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Borrowing Base/Coverage Ratio Approaches in Subscription Finance Facilities

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The key component of any subscription credit facility is the underlying capital commitments that are pledged to secure the facility. Virtually every lender will require some level of over-collateralization – meaning, investor commitments will never receive dollar-for-dollar credit relative to the size of the facility (which would be a 100% advance rate).

However, arriving at the correct underwriting balance between the amount of capital commitments (the collateral package) to the size of the facility (borrowing capacity) can take several forms. While there are variations of each, at a high level, there are two approaches taken in the subscription credit market, which we frequently refer to as: (1) a "borrowing base" approach and (2) a "flat advance" or "coverage ratio" approach.

Regardless of the approach, the credit concept behind this type of asset-based lending is virtually identical to "general asset-based lending" where, for example, the collateral is the accounts receivable and inventory of an operating company. In that type of lending, the accounts receivable from account debtors may get a single advance rate (e.g., 80%) or different types of account debtors will get different advance rates depending upon their perceived likelihood of payment. Further, with respect to inventory, the advance rate will be lower than "A/R" (e.g., 60%), since the process for liquidating that type of collateral for the lender will be much more difficult than collecting cash from an account debtor of a borrower. Further, as discussed in greater detail below, the similarities between this type of lending and subscription lending continue as each type of lending disqualifies assets that fail to meet negotiated criteria that are tied to the perceived likelihood of ultimate payment. Basically, advance rates attempt to approximate and discount the quality and/or hassle factor related to realizing on pledged collateral.

That being said, in this week's article, we will focus on subscription lending and outline the primary approaches for calculating advance rates (borrowing capacity) as well as a few notable features of each and some of the factors that weigh into choosing "one horse over the other."

Borrowing Base Approach

The "Borrowing Base" approach looks at each investor's commitment to the fund and decides how much credit the lender will give to that commitment. Similar to a general lender giving a borrower a higher advance rate for A/R than for inventory – based on likelihood and ease of collection – a subscription lender using the Borrowing Base approach will give more credit to investors that have a higher likelihood of collection.

For this approach, a lender categorizes a borrower's investors using a combination of objective external credit ratings as well as, in some case, a lender's internal ratings. An investor's credit rating, if any, is heavily weighted in this consideration. A lender's familiarity with a particular investor, including an established history of faithful funding, is relevant to the consideration as well. Publicly available financials may be reviewed and considered, especially for investors that do not have a rating from one of the ratings agencies. These are just a few of the many factors that a lender may consider in determining the classification of a particular investor.

Various terms are employed, but for our purposes, we will use "Included Investors" and "Designated Investors" to denote the two groupings of investors based on "likelihood of collection" who are assigned an advance rate with respect to their inclusion in the aggregate Borrowing Base. Included Investors include highly rated investors (commonly BBB+ or higher) or other well-known and creditworthy investors that do not have a credit rating, but lenders deem equivalent to investment grade nonetheless. Investors in this category are typically given a 90% advance rate. It's important to note that investors' inclusion based on a credit rating are typically subject only to the discretion of the Administrative Agent.

Designated Investors include investors deemed less creditworthy than an Included Investor, but still satisfactory for inclusion in the Borrowing Base. However, because of this lower creditworthiness, Designated Investors are typically given an advance rate in the 60-65% range and require all lender consent for inclusion. Generally speaking, for a lender utilizing the Borrowing Base framework, all other investors would be excluded from the Borrowing Base – this exclusion would apply to investors unknown to lenders and also high net worth and family office type investors. However, there are many variations to the above "Borrowing Base" framework and some lenders will agree to additional (albeit lower) advance rates to address the unique nature and composition of each pool of investors. For example, some facilities will include other investors at a much lower advance rate (such as 5-20%), as opposed to simply excluding any investor not classified as an Included Investor or Designated Investor.

The Borrowing Base approach is common in the current subscription market and therefore familiar to many lenders and funds. It represents an investor-by-investor approach to evaluating each fund. While this approach may not provide borrowing base credit for high-net-worth investors, family offices, etc., this approach, and the objective criteria it relies upon, does allow lenders to offer a higher advance rate (i.e., 90% for Included Investors) since, in theory, those investors provide a higher likelihood of collection. Similarly, that structure provides a fund with some level of certainty when raising additional capital, since it will generally know the advance rate proposed investors will receive once included in the fund (and thus the impact on a future Borrowing Base). This same rationale applies to transfers of investor commitments that are permitted by the general partner of a fund. The objective criteria allows for investors to somewhat "float in and out" of a Borrowing Base so long as, for example, a transferee of a commitment from an Included Investor who also meets the same Included Investor criteria will be given the same advance rate – without any additional underwriting.

Flat Advance and Coverage Ratio Approaches

The other commonly employed approach to assessing an investor base is what is frequently called a "Flat Advance" or "Coverage Ratio" approach. The two monikers make these solutions sound like very different approaches. However, in reality they share many similarities and the differences largely arise from a drafting perspective. We will address them in turn for clarity sake, beginning with the Flat Advance.

Flat Advance Approach

This approach begins with the presumption that *all* investors in a fund will be included in the availability calculations. Although a typically at a much lower advance rate, this model applies equally to every investor in a fund. This less engineered cousin of the Borrowing Base simplifies the subscription facility product. The Flat Advance model is, as it sounds, a flat advance rate applied to all investors.

Unlike the Borrowing Base model which has fairly consistent advance rates applied to certain types of investors, there is greater variation across funds in the Flat Advance world. Under this approach, credit analysis involves looking at the investor pool in an amalgamated fashion, and we see a wider spread of advance rates in an attempt to fairly evaluate the composition of investors. Commonly the advance rate applied would be in the 40-65% range. However, in some cases, lenders have applied advance rates lower than this range, and in some rare cases, higher.

From a documentation perspective, this looks a lot like a significantly simplified Borrowing Base (and in fact shares much of the terminology). But in terms of function, it is far more similar to a Coverage Ratio model.

Coverage Ratio Approach

While differing from the Flat Advance approach in terms of drafting and terminology, the Coverage Ratio approach essentially utilizes a similar approach. As in the Flat Advance approach, all investors are presumed to be included. For this reason, Flat Advance and Coverage Ratio models can largely be considered the same model, at least in terms of the overall perspective in which they view an investor pool.

From a drafting perspective, the Coverage Ratio approach does all of the heavy lifting in a covenant that requires the aggregate uncalled capital to "cover" the borrower's indebtedness by a certain ratio. This is perhaps most easily explained with an example – in this case a 2.00 to 1.00 coverage ratio requirement. If a fund has $500MM in callable capital, with a 2.00 to 1.00 coverage ratio, the 'borrowing base/borrowing capacity" of the collateral could support a line of up to $250MM. Failure to satisfy the covenant at any time (which is typically tested quarterly and at the time of borrowing) is an immediate event of default and triggers a mandatory prepayment of any overdrawn amounts.

Depending on the facility, the ratio typically encompasses *all* indebtedness of the borrower (including portfolio company guarantees), even if incurred outside the facility. The rationale for requiring a fund to include third party debt is that the fund's ability to pay its debts generally is directly tied to its access to available capital from its investors. If additional indebtedness is incurred, lenders reason, that additional indebtedness should be factored into the larger picture of the evaluating the likelihood of repayment under the facility – not to mention the overall financial wellbeing of the fund and/or providing the lender with an unsecured, secondary source of repayment should the reliance on the coverage ratio prove unreliable.

To connect the dots to the similarity with a Flat Advance model, note the 2.00 to 1.00 ratio is the exact equivalent of having a 50% flat advance rate.

Eagle-eyed readers will spot that this approach (which is also true of the Flat Advance approach) gives credit to investors that may otherwise be excluded or assessed a very low advance rate under the Borrowing Base approach, such as high net worth and family office investors. One of the other potential advantages to such structures is that administration and management requirements are reduced. From the Fund's perspective, there is no requirement for a detailed investor-by-investor Borrowing Base calculation, and related certificate, in connection with a borrowing request. Instead, the borrower certifies the remaining callable capital available to the fund exceed the set Coverage Ratio and provides supporting documentation.

<u>Similarities in Approaches</u>

Despite the high-level differences of these two approaches, there are many similarities worth noting, which is not surprising since, as noted, the key components of all subscription credit facilities include the pledging of underlying capital commitments to secure the facility and some level of over-collateralization.

For example, in both the Borrowing Base and the Coverage Ratio approaches, investors are only included in those respective calculations after each investor passes certain threshold tests. Regardless of advance rates, all investors are subject to exclusion from the Borrowing Base if there are flaws or issues in their investor documentation (subscription agreement or side letter). Stated differently, even the most highly rated investor might be excluded from a Borrowing Base if there are problematic provisions in that investor's documentation, including any side letter. For example, if a side letter contains cease funding rights that may be exercised by the investor or sovereign immunity issues, that investor would likely be excluded absent a workable solution or appropriate language in the side letter to mitigate such risk. The same level of diligence is required from a legal perspective to ensure the accuracy, completeness and enforceability of the capital commitment documentation, since, under each approach, the quality of the collateral is paramount.

It's important to note that regardless of approach, in almost all cases, the commitments of all investors serve as collateral even if an investor's commitment is not counted by the lender for purposes of determining borrowing capacity. That is true whether or not the investor is not counted because (i) the investor fails to qualify as an Included Investor or a Designated Investor under the Borrowing Base approach or (ii) the investor is an excluded for tripping an Exclusion Event or for other documentation shortcomings under any of the above referenced approaches.

Note that excluded investors, even if not providing support for the Borrowing Base, still provide collateral to secure the facility and factor into the overall credit and underwriting picture. In considering other approaches to assessing a pool of collateral, this factor should be borne in mind. It is ultimately the *overall* picture that must be underwritten and considered. This helps support the thesis of this article which, spoiler alert, is that the two different approaches are likely not as different as may first appear.

In addition, concentration limits are normally applied to investors. In a Borrowing Base context this is done on both an individual and aggregate basis (based on classification). Essentially, if any investor or group of investors exceed certain preset limits on their percentage of the overall investor base, their commitment, for purposes of the Borrowing Base, is reduced accordingly. The Coverage Ratio model also employs concentration limits; however, because of the lack of investor categories, most often there is a single concentration limit that applies to each individual investor (commonly 20%). By employing concentration limits, a lender is able to ensure a healthy diversification and diminish the exposure and risk to any one investor or classification of investors. It is worth pointing out is that lenders may provide temporary relief from concentration limits as newer funds proceed through the fundraising period. This is true for both Borrowing Bases and Flat Advance/Coverage Ratio structure.

In addition, certain highly rated investors that might otherwise be excluded based on adverse side letter provisions or sovereign immunity issues might be deemed Designated Investors in a Borrowing Base approach after funding a certain portion of its commitment (often in the 40-50% range) – frequently identified in loan documentation as "Hurdle Investors." In the Coverage Ratio context, the Hurdle Investor concept is also employed; in that context, once the hurdle condition is satisfied, the investor would simply be included in the calculation of the ratio like any other investor. In either case, such designation is attributable to the fact that lenders generally become increasingly comfortable with an Investor's commitment to fund as such Investor becomes more invested in the fund, and therefore less likely to risk the penalties associated with not funding capital contributions when called.

Conclusion

Ultimately, whether structuring a Borrowing Base or Flat Advance/Coverage Ratio model, lenders are really just taking different approaches to establishing appropriate advance rates/availability. These two different approaches to assessing what that rate is take very different paths to, what many would argue, a similar place. Determining what that advance rate is takes into account numerous factors. Despite different approaches, ultimately lenders care about many of the same factors, rely on many of the same assumptions, share many of the same concerns and employ many of the same risk mitigation techniques.