Morgan Lewis

ADVANCED TOPICS IN HEDGE FUND PRACTICES CONFERENCE

MANAGER AND INVESTOR PERSPECTIVES

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Credit Strategies

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Term A/B Loans and Revolver Loans

a. Repayment: Often have quarterly amortization for Tranche A loans that is more significant than the amortization (if any) for Tranche B loans. Revolving loans do not have amortization but may have a scheduled reduction in commitment over the life of the loan, and otherwise all principal will be due at maturity.

b. Mandatory Prepayment:

   i. From excess cash flow, issuance of debt or equity, extraordinary receipts, change of control, certain asset sales and condemnation or casualty events (subject to reinvestment rights).

   ii. Payments are made to pay down outstanding amounts under the revolver and then to the term loan but may be applied prorata.

   iii. First Lien Lenders may have a provision to reject the application of proceeds and if so, the second lien may have a provision requiring such proceeds to be offered to the second lien for application to their loans.

Term A/B Loans and Revolver Loans

c. Optional Prepayment: Allowed at any time, although:

   i. With respect to revolving loans, may require a corresponding permanent reduction in commitment so the amount optionally prepaid may not be reborrowed; and

   ii. Term loans may have a prepayment penalty/premium and/or make-whole to compensate Lenders for losing the anticipated return on the loans. Note that recent caselaw may not permit the recovery of such penalty/premium/make-whole in an insolvency proceeding if such amount is determined to be "unmatured interest."

Term A/B Loans and Revolver Loans

d. <u>Interest:</u> Payments are due in cash in arrears (due at least quarterly, but may be due monthly or at the end of the interest period if shorter than 3 months).

   i. Usually, a floating rate is based off the Base Rate or SOFR (as elected by the Borrower unless there is an event of default, in which case SOFR loans are often suspended), subject to a floor, plus the Applicable Margin.

   ii. May include a pricing grid, which is determined by the Borrower's leverage ratio (lower leverage, more favorable pricing for the Borrower).

   iii. Default interest is usually set at 2.00% above the interest rate currently in effect and may be due automatically upon an Event of Default, or at the Agent and Required Lenders' demand upon such event or upon Specified Events of Default; may be due only on overdue amounts or on all obligations.

Mezzanine Loans

Repayment

Usually no amortization, with all principal due at maturity.

Mandatory Prepayment

Repaid upon the occurrence of certain events, such as issuance of debt or equity, asset sales, change of control, excess cash flow, casualty, and condemnation events, in each case subject to any senior debt application first and sometimes a financial covenant test.

Optional Prepayment

Usually subject to a no-call period and then incur a prepayment premium.

Interest

Usually have a fixed rate of interest and may have a paid-in-kind (PIK) feature where all or some of the interest may be PIK instead of paid in cash and added to the principal amount of the loans at the end of each interest period. The Borrower may elect to have the interest PIK, which is a "PIK Toggle" feature.

Mezzanine Loans

Definition of Senior Debt

- As in first-lien/second-lien transactions, there is typically a senior debt cap (though not always if the junior debt is deeply subordinated). In these transactions, the subordinated lenders agree to subordinate their claims to a specified principal amount of senior debt. Areas of negotiation include:
  - Cap on principal amount
  - Inclusion of bank products, hedging obligations
  - Cushion
  - PIK interest and fees

Permitted Subordinated Debt Payments

- Subordinated Lenders will want the right to receive all payments due under the subordinated debt documents, unless blocked. Senior lenders will limit payments to "Permitted Subordinated Debt Payments", such as:
  - Scheduled interest payments
  - PIK interest
  - Fees and expenses
  - AHYDO payments
  - What about principal? Mandatory prepayments? Payments after a change of control? Or at maturity?

Mezzanine Loans

Payment Blockage

- After a default under the senior debt documents, payments under the sub debt are subject to payment blockage provisions.

Payment Default

- After a payment default under the senior debt, **no payments are permitted** to be made to the subordinated lenders (other than reorganization securities in a bankruptcy and PIKs).

Covenant Default

- After a covenant default under the senior debt, the senior lenders have the right to stop payment on the senior debt (other than reorganization securities in a bankruptcy and PIKs), typically for up to 180 days per year (or less if the payment default is waived or cured). Senior lenders are entitled to exercise this right a limited and negotiated number of times.

Unitranche Transactions

- Unitranche loans combine what would otherwise be separate first/second-lien or senior/mezzanine facilities into a single credit agreement, where all the debt is subject to the same terms, and with a blended interest rate. Lenders in unitranche facilities typically enter into a so-called “agreement among lenders” (AAL) which legislates priorities among lenders in a manner that may or may not be visible to the borrower, with the “first out” lenders provided priority over the “last out” lenders in exchange for lower pricing.

- <u>Certain Key AAL Provisions</u>
  - <u>Payment Waterfalls.</u> Most AALs include a waterfall trigger event (such as payment default, bankruptcy default, or leverage level above a threshold to be agreed) after which payments are applied in accordance with a “first out-last out” waterfall. After a triggering event occurs, the last-out lenders are required to turn over all payments received to the agent under the credit agreement to be applied in accordance with the waterfall. There is also special treatment of amortization and prepayments, which favors first-out lenders.
  - <u>Interest and Fee Skims.</u> While the borrower pays a blended rate of interest under the credit agreement, the first-out lenders assume less risk than the last-out lenders and therefore agree in the AAL to pay the last out lenders a specified portion of the interest received from the borrower on account of the first-out position.

Split-Lien Transactions

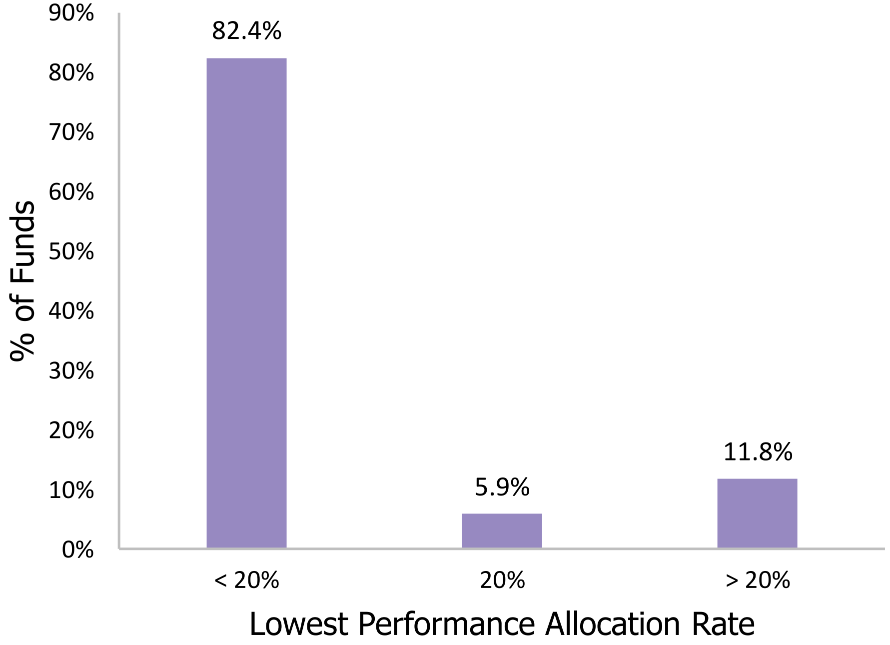
These structures are seen in ABL transactions and generally involve working capital lenders that have a priority lien on the working capital assets (accounts receivable, inventory, and proceeds thereof) and a junior lien on the other assets, and the cash flow lenders have a priority lien on the non-working capital assets and a junior lien on the working capital assets.

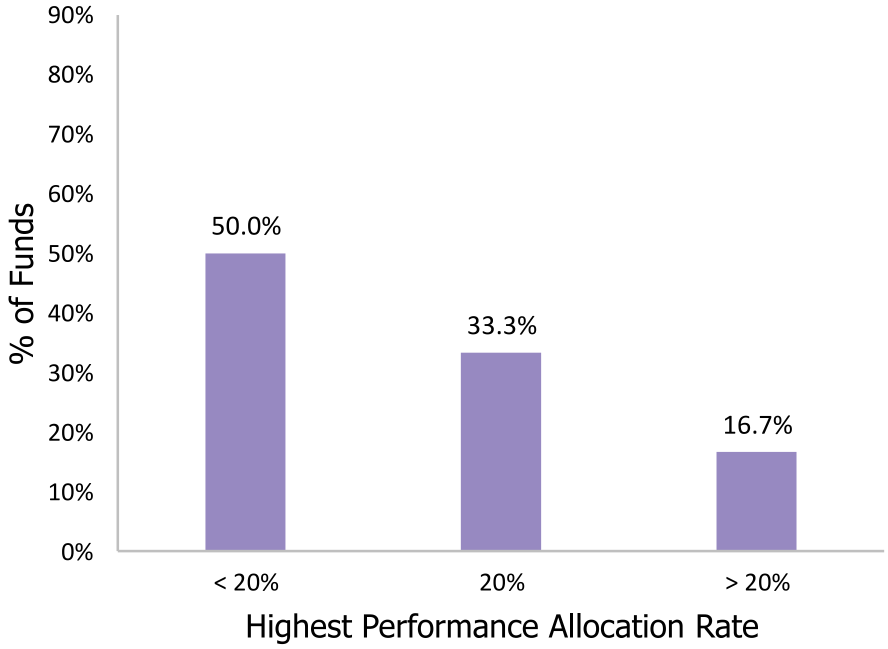
- Typically set up as:
  - Two separate credit facilities, each secured by a lien on (substantially) the same pool of collateral (the "common collateral")
  - One credit facility has a first-priority lien on one portion of the common collateral and a second-priority lien on the rest; the other credit facility has a second-priority lien on the former portion and a first-priority lien on the latter

Comparison of Financing Structures

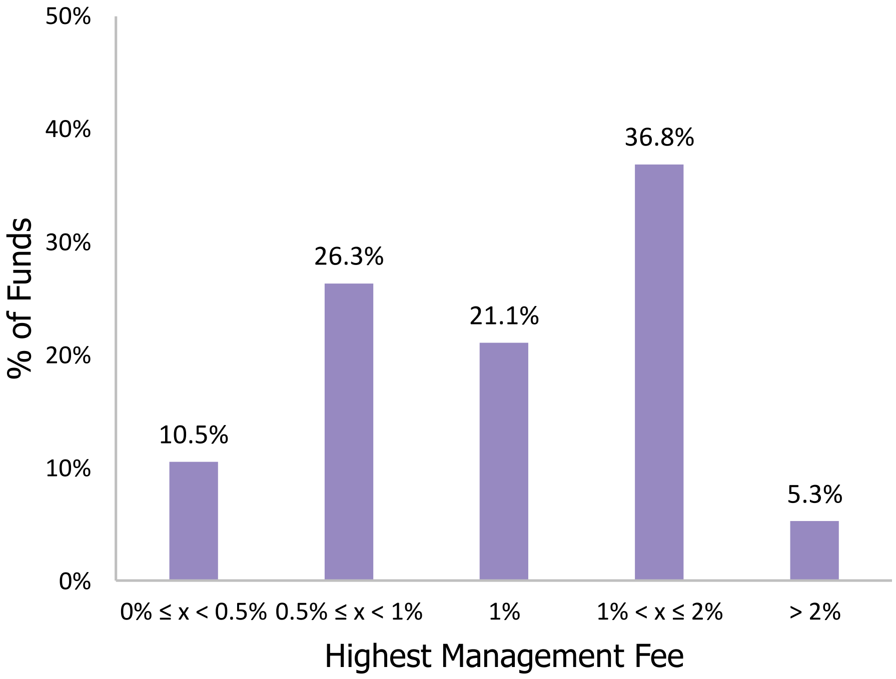
	Structure	Secured	Debt Subordination	Lien Subordination	Debt Caps	Buyout Rights	Documentation
1.	First/Second Lien	Yes	No Debt Subordination	Yes	Yes, for first lien. Sometimes on second lien.	Second lien typically has a buyout right.	2 sets of documents.
2.	Mezzanine	No (though sometimes mezz lenders may have a "silent second")	Yes (for both unsecured and secured mezzanine facilities)	No (unless the mezz has a silent second lien, then yes)	Yes for the senior debt.	Mezzanine lenders sometimes have a buyout right.	2 sets of documents.
3.	Unitranche	Yes	Effectively, yes. A waterfall upon a triggering event applies to payments, with first-out lenders being paid first.	Effectively, yes. A waterfall upon a triggering event applies to proceeds of collateral, with first-out lenders being paid first.	Sometimes.	Last-out lenders typically have a buyout right.	1 set of documents.
4.	Split-Lien	Yes	No	Yes	Yes for the ABL facility. Sometimes for the cash flow facility.	Cash flow lenders typically have a buyout right.	2 sets of documents.

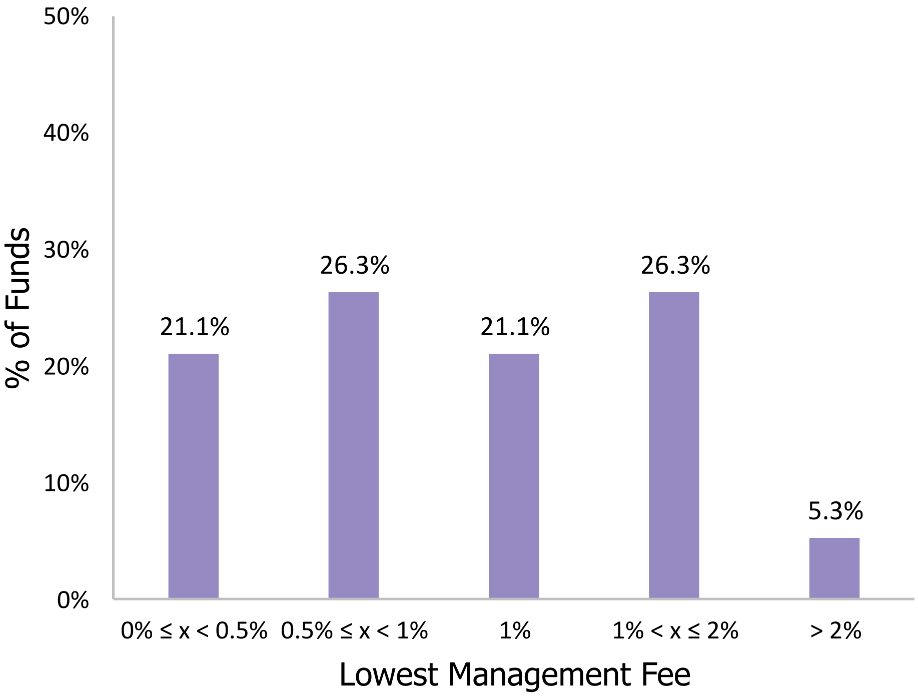
Credit Funds – Performance Allocation





Credit Funds – Management Fee





Evergreen Private Fund Structures

Evergreen private funds and their terms generally fall along a continuum of liquidity:

Minimal Liquidity

Modified Closed-End Funds: Very limited liquidity built into fund that looks like closed-end (capital commitments, carried interest, management fee-based commitments/contributions), except for no term and minimal liquidity option (annual/semi-annual tender offer, best efforts annually with very low gate).

Split Funds

Split Funds: (1) Have liquid and illiquid portfolios within same fund with differing terms applying to each;
(2) Have core, illiquid assets held in a closed-end vehicle and the income in a liquid structure—less common.

Vintage/Series Funds

Vintage/Series Funds: Closed-end sleeves within a vehicle that have shorter terms (3-5 years) and allow LPs to rollover to the next vintage/series and GP has flexibility to sell assets to continuation vehicle or next vintage/series.

Hybrid Funds

Hybrid Funds: A combination of closed-end and open-end fund mechanics. For example, if periodic valuations are more reliable and can allow for monthly/quarterly subscriptions, incentive allocation (perhaps with clawback or deferral mechanic in case of future losses), management fee based on NAV. But liquidity is set up in a way to protect non-redeemers, including slow pay/fast pay and vertical slice mechanics, potentially along with large cap side pockets/designated investments.

Maximum Liquidity

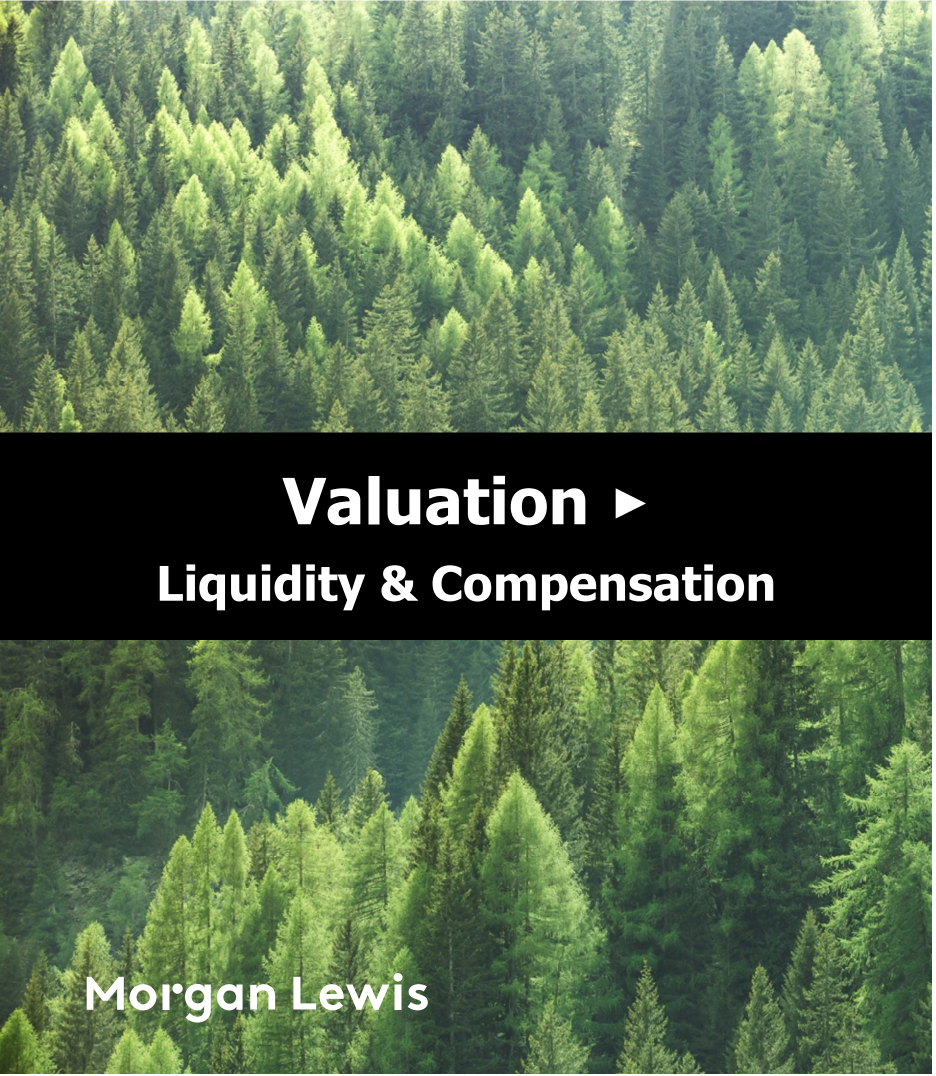
Modified Open-End Funds: Periodic liquidity (monthly/quarterly) with advance notice period (30/60/90 days), large side pocket or designated investment percentage cap, monthly/quarterly subscriptions possible, an annual incentive allocation, management fee based on NAV.

* Keep in mind that some evergreen structures, such as interval funds and collective investment trusts have regulation-mandated terms and considerations.

Evergreen Private Fund Structures

Big Picture Points:

- Referred to interchangeably as evergreen or hybrid
- Used in a number of strategies (but in particular, credit and real estate)
- Offers investors a more diverse pool of assets which was traditionally not available
- While gaining in popularity, still typically used by more established managers



Core issue is valuation—how reliable and easily obtained are valuations of the fund’s assets?

- This then drives the two core questions that need to be answered as part of fund design:*

1. How will investors get their money back?

AND

2. How will the sponsor (and its people) get paid performance-based compensation?

* Valuation is also relevant for other purposes, including to determine how an investor will participate in the existing portfolio, if applicable

Liquidity: How will investors get their money back?

Sponsor needs to model how long it would take to provide 100% liquidity to an investor that is withdrawing in full.

Basic Liquidity Options:

- Tender Offer
- Matching Program
- Best Efforts
- Liquidity Windows (with notice, at certain intervals)
- Slow Pay/Fast Pay (including vertical slice mechanics)
- Periodic Liquidity/ Advance Notice Period

Additional Liquidity Protections:

- Side Pockets/ Designated Investments (high percentage cap)
- Liquidating Accounts
- Lock-Ups (soft or hard)
- Gates
- Suspension
- Long Advance Notice Periods
- Limited Redemption Dates

Evergreen Private Fund Structures

Incentive Compensation

How will the sponsor (and its people) get paid performance-based compensation?

Sponsor needs to project when it will need payments of profits to compensate its people.

Incentive Compensation Options and Features

- Fund-Level Carried Interest
- Current Income vs Asset Sale Carried Interest
- Liquid Portfolio Incentive Allocation vs Illiquid Portfolio Carried Interest
- Rolling Carried Interest Periods
- Investment-Level Carried Interest
- Annual Incentive Allocation
- Annual Incentive Allocation (Liquid Portion) + Carried Interest on Side Pockets/Designated Investments
- Investor protections:
    - Clawback
    - Rolling Periods
    - Escrow
    - Deferral (Forfeiture or Offset Future Management Fee)

Evergreen Private Fund Structures

- Periodic subscriptions; no finite offering period/ periodic need to fundraise
- Committed capital model vs subscriptions on NAV model
  - No-offering period followed by periodic offering periods
- Management Fee Base
  - Commitments/ contributions/ invested capital
  - Net Asset Value
- Expenses—modifications for ongoing offering and valuation
- No finite term/no need to liquidate assets at inopportune time (or to transfer to a continuation vehicle)

Other Terms

Other Considerations

- Conflicts with managing closed-end/evergreen side-by-side
- Side letter & MFN process for ongoing offering
- Redlining sensitivity for existing investors
- Operational differences and higher costs to set up and run
- Confusion for (but also broader access to) investors with rigid buckets of capital
- Tax analysis is critical

Private Credit CLOs – How do they fit in?

- **Private Credit CLOs**
  - A rapidly growing segment of both the private credit market and the broader CLO market, demonstrating the maturation of private credit generally
  - A financing trade for private credit funds, as opposed to the arbitrage model common for the broadly syndicated CLO space
- **Advantages for private credit borrowers**
  - Borrowers that look to private credit funds as lenders benefit from the private credit CLO market in various ways:
    - increased capital availability
    - lower borrowing costs
    - better and more flexible terms