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FUND FINANCE FRIDAY

Term Loan Solutions in Fund Finance

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Interest rates rise, demand exceeds supply and the fund finance market adapts to a changing landscape. As we seek depth and breadth of new liquidity in our market, we have often wondered how to bring more non-bank lenders into agented subline facilities as participants. This search for meaningful non-bank lending continues as banks, funds and their respective teams are working harder than ever to fill capacity in their facilities.

There may be an enticing solution in sight. Specifically, an opportunity may exist in attracting some insurance companies and institutional investors via a term loan tranche. A term loan is more attractive to certain insurance companies because it is fully funded on day one and doesn't require rapid deployment of capital over the tenor of the facility (as is the case in a committed revolver).

Adding a term loan tranche to an existing facility (or, perhaps more likely, closing a new facility with a term loan tranche alongside a traditional revolver) may help syndicators as they push forward to find ever more valuable pockets of capacity. The questions in structuring a term loan tranche are more business in nature than legal. Below are some issues parties should think through as they consider a term loan solution to bring in non-bank participant lenders.

- **Separate Tranches**. The term loan will need to be its own tranche, since the term loan will be fully funded on day one and the commitments of the revolver will vary with time. The market has experience with separate tranches. For instance, we accommodate lenders who cannot fund in an alternative currency with a special U.S. dollar-only tranche. In addition, it is routine for a temporary increase mechanic to have its own separate tranche, with only a subset of lenders being temporary increase lenders. The term loan tranche may be open to bank lenders, but the understanding is that the non-bank lenders, such as insurance companies, would not be in the revolver tranche.
- **Shared Collateral**. In marketing the idea to various stakeholders, it will be important to emphasize the *pari passu* rights of term loan lenders and revolver lenders to a single collateral pool for the lender group as a whole. The collateral would consist of the traditional

subline collateral: the uncalled capital commitments of the investors. There would be a single senior lien securing the obligations of the two different tranches, with a common custodian (the administrative agent) administering the collateral pool for both tranches. The absence of multiple liens of different ranking most likely eliminates the need for an intercreditor agreement.

- **Right-sizing the Commitment**. As part of a day one checklist, parties should consider the relationship among (1) the term loan commitment size, (2) the revolver commitment size and (3) the size of the collateral pool (the uncalled capital commitments of the investors). The interesting challenge for term loan lending in a subline facility is that prong (3), the collateral pool, will decrease over time as the fund calls capital. This means that the loan documents will likely need to contain a coverage ratio covenant for the term loan whereby the term loan commitment must be under a certain percentage of the collateral pool (the revolving lenders are protected automatically via the mechanics of the borrowing base and mandatory prepayments for any borrowing base deficiency). If the fund trips the coverage ratio covenant, term loan lenders would likely want to see a mandatory prepayment to right-size the term loan to the collateral. Based on anticipated drawdowns, the funds and the term loan lenders may even try to match the amoritization schedule of repayment to the decline in collateral pool so as to avoid for as long as possible tripping the coverage ratio covenant. In addition, the larger the term loan commitment is relative to the revolver commitment, the larger the possibility is for there to be divergent interests between the two lender groups, with revolver lenders focused on usage and unused fees. This will not be an area of concern for the term loan lenders, but they, unlike the revolver lenders, will need to think about how to structure a term piece that has guaranteed usage but decreasing collateralization over time. Some might object that, if the term loan lenders are protected by a coverage ratio of outstandings to collateral, they should not be concerned whether the term loan component is too large relative to the collateral pool. However, the term loan lenders, such as some insurance companies, place a high value on a dependable and consistent return stream from their lending. Even with covenant protection, certain insurance companies and non-bank lenders will still want to safeguard their expectations for a return revenue stream, which will in turn drive pricing and the requirement of prepayment penalties. Finally, the most decisive factor in right-sizing will be the borrower's preferences given their cost of capital (debt becoming comparatively more expensive compared to equity) and the size of the fundraise in the current environment. The addition of term loans may therefore occur in a cycle of modestly declining overall facility sizes.
- **Right-sizing the Tenor**. Once you answer "how much?", the next question on the day one checklist of issues is "how long?". The key question will be whether to have two different maturity dates for each tranche or to align such dates. Some insurance companies seek terms of three to five years for these type of investments. Bank lending, however, usually focuses on tenors of one or two years (more rarely these days, three years) due to the high capital charge subline commitments receive on their balance sheet. There are two approaches to this. The first is to keep maturities aligned and recognize that, as a practical matter, while extensions for a revolving facility are generally uncommitted, lenders routinely extend these facilities beyond the initial stated maturity date more often than not. In other words, a deal that is a "two-year deal" may easily hang around until year three or year four as a matter of course, which puts the tenor into the comfort zone for many insurance companies. Managers can get comfortable that revolvers, while extensions are

uncommitted, do get extended routinely. The second approach is to have different maturity dates for different tranches contemplated on day one, recognizing the divergent interests of the two lender groups in usage, repayment and capital charges. When maturity dates differ, however, the parties will need to think through the successor to the original agent for the deal, as the original agent may want out of the deal once the revolver terminates or goes to zero. Likely the term loan lenders will want to have mechanics to retain the agent, replace the agent or to appoint one of their own as a servicer. It may make sense to have an agent successor agreement as a baked-in exhibit in the facility documents or, at minimum, enhance the existing agent resignation provisions to contemplate a third party acceptable to the borrowers and term loan lenders.

- **Ratings**. The administrative agent and the manager should have an early conversation with the ratings agencies on whether the term loan tranche (or the facility as a whole) will be rated, which will be essential for marketing the term loan tranche to certain non-bank lenders. Certain of the ratings agencies have provided exposure drafts for their rating methodology, so please consult counsel and the applicable contacts at the ratings agencies for further guidance.
- **Payments**. The fund and the term loan lenders will need to negotiate one of two options for ordinary course repayment: either an amoritized repayment schedule or a bullet payment for the principal at maturity. From the term loan lender perspective, both approaches have their advantages. The bullet payment at maturity would give such lenders higher yields and a consistent revenue stream. On the other hand, the amortized repayment schedule would reduce outstandings over time as the collateral pool diminishes, which will be desirable from a credit risk perspective. With respect to mandatory prepayments, lenders will want to distinguish “ordinary” mandatory prepayments that result from a borrowing base deficiency vs. payments after an event of default. For ordinary mandatory prepayments, parties may want the borrower to have discretion over what outstandings to pay down (likely the revolver while the term loan stays in place given any prepayment penalties for the term loans). However, in an enforcement scenario, such payments would need to be pro rata according the commitments of each lender regardless of tranche. Finally and as already mentioned in passing, since the term loan is fully funded on day one, there will need to be prepayment penalties for paying the term loan tranche before its maturity to protect the investment expectations of the term loan lenders, with the possibility of the prepayment penalties rolling off after a certain date.
- **Rates and Pricing**. We may expect a pricing split between the term loan and the revolver, although we cannot yet say whether difference will be wide or kept close − say, to a 10 basis points difference. It’s also too early to determine whether parties would negotiate predominantly fixed or floating rates for a term loan component, although given the investment requirements of certain insurance companies, we would expect to see fixed rate term loans. Whatever the outcome, it will be important for agents to include syndication teams at an early stage in the business discussion to gauge the market reaction to differing rates and margins. Even if the syndicate of revolving lenders does not participate in the term tranche, they may be reluctant to approve differing economic terms they view as overly advantageous to the term lenders.
- **Divergent Lender Interests**. Parties will generally want to think through how to deal with a huge gap between utilization of the term loan and the revolver. The preference may be for a

fund that expects to have higher utilization of the revolver than is typical, which would help even the utilization playing field between term loan lenders and revolver lenders. An ideal case may be a fund, perhaps a credit fund, that uses the line for leverage and will have a high revolver utilization. Alternatively, higher unused fees could balance the divergent interests of revolving lenders vs. term loan lenders.

- **Advance Collateral Planning**. The parties may want to consider a collateral flip from uncalled capital commitments to NAV collateral at a certain date late in the life of the fund, so that the term loan can remain in place without being paid down (that is, as the uncalled capital commitment pool declines, NAV collateral can step in to re-collateralize the term loan). This advance collateral planning, while desirable, would be document-intensive and at considerable expense, especially given the uncertain existence of the NAV collateral at the time of the initial closing of the facility.
- **Market Dynamics**. Historically, managers preferred revolvers because the pay-for-what-you-use flexibility lines up with fund borrowing needs. The current market environment changes the calculus. First, the deeply inverted term curve means pricing borrowings based on rates for intermediate tenors (3 to 5 years) may be more attractive compared to front-end floating rates than in the past. Second, events of the past few weeks may have borrowers looking more closely at locked-in term funding. Third, locking in a fixed rate may present a sweet spot that is high enough to attract certain insurance money, but low enough to be well clear of the cost of equity (the fund's preference hurdle).
- **As Always, Relationships Matter**. Smart managers can promise and deliver cross-sale services to banks and keep the revolver lenders happy and in place, which would allow more runway for the term loan to remain in place. In this instance, as in many others, a trusted lender relationship may serve the interest of the manager more than a cheaper option when picking an administrative agent to lead the deal.

- **An Opening to Securitization**. The term loan tranche (alongside other potential deal structures) may provide one possible path for the partial securitization of the product. A term loan can be easier to securitize than a revolver, given a term loan has a predictable revenue stream and no contingent funding obligations. If a term loan piece gains widespread adoption in the market, the network effect of having a broad base of term loans may make it easier to implement certain securitization mechanisms. There are a number of structures the market may use for securitization, and the term loan piece is just one of other possible avenues, but it's worth noting that implementing non-securitized term loan tranches now may be an incremental step toward a broadly securitized future.

This has been a busy and productive quarter for Cadwalader's fund finance practice. From our data and our conversations with market participants, we believe the product is extremely robust and demand is far outstripping supply. However, there is no denying that rising rates have posed some challenges on the supply side of the market and on fundraising on the demand side. While rising rates have led to challenges, they are also a source of opportunity in that higher yields are attracting new entrants into the market. With a term loan component, these new entrants may include certain insurance companies and other non-bank lenders as participants. In fact, we may be hitting a sweet spot where interest rates are high enough to attract some non-bank lender attention but not so high as to dampen usage for the product itself. While structuring a term loan component in a subline revolver presents complexities, we at Cadwalader are ready to help with any questions or opportunities. With some luck and hard work, we may be entering a golden age of non-bank participation.