Private Credit Explained: Delayed Draw Term Loans

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A typical European leveraged loan will comprise of various tranches of debt, for a variety of purposes, all documented within a single facilities agreement. In a leveraged buyout scenario, the standard structure will be a term loan to finance the acquisition (typically either a unitranche loan provided by one or more private credit lenders or a term loan B in the broadly syndicated loan ("BSL") market) with, in each case, a revolving credit facility provided for working capital purposes. Depending on the business model and any anticipated future acquisitions, the sponsor may also wish to consider additional lines of liquidity.

The sponsor may need committed financing, for anticipated acquisitions in the future, but may not wish to pay the full interest expense on that portion of the committed debt until the funds are actually required. This future financing requirement can be structured as an additional term facility with delayed draw mechanics, for specific purposes, which is available for a limited period after closing (subject to certain agreed parameters). This arrangement is known as a delayed draw term loan ("DDTL"), which is a committed line of credit. They are usually labelled as a capex, CAF or acquisition facility in the private credit market. These DDTLs provide the borrower flexible access to additional funds at a later date, on pre-agreed terms, rather than being obliged to draw down the entire amount of debt at closing.

DDTLs are a regular feature in private credit mid-market deals, but have become increasingly popular in the large cap space where private credit competes with the BSL market.

Structuring

Commitment Length / Availability

The structure of each DDTL is deal specific, but they are generally similar in nature to the other tranche of term debt, the day one unitranche loan. DDTLs are typically committed from closing (i.e. after the unitranche has been drawn in full and the day one acquisition has completed). They usually have an availability period between three to four years, can be drawn in multiple tranches (subject to a minimum draw amount) and, once drawn, they cannot be re-borrowed following prepayment. DDTLs typically have the same ranking and priority as the unitranche term loan, therefore there will be no inside maturity permitted, with the DDTL due for repayment on the same final maturity date as the unitranche term loan. Voluntary and mandatory prepayments will usually be required to be applied pro rata between the unitranche term loan and the DDTL.

Use of Proceeds

Given the increasingly borrower friendly market in recent times, the purpose clause will be broadly drafted. The borrower can access the DDTL facility for a variety of reasons including capital expenditures, to fund permitted acquisitions, to refinance any other existing indebtedness, to repay any sponsor bridging equity used to fund a go-forward acquisition or even to simply place the cash on the balance sheet (with the future intention of using the proceeds to fund the agreed purposes).

Conditions for Use

In addition to customary conditions precedent to draw funds under the facilities agreement, such as no event of default and repeating representations, the following conditions to utilisation will typically be included:

- the proposed utilisation will not result in the leverage exceeding opening leverage on a pro-forma basis;
- the unitranche debt has already been fully drawn;
- certification from the borrower that the purpose for the DDTL is one that is permitted; and
- in certain situations, a restriction on the borrower entering into any uncommitted incremental facility until these committed funds under the DDTL are utilised in full.

Minimum Utilisation

Where DDTLs are permitted to fund capex, particularly where the size of the committed DDTL is substantial, lenders require larger minimum utilisation amounts. These will often be amounts in excess of, for example, £1 million / €1 million, to avoid the administrative burden of requesting LPs to fund smaller amounts. However, these minimum utilisation conditions may not align with the specific capex requirements of the borrower. Lenders and borrowers may need to negotiate a level that balances the lenders' operational workload with the borrower's requirement for liquidity to meet the ongoing needs of the business.

“Certain Funds” Requirements

In certain situations, private credit funds may be willing to provide DDTLs on a “certain funds” basis where appropriate. From a lenders’ perspective this will mean that there are fewer documentary requirements that the borrower group needs to satisfy before the lenders are required to fund. Generally, most DDTLs are documented with no specific acquisition confirmed. Therefore a borrower may need to request a loan on a certain funds basis for a specific acquisition, but the lenders will typically limit this reduced conditionality for a period not exceeding six months from the date of signing of that specific acquisition.

Lenders should ensure that the requirement to meet a set leverage test is still incorporated into the criteria for a certain funds utilisation. This can sometimes be inadvertently missed as utilisation of a loan at closing, on a certain funds basis, does not typically include a leverage test.

Ranking

As mentioned above, DDTLs typically rank pari passu with the unitranche loan for all purposes (i.e. both pre and post enforcement).

Economics

Upfront Fee / Arrangement Fee

There are a variety of ways to structure the upfront / arrangement fee for the DDTL. It may be payable upfront in its entirety on the closing date, but it is more common to see the upfront fee split 50:50. In classic mid-market deals, 50% of the fee will be payable on the closing date, with the remaining 50% due on the earliest to occur of (i) any utilisation, (ii) the end of the availability period, (iii) any prepayment of the DDTL whether mandatory or voluntary, and (iv) cancellation of any unused amount of the DDTL. In some deals where the DDTL can be utilised in multiple drawings, the remaining 50% fee is paid as a proportion of the principal amount of each drawdown under the DDTL. While it is unusual, in more aggressive deals, no upfront fees are payable on closing; instead, the fee is a pro rata amount paid on each drawdown or cancellation. In the larger cap market, the arrangement fee may only be paid pro rata for each utilisation, with no fee due upon cancellation.

Commitment Fee

There is usually a financial cost for the borrower in relation to the availability of committed funds for the DDTL. Interest expense is not incurred until or unless the DDTL is drawn (in part or in full). However, lenders typically charge a non-utilisation or commitment fee for maintaining the commitment to fund the DDTL. This fee is usually described as a commitment fee and accrues on the undrawn DDTL commitments. These commitment fees begin accruing from an agreed time until the DDTL is fully drawn or, if some or all the DDTL remains undrawn, the end of its availability period. Normally, the commitment fee starts accruing from the closing date and is payable quarterly in arrears. In larger deals, there may be a commitment fee holiday, where fees only start accruing three or six months after closing.

DDTL vs Incremental Facilities

Following the economic uncertainty in recent times, borrowers find a pre-agreed committed facility with set pricing for anticipated acquisitions particularly appealing. Such facilities eliminate concerns about a borrower’s funding sources and remove the need for negotiations on pricing and terms at a time in the future when, depending on market conditions, economic and documentation terms may be less favourable for the borrower. Access to funds is immediate, as lenders are already committed to fund upon satisfaction of the requisite conditions precedent. For borrowers, this certainty of funding in comparison to negotiating an incremental facility typically justifies the additional fees associated with DDTLs.

Recent Developments: “Synthetic PIK”

The flexibility afforded by a DDTL has been utilised in a more innovative manner recently, in what has been described as “synthetic PIK”. PIK debt, where the interest is paid in kind as opposed to cash, can be attractive in an environment where liquidity and cash flow are challenging issues for a business. The borrower can add the amount of their interest payment to the principal amount of the total debt outstanding and defer payment until the debt matures. Failure to make a cash interest payment will result in a “default” under finance documents, so the ability to defer a cash payment can be beneficial in times of illiquidity and in high interest rate environments.

Private credit lenders are generally able to offer some elements of PIK debt as part of the deal, which provides a competitive edge when vying with bank lenders to provide debt to sponsors. Unfortunately, there can be limits on the quantum of PIK debt that a private credit lender can offer. In these situations a “synthetic PIK” could be offered to sponsors, which is structured through a DDTL, as an alternative. The lender will provide the unitranche loan, typically drawn in full at closing, with a delayed draw tranche of term debt also being provided as part of the debt package. When cash interest becomes payable on the unitranche loan, the borrower has the ability to draw the DDTL to service this debt (a “Payment DDTL”), which is in effect a synthetic PIK. The cash pay interest is paid, but by the borrower adding more debt to its balance sheet.

Lenders are using this synthetic PIK option to offer PIK terms to a borrower, without breaching any cap imposed on the amount of PIK debt permitted, as technically the interest on the unitranche debt is being paid in cash. These Payment DDTLs are a relatively new concept and their terms are typically deal specific, including how the interest accrues and how it is paid on the Payment DDTL. Some transactions permit the Payment DDTL to be further utilised to repay the DDTL interest, or the Payment DDTL may be structured without an interest component but with additional fees. These structures are novel and the exact scope and application of synthetic PIKs are still developing in the market, especially in the US where this structure appears to have originated.

Conclusion

DDTLs remain an attractive option for sponsors due to their provision of easy access to debt on pre-agreed terms, which should ensure their sustained popularity. In a competitive market, where sponsors wish to swiftly acquire attractive assets, we have seen syndicated lenders trying to offer these loans to compete directly with the private credit market. In the leveraged loan market sponsors are striving for increasingly favourable terms. New innovative use of DDTLs as synthetic PIK, provided by private credit lenders, may be a feature that is seen in the coming year in the European leveraged loan market.

This is the first article in our Private Credit Explained series. The second season of our successful and well received Proskauer Private Credit Academy will commence in London on Wednesday 25 September 2024, where we will discuss liability management transactions. If you are interested in attending, please reach out to your usual Proskauer Private Credit Group contact or to any of the authors of this article.

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