

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.

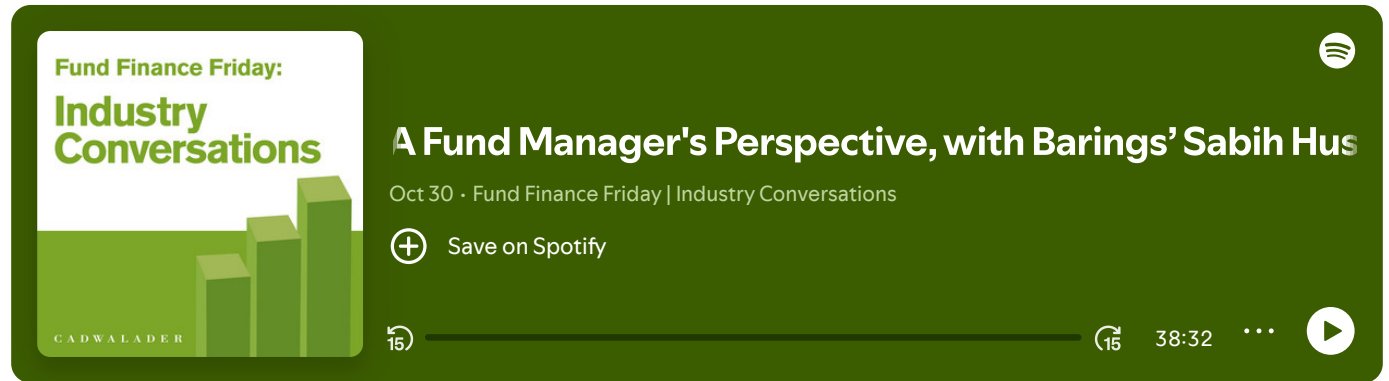
As further suggested reading on this topic, prior articles include "[Diligence Considerations for Fund Executive Facilities](#)," "[Diligence Considerations for GP Facilities](#)," and "[Getting Personal – Lending to Fund Executives](#)."

'Fund Finance Friday: Industry Conversations' – A Fund Manager's Perspective, with Barings' Sabih Hussain

October 30, 2020 | Issue No. 101

In this week's *Fund Finance Friday: Industry Conversations*, Barings' Sabih Hussain joins Samantha Hutchinson to provide his take on the impact of COVID on the private credit markets and his experience of using fund finance products through the pandemic.

If you cannot access the podcast below, please [click here](#) to listen.



Subscribe on [Apple Podcasts](#), [Google Podcasts](#) or [Spotify](#) to never miss an episode.

ESG and Green Loans: Some Perspectives

October 30, 2020 | Issue No. 101



By Amira Hajili
Head of Equity Bridge and Hybrid Fund Financing (EMEA) | Natixis
Professor | Conservatoire National des Arts et Métiers (CNAM)

Introduction: Why are funds and lenders considering and using Environmental, Social, and Corporate Governance (ESG) and Green Loan principles in financing?

Investors are increasingly demanding greater transparency about how their money is invested, and ESG is seen as a value-generating component and a new growth driver for asset managers. Although investors are not usually directly involved in the General Partner (“GP”) investment decisions (for legal and operational reasons), they have considerable influence on the overall investment policy of the fund and the context in which the decisions are taken through the setup of the fund. During the marketing phase, investors (also called Limited Partners) in funds (also referred to as Limited Partnerships) can and increasingly do require, through the fund’s documentation (Limited Partnership Agreement and/or individual investor’s side letter), a commitment from the GP to adopt specific ESG criteria in its investment policy. As a consequence, responsible investment* and compliance with set ESG parameters and measures are increasingly seen as some of the key indicators of the operational capability and excellence of a fund manager. Where the fund is looking for financing, these ESG measures will also and inevitably form part of the financing criteria.

ESG Financing and Green Financing

A. Differences

It is important to stress that ESG and Green Financing are two different types of financing, although both fall under the general umbrella of sustainable financing. Determining which is which depends substantively on what the proceeds of each type of financing are used for. Green Financing includes any type of finance instrument where the proceeds are exclusively applied to finance or re-finance, in part or in full, new and/or existing eligible green assets with environmental benefits aligned with the eligibility criteria. The related criteria are basically set forth in a specific Green Financing framework (“GFF”) and/or in the facility agreement. The loan is often structured at the asset level, though Green Loans can also be structured at the fund level if the main strategy of the fund is green. In contrast, ESG (also referred to in this article as “Sustainability Linked Loans” or “SLLs”) is a financing where the SLL is not dependent on the proceeds being used specifically and exclusively for eligible green assets. The main specificity of an SLL is the pricing adjustment which it offers if the borrower meets pre-agreed sustainable or ESG key performance indicators (“KPI”) or targets.

B. Structure

Both Green and ESG Loans can be structured throughout the fund’s lifecycle and at different levels: holding company, fund, co-investment funds and/or asset level. Financing can start with the subscription/capital call phase and move on through to the acquisition/NAV phase, with appropriate shifts in the structure of the underlying loans and the way in which the relevant Green or ESG/SLL principles are applied to reflect the stage in the lifecycle. The category of loan will to some extent determine where in the structure that loan is more likely to fall.

Green Loans are generally more suited to being structured at the fund level and, in particular, at the level of a specific fund with a dedicated green investment strategy, e.g., low carbon real estate development fund, infra or renewable fund. Similarly, ESG/SLL structure is possible at the fund level for specific funds where KPIs can be set. Financing at the fund level can be through a Green or ESG/SLL subscription facility, NAV facility or hybrid and asset-backed facility.

When it comes to the holding company level, it is easier to consider ESG/SLLs, as this is where information is consolidated. The most common financing structures at the holding company level are mainly unsecured term loan or revolving facilities.

At the investment company level, either Green Loan or ESG/SLLs can be considered, although Green Loans fit perfectly in individual assets or in the investment vehicle holding a pool of eligible green assets. ESG/SLL Loans may be suited to portfolio companies that could include ESG KPI referencing individual assets – for example, an operating company for renewable infrastructure projects. Typical financing structures at this investment company level are unsecured NAV or asset-backed facilities.

So, Green and/or ESG/SLL concepts can be included in all stages of the debt lifecycle of the fund.

C. Focus on Green and ESG/ SLL Subscription Facilities: Features

Green subscription facility: a fund manager with a green investment strategy (e.g., energy transition, global warming reduction, low carbon strategy) can benefit from a Green Loan to bridge the fund's commitment towards underlying green, eligible investments. This Green Loan will be backed by investor commitments, as is the case for a standard subscription facility. A Green Financing Framework in accordance with the Green Loan Principles ("GLP") can be included in the financing documents. This document will include all criteria required to be met for eligible green underlying assets with the potential expected environmental benefit and climate change mitigations. All proceeds of the Green subscription loan will need to be allocated to eligible green investments as soon as possible after they have been utilized under the facility and, in any event, before the maturity of the facility. The GLP require borrowers to provide regular reports on the allocation of proceeds and the positive environmental impact of their projects.

ESG/SLL subscription facility: In contrast to a Green Loan subscription facility, this structure doesn't involve any specific requirement for allocation of the financing proceeds to any particular purpose. In the current market, the key feature of such loans is a pricing incentive offered if the fund meets pre-defined KPIs such as renewable, low carbon targets or gender diversity indicators. KPIs are always based on the ESG policy of the fund/GP and the defined investment strategy. They need to be carefully considered and agreed between the lender and the fund/GP on this basis so that a set of objective, well-defined and measurable KPIs can be included in the loan documents.

While there is currently no single "market" position for any pricing incentive for ESG/SLLs which we see in the market (and indeed sometimes there is no specific pricing incentive at all), it is a general feature of the financing structure as stated above that it rewards borrowers when they achieve their sustainability targets by decreasing the pricing by a pre-agreed pricing level, while a failure to meet those targets will lead to an increase in pricing. Sometimes these decreases and increases may be subject to ratchets, and it is important to note that the pricing adjustments are relatively small. There is a move in the market in some transactions to include draw stops or default events relating to Green/ESG loans, but it is also important to note that these are not based around compliance or non-compliance with the relevant KPIs themselves but more around any misrepresentation (particularly where there is a degree of fault on the part of the borrower for such misrepresentation) in the reporting related to KPI compliance.

D. Specific Criteria for KPIs

Although as stated there are no absolute "market" standards for the specific KPIs that would be part of an ESG/SLL loan, there are some general criteria worth listing. KPI around investment portfolios will typically look at the integration of the following into investment portfolio selection:

- Environmental, social and governance;
- Percentage of women on boards;
- Percentage of disabled people;
- A healthy living environment;
- A resilient building; and
- The Paris Climate Goal (1.5/2°C alignment), the United Nations Sustainable Development Goals for low-carbon transition assessment

E. Greenwashing

"Greenwashing" is a description of any actions taken by a company or fund that leads people to believe that the company or fund is doing more to protect the environment or follow ESG principles than it really is. Green financing can be impacted by Greenwashing. It is important, therefore, that funds and lenders do not simply pay lip service to ESG principles, and that ESG compliance and KPIs are properly set and measured. To do this, both funds and lenders should seek to agree on suitable "stretch" targets, which are measurable, verifiable and adequate as well as proper and regular reporting criteria to enable compliance with KPIs to be monitored. In terms of assessing compliance, lenders should also look to appoint a specialist "monitor" or opinion party to ensure that reporting and compliance can be properly assessed. Unless all of this is put in place, there is a danger that funds (and lenders) could simply talk about fulfilling ESG criteria without any substantive intention to comply.

The involvement of a monitor or secondary opinion party is useful in such structures not only in validating and monitoring the ESG/Green structure based on the investment strategy of the fund but also in structuring the relevant KPIs. There are now a number of market participants who offer this specific service.

From the fund side, measurable and achievable KPI and covenants can be set based on a comprehensive decision-making investment process, including a specific process allowing for consideration of ESG factors and responsible investment and engagement practices as part of any investment decision.

F. Issues

There is currently no “market standard” for terms for SLL or Green Loans and, to some extent, each transaction will incorporate its own criteria and provisions. It is worth noting that the LMA/LSTA and APLA have produced some high-level “Sustainability Linked Loan Principles,” which summarise the current state of the loan market in adopting or adapting to SLL principles and the various considerations underlying these which are helpful at least in summarising the type of issues which lenders and funds need to consider. To the extent that there might be said to be a “market” position developing, there is currently general consensus that achieving (or failing to achieve) agreed KPIs may lead to a pricing adjustment downwards or upwards in margin (usually fairly minor relative to overall pricing). It is rarer to see any draw stops or defaults linked directly to KPIs, although there are some loans in the market where draw stops or events of default are applied to misrepresentation (often as stated above, where there is a degree of borrower “fault” in such misrepresentation) in KPI reporting.

Similarly, while there are a number of recommendations and principles which apply to SLLs, there is no specific common regulatory or risk management process for Green or ESG/SLL financing shared by lenders. Each lender has its own policy.

In addition, there is no “market” policy green framework to identify measurable KPI and targets to achieve SLL/ESG or Green standards.

G. Solutions and the Future for Green and SLL/ESG Loans

We can expect ESG/SLL loans and, for the right investment strategy, Green Loans also increasingly to become part of the common landscape in Funds Finance as the pressures and incentives to fit loans within these categories continue to build.

We expect that the market will coalesce around more common “market” principles in terms of lenders’ criteria, as well as measurement of and compliance with KPIs.

We would anticipate that, at some point, although this may be some way off, lenders may be subject to more explicit capital requirements which favour (and give some more significant pricing differential than is currently the case to) Green and/or ESG/SLL loans, either through internal capital allocation or incentives and/or through the creation and imposition of external regulations designed to encourage these activities by impacting capital generally.

For the relatively near term, we would anticipate the continuation of minor pricing adjustments as per the above to remain the main feature of ESG/SLL lending, possibly with the addition of default/draw stop events around the reporting relating to KPIs being included. We do not see, in the near term, any likelihood of defaults or draw stops being expanded to cover non-compliance with KPIs themselves.

* PRI responsible investment is defined as a strategy and practice to incorporate environmental, social and governance (ESG) factors in investment decisions and active ownership.

Amira Hajili heads the Fund Financing (EMEA) business for Natixis, where she is responsible for the origination, structuration and execution of fund financing solutions (subscription facilities, hybrid financing, and any bespoke financing solutions) for private capital funds. She also collaborates with the U.S. and APAC fund finance teams.

She also has a PhD in Finance from University Pantheon-Assas and is a Professor of Finance at Conservatoire National des Arts et Métiers (CNAM).

Women in Fund Finance: A Conversation with Leading Women in Energy

October 30, 2020 | Issue No. 101

Join Women in Fund Finance on Tuesday, November 10 for a conversation with Jill Lampert (NGP), Alexandra Pruner (Tudor, Pickering, Holt & Co; Independent Board Director: Plains All American; NRG Energy; and Encino Acquisition Partners), and Staci Taruscio (Rebellion Energy, LLC). The speakers will provide an update on the energy market and the impact of COVID-19, and will address the energy industry talent pipeline and board service. This virtual conversation will be moderated by Erin England (Katten Muchin Rosenman LLP).

Register [here](#).

Bill Ackman Keynote, Fund Finance Panels at Fifth Annual (Virtual) Finance Forum on November 12

October 30, 2020 | Issue No. 101

As we announced in last week's *FFF*, Bill Ackman, the CEO and Portfolio Manager of Pershing Square Capital Management, L.P., will give the keynote address at this year's Finance Forum. Ackman is also the Chairman and CEO of Pershing Square Tontine Holdings, Ltd., a newly organized SPAC that raised \$4 billion in its initial public offering in July, making it the largest SPAC IPO in history. The Finance Forum takes place virtually on the afternoon of November 12th.

Ackman will join Cadwalader partner Stephen Fraidin for a discussion covering the current state of the financial markets, implications of the presidential election, the resurgence of SPACs in 2020, and more.

This year's Finance Forum will also once again feature live panel sessions with leaders in the U.S., UK, and Europe discussing commercial real estate, fund finance, middle market lending, distressed finance and securitization.

Two panels of particular interest to *FFF* readers include:

- "NAVigating Alternative Liquidity Solutions." This panel will be moderated by Cadwalader partner Samantha Hutchinson and will feature Cadwalader partner Brian Foster; Richard Golaszewski, Investment Director, 17 Capital; Matthew Houlden, Associate, Private Capital Advisory, Lazard; James Rock-Perring, Head of Fund Finance Advisory, Intertrust Group; and Ian Wiese, Head of Secondaries, Fund Solutions, Investec.
- "Fund Finance by the Numbers: Looking at the Data Pre- vs. Post-COVID." This panel will be moderated by Cadwalader partner Wes Misson and will feature Cadwalader partner Tim Hicks.

More than 1,000 industry leaders are already registered for the event.

For more information and to register, click [here](#).

On the Move – Fund Finance Tidbits

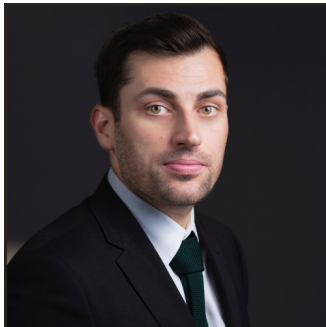
October 30, 2020 | Issue No. 101

On the Move



Rushika Athia of First Republic Bank has been promoted from Senior Credit Analyst to Director. Rushika joined First Republic in 2018 and hit the ground running with the NY PE Finance Team.

Said First Republic Sr. Managing Director Jeff Maier: “Through her outstanding underwriting work, attention to detail, and engagement with clients and colleagues, Rushika has been instrumental in the team’s ability to grow and maintain a pristine loan portfolio. Rushika has been paramount in running with some of the team’s more complex credits and has gained the trust and respect of senior credit committee members.”



Jack Chaplin has joined Deloitte’s Debt & Capital Advisory team as an Assistant Director, with a specific focus on building out the Fund Finance advisory business alongside Jamie Mehmood and Ben James. Jack was previously part of Lloyds Bank’s fund finance relationship team in London, having spent six years with the bank.

Fund Finance Hiring

October 30, 2020 | Issue No. 101

Fund Finance Hiring

Cadwalader is looking to hire a mid-level associate in its Fund Finance group in the Charlotte or New York office. Ideally, the candidate would have 3-5 years of experience working as borrower or lender side counsel on financing transactions. For more information, or to suggest candidates, please contact [Holly Loftis](#).

We are also looking to hire a senior associate, with 6 or more years of experience, in the Charlotte or New York office. For more information, or to suggest candidates, please contact [Wes Misson](#).

For both positions, we are seeking a highly motivated individual who enjoys working in a fast-paced environment, structuring and managing transactions, drafting complex loan documentation and overseeing other attorneys.