

Fund Finance Friday



Second Lien Loans in Subscription Finance

November 8, 2024



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Although second lien loans in subscription line finance have been discussed with interest over the years, their use has been sporadic and it has only been very recently that we have started to see a real uptake in the use of these structures, especially here in Europe.

So why the increased use of second lien facilities?

Liquidity: It is common knowledge that there are liquidity concerns across the fund finance market. This has, in part, been caused by the increase in demand from GPs for more capital to support their portfolio companies coupled with the increase in the size of many of the funds, especially for top tier GPs. This requirement for additional cash has come at a time when traditional subscription line providers may not have the capacity to meet these capital demands. Increasing regulation, risk management policies and capital adequacy requirements are putting constraints on what such lenders are able to provide.

In order to meet this need, GPs have been looking at solutions used in other debt markets (principally the leveraged finance market), in order to access the required credit from non-traditional sources.

Pricing: Due to the additional risk, the pricing on second lien loans is noticeably higher than that seen for traditional, first ranking subscription facilities. These higher returns can, depending on the structure of the second lien loan, present an attractive opportunity for alternative lenders on the hunt for higher yields.

Economic uncertainty and investor preferences: Given the current economic uncertainty, GPs have been keen to have borrowing facilities in place so they can deal with any unforeseen capital needs, or in order to bridge cash flows. Additional headroom can be sourced by extending the existing credit via a second lien loan without displacing any existing senior loans.

Second lien loans in this context are still subscription lines and therefore a product that investors know well. They are able to get comfortable with how this additional headroom is provided to the fund. It is helpful that any such second lien will, in the ordinary course, be subject to any leverage restrictions in the fund documentation, which investors are relying on.

What is a second lien loan?

Historically second-lien financing was a form of distressed debt which originated out of restructurings allowing borrowers in financial difficulty to raise new (more expensive) capital quickly.

The terminology for this financing originated in the US, a “lien” here in England being the equivalent of a security interest or charge.

The main characteristic of this type of financing is that the second lien lenders provide capital secured by the same collateral as the senior debt, but under an intercreditor arrangement agree to subordinate their claims in respect of the proceeds of that shared collateral to those of the senior debt providers.

Under a typical subscription line facility the primary collateral is the right to draw down the undrawn commitments of the investors. The amount a fund is able to borrow will depend on the borrowing base set by the lender.

Under a traditional borrowing base structure, the investor base would be made up of certain investors against whose undrawn commitments (and subject to any concentration limits) an advance rate is applied in order to determine the amount that the lender is willing to lend. The advance rates will be set depending on a lender's approach to categorizing each investor, with higher rates being applied against investors that the lender believes are more creditworthy and therefore more likely to comply with any funding obligations. Not all investors will receive borrowing base credit; for example, it is not uncommon for high-net-worth investors or family offices to have an advance rate of zero.

Typically: (i) not all investors may be included in the investor base; and (ii) advance rates and concentration limits will exclude some of the commitments of investors that are included in the borrowing base. As such, there is usually an amount of undrawn commitments for which the borrower is not receiving credit (notwithstanding that security will still have been granted over such commitments). It is this pool of "over collateralized" assets which can be offered to second lien lenders.

A second lien lender (in return for a higher margin) is able to lend against the undrawn commitments in this overcollateralized pool and provide the additional headroom required by the borrower.

What documentation is required?

It may be the case that an existing subscription line is in place. If that is the case, a separate standalone second lien facility agreement will be needed, provided that the consent of the first lien lenders for the incurrence of new indebtedness and security over the existing collateral has been obtained (as such arrangements will typically be prohibited under the terms of the existing subline). In such circumstance, assuming that the first lien security has already been put in place, new security documents will be required together with an intercreditor agreement that will govern the ranking of the shared collateral, triggers on enforcement and the application of proceeds. To the extent separate, second ranking security is needed, lenders will want to ensure that counsel in all relevant jurisdictions are comfortable with the validity and enforceability of such security – especially where the relevant security consists of an outright disposition of the legal rights. Consideration will also need to be given as to whether separate notices to the investors will be required and whether this will be a contentious point for the fund, given the commercial sensitivities here.

We have also seen instances where the first lien and second lien loans are included in the same facility agreement as separate tranches (e.g. Tranche A and Tranche B). It should be noted that the second lien loan can take the form of either a revolver or a term loan to be used for specific purposes. In these circumstances, the security documents would be drafted so as to secure all of the liabilities under both tranches, the Security Agent would act for the lenders under both tranches and the enforcement of the security would be subject to relevant intercreditor arrangements.

Intercreditor agreement

Having additional tranches of debt secured against the same assets in favour of different lenders will naturally require an intercreditor to be agreed upon between the relevant parties. The use of intercreditor agreements, whilst relatively rare in the context of subscription lending, is clearly nothing new in the world of secured lending. As such, many lenders will be familiar with these arrangements and comfortable with the way they work. Further details on the key provisions found in typical intercreditor agreement are explored in [Leah Edelboim's](#) article "[Intercreditor Arrangements in Fund Finance Transactions](#)," which provides a high level primer of intercreditor concepts.

Conclusion

As the cliché goes, necessity is the mother of invention. The current concerns around liquidity in the subscription line space, combined with increased regulatory pressure for traditional subline lenders, has meant that participants in the fund finance market have been forced to be more flexible. New market entrants with a different risk/reward appetite have come into the market. The tools they are using (such as second lien facilities) are not new financing techniques and have been widely used in connection with other financial products for many years. For as long as liquidity constraints remain, borrowers will source additional capital from non-traditional sources. Second lien (or "Tranche B")

financings are clearly one of the many new and innovative products we are seeing within the fund finance market to help bridge the liquidity gap.