverage Additional financial covenants, such as leverage, may apply if asset coverage tests are not met	High investment grade companies have 0-1 financial covenants, often leverage Non-investment grade companies have 2 or more financial covenants, typically leverage and coverage
Due Diligence and Monitoring	Field audits and appraisals Control over cash Frequent receivables and inventory reporting	Initial receivables aging and inventory reports Periodic borrowing base certificates

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