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In Practice

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Private equity sponsors as lenders

In this In Practice article, the author highlights some of the key challenges posed by a sponsor affiliate being a lender in a club or syndicated loan transaction, and discusses practical approaches to limiting the associated risks for third party lenders.

Growth in the European market for private debt (debt financing that comes mainly from institutional investors such as funds rather than banks) continues apace, with the average fund size increasing year on year, and increasing confidence in the asset class resulting in rising allocations from institutional investors.

Unsurprisingly, there is sustained interest among UK based private equity firms in establishing their own private debt funds or otherwise investing in private debt. Developing different asset classes has proved successful for a number of sponsors already, and the credit businesses of certain of the larger sponsors now account for a significant proportion of their assets under management.

When sponsors form part of a club or syndicate of lenders lending, through dedicated debt funds affiliated to the sponsor or otherwise, to their portfolio companies (or indeed to another sponsor's investee company), some unique practical challenges arise.

A BONUS FOR BORROWERS

From the portfolio company's perspective, it is typically commercially advantageous to have the sponsor or a sponsor affiliate providing part of its facilities. The facilities will still be documented on arm's length terms, but in practice the sponsor lender's interests are more closely aligned with the borrower's than a third-party lender's would be. In practice, that means they are more likely to provide additional flexibility to the borrower in the documentation, consent to future amendments or waive defaults.

BUT MORE DIFFICULT FOR OTHER LENDERS ...

As a third-party lender, lending as part of the same club or syndicate as a sponsor lender, it is a more complex assessment. The sponsor's investment in the debt as well as the equity of the portfolio company evidences its commitment and confidence in the business. However, the risk remains that the sponsor lender will be more accommodating and "borrower-friendly" in its actions than the third-party lenders.

How significant this is will depend on various factors, including:

- the proportion of commitments held by third party lenders;
- the nature of the relationship between the sponsor and the sponsor lending entity;
- whether the sponsor lender holds commitments sufficient to block Majority Lender and/or Super Majority Lender decisions; and
- the group's financial performance.

ESPECIALLY ON ENFORCEMENT

Looking ahead to an enforcement scenario, the third-party lenders should also consider how the sponsor lender is likely to behave – what actions will it, as an affiliate to the sponsor, be unwilling or unable to take? Again, the associated risk for third party lenders will depend on the quantum of debt held by the sponsor lender relative to total commitments.

Even before enforcement becomes a consideration, the third-party lenders may feel it is unacceptable for the sponsor lender to have a vote and be privy to ongoing lender discussions.

SPONSORS RE-ENFRANCHISED?

The LMA leveraged facilities agreement includes a "sponsor disenfranchisement" clause. This provision is designed to allow a sponsor affiliate to acquire the debt, but to prevent it from then being classed as a lender for the purpose of voting and meeting minimum lender approval thresholds. This prevents a sponsor affiliate acquiring the debt and subsequently voting in a skewed way given its dual role, and serves as a useful protection for third party lenders.

When reviewing facilities agreements where a sponsor entity holds part of the debt from the outset, or wants to preserve the flexibility to acquire debt in the future, this clause will warrant closer attention.

The changes required to this clause and related definitions will depend, among other things, on:

- whether a sponsor affiliate will hold day-1 commitments, or intends to acquire the debt thereafter;
- how the sponsor affiliate is connected to the sponsor; and
- for how long such sponsor affiliate has been established.

Note for instance that the LMA definition of "Sponsor Affiliate", ie those entities that are disenfranchised as lenders, carves out any entity established for a specified minimum period of time (six months is suggested, and is usual) "solely" to invest in debt and which is managed "independently" from the sponsor's and its affiliates' equity investments.

Where the sponsor holds commitments from the start, it may be logical to remove the restriction entirely, carve out the sponsor's debt funds by name, or disapply disenfranchisement in respect of those day-1 commitments. In contrast, where a sponsor holds only equity at the start but may wish to invest in the debt in future, the third-party lenders will be keen to preserve the restriction but may accept a specific carve out for the sponsor's debt fund (if established). If a sponsor intends to establish private debt investment entities, but has not done so at the time the agreement is executed, and wishes to preserve the flexibility to invest in this loan, the minimum period of establishment in the LMA carve out may need to be shortened or removed.

Biog box
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COMPETITIVE CONCERNS

Given the number of sponsors currently investing in the private debt market, sponsors are also keen to ensure a competitor sponsor is not able to acquire debt in its investee company. An immediate risk is that the competitor may gain a potentially valuable insight into the terms of that sponsor's debt and the portfolio company's performance. This is notwithstanding the ethical barriers that sponsors put in place between their private equity and debt functions. Where the borrower experiences financial difficulties, there is also the risk of a competitor seeking to implement a "loan to own" strategy or other aggressive tactics in response to future requests for consents or amendments.

The transfer restrictions in a leveraged facility are commonly negotiated to limit the ability of lenders to transfer debt to competitors *of the borrower* for the same reason. As part of wider discussions on transferability, sponsors may therefore seek to extend this restriction to also capture their competitors. Depending on how "competitors" is described or defined in the facilities agreement, lenders may consider this to be too broad a restriction, impractical to enforce and restricting the liquidity of the debt. In practice, the negotiated position may come down to the strength of the sponsor or its appetite to push this point.

EXTENDED TIMEFRAME FOR REVIEWABLE TRANSACTIONS

Lenders should also have in mind the impact of the sponsor being a "connected party" for the purpose of certain reviewable transactions. Where an obligor has entered a formal insolvency process, certain antecedent transactions may be challenged by the insolvency practitioner. These are subject to time limitations, which are extended where the party in question (being the sponsor lender here) is "connected" with the insolvent company at the time of the transaction.

The consequence of a party being "connected" is that the look back test for determining whether a preference has been granted or whether a floating charge may be avoided is extended from six or 12 months respectively to two years. Whilst such challenges are generally a remote possibility in secured lending (particularly where the financing is extended on arm's length terms), it will likely be something third party lenders need to consider as part of their credit processes.

CONCLUSION

The rise of private debt, and the interest among private equity firms in diversifying into this asset class, looks set to continue. Whilst third party lenders are right to be wary of how their interaction with sponsor lenders works in practice and to ensure the documentation adequately protects them, the commercial need to maintain relations with key sponsors and their debt functions, and to operate loans effectively with related lenders, is set to stay. ■

Further Reading

- The new breed of transfer restrictions in leveraged lending transactions: a new paradigm or just a sign of the times? (2018) 4 JIBFL 222.
- Preying on distressed debt: limiting the scope for transfer to vulture funds (2018) 1 JIBFL 9.