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Subscription Credit Facilities: A Comparison of Borrowing Base Structures

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Subscription credit facilities, which are lines of credit in favor of private equity and similar investment funds primarily secured by the capital commitments of the fund's investors, are most commonly structured using a borrowing base structure similar to other types of asset-backed loans. Many factors will dictate the best borrowing structure for a fund, the most important of which are the make-up of the fund's investor pool and where the fund is in its life cycle (raising capital, harvesting investments, etc.).

Historically, each market lender has been tied to a single borrowing base philosophy that keyed squarely into its unique credit and underwriting requirements. As industry competition has continued to grow, banks have realized that a one-size-fits-all approach may not be the best long-term approach in the market. Accordingly, many lenders have adjusted their credit and underwriting policies to permit more flexibility in structuring borrowing bases to better fit a particular fund's investor pool. Sometimes this has been accomplished by adjusting the borrowing base inclusion criteria, advance rates or concentration limits, while other times, it is accomplished by taking a completely different approach to structuring the borrowing bases.

Prior to discussing the differences between the various borrowing base structures, it is helpful to first outline the common tenants of the various borrowing base structures:

- **Calculation of the Borrowing Base:** A subscription credit facility borrowing base is usually calculated by taking (x) uncalled capital of each Eligible Investor *multiplied by* (y) the Advance Rate with respect to such Eligible Investor and (z) subtracting any haircuts related to Concentration Limits and/or Borrowing Base Deductions.
- **Eligible Investors:** The uncalled capital commitments of some investors will be included in the calculation of the borrowing base ("Eligible Investors") and the uncalled capital commitments of other Investors will not be ("Excluded Investors"). Determining which investors will and will not be included varies greatly in the different market approaches to structuring a borrowing base. Typically, both an investor's creditworthiness and its investor documentation (e.g., the existence of a problematic side letter provision) will be the key factors in determining if an investor will be included or excluded from the borrowing base. As described below, some borrowing base approaches use bright-line categories of Eligible Investors, meaning the inclusion process, approval rights, and requirements for these categories are explicitly set forth in the loan documentation, while other approaches employ more relaxed standards. It is important to note, that even though Excluded Investors do not contribute to the calculation of the Borrowing Base, their

uncalled capital is collateral and, similar to other asset-backed lending structures, provides the lender with "over-collateralization."

- **Exclusion Events:** Upon the occurrence of certain negative events, Eligible Investors will automatically be excluded from the borrowing base and become Excluded Investors. Standard exclusion events include, among others: (a) an investor elects to stop funding its commitment or such investor repudiates or challenges the enforceability of its commitment; (b) an investor fails to fund its capital contribution when due; (c) an investor defaults in any representation or warranty made in any fund document; (d) rated investors fail to satisfy the applicable requirement (or any other inclusion standard) or unrated investors have a significant drop in net worth; (e) an investor transfers its interest or otherwise ceases to be an investor or requests a withdrawal from the fund; and (f) bankruptcy of an investor.
- **Advance Rates:** This is the percentage of uncalled capital commitments of each Eligible Investor that will be used in the calculation of the borrowing base. It is typically less than 100% to provide additional over-collateralization.
- **Concentration Limits:** In order to provide greater risk diversification, concentration limits are often included in subscription credit facilities. Concentration limits are restrictions on how much borrowing base credit will be given to any particular investor's uncalled capital commitments—often calculated as a percentage of an individual investor's uncalled capital commitment against the total amount of all uncalled capital commitments or all Eligible Investor uncalled capital commitments. Additionally, aggregate investor class concentration limits might be included. Like Excluded Investors and Advance Rates, Concentration Limits provide over-collateralization.
- **Borrowing Base Deductions:** Some lenders may also include deductions from the borrowing base that limit the amount available under the facility. For instance, recourse debt outside of the facility is commonly deducted from the borrowing base on a dollar-for-dollar basis. This concept is premised on the lender's understanding that all debt (and not just their borrowings) should be covered by the borrowing base.

With the above background, there are three standard borrowing base approaches common in the US subscription facility market: (1) a borrowing base of only highly-rated included investors with a high advance rate (the "Included Investor Model" or "II Model"); (2) a two-tier approach, which provides for both highly-rated included investors with a high advance rate and a designated investor class, where the latter has a lower advance rate (the "Included/Designated Model" or the "II/DI Model"); and (3) a flat advance rate across all (or most) investors (the "Flat Advance Rate Model"), which may also be structured as a coverage ratio (the "Coverage Ratio Model").

Below we explore these traditional structures and then discuss how these structures are evolving to address increased competition and the particular needs of fund borrowers.

A. Included Investor Model

In the traditional Included Investor Model, only highly-rated investors that meet a pre-defined set of criteria (e.g., a minimum credit rating (typically set at BBB+) and, with respect to pensions, a minimum "funding ratio" (often 90%) or, in some cases, minimum assets (typically $1 billion)) will be designated Eligible Investors ("Rated Included Investors"). For these investors, typically the only approval right is in favor of the administrative agent (and not any facility lenders). Other non-rated investors that, in the determination of all lenders, would be rated investment-grade if they had a rating ("Non-Rated Included Investors") will also usually be Eligible Investors in an II Model.

The Advance Rate for all Eligible Investors in an II Model is typically set between 80% and 100%[2] and Concentration Limits have historically been determined by a static grid ranging from 5-15%, in each case dependent on the Eligible Investor's rating or classification as a Non-Rated Included Investor. Non-Rated Included Investors (and sometimes lower-rated Rated Included Investors) are usually also subject to an aggregate Concentration Limit.

Since the borrowing base only includes uncalled capital commitments of investment-grade investors, lenders typically offer favorable pricing and looser terms compared to other borrowing base structures. Funds that use the II Model usually have a diversified class of highly rated investors and use subscription facilities mostly for bridging purposes—and not long-term leverage. These funds typically don't require high overall effective advance rates against the entire investor pool because they regularly repay borrowings and prefer the less expensive pricing and looser terms that the II Model provides.

B. Included/Designated Model

The Included/Designated Model builds off the II Model's technology. In addition to classifying Rated Included Investors and Non-Rated Included Investors (collectively referred to as "Included Investors") as Eligible Investors, the II/DI model includes a third category of investor that the lenders have determined is less creditworthy than the Included Investors, but still maintains sufficient creditworthiness to include in the borrowing base (these investors are commonly referred to as "Designated Investors"). The inclusion of any Designated Investors typically requires all lender consent and has historically required some evidence of credit-worthiness or credit support, such as publicly available financial information or evidence of a strong relationship with a creditworthy parent.

Advance Rates and Concentration Limits with respect to Included Investors usually mirror the Advance Rates and Concentration Limits typically used in the II Model. The Advance Rate for Designated Investors is typically set at either 60% or 65%. Additionally, Designated Investors are usually subject to both individual and aggregate Concentration Limits. We often see a 5% individual Concentration Limit and an aggregate Concentration Limit of 35% with respect to Designated Investors.

The II/DI approach is currently the most commonly used in the syndicated market. This approach is often used by funds that need larger credit facilities with a borrowing base than a traditional II Model or Flat Advance Rate Model approach would be unlikely to support over the life of the fund, and usually offers the highest overall effective advance rate. To account for the fact that lower-rated investors are included in the borrowing base, pricing may be higher than facilities employing the II Model and these facilities may be tighter on other terms and reporting requirements than the other models.

C. Flat Advance Rate Model and Coverage Ratio Model

Unlike the other two approaches that have highly structured inclusion criteria, the presumption in a Flat Advance Rate Model is that all investors will be included in the borrowing base unless something is problematic about an investor or type of investor (for example, high net worth investors or investors that are affiliated with the fund are often not included in a Flat Advance Rate borrowing base). Accordingly, Flat Advance Rate Model transactions typically include all or almost all investors in the borrowing base at a single "flat" advance rate. The advance rate may vary widely based on the composition of the investor base but typically range from 50-65% (however, we have seen advance rates range from 20-90% depending on the fund and the makeup of the investor pool). Usually, Flat Advance Rate Models do not include concentration limits. Flat Advance Rate transactions are most often bilateral or club deals.

A Flat Advance Rate borrowing base can be structured as a coverage ratio covenant in the loan documents. This requires that the uncalled capital commitments of the investors shall, at all times, cover the amount of outstanding loans under the credit facility at an agreed upon ratio. The Coverage Ratio Model is currently more common in Europe but is also seen in US bilateral deals done as accommodations for sponsors. These Coverage Ratio Model deals will include Borrowing Base Deductions for other indebtedness of the fund (including guaranties of portfolio companies) and equity commitments the fund has made to its portfolio companies or third parties.

Both the Flat Advance Rate Model and Coverage Ratio Model are used in a wide variety of circumstances, including: (1) where a fund does not desire or need a large facility amount and prefers lighter legal documentation and relaxed reporting requirements, (2) when a lender is advancing a small facility as an accommodation to the sponsor (to curry favor with the sponsor), (3) in uncommitted and on-demand credit facilities (where the bank takes comfort in the fact that a decline in the credit quality of the overall investor pool can be rectified by calling the facility or refusing to fund), (4) where the investor pool would not support a borrowing base under the II Model or the II/DI Model, and (5) where the fund's investor pool is highly concentrated, such that traditional concentration limits would be problematic. Depending on the circumstance, the pricing of these facilities varies greatly, but they are often priced similar to or higher than facilities using the II/DI Model.

While the foregoing approaches have been historically rather inflexible—forcing funds to pick one approach—lenders are now blending the aspects of the different approaches and employing tailored variations. While this trend is noticeable (and likely the result of increased competition), in our experience, lenders are altering their approach judiciously and carefully evaluating and structuring around the risks. Listed below are some of the more common variations currently being utilized:

- **Concentration Limit Holidays** – A common accommodation used in connection with the II/DI Model is to not apply any Concentration Limit to the Rated Included Investors in the borrowing base until the earlier of (x) one year after the credit facility closing date and (y) the fund's final closing date. While the Concentration Limits with respect to Non-Rated Included Investors and Designated Investors typically still apply, this variation gives funds flexibility during the early stages of fundraising and when their investor base might be highly concentrated. Lenders cite comfort in the fact that this approach is used at the beginning of the fund's lifecycle before any possible unexpected negative investment performance is likely to surface which may impact investor confidence in the fund.

- **Concentration Limit Waivers** – Similarly lenders are now selectively waiving concentration limits if investors deliver investor letters in favor of the lender. Since these investor letters provide direct contractual privity and reinforce the key aspects of the facility, lenders are more willing to take a greater concentration risk on an investor.
- **Relaxed Concentration Limits** – Although the concentration grids employed in the II Model and the II/DI Model have historically been static and non-negotiable, lenders have slowly started to relax concentration limits—especially in bi-lateral deals with strong borrowing bases. This allows funds to receive an advance rate against greater percentages of the uncalled capital commitments, even with less diversification in the investor pool.
- **Hurdle Investors** – The accommodation that has perhaps gained the most traction in the market is the designation of "hurdle" investors. This approach is often used where investors either have legal or side letter issues (e.g., sovereign immunity concerns, placement agent issues) or other concerns regarding their ability to honor capital contributions to a lender (e.g., insufficient financial information available to validate the investor's creditworthiness). These investors will initially be excluded from the borrowing base, and after satisfying certain conditions, will "hurdle" into the borrowing base as a Designated Investor. While such "hurdle" designation is always linked to the applicable Investor having funded a certain percentage (often 40%) of its total capital commitment, some lenders are also requiring the fund to maintain a pre-negotiated minimum net asset value. Oftentimes, these "Hurdle Investors" will toggle back and forth between Designated Investor and Excluded Investor status, depending on whether the conditions remain satisfied (i.e., if net asset value declines below the negotiated minimum or if funded capital drops below the threshold as a result of returned capital). The market has generally accepted the use of Hurdle Investors because once the hurdles are satisfied, the investor has "skin-in-the-game" (reflective of the funding requirement), which is subject to loss if the investor fails to make capital contributions when required[3] and, accordingly, the investor has an incentive to maintain its investment since the fund is performing (reflective of the net asset value prong).
- **Hurdle Advance Rates and Hurdle Concentration Limits** – With the market increasingly comfortable with Hurdle Investors, some lenders have started to employ the hurdle technology to Advance Rates and Concentration Limits. Instead of investors "hurdling" from Excluded Investor status to Designated Investor status, under this approach, a pre-defined select group of high-quality investors will "hurdle" into higher Advance Rates and/or relaxed Concentration Limits when the hurdle conditions are satisfied. Like Hurdle Investors, Hurdle Advance Rates and Hurdle Concentration Limits typically toggle to account for net asset value and the amount of capital funded. This approach is seen most regularly as being applied to high net worth investors and other investors that are not investment grade.
- **After-Care Flat Advance Rates** – Many lenders and funds convert transactions formerly based on the II/DI Model to a Flat Advance Rate Model after the investment period has expired (such facilities, "Aftercare Facilities"). While these credit facilities are usually smaller than more traditional

subscription facilities, they often have a high Flat Advance Rates (up to 80-100%). Lenders often include additional net asset value covenants and may take a pledge of the other assets of the fund to secure the obligations (thereby converting the subscription facility to a hybrid facility—at least from a collateral perspective). Similar to the analysis underpinning the hurdle concepts explored above, lenders take comfort in the fact that investors have "skin-in-the-game" and the fund is performing.

- **Relaxing Designated Investor Criteria** – As noted above, unlike in Flat Advance Rate Model deals, the default classification in the other models is Excluded Investor. The II/DI Model has historically required that lenders have strong visibility into the creditworthiness of potential Designated Investors and that the lender determine that there is creditworthy value in the uncalled capital commitment of such potential Designated Investors. While that presumption remains true, many lenders have recently relaxed their criteria on classifying Designated Investors—oftentimes requiring less insight into the investor's financial standing and/or less concrete linkage to a high-quality parent.
- **Short-Term Bridge Facilities** – Instead of entering into a long-term facility in connection with their initial closing, some funds are now entering into short-term bridge facilities during their fundraising period. Such short-term facilities are often structured on an uncommitted/on-demand basis using the Flat Advance Rate Model or a bilateral deal with relaxed concentration limits that could be difficult to support in a subsequent syndication. This approach allows the fund to determine which borrowing base approach will work best for their ultimate pool of investors once fundraising has been completed. The risk of this tactic is that the fund might not be able to lock down favorable pricing or other terms if the market turns for the worse and will likely have to negotiate two separate facilities.
- **Multiple Borrowing Bases** – One of the more creative approaches being used is including multiple borrowing base models into the loan documentation. Under this approach, the fund has a one-time option to switch to an alternative borrowing base approach within a short window following the final investor closing (e.g., starting with a II Model and switching to a II/DI Model). For the fund, this foregoes the expense of negotiating two credit facilities and locks down pricing (even if that pricing toggles upon any conversion of the borrowing base approach) and other terms. For the lender, this approach offers a competitive advantage against other lenders that may not be able to provide such flexibility.
- **Syndicated Flat Advance Rates** – Many funds prefer the simplicity of the Flat Advance Rate Model due to the relatively lax reporting requirements and inclusion criteria associated therewith. While Flat Advance Rate deals have not been historically used for large syndicated facilities in the US, recently lenders have been more open to use a Flat Advance Rate Model with top-tier sponsors. Unlike traditional Flat Advance Rate deals, however, other parts of these transaction remain highly structured.

Unlike pricing and tenor—where the market has been relatively uniform—there has been significant creativity in structuring borrowing base approaches in the subscription credit facility market recently. We expect this trend to continue as more lenders change their longstanding credit and underwriting policies to allow more tailored solutions to a wider range of investor pools.

Endnotes

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[2] In most syndicated facilities, a flat 90% Advance Rate is typically applied to all Eligible Investors in light of many credit policies prohibiting a 100% advance rate to any investor.

[3] Organizational documents of funds typically include a contractual remedy to reduce an investor's capital account and/or sell an investor's interest in the fund at a steep discount if an investor fails to honor its capital commitment or otherwise defaults with respect to its contractual obligations.

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