

FUND FINANCE FRIDAY

Subscription Finance Loan Agreement Series — Part 2

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Borrowing Base/Leverage (or coverage)-based covenants: Considerations and issues with each.

In last week's kick-off to this series, we considered the parties to the Loan Agreement. In Part 2, we look at a (if not *the*) core part of the Subscription/Capital Call Facility certainly from a credit perspective, which is the extent to which investor commitments can be and should be counted in calculating the amount of facilities that can be made available to a borrower in a fund context. In doing so, we are going to take a look at two distinct approaches to this – one is a more traditional “European” approach (which is to look at the overall leverage, or coverage, as against the fund's investors in general) and the other is a more “U.S.” approach (increasingly adopted also in Europe and Asia) where the investor commitments are rated using (in broad terms) a ratings model. It is worth noting that in Europe, at least, both models remain current, with certain lenders (particularly where the facilities are bilateral) continuing to work with the leverage/coverage model and others (whether in bilateral or clubbed deals) tending to adopt the ratings model (commonly referred to – and described in the relevant loan agreements – as a “Borrowing Base”).

So, first, what is a “leverage/coverage” model and how does it work? In broad terms, this model takes the entire investor base and then applies a ratio (determined by credit appetite) of indebtedness (usually both specific to the facility and total indebtedness) to uncalled/uncommitted investor commitments generally. The ratios in terms of the facility will vary considerably depending on the make-up of the investor base, between a range of around 1.8:1 to 1.2:1. Considerations that will affect this, in particular, are the geographical spread of the investor base, the numbers of investors and their concentrations, and the extent to which the investor base consists of individuals or family offices as opposed to corporate, sovereign wealth or pension funds. Similar to a “borrowing base” model, certain investors will be excluded (*i.e.*, will not count towards the leverage/coverage ratio) to the extent that events occur to such investors which are likely to call their ability or willingness to meet their commitments into question. Often (and in contrast to a “borrowing base” model) the inclusion of a leverage/coverage model will be accompanied by a significant degree of discretion on the part of the lenders as to which investors (in particular, where there are investor transfers) to accept into and count towards the leverage/coverage ratios. In some transactions, lenders may agree the ratio may be subject to (downward) ratchets, usually based on either or both of

percentages of paid-in commitments and/or, where the facility contains covenants relating to asset or investment NAVs, increases in the NAV of such investments.

In contrast to a “leverage/coverage” model, while a “borrowing base” model will look at the entire investor base, it will then apply different advance rates to different categories of investor based as stated in the introduction on a combination of external and internal ratings, and some investors (which do not meet any relevant ratings criteria) can be excluded from the borrowing base altogether. Exclusion of investors from a borrowing base model on this basis has nothing to do with their perceived inability or unwillingness to pay (as mentioned in the paragraph above, investors will also be excluded for this reason from a “borrowing base” model). In general, a borrowing base will allow somewhere around 90% or above as an advance rate against the “top rated” investors, then scaling down to around 60/65% for investors which are on a lesser rating, and then down again to as little as 5% to investors with inferior ratings or investors which are not rated. In addition to separate advance rates, a “borrowing base” model will also generally include specific concentration limits for different categories of investor, so as to ensure that facility limits cannot be “skewed” by including excess concentrations of particular types of investor. The “borrowing base” will also commonly include a “quasi ratings” advance rate for investors which may have significant financial standing but not have a formal public rating (for example, certain types of corporate entity). Because the “borrowing base” model is much more dependent on ratings and formulae for the inclusion or exclusion of investors, it is (in contrast to a leverage/coverage model) somewhat rare for lenders to be in a position to exercise discretion on the admission of new/transferee rated or credit supported investors to the borrowing base. They will usually be included (or excluded) automatically based on the specific borrowing base criteria as laid out in the facility.

Leaving aside specific policy or other guidelines (which will often dictate following one model or the other, and usually the “borrowing base” model), the choice of which model to use (leverage/coverage or borrowing base) will depend from the lender’s side on the general investor profile. From the fund’s side, the question is whether one or the other model might lead to a significantly different result in terms of the size of the available facility. Funds will also consider the level at which the fund may be anticipating transfers as between investors in the fund and the extent to which therefore the relative “certainty” of the “borrowing base” model and the ability to apply it to transferees may override the slightly less certain “leverage/coverage” model.