CADWALADER

Fund Finance Friday

Financial Covenant Protection in GP Facilities

October 30, 2020 | Issue No. 101

Previous *Fund Finance Friday* articles have looked at due diligence and structuring considerations with respect to GP and co-invest facilities. This article builds on those topics to look at how financial covenants are generally structured in the context of a GP facility in Europe.

By way of refresher and in general terms, a GP facility relies on the GP profit share (or "GPPS") as the source of funds for repayment of the facility. Subject to LPA considerations previously discussed **here**, the security package for the facility will generally compromise security over the right of the GP (or manager) to receive the GPPS and security over the account into which the GPPS is paid. Although the LPA will usually allow for capital to be called from investors to pay the GPPS (particularly in the early life of the fund), GP facilities would not ordinarily have the benefit of any security with respect to the right to call capital.

As previously discussed, co-invest facilities are often structured so that there is recourse to the GPPS as well as distributions to co-invest entities. To keep things simple, this article will continue to refer to GP facilities, but the financial covenant considerations below are equally relevant to those co-invest facilities where the GPPS forms part of the collateral package.

Unlike subscription facilities where there is a fairly well-trodden path with respect to financial covenants (or a borrowing base equivalent), the financial covenants in GP facilities are more bespoke, with different lenders focusing on varying elements of financial performance. With that said, there are two common themes across most GP facilities – namely, a measure of either debt service or leverage and a measure of actual GPPS received in each testing period.

1. Debt service/leverage

A GP facility will almost certainly contain a metric to test debt service or, as an alternative, some may measure leverage.

Debt service is, unsurprisingly, a measure of debt service obligations of the loan party/obligor entities to the net amount of GPPS received in the same period. As an alternative, leverage measures total indebtedness of the obligors against net GPPS.

The main negotiation point here does not tend to be about how the debt side of the equation will be calculated, though there may well be discussions about how debt service will be measured – particularly if the facility has a revolving tranche or doesn't amortise over its full term or in equal installments. Rather, and bearing in mind that a percentage of net GPPS may well need to be applied in mandatory prepayment (meaning that the borrower is motivated to reduce net GPPS as far as possible without causing a covenant breach), the focus tends to be on how GPPS can be netted.

A straightforward net GPPS definition will normally take GPPS received for the testing period and net-off taxes and business/operating costs and expenses. The amount of such operating costs and expenses may be, but often is not (on the basis that such costs are reported in the financials), capped. However, where a portion of net GPPS is required to be applied in mandatory prepayment, sponsors are increasingly looking to the leveraged finance market and finding inspiration from the capex financial covenant that, at least until the rise of cov-lite in Europe, was a staple of most European leverage deals. As a result, where there is a requirement to make a mandatory prepayment out of net GPPS, we are increasingly seeing requests for carry-forward and carry-back baskets for operating costs and an ability to reserve for projected costs and expenses.

More commonly where the test is leverage rather than debt service, the borrower may be given a cure right on breach of the financial covenant with an ability to reduce indebtedness to a level that would achieve covenant compliance. As with most cure features, we would expect to see limitations on the number of times this can be used during the term of the facility and the ability to utilise the cure in consecutive periods.

2. Actual GPPS

Another fairly usual financial covenant is a straightforward test of GPPS received during a testing period. Here, the facility will ordinarily contain a table that sets out minimum amounts of GPPS for each period during the term of the facility, with the amounts in the table based on the GPPS figures on which the financing is predicated.

In general terms, although this may vary across funds, GPPS will typically be calculated by applying the profit share percentage in the LPA against capital commitments up until the end of the investment period, and then by applying the profit share percentage for the post-investment period against the level of capital that has been deployed and that has not yet been returned to investors during each period.

Testing received GPPS provides a helpful indication of the health of the fee stream against that projected by the fund and lender, but at the time of putting the facility in place, it can be difficult to accurately assess the fees to be received, particularly in the post-investment period when the fee level is a function of the speed with which the fund is able to liquidate assets. For this reason, lenders and funds need to agree to a headroom on projected GPPS that also takes into account the fund's competing desire to set the GPPS as close as possible to a minimum figure by which the facility will be repaid (and at which other net costs can still be met).

Failure to meet the minimum GPPS test on one or more occasions may result in a need to pay down the facility or an event of default, depending on the negotiated position and the size of the fee shortfall.

Other possible financial measures

Although the above are the two core financial covenants that we would expect to see in a GP facility, there are a few other financial measures that we also find in some GP facilities.

The first is a measure of the performance of the fund via a ratio that compares the current value of assets (based on the most recently reported valuation) against the acquisition costs of such investment. Generally, lenders will rely on the LPA definitions when defining acquisition costs for the purposes of the facility and on the fund reporting with respect to current value of assets but, particularly with acquisition costs, care should be taken to ensure that the LPA acquisition cost concept is in line with the lender's expectation.

The "value" figure in the most recent financials will also need to be adjusted to give effect to events between the reporting period end date and the date of calculation, such as disposals or acquisitions of assets, distributions from assets, and further financial investments in existing assets.

Other financial tests in GP facilities may include a straightforward test of the amount of uncalled commitments or a test of expected GPPS for the coming period (as a means of bringing forward the test of actual GPPS received).

Finally, as mentioned above, the GPPS will often form an element of collateral for a co-invest facility. Where that is the case, in addition to the GPPS-based financial covenants, a facility may seek to measure financial performance with respect to the co-invest interests that are being funded by the facility. For example, it might seek to test obligor indebtedness against co-investment fund value or minimum distribution amounts received.

As further suggested reading on this topic, prior articles include "**Diligence Considerations for Fund Executive Facilities**," "**Diligence Considerations for GP Facilities**," and "**Getting Personal – Lending to Fund Executives.**"