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ALTERNATIVE LENDERS: A NEW ERA FOR FUND LEVERAGE

As debt and other credit funds continue to increase their share of the lending market, we have seen fund managers diversifying their fund terms through the use of leverage. Whilst investor call bridges, subscription or capital call facilities are used by the majority of funds, permanent leverage has traditionally been trickier to incorporate in funds' investment strategies, being limited both by funds' constitutional documents and managers' relationships with their investors.

However, with the increased use of leverage, the market is seeing a convergence of structured finance technology with more conventional fund finance facilities.

In this publication, we explain some of the key features of this new era of debt fund leverage in the alternative (direct) lending market and why a manager might consider using it.

FEATURES OF TRADITIONAL LEVERAGE FACILITIES

Most leverage facilities are based on similar terms and adopt a similar structure to warehouse facilities used preparatory to asset-backed securitisations. They are usually based on a Loan Market Association (LMA) form of facility agreement under which the borrower is a newly established special purpose vehicle. They include:

- an advance rate (i.e. a set percentage of the face value of the loan (or other credit) receivables which the lender will advance as a loan);
- representations as to various matters;
- financial covenants;
- in some cases, covenants in relation to the performance of the portfolio of receivables;
- restrictions on the operations of the borrower;
- events of default triggered by, for example, non-payment; and
- various other elements of the LMA form of facility agreement designed to protect lenders (including tax gross-up and increased cost provisions).

The borrowing base (the portfolio of receivables in respect of which the advance rate is set) is integral to both leverage facilities and warehouse lines. It comprises the receivables against which the lender is prepared to lend and forms the substance of the lender's credit decision. Accordingly, eligibility criteria are included in the facility agreement which the receivables must meet in order to form part of the borrowing base. The facility might include different advance rates for different types of receivable, however, if a receivable doesn't meet the eligibility criteria for its type it cannot be advanced against. Therefore, the receivable should not be acquired (and / or must be sold) by the borrower or, if acquired, cannot be part of the borrowing base.

One of the most significant differences between leverage facilities and warehouse facilities is that a leverage facility is designed to match the investment period of the fund for which it is providing leverage. A warehouse facility, on the other hand, is designed to last for a set period of time (between 12 to 18 months, with the possibility of extension to 36 months) during which the relevant portfolio is acquired and built to a size sufficient to launch a securitisation.

In addition, a leverage facility lender has recourse both to uncalled capital commitments of investors in the fund as well as to the underlying assets. The credit enhancement provided by recourse to fund investors might appear to negate the need for significant lender protection. However, that additional structural feature, together with the extended duration of the leverage facility, frequently results in additional covenants in relation to the operation of the borrower, the fund and the underlying portfolio compared to a warehouse line.

FUND LEVERAGE IN PRACTICE

Leverage is particularly suited to credit funds, being the type of fund whose investments represent, in the main, mid to long-term duration loan (or other credit) receivables. These receivables constitute a stable and predictable cash flow for the fund which can be modelled, and against which a leverage provider (generally a clearing or investment bank) is able to advance credit.

A collateralised loan obligation (CLO) is a prime example of the use of leverage by a manager in the creation of what is essentially a debt fund. The equity in a CLO is not provided by limited partners; instead it is represented by the lowest ranking class of notes issued by the CLO (which suffer losses on the credit portfolio ahead of senior-ranking classes, just as a limited partner would do ahead of a lender to a fund). In both loan funds formed through limited partnerships and CLOs, a manager is tasked with achieving and / or maximising returns for the investors through (to a greater or lesser degree) discretionary management of a portfolio of loans. Both debt funds and CLOs have a limited life based on an investment or reinvestment period of a number of years (between three to four) from first close of the fund or first issuance of notes.

The similarity of debt fund and CLO structures has become more acute with the increasing use of leverage by debt funds.

THE (MID-MARKET) LEVERAGE FACILITY / PRIVATE CLO HYBRID

The leverage facility, as indicated above, is relatively well established. However, the increased demand for leverage and the larger facilities being requested by managers has begun to lead to different forms of leverage being provided by lenders.

Historically, in order to obtain significant size of commitments from banks, managers have often had to accept leverage facilities on an uncommitted basis (in a similar manner to some investor call bridge facilities). Some managers remain content to operate without a commitment from their lender(s) but more cautious managers (in relation to the availability of bank lines when needed and the certainty of execution for their lending transactions) are unable or unwilling to take that approach.

To ensure a certainty of commitment, we have seen a number of lenders providing leverage in the form of what is essentially a private CLO. The commitment is provided through a facility which takes the form of a loan or a privately placed note issuance. The terms of that facility are largely similar to those of a standard leverage facility (as described above) but with a significantly increased focus on the borrowing base, mostly accounted for by the greater leverage provided to the fund. That increased focus takes the form of more detailed eligibility criteria and the inclusion, or increase in number, of portfolio covenants, largely borrowed from the public CLO market.

Another key difference compared to a more standard leverage facility is that the commitment is classified as a securitisation for regulatory capital purposes (principally the Capital Requirements Regulation (CRR)). That can enable the lender to allocate a different portion of its balance sheet to the lending exposure than it would have applied to a corporate (or other) exposure. Accordingly, the lender is able to provide a larger commitment (against which regulatory capital needs to be held) than if the exposure had been classified differently.

Notably for managers, the classification as a securitisation brings with it the need to comply with the risk retention requirements of the CRR as well as those of the Alternative Investment Fund Managers Directive (AIFMD) and Solvency II once in force, and those to be brought in for UCITS funds. These requirements specify that a qualifying retaining entity must hold a 5 per cent "material net economic interest" in the securitisation. In effect, this means that managers have to find an entity that can retain a 5 per cent interest in the transaction, with an accompanying capital burden on that entity. A lender subject to the CRR who fails to satisfy these requirements will face a punitive regulatory capital charge and / or the fund / its investors will be prevented from taking part in the transaction. In addition, proposed changes to the above regulations will place the burden of compliance on the entities involved in establishing the securitisation (which potentially includes the fund and / or the manager) alongside the lender.

Whilst the above retention requirements present an additional hurdle for managers to overcome, several structures have been developed to accommodate them. They are simply factored into the cost of obtaining greater leverage for a fund. These structures are starting to be copied, or adapted, by managers using this form of hybrid loan facility / CLO and we expect that to continue.

We have seen an increasing trend of managers operating middle-market credit funds using leverage in this form. This is largely a reflection of the activity levels within the middle-market leveraged finance market where alternative / direct lenders are putting their money to work. It is also reflective of the need for middle-market fund managers to offer lenders more in the way of credit enhancement and covenant protection than the larger cap debt funds. With direct lending in the middle market showing no signs of slowing down, we expect this trend to continue for some time to come.

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