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Credit Portfolio Finance – a Primer on Back-Leverage

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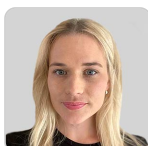

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The combination of increased regulatory pressure and additional investor demand for higher yield has seen numerous banks gradually displaced by private debt funds in the corporate lending sector (particularly for mid-market and SME borrowers). However, many banks, alongside an increasing pool of alternative lenders (collectively, "ABL Providers"), are comfortable lending to these private credit funds through so-called “credit portfolio finance” or “ABL facilities."

Whilst there is nothing new about lending to private credit managers, the continued growth of the direct lending market has been accompanied by the increased use of back leverage at fund level through these facilities.

In this article, we look at some of the key issues for ABL Providers under these transactions in the European market.

Purpose

Private debt funds typically invest in assets comprised of loans and other debt-like instruments (sometime coupled with preferred or equity interests). Debt fund managers often invest via so-called “levered sleeves” as a means of increasing investment capacity and enhancing internal returns by utilising debt at a lower cost of capital than would be the case if such investments were funded via the equity commitments. ABL facilities are often structured as private securitisations which can be beneficial to both the ABL Provider from a risk-weighted assets perspective and to the fund which can obtain attractive terms on pricing as result.

Structure

As the name would suggest, ABL facilities are backed by a specific portfolio of loan assets. Typically, ABL Providers will insist that the fund establishes an insolvency remote SPV which will act as borrower under the facility – thereby isolating the portfolio from the credit risk of the fund. The insolvency remoteness of such vehicle is a key mitigating factor with respect to the “double credit risk” that an ABL Provider is taking on the borrower and the underlying obligors in respect of the underlying loans. The holding of the portfolio is then financed by a loan provided by the ABL Provider and “equity” provided by the fund.

The portfolio of loan assets may be static or revolving whereby principal received on the underlying assets may be reinvested during a pre-determined “reinvestment period.” Where the porfolio is revolving, any new loan asset to be included in the portfolio will need to satisfy certain pre-agreed “eligibility criteria.” In addition, some ABL facilities require the borrower to obtain the consent of the lender to the inclusion of any new loan asset even where it satisfies the eligibility criteria.

ABL facilities are typically structured as term loans (although they do sometimes include a revolving tranche) with tenors typically ranging from three-seven years. This is an important factor for ABL Providers backed by institutional

capital (from insurers and/or pension funds, for example) that can only deploy capital in a way that maximizes long term gains on their investment. It is also common to see ABL Providers insist that a prepayment fee is payable in circumstances where the loan is repaid within a specified period during the life of the facility.

Security

Collateral packages for these facilities vary but we would typically expect that an ABL Provider will want to take security over (i) the borrower's rights in respect of the portfolio of underlying assets (including any assets it may acquire during the life of the facility); (ii) any accounts through which those assets are held as well as any accounts into which distributions from those assets are paid; and (iii) the fund's equity interest in the borrower.

It is also worth noting that a number of ABL facilities are structured as hybrid facilities whereby the ABL Provider is also given secured recourse to the uncalled investor commitments of the fund (and the usual capital call security package is provided). Navigating the interplay between the two security packages (and the related covenant packages) is something that requires careful consideration at the term sheet stage and in the facility documentation itself.

Due Diligence

The scope of due diligence for these kinds of transactions varies but ABL providers tend to focus primarily on the ability of the borrower to (i) grant security over its rights under each of the loans/debt instruments within its portfolio; (ii) transfer its rights under the loans to a third-party purchaser (in an enforcement scenario); and (iii) disclose confidential information relating to the underlying loan to prospective assignees, transferees or sub-participants.

Loans made available by the borrower to the underlying obligors will often be subject to restrictions on lender transfers, assignments or sub-participations without the consent of the underlying borrower (subject to certain exceptions). Those transfer provisions may also include outright restrictions on transfers to "Competitors" or "loan to own" vehicles and such restrictions will ultimately reduce the universe of potential purchasers that an ABL Provider may sell the investments to in an enforcement scenario.

Financial Covenants

ABL facilities typically employ a borrowing base model whereby the ABL Provider will apply certain advance rates to the principal balance outstanding under the "Eligible Loans" within the borrower's portfolio.

The advance rate will be applied on an "asset by asset" basis and will vary depending on, amongst other negotiable factors, the seniority of the asset in the capital structure of the underlying obligor. ABL Providers will also usually apply a haircut to any Eligible Loans that exceed any applicable concentration limits/diversity criteria. Concentration limits are imposed to ensure that the eligible portfolio of assets is sufficiently diversified in terms of, but not limited to: obligor, geography, industry/sector, seniority, repayment profile and credit rating.

ABL Providers will also look to include revaluation mechanics permitting the revaluation of the Eligible Loans following the occurrence of any "Revaluation Event." Any haircuts or adjustments resulting from that revaluation would need to be taken into account for the purpose of the borrowing base calculation. Again, the scope of revaluation triggers (and their consequences) will be subject to commercial negotiations. Some facilities will give the ABL Provider sole discretion to determine the asset value whereas others will require an independent valuation or a revaluation by the fund.

The borrowing base mechanics are often accompanied by additional financial covenants (particularly where the facility is structured as a hybrid) including coverage tests in respect of uncalled investor commitments and interest cover ratios.

Securitisation

As mentioned above, ABL facilities are often structured as private securitisations. ABL Providers should be aware of the requirements of the Securitisation Regulations that may affect certain UK and EU regulated ABL Providers. The definition of "securitisation" for the purposes of the Securitisation Regulations is broad and, in short, includes arrangements where the credit risk associated with an exposure or pool of exposures is tranched – thereby having the potential to capture ABL facilities. ABL Providers will need to consider carefully the potential implications of the Securitisation Regulations including any risk retention and reporting requirements.

The above provides only a summary of some key issues to consider when putting in place an ABL Facility, and prospective lenders under these facilities should always seek a specialist's advice on all transactions.

Please do not hesitate to reach out to the Cadwalader Fund Finance team should you have any queries.