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Fund Finance Friday

Iran Conflict Impact on Middle East Limited Partner Exposure

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With the ongoing conflict in Iran, there is understandably some concern as to what impact this conflict is having and how it could potentially impact the fund finance space. Given uncertainty as to when this conflict might be resolved, we believe it would be helpful to provide some data regarding Middle East limited partners generally, along with providing ways in which lenders can protect themselves, or are already protected, by terms and provisions typically included in credit agreements and the other loan documents.

Lenders are always going to be concerned whenever there is a chance it will be problematic for a limited partner to fund its capital commitment or a capital call. In fact, this is the entire basis as to how a lenders can get comfortable making loans to a fund. Although this conflict may seem unique and would create issues not previously anticipated, lenders should have some comfort as most credit agreements already include protections that mitigate the risk of a limited partner failing to fund. Some typical provisions include, or have something to the effect of, what is outlined below (noting this list is not exhaustive of all protections but simply a few examples):

1. Exclusion Events, including (1) where a limited partner repudiates or challenges its obligation to make contributions or disaffirms provision of its subscription agreements; (2) an investor fails to make a contribution of capital when due or is declared a defaulting partner under its LPA; or (3) there is an occurrence of any circumstance or event, in the discretion of the administrative agent, that could reasonably be expected to have a material and adverse impact on the financial condition of the investor or reasonably be expected to impair the obligation of the Investor to fulfill its obligations under the subscription agreement.

2. Covenant that the a sponsor will not allow a limited partner to cancel, reduce, excuse or abate its capital commitment without the prior written consent of the lenders or relieve, excuse or otherwise delay or postpone an investor from making a capital contribution, other than an in regards to an excuse right.

3. Concentration limits applicable to a group of limited partners.

In practice, assuming the Middle East limited partner is part of the borrowing base, the above exclusion events would protect the lenders in that, once a Middle East limited partner was no longer part of the borrowing base due to an exclusion event, this results in a reduction of the borrowing base capacity.

In such instance, (i) if such reduction results in the obligations exceeding the borrowing base capacity, a mandatory prepayment would typically be triggered and the sponsor would be obligated to repay the outstanding obligations to bring the fund in line to no longer exceed the borrowing base or (ii) the borrowing base is reduced, which results in the lenders having less lending exposure to such fund.

The covenants which prevent the sponsor from reducing or canceling the capital commitment of the Middle East limited partner or otherwise relieve such limited partner from making capital contributions provides additional comfort that the sponsor cannot allow such limited partner to not fund its capital contribution without lender consent.

Although the covenant typically allows for an excuse right, we would note that in our experience, the LPAs and side letters of investors do not typically provide for either an excuse right for simply having difficulty in funding a capital commitment or include any force majeure rights with respect to funding a capital call.

However, in the limited instances where there are force majeure rights, these typically only allow for the limited partner to receive additional time to fund its capital commitment, and does not typically allow for a cease funding right (but this is something that a lender and its counsel should review on an investor-by-investor basis to confirm).

In many instances, a Middle East limited partner may have a substantial capital commitment in a fund and could make up a significant portion of the aggregate capital commitments. The concentration limits included in a typical credit agreement should prevent such Middle East limited partner from making up too significant of a portion of the borrowing base from the outset and act as a mitigant from any lender providing too much borrowing base capacity based on such Middle East limited partner.

Additionally, in certain instances, it may make sense to include a hurdle condition for a Middle East limited partner whereby such investor will be required to fund a certain threshold percentage of its capital commitment before being included in the borrowing base. Such hurdle condition is generally viewed as a mitigating factor as once such certain threshold is met, as the limited partner would be considered less likely to decide to no longer fund its capital commitment as it would have sufficient “skin in the game” once the hurdle condition has been met and would want to avoid any punitive measures against it for not funding further capital commitments.

We would also note that, as a practical consideration, many of the Middle East limited partners are established sovereign limited partners and/or institutional investors. Even if such mitigating factors were not taken into account, some comfort can be taken that if any Middle East limited partner failed to fund a capital call, the impact on such limited partner would not be restricted only to the fund where the limited partner failed to fund its capital call, but would impact its reputation across the entire fund finance market and cause serious damage to its reputation overall.

The above analysis is in relation to Middle East limited partners that are included in funds with a large and diverse group of limited partners. A separate review and analysis should be applied in the context of a Middle East sovereign wealth fund (or other similar type limited partner) being part of an SMA.

Although we have seen a few deals with an SMA of such type of limited partner (as lenders are generally able to get comfortable based on the reputational risk such limited partner would face by not funding as noted above, typically requiring an investor comfort letter and including additional SMA terms and provisions in the relevant loan documents), it would be prudent to take closer look at the risks involved for this particular type of SMA, especially if this conflict looks poised to continue for an extended period of time.

Overall, **according to FitchRatings**, “Middle East-linked limited partner exposure is modest across most Fitch-rated subscription finance facilities, although a small number have higher concentrations. Fitch-rated portfolio covers 254 active facilities, with Middle East limited partners making up 6.7% of uncalled capital commitments, indicating limited exposure. More concentrated facilities could be more sensitive if the credit quality of region-linked limited partner weakens, or if this leads to transfers to weaker entities.”

The article provides a further breakdown of where such Middle East limited partners are located, but in most instances where there are a diverse group of limited partners in a fund, Middle East limited partners do not make up a substantial part of the aggregate capital commitments of a fund.

Concluding Thoughts

In conclusion, this continues to be an ever evolving situation and certainly the above analysis could change as this conflict progresses. It would be prudent for each lender to continually update and analyze any new developments as they occur. As always, we remain available for any questions and concerns you may have with regards to how any Middle East limited partners and their obligations to fund may be impacted by this ongoing conflict.