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Fungibility of Incremental Term Loans: Calibrating Amortization Terms

by Yair Galil and Victoria Jones Yilmaz, Gibson, Dunn & Crutcher LLP

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A Practice Note discussing the concept of fungibility of incremental term loans. It explains why achieving fungibility is important for creating a deeper and more liquid trading market, particularly in the term loan B market. It also highlights a common but often overlooked hurdle to true fungibility, calibrating amortization terms, and demonstrates how simplistic drafting of amortization provisions for incremental debt can lead to economic differences between the new and original loan tranches, even when the stated rates are identical. The Note further examines how prior voluntary or mandatory prepayment events can introduce additional complexities to the amortization profile, creating another potential barrier to fungibility.

The accordion feature of many leveraged loan facilities affords borrowers financing flexibility by providing a convenient path to on-boarding additional term and/or revolving facilities and housing them within the existing credit agreement. Covenants and most other terms, as well as the guarantee and collateral credit support of the original loan facility, apply to the new loans. Incremental facilities are often used to obtain debt financing for acquisitions or other investments, as well as for leveraged recapitalizations, on attractive terms. Since these loans benefit from the full credit support package, they can generally be offered at lower yields than a new junior lien or unsecured loan facility or note issuance offered under separate documents.

For more information on incremental facilities, see Practice Notes, Lending Overview: Incremental Loan Facility and What's Market: Incremental Facilities.

Fungibility

When practicable, in particular in the term loan B market where loan trading figures most prominently, borrowers and lenders will often seek to structure incremental term loan facilities so as to achieve fungibility between the new incremental loans and the existing term loan facilities. By ensuring both "tax fungibility" (identical tax attributes) and "terms fungibility" (identical terms, including maturity, interest rate, call protection, covenant coverage, ratable prepayments, and amortization), a deeper and more liquid market is established for the new tranche, as it can trade interchangeably with the existing tranche or tranches.

Tax fungibility, which is beyond the scope of this Practice Note, depends among other things on the pricing at which the loans are offered initially, including upfront fees and original issue discount. Terms fungibility, by contrast, is based on the attributes of the loans themselves, such as the date on which the prepayment premium rolls off. When loans are fully fungible, the holder should be indifferent to whether they hold an initial or incremental term loan, even though they may have acquired the loan at a different price than other holders.

The importance of attaining fungibility is most pronounced when the proposed incremental term loan facility is not itself of "benchmark size" (generally considered to be in the range of about $100 million to about $500 million). These smaller facilities are not deemed to be liquid enough on a stand-alone basis and derive greater benefit from being pooled with a pre-existing tranche of term loans. For this reason, most incremental term loan mechanics allow for either increases in existing classes of term loans or the creation of new classes of term loans. When aiming for fungibility for the new facility, lenders will seek to use the provisions allowing for increases in existing term loan classes.

The Amortization Problem

Although incremental loan documentation is often drafted with fungibility in mind, a frequent hurdle to achieving true fungibility arises in the treatment of amortization. Simplistic drafting of the amortization provisions can lead to inadvertent gaps in the amortization schedules between original and incremental term loans. The following scenario, using simplified numbers and adopting the customary term loan B amortization rate of 1.00% per annum payable quarterly, demonstrates the issue:

- A borrower enters into a $10 million term loan. After one year and four quarterly amortization payments of 0.25% of the initial principal ($25,000 per payment), the outstanding principal is $9.9 million.
- The borrower then incurs an additional $10 million in incremental term loans.
- The original provision, stating that the initial term loans amortize in quarterly installments of 0.25% of the original principal amount, is supplemented by a new provision, stating that the incremental term loans will also amortize in quarterly installments of 0.25% of the original principal amount.
- At the next amortization date:
  - the original loan holders receive 0.25% of $10 million = $25,000; divided by the then-outstanding $9.9 million of principal, this equates to $2.52525 per thousand dollars of loan held; and
  - the incremental loan holders receive 0.25% of $10 million = $25,000; divided by the then-outstanding $10 million of principal, this equates to $2.50 per thousand dollars of loan held.

This difference may seem modest, and in small club deals may be glossed over by the lender group and the administrative agent, but it is a difference in economic treatment and prevents true fungibility of the loans.

Achieving Amortization Fungibility

To resolve the discrepancy and maintain fungibility between tranches of loans, the most straightforward solution is to modify the amortization percentage for the incremental loans slightly upwards.

In the example above, it would appear to be simplest to adjust the amortization of the initial term loans to reset it to a clean 0.25% per quarter on the outstanding principal amount as of the incremental amendment date. However, that is a reduction in the amortization rate and typically cannot be effected without the consent of all affected lenders. Instead, the amortization rate of the incremental term loans could be adjusted to 0.252525% per quarter on the outstanding principal amount as of the incremental amendment date (that is, on the original principal amount of the incremental loans) and this would bring them to parity with the initial term loans.

This solution can also be expressed mathematically.

Mathematical Solution

R_inc = (R_orig × P_orig) / B_orig

Where:

- **R_inc:** Amortization percentage to apply to incremental term loans.
- **R_orig:** Stated (original) amortization percentage for the initial term loan (for example, 0.25% per quarter).
- **P_orig:** Original principal amount of the initial term loan.
- **B_orig**: Outstanding balance of the initial term loan at the time the incremental loan.

Using the amounts from the above example and plugging them into the formula yields the following:

- P_orig = $10 million (original principal of initial loan).
- B_orig = $9.9 million (outstanding balance after one year of amortization).
- R_orig = 0.25% (quarterly amortization percentage on original principal).
- P_inc = $10 million (original principal of incremental loan).

So:

- R_inc = (0.25% × $10 million) / $9.9 million.
- R_inc = $25,000 / $9.9 million.
- R_inc ≈ 0.252525%.

Effect of Prior Prepayments

A further complicating factor can be introduced in the event the initial term loan tranche has had a voluntary or mandatory prepayment event. The manner in which a prepayment is applied to the remaining principal of a loan can differ from one credit agreement to another, and these differences will impact the amortization profile of a loan in varying ways.

If a prepayment is applied ratably across all remaining amortization bullets and the maturity bullet, the effect is to reduce future amortization payments but maintain the existing amortization schedule for a given amount of principal. Looking back to the hypothetical $10 million initial term loan, if the borrower were to prepay $5 million applied ratably to all remaining scheduled payments, the amortization schedule would remain unaffected with each $1,000 of principal amount entitled to a quarterly amortization bullet of $2.50 (assuming no prior amortization bullets before the prepayment event).

However, prepayment provisions are commonly drafted so that the prepayment amount is applied in direct order of maturity, at least up to one or two years ahead (that is, to the next four or eight installments of amortization, with the rest ratably shared among the remaining installments). This creates an amortization holiday for the initial loans, one that is not explicitly reflected in the amortization provisions but rather results from the operation of the prepayment provisions based on the prepayment event. To ensure that the incremental loans align fully with the amortization schedule of the existing term loans, it is necessary to map out the impact of any prior prepayments and tailor the amortization schedule of the new incremental term loans accordingly.

Practical Implications

This Practice Note highlights an important yet sometimes-overlooked aspect of incremental loan structuring that is necessary to consider in order to attain true fungibility of the incremental term loans with existing initial term loans. Careful review of the current effective amortization rate of the initial term loans (as opposed to the facial amortization rate in the credit agreement), as well as due regard to the impact of prior prepayment events, can help avoid inadvertent misalignment of amortization schedules that could interfere with full fungibility.