Feature

KEY POINTS

- Although macroeconomic and geopolitical uncertainty remain, windows of opportunity for greater initial public offering (IPO) activity may open during 2024.
- Under the terms of corporate facility agreements, companies may be left with no option other than to carry out a full refinancing or seek lender consent in connection with a proposed IPO.
- In the leveraged finance context, "qualifying IPO" provisions serve as an automated mechanism to alter the economic and other terms of the facility agreement upon the successful completion of an IPO, making it suitable for a public company.
- Against the backdrop of the current credit environment, however, many lenders will be cautious when negotiating pre-agreed qualifying IPO adjustments, particularly where the IPO is not accompanied by a meaningful reduction in leverage.

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Going public: the impact of IPOs on facility agreements

In this article the authors consider the current state of the initial public offering (IPO) market – including why a company might choose to seek an IPO – and look at the potential impact of an IPO on a company's facility agreement. They explain how IPOs are typically regulated in corporate facility agreements and explore the mechanisms that sponsor-backed companies and their lenders often employ to automatically modify the terms of a leveraged financing so that it remains suitable for a publicly traded company post-IPO.

INTRODUCTION

An initial public offering (IPO), including the decision by a privately-owned company to obtain a listing on an international stock exchange and allow its shares to be traded freely, is a major milestone in the evolution of a company's lifecycle and strategic direction. There are a range of reasons why a company might choose to seek an IPO and undertake the significant and time-consuming work entailed to achieve one.

Some of the most common reasons for pursuing an IPO include:

- **Raising capital and expanding opportunities for future access to capital:** In addition to raising equity capital at the time of an IPO, it is generally easier from a legal and regulatory perspective for a public company, following an IPO, to raise further capital from a wider range of sources, including retail investors.
- **Increasing liquidity for a company's shares**: Founders, shareholders and employees are able to sell shares more easily when they are freely tradeable among all investors on a stock market.
- **Creating "M&A currency"**: Having liquid and publicly tradeable shares enables a public company to use its shares as consideration for funding an acquisition (ie it can pay vendors of target companies or businesses with shares in the public company).
- **Attracting and compensating employees with public company shares and share awards**: Public companies often have a wide range of share incentive programs (including share option plans) for their employees and it is easier for those employees to sell shares when they are freely tradeable on a stock market.
- **Creating publicity, brand awareness or prestige for a company**: Being a public company can add credibility to a company's brand and ensures that existing and future stakeholders (including customers) have access to audited financial statements as well as other financial and operational disclosures.
- **Demonstrating public company status to the outside world, particularly regulators**: being a public company tends to imply a level of scale and sophistication for customers and suppliers deciding between a company and its competitors, and regulators may be more open to working with companies that have reached a certain level of maturity.

Although investors have been less supportive of IPOs in the last 12 to 18 months, and IPO activity on major international exchanges has been subdued – with record low numbers of completed transactions, both in terms of volume and value, not seen since the 2008/09 financial crisis – there are signs recently of investor sentiment and confidence improving. As key stock exchanges have demonstrated in H2 2023, the IPO market is open for high-quality companies who are sensitive to investor expectations around valuation and pricing. Although macroeconomic and geopolitical uncertainty remain, the hope is that once persistently high inflation subsides and interest rates have peaked, windows of opportunity for greater IPO activity will open during 2024.

While for some shareholders an IPO might be an opportunity to exit and realise a gain on their investment, for a company itself an IPO will result in significant changes in the way in which it interacts and engages with stakeholders – including its shareholders, employees, suppliers, customers, regulators and, where a company has existing debt financing, its lenders.

This article looks at the potential impact of an IPO on a company's facility agreement. It will explain how IPOs are typically regulated in corporate facility agreements and explore the mechanisms that sponsor-backed companies and their lenders often employ to automatically modify the terms of a leveraged financing so that it remains suitable for a publicly traded company post-IPO.

CORPORATE FACILITY AGREEMENTS AND CHANGE OF CONTROL

One of the key ways corporate facility agreements (including those in respect of

working capital revolving credit facilities and investment grade acquisition financings) regulate IPOs is via change of control clauses, which are triggered when a company undergoes a substantial change in ownership or governance structure (which could consequently alter its strategic direction or operational dynamics). Whilst there can be variation from deal to deal, a "change of control" will typically be deemed to have occurred for the purposes of a facility agreement if the existing shareholders:

- cease to have the power to appoint directors of the company which control the majority of the votes which may be cast at a board meeting of the company; or
- cease to beneficially own and control more than 50% of the issued voting share capital of the company.

If a change of control occurs, the mandatory prepayment provisions in the facility agreement will be triggered. Traditional mandatory prepayment provisions provide that, upon the occurrence of a change of control, the facilities are cancelled in full and all outstanding amounts, together with accrued interest, become immediately due and payable.

However, some borrowers have achieved greater flexibility in this area with the inclusion of an individual lender put-right upon a change of control. Under this formulation, upon the occurrence of a change of control, each individual lender may elect to (but is not obliged to) cancel its commitments and require the prepayment of its participations in any outstanding loans within a prescribed timeframe. Any lender which does not notify the company of its intention to cancel commitments and require prepayment within that timeframe will be deemed to be a "non-responding lender" and its right to cancel its commitments and be prepaid will cease.

Where financing arrangements include traditional mandatory prepayment provisions or where lenders can exercise put-rights, companies may be left with no option other than to carry out a full refinancing or seek lender consent in connection with a proposed IPO. Extensive amendments to the relevant financing documents may also be required to ensure they are fit for purpose post-IPO.

A refinancing or consent/amendment process will need to run in parallel to the IPO workstream and can have a significant impact on the company, both from a resource perspective (ie substantial company input will be required at a time when the company is likely already stretched due to the IPO) and from a risk perspective (ie whether the refinancing or consent/amendment process can in fact be achieved with sufficient support from the market and within the relevant timeframe).

LEVERAGED FACILITY AGREEMENTS AND THE QUALIFYING IPO REGIME

On a leveraged finance transaction, where it is clear from the outset that an IPO is one of the key potential exits for the private equity sponsor, the facility agreement will typically include "qualifying IPO" provisions. These provisions – which are intended to mitigate the borrower-side issues discussed above – serve as an automated mechanism to alter the terms of the facility agreement upon the successful completion of an IPO, making it suitable for a public company.

Whilst formulations vary from deal to deal, there are often two components to a qualifying IPO. The first broadly captures any listing of all or part of the share capital of a member of the borrower group on a recognised investment exchange. The second is that the borrower group must have achieved meaningful deleveraging (ie through applying IPO proceeds to debt prepayment) and/or an investment grade corporate credit rating. However, in recent years, some sponsor-backed borrowers have successfully negotiated qualifying IPO regimes that apply without any requirement to de-lever or achieve an investment grade rating.

AUTOMATIC ADJUSTMENTS

At the core of qualifying IPO provisions lies the concept of automatic adjustments. Such adjustments are carefully negotiated to ensure that upon the successful completion of a qualifying IPO, the facility agreement undergoes predefined alterations to align it with the requirements of a public company. These adjustments are intended to eliminate the need for time-consuming and uncertain pre-IPO negotiations, providing a seamless transition for all parties involved.

Automatic adjustments typically include the following:

Change of control

As noted above, change of control provisions play a crucial role in safeguarding the interests of lenders. However, following an IPO, the dynamics of company ownership change dramatically. The company's shares are now available to the public, and there is a possibility of varied shareholder compositions, including the emergence of new majority stakeholders. To adapt to this new environment, the change of control provisions are revised to ensure they provide the company with sufficient flexibility whilst still protecting the lenders' interests.

One common approach is to adjust the ownership or control threshold for the initial private equity investors. Instead of the pre-IPO 50% requirement, this threshold is often reduced to a lower level, such as 30%. This adjustment acknowledges the reality that the initial private equity investors will often divest more than 50% of their holding in the company via the IPO, but at the same time maintain a significant say in the company's affairs, given their foundational role and substantial investment.

An alternative method to address post-IPO change of control concerns is by focusing on the acquisition of voting rights. In this scenario, a post-IPO change of control is deemed to occur if a third party (ie not one of the initial private equity investors) manages to acquire more than 50% of the voting rights of the now-listed company. This approach ensures that the lenders are protected if any significant shift in control away from the initial equity investors, especially one that could influence the company's strategic decisions, occurs.

Interest rate realignment

Interest rate realignment is a key aspect of qualifying IPO provisions which seeks to adjust interest rates in line with the evolving financial dynamics of a company that is transitioning from a private to a public entity.

When a company is private, the interest rates on its borrowings are typically set based

on various factors including its financial health, industry norms for similar private entities, and the perceived risks associated with lending to such a company in the current leveraged finance market.

However, the risk assessment shifts once a company undertakes an IPO. With the infusion of public capital, a company often experiences enhanced liquidity, meaning it has more readily available cash or assets that can be quickly converted to cash. This improved liquidity can reduce the company's reliance on borrowed funds, thereby potentially decreasing its leverage level and overall borrowing costs.

Moreover, being publicly traded brings about increased transparency, as the company is now required to adhere to rigorous regulatory and financial reporting standards. This transparency can alter market perceptions of the company, generally moving towards a more favourable view given the detailed financial disclosures and regular audits.

Additionally, public companies are generally perceived as less risky compared to their private counterparts, primarily because of the increased transparency, diversified shareholder base, and the broader scrutiny they are subjected to. As a result, lenders might be more inclined to offer interest rates that reflect this reduced risk.

Given these shifts, qualifying IPO provisions incorporate mechanisms that trigger an automatic reduction of interest rates once the company goes public. This realignment seeks to ensure that the company is neither overburdened with interest rates that are misaligned with its new status nor benefits unduly from rates that are too lenient ie the adjusted interest rates are intended to reflect the market norms for similar publicly traded entities.

Financial covenants

Financial covenants play a pivotal role in determining the financial health of a company, especially in the context of pre-IPO financings. Whilst there has been a general trend away from extensive financial covenants on leveraged financings in recent years, before a company goes public its financing arrangements may come with one or more financial covenants. These covenants are essentially financial performance metrics that the company must adhere to, ensuring they maintain a certain level of fiscal responsibility and stability.

However, once a company undergoes an IPO, there's a shift in the dynamics. Not all previously established financial covenants remain relevant or necessary. As such, many of these covenants will be phased out upon a successful IPO. In most cases, only the most fundamental metrics, for example leverage ratios and potentially interest cover tests, will persist post-IPO.

But even these remaining covenants will undergo modifications to accommodate the new public status of the company. In particular, the testing levels of these covenants will be adjusted. This is done to provide the company with increased financial flexibility, often referred to as "headroom". Moreover, to reduce administrative burdens and to align with the reporting schedules of publicly traded companies (see below), the frequency of covenant testing will typically shift from quarterly to semi-annual.

Tailored undertakings

Undertakings are an integral part of leveraged facility agreements, regulating what the company and its broader group can and cannot do. They can cover a broad range of matters, including the group's ability to make acquisitions, incur debt and pay dividends.

However, when a company undergoes an IPO, it becomes subject to a new set of regulatory requirements, faces diverse investor expectations and gains access to a significantly broader capital base. Consequently, the original undertakings, tailored for a private entity, may no longer be compatible with the company's new status and its associated demands.

Recognising this shift, qualifying IPO provisions incorporate mechanisms to adjust these undertakings. For instance, post-IPO, the borrower group might be granted more leeway in its operational decisions. This could take the form of relaxed restrictions around acquisitions, allowing the company to aggressively pursue growth opportunities in the market. Similarly, the company might be granted the flexibility to incur additional debt, albeit within the confines of more lenient financial covenants (discussed above), to fund its expansionary endeavours.

Another notable area of adjustment relates to dividend payments. Pre-IPO undertakings often impose stringent controls over dividend distributions to ensure that the company prioritises its debt obligations. However, post-IPO, these restrictions might be eased or altogether removed. This is to cater to the expectations of public shareholders, who often expect regular dividend pay-outs as a return on their investment. The modified provisions might allow the company to distribute dividends either without any cap or up to a pre-determined percentage of its earnings.

Additionally, it is not uncommon for companies to negotiate terms pursuant to which certain monetary thresholds or "baskets" associated with undertakings automatically expand post-IPO. Typically, these baskets are increased by an agreed percentage, often ranging between 25% and 50%, upon the successful completion of an IPO.

Mandatory prepayments

The mandatory prepayment provisions are a critical feature in many leveraged facility agreements, designed to ensure that the company utilises specific cash inflows to reduce outstanding loan balances. By doing so, lenders can minimise their exposure and enhance the likelihood of recouping their funds. Typically, these mandatory prepayments are triggered by certain predefined events that result in a significant influx of cash to the borrowing group.

There are many possible triggers for mandatory prepayments. Historically, one common trigger has been the generation of "excess cashflow" by the borrower. In this context, excess cashflow broadly refers to surplus operational cash that remains after the borrower has met all its financial commitments, including capital expenditures, working capital needs and regular loan service requirements. The rationale behind this provision is straightforward: if a company

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generates surplus cash from its operations, it should utilise it to reduce its debt load, thereby decreasing the risk to its lenders.

Additionally, net proceeds from asset disposals also often act as a trigger. When a company sells a significant asset or a set of assets, it receives a lump sum amount. Lenders, through the facility agreement, typically mandate that such net proceeds be used to prepay the loan, ensuring that the borrower does not divert these funds for other potentially riskier ventures.

The same logic applies to the receipt of insurance and recovery proceeds. If a company receives a substantial amount from an insurance claim or as recovery under M&A-related documents, the lenders expect these funds to be used to offset the outstanding loan balance, further safeguarding their interests.

However, the dynamics change when a company undergoes an IPO. Given the enhanced liquidity, broader capital base, and the stringent regulatory oversight associated with being a publicly traded entity, many of the traditional triggers for mandatory prepayments are viewed as being redundant or less relevant. As such, qualifying IPO provisions often relax or altogether eliminate certain mandatory prepayment requirements. For instance, post-IPO, the obligation to prepay loans using excess cashflow or disposal, insurance or recovery proceeds might be dispensed with altogether, given the company's improved financial health and the need for flexibility in capital allocation.

However, even after an IPO, certain significant events will still typically necessitate mandatory prepayments. Two of the most important triggers in this context are the sale of all or substantially all of the company's assets or a post-IPO change in control (ie one which triggers the more flexible criteria discussed above). The sale of all or substantially all assets signifies a fundamental transformation in the company's business, whilst a change of control post-IPO can introduce new risks or alter the company's strategic direction, in each case prompting lenders to seek prepayment to safeguard their interests.

Reporting requirements

Reporting requirements play a pivotal role in the relationship between a borrower and its lenders, particularly in the context of leveraged facility agreements. Prior to a company's IPO, lenders rely heavily on regular financial reports, such as budgets and monthly accounts, to keep a close eye on the borrower's financial health and operational performance. These reports help lenders assess the company's ability to service its debt, identify potential risks early on, and take preventive measures if necessary.

However, the approach to financial reporting undergoes a significant shift when a company transitions from being privately held to publicly traded. The move to public status comes with a set of stringent regulatory requirements aimed at ensuring transparency, investor protection, and fostering trust in the capital markets. Regulatory bodies, such as securities commissions or stock exchange authorities, impose rigorous disclosure standards on publicly traded companies. As a result, these companies are obligated to disclose a wide array of financial and operational information to the public at regular intervals.

Given this enhanced level of transparency and the wealth of information available through public filings, the traditional reporting requirements stipulated in leveraged facility agreements often become redundant post-IPO. Recognising this redundancy, qualifying IPO provisions usually adapt to the new reality by adjusting the reporting obligations of the borrower.

In practical terms, this adjustment often means that certain reporting requirements are relaxed or eliminated altogether. For instance, the obligation for a company to provide detailed budgets or monthly accounts to its lenders is typically suspended. The rationale behind this is that, since lenders can now access a plethora of financial data through public filings, there's little added value in receiving these additional reports (and indeed the provision of such information may be in breach of regulatory requirements applicable to public companies, including those relating to market abuse and inside information).

Security and guarantor coverage

Security and guarantor coverage are foundational elements of most leveraged finance transactions, offering lenders a safety net in the event of potential defaults or borrower financial difficulties. In the context of an IPO, these two elements often undergo significant re-evaluation due to the change in a company's financial position and public status.

Specifically, given the company's enhanced liquidity, improved creditworthiness, and heightened public scrutiny post-IPO, leveraged facility agreements often contain provisions for the automatic release of specified transaction security and/or for the relaxation of the guarantor coverage requirements upon an IPO.

CONCLUSION

When negotiating finance documentation at pre-IPO stage, companies and, where relevant, their private equity sponsors should remain cognisant of future-proofing their financing package.

In the leveraged finance context, a well-negotiated qualifying IPO regime can provide a company with valuable flexibility and certainty and ensure that its existing financing arrangements can remain with the company through its next stage of growth. Against the backdrop of the current credit environment, however, many lenders will be cautious when negotiating pre-agreed adjustments, particularly where the IPO is not accompanied by a meaningful reduction in leverage. Accordingly, understanding the nuances and implications of qualifying IPO adjustments – particularly with windows of opportunity for greater IPO activity likely on the horizon – is vital for both borrowers and lenders. ■

Further Reading:

- Credit portability: the issues and considerations for debt investors (2017) 11 JIBFL 703.
- Mandatory means mandatory? Recent trends in leveraged finance prepayment clauses (2018) 9 JIBFL 550.
- Lexis+® UK: Banking & Finance: Practice Note: Portability.